RESPONSE TO SUBMISSIONS

Revisions to the prudential framework for Large Exposures

December 2017

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Executive summary

On 12 April 2017, the Australian Prudential Regulation Authority (APRA) proposed to make a range of changes to the current framework for Large Exposures to strengthen the management of concentration risk, reduce system-wide contagion risk and strengthen the oversight of exposures that arise for an authorised deposit-taking institution (ADI) from underlying assets within investment structures.

Broadly, the proposals reflected the Basel Committee on Banking Supervision's (Basel Committee) *Standards: Supervisory framework for measuring and controlling large exposures* (Basel large exposures framework) released in April 2014, but included several adjustments to recognise local circumstances.

A number of submissions on the proposals indicated that whilst they were broadly supportive of APRA's decision to align with the Basel Committee on key aspects, there would be various complexities with implementing the proposed large exposures framework and some respondents requested a longer transition period. In particular, respondents indicated that the proposals to limit exposures between domestic systemically important banks (D-SIBs) and exposures to a global systemically important bank (G-SIB) would be challenging to meet. New requirements relating to grouping connected counterparties and looking through exposures to structured vehicles would also require ADIs to dedicate significant resources to appropriately capture and monitor large exposures.

In response to the issues raised, APRA has made a number of amendments to the framework. APRA considers that the new *Prudential Standard APS 221 Large Exposures* (APS 221) provides an appropriate balance between financial safety and stability, efficiency, competition, contestability and competitive neutrality.

This paper sets out the material issues raised in submissions and APRA's response to those issues. APRA will require ADIs to implement most aspects of the new APS 221 by 1 January 2019. For requirements relating to groups of connected counterparties and structured vehicles, a transition period will be provided, with ADIs being required to fully implement the large exposures framework by 1 January 2020.

This response paper, prudential and reporting standards, and non-confidential submissions are available on APRA's website at www.apra.gov.au.

Glossary

ADI	Authorised deposit-taking institution
ABS	Asset-backed securities
APRA	Australian Prudential Regulation Authority
APS 120	*Prudential Standard APS 120 Securitisation*
APS 210	*Prudential Standard APS 210 Liquidity*
APS 221	*Prudential Standard APS 221 Large Exposures*
APS 222	*Prudential Standard APS 222 Associations with Related Entities*
ARS 221.0	*Reporting Standard ARS 221.0 Large Exposures*
Basel Committee	Basel Committee on Banking Supervision
Basel large exposures framework	*Standards: Supervisory framework for measuring and controlling large exposures*, April 2014
CET1 Capital	Common Equity Tier 1 Capital
CRM	Credit Risk Mitigation
LEI	Legal Entity Identifier
PCR	Prudential Capital Requirement
RMBS	Residential mortgage-backed securities

Chapter 1—Introduction

On 12 April 2017, the Australian Prudential Regulation Authority (APRA) released for consultation a discussion paper which outlined proposed revisions to the prudential framework for large exposures of authorised deposit-taking institutions (ADIs). Broadly, the proposals reflected the Basel Committee on Banking Supervision's (Basel Committee's) *Standards: Supervisory framework for measuring and controlling large exposures* (Basel large exposures framework) released in April 2014, but included several adjustments to recognise local circumstances.

The proposals were designed to strengthen the prudential framework for large exposures, reduce system-wide contagion risk and strengthen the oversight of exposures to the underlying assets of structured vehicles. The proposals also aimed to mitigate contagion risks pertaining to systemically important financial institutions, whose material losses are more likely to cause systemic consequences and impact financial stability in the event of a crisis.

APRA's prudential requirements for managing large exposures are set out in *Prudential Standard APS 221 Large Exposures* (APS 221). The key proposals set out in the discussion paper were:

- a change in the measurement basis for large exposure limits from Total Capital to Tier 1 Capital;
- a recalibration of existing large exposure limits and the introduction of a limit to a global systemically important bank (G-SIB) and for exposures between domestic systemically important banks (D-SIBs);
- stronger criteria for identifying a group of connected counterparties; and
- clear requirements to measure large exposure values, including specific treatments to be applied for credit risk mitigation, trading book positions, covered bonds, structured vehicles, non-qualifying central counterparties and clearing activities.

It is important to note that prudential requirements for an ADI's exposures to its related entities are included in *Prudential Standard APS 222 Associations with Related Entities* (APS 222), which is currently the subject of a separate review.

Feedback from consultation

APRA received submissions from a range of stakeholders including four ADI industry associations and nine APRA-regulated institutions. Nine submissions were made confidentially.

Submissions broadly supported the revisions to the prudential framework for large exposures and alignment with the Basel large exposures framework to enhance comparability and consistency across jurisdictions. However, some submissions also expressed concern that certain proposals could result in complexities and implementation challenges with the prudential framework.

Structure of this paper

This paper includes responses to matters raised in submissions.

Chapters 2 and 3 summarise the main issues raised in submissions, along with APRA's responses, regarding large exposure prudential limits and the measurement of large exposures.

Chapter 4 discusses other matters raised in submissions, minor amendments and changes to large exposures reporting.

Chapter 5 discusses implementation of APRA's new prudential framework for large exposures.

In some circumstances, amendments have been made to APS 221 in response to issues raised in submissions. However, due to their minor and technical nature APRA has not detailed its specific response to these issues in this response paper.

Chapter 2—Large exposure prudential limits

This chapter sets out issues raised in submissions relating to prudential limits and APRA's response to these issues.

2.1 Limit on exposures to a group of connected counterparties

APRA proposed that the aggregate large exposures of an ADI to a counterparty or a group of connected counterparties must not exceed 25 per cent of the ADI's Tier 1 Capital.

Comments received

One submission expressed concern that the proposed downward revision from 50 per cent of Total Capital would limit the flexibility of ADIs in managing their liquidity requirements. Respondents who raised this concern recommended that APRA retain the existing limit of 50 per cent of Total Capital specifically for ADIs under the Minimum Liquidity Holdings regime.

APRA response

To the extent possible, APRA is committed to aligning with the internationally agreed Basel large exposures framework. In particular, it is considered appropriate to remove the concessionary limit in APS 221 of 50 per cent of Total Capital for an exposure to an unrelated ADI and its subsidiaries. APRA is of the view that exposures between ADIs should not be higher than 25 per cent of Tier 1 Capital other than on an exceptions basis.

APRA expects that ADIs will be able to meet the new limit of 25 per cent of Tier 1 Capital for their exposures to unrelated ADIs by 1 January 2019. ADIs that need an alternative approach are able to apply for an exemption under the new APS 221 by clearly justifying the exemptions that are requested (see Chapter 4.1 Exemptions).

In the case of an exposure to a foreign government or central bank that was previously eligible for the higher limit of 50 per cent of Tier 1 Capital but needed to comply with this lower limit, APRA would expect the ADI to notify it immediately of the situation and to manage its exposure downward in a timely and orderly fashion.

2.2 Limit on exposures between D-SIBs

APRA proposed that an ADI designated as a D-SIB by APRA would be required to limit its exposures to another APRA-designated D-SIB to 15 per cent of its Tier 1 Capital. Consistent with the application of all large exposure limits, all counterparties may also be a member of a group of connected counterparties.

Comments received

Submissions raised concerns about the impact of APRA's proposed limit of 15 per cent of Tier 1 Capital for exposures between APRA-designated D-SIBs. Submissions contended that there would be complexities with the proposed limit. Given existing exposure levels between

D-SIBs and changes in the measurement of large exposures, the new limit may not provide sufficient flexibility for ADIs to operate, particularly with respect to liquidity management. It was recommended that APRA consider a revision to the limit or consider an alternative measure for exposures captured by the limit.

APRA response

APRA is of the view that exposures between D-SIBs create great contagion risks and should therefore not be permitted to be as large as exposures that might exist between other ADIs. Contagion risk resulting in material losses for exposures between D-SIBs are more likely to have systemic implications and impact financial stability.

In response to concerns about complexity, however, the new APS 221 has been modified to require D-SIB to D-SIB exposures to comply with a limit of 20 per cent of Tier 1 Capital. This revision aims to balance prudential concerns over contagion risks with the need for these ADIs to have appropriate operational flexibility. All D-SIBs are currently operating within this 20 per cent limit.

2.3 Limit on exposures to G-SIBs

APRA proposed that, consistent with the Basel Committee's recommendations, an ADI's exposure to a G-SIB and its group of connected counterparties must not exceed 15 per cent of the ADI's Tier 1 Capital; this would be in comparison to the proposed limit of 25 per cent of an ADI's Tier 1 Capital for its exposure to a counterparty or a group of connected counterparties.

Comments received

Submissions argued that the proposed limit to a G-SIB was too low and unnecessary and would not provide ADIs sufficient flexibility to manage their positions. G-SIBs are typically major correspondent banking providers and trading counterparties with ADIs and adopting the proposed limit could result in ADIs being required to diversify their exposures to counterparties that are currently outside their credit risk appetite.

APRA response

It is appropriate for ADIs to manage their concentrations to G-SIBs in a prudent manner. Concentrations to G-SIBs may carry heightened contagion risks that have the potential to affect financial stability. However, in proposing the limit, APRA's intent was not to unduly disrupt correspondent banking and trading arrangements. As a result, in the new APS 221, the G-SIB limit has been removed. Exposures to G-SIBs will instead be measured against the limit of 25 per cent of Tier 1 Capital of an ADI's exposure to a group of connected counterparties.

Additionally, recognising that exposures to G-SIBs should be given heightened attention, where APRA is of the view that an ADI is exposed to a significant level of risk concentration, as per paragraph 39 of the new APS 221, APRA may impose higher risk-weights in relation to those exposures, require an ADI to reduce its level of risk concentration or require the ADI to maintain a higher prudential capital requirement (PCR).

Chapter 3—Measurement of large exposures

This chapter discusses the material issues raised in submissions relating to the measurement of large exposures, in particular how exposures should be aggregated where there are related risks, or disaggregated into underlying economic risks when an ADI has an exposure to a structured vehicle.

3.1 Aggregation of exposures

APRA proposed to adopt the definition of a group of connected counterparties from the Basel large exposures framework. Broadly, this meant that if there were specific relationships or dependencies between counterparties such that the failure of one counterparty was likely to cause the failure of another counterparty, an ADI was required to form a group of connected counterparties between these counterparties.

3.1.1 Economic interdependence

APRA proposed that one of the conditions that would require ADIs to form a group of connected counterparties was economic interdependence. Economic interdependence was defined to exist between two counterparties if the financial soundness of one counterparty could affect the financial soundness of another counterparty.

Comments received

There was some support for APRA's proposal to align with the Basel large exposures framework by including a threshold of five per cent of Tier 1 Capital below which an ADI would not be required to apply the economic interdependence criteria as this provided a more appropriate balance against regulatory burden. However, various issues were raised relating to the cost and complexity of system implementation, whether interdependence was needed between two or more counterparties to require aggregation, which counterparties were intended to be captured and the extent of connectivity.

Respondents also recommended that where an ADI assessed that certain counterparties should not be treated as a group of connected counterparties, the ADI should be allowed to exempt the aggregation of these counterparties without prior approval from APRA. Submissions also recommended that APRA consider excluding retail counterparties from the scope of connected counterparties.

APRA response

The proposals in the discussion paper relating to economic interdependence are largely consistent with the Basel large exposures framework. APRA considers that economic interdependence is a key component of the new APS 221, designed to ensure that ADIs can appropriately identify, monitor and limit potential contagion risks in the financial system. Implementation of the requirements should also promote financial safety and lead to greater consistency in aggregation practices across ADIs.

The criteria for economic interdependence are considered appropriate and in line with the intention of the Basel requirements, one counterparty's dependence on another may be sufficient to require aggregation.

To balance financial safety with efficiency, however, ADIs will be able to exclude a counterparty from a group of connected counterparties when the ADI assesses that the counterparty would be able to overcome financial difficulties associated with another counterparty's default by finding alternative business partners or funding sources within a reasonable period of time.

Further, to address concerns raised in submissions regarding efficiency, the new APS 221 will allow an ADI to exclude a retail counterparty from a group of connected counterparties even if the relationship meets the economic interdependence criteria. A definition of retail exposures is provided in APS 221 to clarify the scope of excluded counterparties. ADIs will still be expected to have regard to aggregation requirements for all counterparties when assessing risk concentrations as part of their risk management framework.

With the provision of greater flexibility, ADIs will be required to review the reasons for not treating certain counterparties as groups of connected counterparties within a timely manner. In making these adjustments to APS 221, APRA may also require certain counterparties to be treated as a group of connected counterparties if in APRA's view two or more counterparties meet the criteria in paragraph 21 of the new APS 221.

A transition period is also provided until 1 January 2020 for the implementation of the new requirements in relation to groups of connected counterparties (see Chapter 5).

3.1.2 Government-related entities

APRA proposed that government-related entities (GREs) would include public sector entities, state owned enterprises and all entities controlled by a government or central bank. APRA proposed that GREs were not to form part of a government or central bank's group of connected counterparties. GREs, however, were required to be connected to other counterparties. This included forming a group of connected counterparties containing GREs that were controlled by the same government or central bank.

Comments received

One submission contended that APRA should align with the Basel large exposures framework by exempting GREs that are commonly controlled by a government from being connected in the same group of connected counterparties. It was argued that not providing such an exemption may result in an extensive group of GREs in each jurisdiction. The submission recommended that if APRA were to continue with this proposal, GREs should only be aggregated by the level of government at which the GREs were commonly controlled (i.e. GREs controlled by local governments would be aggregated together, but not with GREs controlled by state governments). Clarification was also sought on whether the definition of GREs was intended to capture sovereign wealth funds as the treatment of these varies across jurisdictions.

APRA response

Recognising the matters raised, the new APS 221 will not require GREs that are controlled by a common government or central bank to be aggregated. ADIs will still be required to manage their large exposures and risk concentrations to various types of counterparties, including groups of GREs, as part of their risk management framework.

APRA may also require certain counterparties to be treated as groups of connected counterparties if APRA is concerned that an ADI is exposed to increasing concentration risks. Where APRA is of the view that an ADI is exposed to a significant level of risk concentration, as per paragraph 39 of the new APS 221, APRA may also impose higher risk-weights in relation to those exposures, require an ADI to reduce its level of risk concentration or require the ADI to maintain a higher PCR. *Reporting Standard ARS 221.0 Large Exposures* (ARS 221.0) will also require that ADIs report their twenty largest exposures to GREs, under an additional reporting item.

3.2 Structured vehicles

ADIs may have exposures to structured vehicles (e.g. funds, securitisation vehicles, structured finance products) such that exposures arise not only from direct investment in assets but also from the assets underlying structured vehicles.

3.2.1 Look-through requirement

APRA proposed that an ADI that has an exposure to a structured vehicle which invests in other assets would be required to look through the structured vehicle to the underlying assets and counterparties for the purposes of large exposure limits, subject to a materiality test.

Comments received

A number of submissions considered that the requirement for ADIs to look through a structured vehicle to the underlying assets would be too burdensome and require significant investment in systems and processes. Submissions contended that as current practices in the reporting of such entities lacked transparency and the underlying assets of these entities varied frequently, it would be difficult to provide an accurate position of an ADI's exposure to the underlying assets.

Some respondents also sought greater clarity on the types of exposures that ADIs would be required to look-through and recommended that the provision of banking services and facilities should not result in a requirement to look through a structured vehicle. For these exposures, it was suggested that the exposures should be recognised to the structured vehicle itself rather to the underlying counterparties. It was also recommended that structured vehicles which only invest in underlying assets with no counterparty or credit obligations should be excluded from the look-through requirements.

APRA response

Whilst there may be complexities associated with implementation, APRA considers that it is appropriate for ADIs to recognise the underlying risks of their exposures to structured

vehicles. This is prudent to ensure that any material concentration risks in underlying assets or counterparties have been appropriately identified and measured. In addition, as exposures to underlying assets may give rise to risk concentrations (e.g. concentrations in particular asset classes or sectors), it would be prudent to recognise these concentrations for risk management purposes. This is consistent with the intention of the Basel large exposures framework.

To address concerns raised regarding regulatory burden, APRA has made two changes to the application of the look-through requirements:

- ADIs will not be required to apply the look-through requirements for structured vehicles which only hold the assets of retail counterparties (e.g. residential mortgage-backed securities (RMBS) and other asset-backed securities containing exposures of a retail nature). This is consistent with the proposed exclusion of RBA repo-eligible RMBS in the discussion paper due to the diversity of these exposures. However, an ADI which has an exposure to a structured vehicle that holds non-retail assets will be required to identify and measure the structured vehicle's underlying assets subject to meeting the look-through requirements.
- It is APRA's intention that the new APS 221 comes into effect on 1 January 2019 (refer to Chapter 5). From that date, ADIs will be required to recognise the exposure to the structured vehicle itself in line with the current large exposure practices. A transition period will be provided so that ADIs will not need to measure underlying assets, for large exposure purposes, until 1 January 2020.

Revisions have also been made to clarify that, under the new APS 221, in addition to the look-through requirements, ADIs will need to continue with the current approach in APS 221 where an ADI's aggregate exposure to the structured vehicle itself must also be recognised in full. This ensures that an ADI's aggregate exposure to a structured vehicle is appropriately captured within the prudential limits.

It is appropriate for ADIs to have visibility over the material economic risks of the assets held by a structured vehicle. Therefore, to balance the revisions in the new APS 221, where an ADI has an exposure to a structured vehicle that is exempt from the look-through requirements, it must assess the risk concentrations of the underlying assets of the structured vehicle on an annual basis.

3.2.2 Third parties and additional risk factors

APRA proposed that an ADI would be required to identify third parties which contribute an additional risk factor inherent in the structured vehicle itself rather than in the underlying assets. Where structured vehicles share a common additional risk factor, an ADI would be required to aggregate its exposure to these vehicles to form a group of connected counterparties and assign the aggregate exposure to each third party. Further, it was proposed that an ADI would need to add its exposures to the structured vehicles associated with a third party to other exposures (e.g. a loan) that the ADI has to that third party if there were risks to either of these exposures.

Comments received

A number of submissions sought clarification as to whether the existence of common third party service providers with non-financial service obligations would require an ADI to aggregate exposures to multiple structured vehicles. These submissions were of the view

that aggregation of exposures to structured vehicles were not appropriate especially where the structured vehicle has complied with the requirements of *Prudential Standard APS 120 Securitisation* (APS 120), is bankruptcy remote and service providers may legally be replaced.

Submissions also highlighted that aggregating exposures across multiple structured vehicles to a common additional risk factor could result in an exposure to the third party that was well above its commitment to those structured vehicles. Respondents also sought clarification over whether the presence of a common lenders mortgage insurance provider across structured vehicles might require aggregation of the structured vehicles.

APRA response

APRA considers it appropriate for ADIs to undertake risk-based assessments of their exposures to structured vehicles as there may be motivating factors (e.g. the potential for fraud or poor lending practices) that would make it appropriate for an ADI to aggregate its exposures to structured vehicles. This is also consistent with the Basel large exposures framework.

APRA has made minor adjustments to clarify that ADIs should take a principles-based approach to the requirements in relation to third parties and additional risk factors. The new APS 221 clarifies this with a two-step approach. Firstly, an ADI is required to identify third parties which contribute an additional risk factor inherent in the structured vehicle. Secondly, an ADI must undertake a risk assessment to determine whether these additional risks are considered material enough to require the ADI to aggregate structured vehicles together, assign aggregate exposures to certain structured vehicles to the third party or aggregate exposures to structured vehicles with other direct exposures an ADI may have to the third party.

In conducting this risk assessment, whether a structured vehicle is bankruptcy remote or meets the requirements of APS 120 will only be one factor in an ADI's assessment of the connectivity between an additional risk factor and the structured vehicle. Consistent with other amendments to APS 221, an ADI will be required to review the reasons for not including structured vehicles in groups of connected counterparties. To balance this, APRA may require the ADI to include structured vehicles in a group of connected counterparties if APRA is of the view that the criteria in paragraph 21 of the new APS 221 have been met.

Consistent with the implementation of the look-through requirements by 1 January 2020, APRA will also allow ADIs the same transition period in relation to the third parties and additional risk factor requirements.

3.2.3 Marketplace lenders

APRA proposed that the look-through requirements would apply to ADI exposures to structured vehicles but did not clarify the treatment of exposures to marketplace lenders.

Comments received

One submission requested that, with the introduction of requirements relating to structured vehicles, APRA clarify the treatment of exposures that are for the purpose of funding loans through marketplace lenders. Under the current APS 221, smaller ADIs treat their total loans provided through a marketplace lender as an aggregated exposure to the marketplace lender

rather than to the individual underlying counterparties. However, for accounting and management purposes, some ADIs look through the marketplace lender and monitor and treat each exposure individually. The submission requested that ADIs should have the option to look through the marketplace lender to the individual exposures.

APRA response

In general, an ADI's exposure to a marketplace lender should be treated in an equivalent manner to exposures to structured vehicles which hold other assets. However, given marketplace lenders have varying structures, this approach may not always be appropriate.

APRA has clarified in the new APS 221 that, firstly, ADIs are required to report and treat exposures to a structured vehicle on an aggregated basis; it is not prudent, for example, for an ADI to have unlimited exposures to structured vehicles of a given marketplace lender especially when that lender may carry operational risks. Secondly, ADIs must also recognise the underlying economic risks of structured vehicle investments where they hold non-retail assets and pose material risks to the ADI (e.g. where an underlying asset is greater than 0.25 per cent of the ADI's Tier 1 Capital).

Chapter 4—Other matters

This chapter discusses other matters raised in submissions in relation to existing exemptions and minor amendments.

4.1 Exemptions

The current APS 221 includes provision for APRA to approve exposures in excess of the specified limits or to set alternative limits for an ADI; over the years, APRA has exercised its discretion for such exemptions from time to time. In the discussion paper, APRA considered that it was timely to reconsider the ongoing relevance and suitability of existing large exposure exemptions and the provision of alternative approaches for certain ADIs. Views were requested on the need for an alternative approach for some ADIs, such as service providers, and how the large exposures framework may be applied to such ADIs whilst balancing the need for reduced system-wide contagion risk.

Comments received

A number of submissions were received from service providers, other ADIs, and an industry association. Broadly, submissions from service providers contended that their business models are unique and that implementing the proposed large exposures framework would substantially impact their business and clients. These submissions recommended that APRA continue existing exemptions under the new APS 221 and, in some cases, argued for small adjustments to existing exemptions.

One submission suggested that APRA consider extending exemptions for smaller ADIs that have exposures to service providers as these exposures are strictly for operational requirements. If APRA were to require compliance with the new prudential limits in APS 221, ADIs would be required to split their business across multiple providers. It was requested that APRA explain and manage the exemption process to ensure there is little disruption of ongoing and longstanding relationships with existing service providers.

A number of submissions from other ADIs also encouraged APRA to continue existing exemptions under the new large exposures framework.

APRA response

The new APS 221 includes the standard wording that APRA is now including in prudential standards in relation to relying on a previous exercise of discretion by APRA. Prior to the commencement of the new APS 221, an ADI will need to contact APRA if it seeks to place reliance on an exemption or other exercise of discretion made under a previous version of APS 221. This provides supervisors an opportunity to review past decisions, but does not require the exemption or other discretion to be re-determined. APRA intends to finalise any review of exemptions by mid-2018.

4.2 Other amendments

In addition to the topics discussed in this response paper, APRA has made a number of minor amendments to APS 221 and ARS 221.0.

Other amendments to the large exposures framework include:

- a definition of retail exposures for the purposes of APS 221 to clarify which exposures will be excluded from certain requirements;
- maintaining the exclusion in the current APS 221 in relation to exposures arising in the course of settlement of market-related contracts, subject to certain conditions. ADIs will be required to report these exposures in ARS 221.0 along with certain other exposures that have been excluded;
- clearer requirements outlining that counterparties may be connected via a control relationship if a different entity (including another counterparty) has control over those counterparties;
- a requirement for ADIs to define in their Board-approved policies, limits on exposures to counterparties who provide credit risk mitigation (CRM). Counterparties captured by this include, but are not limited to, those who provide CRM as described in APRA's risk-based capital framework;
- modifications to the prior consultation requirements to require an ADI to notify APRA prior to committing to any proposed large exposure to non-government and non-ADI counterparties;
- clearer requirements for ADIs to apply higher risk weights where APRA is of the view that an ADI is exposed to significant concentration risk;
- inclusion of transitional provisions to clarify the commencement date of new requirements in relation to groups of connected counterparties, structured vehicles and third parties and additional risk factors;
- a new Attachment B has been added incorporating the definition of a *group of related counterparties*, which will continue to apply until 31 December 2019;
- a requirement in ARS 221.0 for ADIs to report a counterparty's legal entity identifier to enhance consistency of reporting and the usability of data; and
- insertion of a provision in ARS 221.0 to allow a foreign ADI, subject to APRA's approval, to apply the requirements and definitions of its offshore prudential regulator when measuring and reporting its largest exposures under ARS 221.0. APRA considers that this is appropriate to limit the cost and burden associated with implementing additional systems to comply with APRA's large exposure reporting requirements.

Chapter 5—Implementation

APRA proposed that the new APS 221 would commence on 1 January 2019. APRA also proposed to facilitate a period of best endeavours reporting for six months prior to this implementation date.

Comments received

A number of submissions highlighted that there were significant complexities associated with the implementation of the proposed large exposures framework. In particular, responses highlighted that the requirements in relation to groups of connected counterparties and the look-through approach to structured vehicles would require ADIs to invest significant time and resources in order to implement the required systems and processes. Multiple submissions requested a two-year transition period from the release date of the final standard, before full implementation of the large exposures framework.

APRA response

As the new requirements in relation to groups of connected counterparties, look-through for exposures to structured vehicles and third parties and additional risk factors will require significant resources, ADIs will have until 1 January 2020 to comply with these requirements. This transition period will also allow APRA to monitor the implementation of the new framework. All other changes to APS 221 will come into force on 1 January 2019, in line with the original proposed implementation date.

As the new requirements in relation to the aggregation of counterparties and structured vehicles will not come into effect until 1 January 2020, prior to this date, an ADI will be required to form groups of related counterparties in line with existing requirements in the current APS 221 for the purpose of measuring large exposures.

The new APS 221 has been revised to reflect that:

- the requirements in relation to groups of connected counterparties, the look-through approach to structured vehicles and third parties and additional risk factors will be required to be implemented by 1 January 2020; and
- until 31 December 2019, where there are references to groups of connected counterparties in the new APS 221, ADIs are to read this as groups of related counterparties and use the definition in Attachment B of the new APS 221.

The new ARS 221.0 has been revised to reflect that:

- ADIs will no longer be required to undertake a period of best endeavours reporting for a period of six months prior to this implementation date.

Annexure A—Regulatory costs

This Appendix formalises and sets out the steps taken in finalising the new APS 221.

In April 2017, APRA released for public consultation a discussion paper which outlined three options for the future application and operation of the large exposure requirements set out in APS 221 and associated reporting requirements in ARS 221.0. Those three options were:

- option 1—status quo: maintain APRA's existing prudential requirements for large exposures;
- option 2—full implementation: implement the Basel large exposures framework with no changes; and
- option 3—implement the Basel large exposures framework with some adjustments to reflect Australian and ADI-specific conditions.

APRA's public consultation was open for three months. Thirteen submissions were received from a range of stakeholders including ADIs, foreign ADIs and industry bodies.

Assessment of regulatory costs

As part of its public consultation, APRA sought information from stakeholders on the compliance impacts of the proposed changes set out in the discussion paper, including associated substantive costs. Respondents were asked to use the Australian Government's Regulatory Burden Measurement Tool (RBMT) to assess regulatory costs.

None of the submissions provided regulatory cost estimates using the RBMT. However, some respondents provided high-level cost estimates of the expected cost impacts of implementing the Basel large exposures framework (option 2). APRA has factored these estimates into its own cost estimates for each option and extrapolated the cost impacts for all ADIs on this basis, as well as the estimated impacts of the variations to the Basel large exposures framework to reflect Australian and ADI-specific conditions (option 3).

APRA has considered relevant compliance costs (e.g. administration, substantive and financial compliance costs as applicable) in estimating the regulatory cost of each option. This includes the costs of complying with the new large exposures framework, which primarily relates to system costs to reflect the changes to large exposure limits, costs to identify and connect counterparties, update internal policies, procedures and processes and to train staff about any new requirements. APRA has also made assumptions about the nature and extent of cost impacts including the extent of work involved based on staff numbers and associated staff costs as well as the size of an ADI. In addition, when estimating the cost impacts it has been assumed that while ADIs will be directly affected, there are no anticipated direct cost impacts for other stakeholders. All costs represented in the Tables in this section reflect the amortised cost per year over a 10-year time horizon.

Option 1—Status quo

Under this option, ADIs and other stakeholders would not incur any additional compliance costs as the current large exposures framework would be retained without change (refer to Table 1 below). However, there would be indirect costs as ADIs would no longer be in

compliance with international obligations for large exposures which may affect their ability to participate in international markets.

Table 1 – Average annual regulatory costs

Sector	Business	Community organisations	Individuals	Total change in costs
Total change in cost by sector ($ million)	0	0	0	0

Option 2—Full implementation of Basel large exposures framework

Under this option, ADIs would incur additional costs as the existing large exposures framework would be modified to comply with the revised Basel large exposures framework. As noted previously, these costs stem from system costs to reflect the changes to large exposure limits, costs to identify and connect counterparties, update internal policies, procedures and processes and to train staff about the new requirements (refer Table 2 below).

These costs arise as a result of a number of material changes to the large exposures framework as outlined in the discussion paper. They include changes to the level of capital (from Total Capital to Tier 1 Capital) used in the definition of large exposures, certain exposures excluded from the large exposure requirements, requirements to form a group of connected counterparties and changes to certain large exposure limits and the introduction of new limits, including introducing limits for systemically important banks to recognise the heightened contagion risks and potential for increased financial instability from these exposures. ADIs would also be required to amend systems to report large exposures under the new framework. This option would apply from 1 January 2019 in line with the Basel large exposures framework.

Table 2 – Average annual regulatory costs

Sector	Business	Community organisations	Individuals	Total change in costs
Total change in cost by sector ($ million)	5.81	0	0	5.81

Option 3—Implement the Basel large exposures framework with some adjustments to reflect Australian and ADI-specific conditions

This option is a variant of option 2 with amendments to reflect Australian conditions and the operation of the Australian ADI industry. This option essentially makes a number of changes based on issues raised in submissions to APRA as part of the consultation process. These changes, which are discussed in detail in this paper, include:

- allowing ADIs to exclude retail counterparties from the concept of a group of connected counterparties;
- not requiring look through for structured vehicles which hold retail assets; and

- an extended transition to 1 January 2020 before ADIs are required to look-through to the assets of structured vehicles and form groups of connected counterparties according to new requirements.

Table 3—Average annual regulatory costs

Sector	Business	Community organisations	Individuals	Total change in costs
Total change in cost by sector ($ million)	5.45	0	0	5.45

Conclusion

Under option 1, there would be no additional compliance costs. This is because option 1 involves maintaining the existing large exposures without any change.

Both options 2 and 3 involve compliance costs for industry. Option 3 involves lower costs as APRA would provide a number of concessions to ADIs. APRA considers that option 3 is the better option as it recognises a number of difficulties and complexities in implementing the Basel large exposures framework, the costs of which are considered to outweigh any benefits that would arise if option 2 was implemented. In APRA's view, option 3 achieves an appropriate balance between calibrating the large exposures framework that ADIs are required to meet but without significant deviation from the Basel large exposures framework. On this basis, APRA will adopt option 3 as detailed in this response paper.

Table 4—Summary of net benefits of each option

	Option 1	Option 2	Option 3
Compliance cost	No change	Moderate cost	Moderate cost
Reduce system-wide contagion and strengthen oversight of large exposures	No change	Meets this criteria	Meets this criteria
Complies with Basel large exposures framework	Does not meet this criteria	Meets this criteria	Largely meets this criteria
Reflects local conditions	Does not meet this criteria	Does not meet this criteria	Meets this criteria
Overall	Low net cost	Moderate net cost	Moderate net cost

Implementation and review

On release of APS 221, ADIs will have until 1 January 2019 to comply with the requirements under the new prudential standard and until 1 January 2020 for requirements in relation to groups of connected counterparties and look-through of structured vehicles.

Under APRA's policy development process, reviews of new prudential measures are typically scheduled for two to three years from implementation date or as otherwise considered appropriate. Such a review would consider whether the requirements continue to reflect good practice, remain consistent with international standards and remain relevant and effective in facilitating sound risk management practices. APRA would also take action within a shorter timeframe where there is a demonstrable need to amend a prudential requirement.

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