

Banking (prudential standard) determinations Nos. 1 and 2 of 2018

EXPLANATORY STATEMENT

Prepared by the Australian Prudential Regulation Authority (APRA)

Banking Act 1959, section 11AF

Under subsection 11AF(1) of the *Banking Act 1959* (the Act), APRA has the power to determine standards (prudential standards), in writing, in relation to prudential matters to be complied with by authorised deposit-taking institutions (ADIs) and authorised non-operating holding companies (authorised NOHCs). Under subsection 11AF(3) of the Act, APRA may, in writing, vary or revoke a prudential standard.

On 19 April 2018, APRA made the following determinations (the instruments):

- (1) Banking (prudential standard) determination No. 1 of 2018 which determines *Prudential Standard APS 180 Capital Adequacy: Counterparty Credit Risk* (APS 180);
- (2) Banking (prudential standard) determination No. 2 of 2018 which revokes *Prudential Standard APS 112 Capital Adequacy: Standardised Approach to Credit Risk* (existing APS 112) made under Banking (prudential standard) determination No. 5 of 2012 and determines a new *Prudential Standard APS 112 Capital Adequacy: Standardised Approach to Credit Risk* (APS 112).

The instruments commence on 1 July 2019.

1. Background

APRA's prudential framework includes a suite of prudential standards that impose capital requirements for ADIs to ensure they hold sufficient capital to address risks associated with their operations. One of these standards is the existing APS 112 which includes requirements in relation to counterparty credit risk – being the risk that an entity suffers a loss due to a counterparty defaulting on its obligations under a contract. ADIs are required to hold capital for counterparty credit risk that arises from certain types of transactions – including, over-the-counter (OTC) derivative transactions, exchange traded derivative transactions, securities financing transactions and long settlement transactions.

In 2014, the Basel Committee on Banking Supervision (Basel Committee) – which is the international standard setter for banks – finalised revisions to its framework relating to the measurement of counterparty credit risk exposures as set out in *The standardised approach for measuring counterparty credit risk exposures* (March 2014). The revisions introduced a new non-internal model for measuring counterparty credit risk exposures (SA-CCR) which is intended to replace existing non-model approaches in the Basel framework. As part of updating its requirements for counterparty credit risk, APRA has introduced a dedicated prudential standard on this topic – APS 180 – which will incorporate relevant existing requirements in APS 112.

2. Purpose and operation of the instrument

Banking (prudential standard) No 1 of 2018

The purpose of this instrument is to make the new APS 180.

APS 180 is a new prudential standard that requires an ADI to adopt risk management practices and hold sufficient regulatory capital for counterparty credit risk exposures arising from over-the-counter derivative transactions, exchange-traded derivative transactions, securities financing transactions and long settlement transactions.

This instrument consolidates the Basel Committee's framework for counterparty credit risk, including existing requirements in APS 112, into a single prudential standard. APS 180 implements the SA-CCR which will apply to ADIs who are accredited to use the internal ratings-based approach (IRB) to credit risk while all other ADIs will be able to use a simplified approach – the adjusted current exposure method for measuring counterparty credit risk.

Banking (prudential standard) determination No. 2 of 2018

The purpose of this instrument is to revoke existing APS 112 and replace it with a new version of APS 112.

APS 112 requires an ADI to hold sufficient regulatory capital against its credit risk exposures, including both on-balance sheet assets and off-balance sheet exposures.

This instrument removes existing counterparty credit risk requirements contained within APS 112, as they have been moved to the new APS 180.

Where APS 112 or APS 180 refers to an Act, Regulation or prudential standard, this is a reference to the document as it exists from time to time. These documents are available on the Federal Register of Legislation at www.legislation.gov.au.

3. Consultation

APRA undertook two rounds of consultation on its proposed prudential framework for counterparty credit risk for ADIs, the first in September 2016 and the second in August 2017. Submissions were received from, and discussions held with, numerous ADIs, industry bodies and other interested parties. As part of the September 2016 consultation, APRA also invited views from industry on the potential introduction of an alternative approach for measuring counterparty credit risk exposures for ADIs with immaterial levels of such exposures.

APRA received five submissions in response to its initial discussion paper. Submissions were generally supportive of APRA's proposals but raised concerns regarding implementation timing, scope of application of the SA-CCR amongst other matters. Submissions also expressed support for consideration of a simple, conservative alternative methodology for ADIs with immaterial counterparty credit risk exposures.

APRA, in its August 2017 discussion paper, proposed a simplified counterparty credit risk measurement approach for those ADIs who calculate credit risk using a standardised approach to credit risk – being the majority of ADIs. Seven submissions were received on the August 2017 discussion paper. Submissions raised various issues, some of a general nature and some covering technical aspects of the proposals set out in the discussion paper and accompanying prudential and reporting standards.

The public discussion papers and other documents released during the consultation period were:

- September 2016: Discussion Paper *Counterparty credit risk for ADIs*;
 - Draft Prudential Standard APS 112 Capital Adequacy: Standardised Approach to Credit Risk (APS 112);
 - Draft Prudential Standard APS 180 Capital Adequacy: Counterparty Credit Risk (APS 180);
- August 2017: Discussion Paper *Counterparty credit risk for ADIs*; and
 - Draft Prudential Standard APS 112 Capital Adequacy: Standardised Approach to Credit Risk (APS 112);
 - Draft Prudential Standard APS 180 Capital Adequacy: Counterparty Credit Risk (APS 180);
 - Draft Reporting Standard ARS 112.2 Standardised Credit Risk — Off-balance Sheet Exposures;
 - Draft Reporting Standard ARS 118.1 Other Off-balance Sheet Exposures; and

- Draft *Reporting Standard ARS 180.0 Counterparty Credit Risk*.

4. Regulation Impact Statement

APRA prepared an independent review, which involved an equivalent process and analysis to that required for a Regulation Impact Statement, which has been lodged as supporting material.

5. Statement of compatibility prepared in accordance with Part 3 of the Human Rights (Parliamentary Scrutiny) Act 2011

A Statement of compatibility prepared in accordance with Part 3 of the *Human Rights (Parliamentary Scrutiny) Act 2011* is provided at Attachment A to this Explanatory Statement.

ATTACHMENT A

Statement of Compatibility with Human Rights

Prepared in accordance with Part 3 of the *Human Rights (Parliamentary Scrutiny) Act 2011*

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The legislative instruments are compatible with the human rights and freedoms recognised or declared in the international instrument listed in section 3 of the *Human Rights (Parliamentary Scrutiny) Act 2011* (HRPS Act).

Overview of the Legislative Instruments

The purpose of the instrument is to make a new *Prudential Standard APS 180 Counterparty Credit Risk* (APS 180) and revoke *Prudential Standard APS 112 Capital Adequacy: Standardised Approach to Credit Risk* determined by APRA in 2012 and replace it with a new *Prudential Standard APS 112 Capital Adequacy: Standardised Approach to Credit Risk* (APS 112).

APS 180 sets out requirements for authorised deposit-taking institutions (ADIs) to adopt risk management practices and hold sufficient regulatory capital for counterparty credit risks exposures arising from certain transactions. ADIs are bodies corporate authorised to carry on banking business in Australia.

APS 112 is being remade to remove existing counterparty credit risk requirements which are now included as part of APS 180.

Human rights implications

APRA has assessed the instruments and is of the view that they do not engage any of the applicable rights or freedoms recognised or declared in the international instruments listed in section 3 of the HRPS Act. Accordingly, in APRA's assessment, the instruments are compatible with human rights.

Conclusion

The instruments are compatible with human rights as they do not raise any human rights issues.