

Banking (prudential standard) determination No. 7 of 2020

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). Under subsection 11AF(3) of the Act, APRA may, in writing, vary or revoke a prudential standard.

On 8 December 2020, APRA made Banking (prudential standard) determination No. 7 of 2020 (the instrument) which revokes *Prudential Standard APS 222 Associations with Related Entities* made under Banking (prudential standard) determination No. 9 of 2014 and determines a new *Prudential Standard APS 222 Associations with Related Entities* (APS 222).

The instrument commences on 1 January 2022.

1. Background

APRA's mandate is to ensure the safety and soundness of prudentially regulated financial institutions so that they can meet their financial promises to depositors, policyholders and fund members within a stable, efficient and competitive financial system. A key component of this is requiring ADIs to have prudent processes and systems for identifying, measuring, evaluating, monitoring, reporting and controlling or mitigating material risks that may affect their ability to meet obligations to depositors.

APS 222 requires ADIs to implement prudent measures and to set prudent limits on exposures arising from their associations and dealings with related entities and introduces requirements relating to dealings with entities where an ADI is likely to provide support beyond any legal obligation (step-in risk entities).

Associations with related entities introduce the potential for material contagion risk within the banking sector. When an ADI has dealings with related entities, there are contagion risks which would otherwise not exist when dealing with unrelated entities. As demonstrated during the global financial crisis, these contagion risks can be severe if there are deficiencies in controls to mitigate the flow of this risk to an ADI. Such deficiencies can ultimately manifest in financial and reputational contagion, and adversely impact Australian depositors, particularly in a stress scenario. Financial contagion risk may arise when an ADI has a concentration of exposures to its related entities. Furthermore reputational contagion may arise where investors perceive that a related entity faces operational or financial difficulties or where an ADI could be seen to step in to support a group member beyond any legal obligation.

2. Purpose and operation of the instrument

The purpose of the instrument is to revoke APS 222 and replace it with a new version of APS 222. The changes to APS 222 strengthen the requirements for ADIs to monitor, limit and control risks arising from transactions and other associations with related entities and those entities where an ADI is likely to provide support beyond any legal obligation (step-in risk entities). The changes incorporate lessons from the global financial crisis on mitigating contagion flowing from one group entity to another, align Australian requirements with international standards where appropriate, and also ensure broad alignment with requirements relating to an ADI's exposures to unrelated entities in APRA's revised large exposures framework, *Prudential Standard APS 221 Large Exposures*.

In finalising APS 222, APRA has made a number of modifications to assist ADIs in both implementing and complying with APS 222 while continuing to meet the objective of identifying, monitoring and controlling contagion risks. The key changes in APS 222 needed to address the problems outlined above are:

- a broadened definition of related entities, including a principles-based definition, to capture all entities and individuals that may expose an ADI to conflicts of interest and contagion risk, such as substantial shareholders and individuals on the board of directors;
- revised limits on exposures to related entities;
- new and revised minimum requirements on contagion risk assessments;
- stronger requirements to mitigate contagion flowing from one group entity to another, or to the ADI due to reputational reasons, particularly where these entities share common logos or brands with the ADI;
- new requirements for the measurement of exposures to related entities which align with the measurement of exposures to unrelated entities;
- new requirements relating to dealings with step-in risk entities, including maintaining risk appetite statements and adequate systems and controls for exposures arising from such entities;
- updated and new requirements relating to an ADI's associations with a funds management vehicle that is a related entity of the ADI; and
- amended requirements to address risks arising from subsidiaries, which hold or invest in assets, that are treated as part of an ADI's extended licensed entity (ELE) i.e. consolidated with the ADI for prudential purposes.

Where APS 222 refers to an Act, Regulation or prudential standard, this is a reference to the document as it exists from time to time, and which is available on the Federal Register of Legislation at www.legislation.gov.au.

APS 222 provides for APRA to exercise various discretions. Decisions made by APRA exercising those discretions are not subject to merits review. This is because

these decisions are preliminary decisions that may facilitate or lead to substantive decisions which are subject to merits review.

A breach of a prudential standard is a breach of the Act, as section 11AG of the Act provides that ADIs must comply with applicable prudential standards. However, there are no penalties prescribed for breach of a prudential standard. Instead, an ADI's breach of a provision in the Act is grounds for APRA to make further, substantive decisions under the Act in relation to the ADI. Those decisions are:

- (a) to revoke an authority to carry on banking business (section 9A of the Act); and
- (b) to issue a direction to the ADI, including a direction to comply with the whole or part of a prudential standard (section 11CA of the Act).

It is only at this stage that an ADI is exposed to a penalty: loss of its authority under section 9A or 50 penalty units if it breaches the direction (section 11CG of the Act). The subsequent substantive decisions by APRA to impose a direction or revoke an authority are subject to merits review. In nearly all cases¹ the decision is preceded by a full consultation with the ADI to raise any concerns it may have in relation to the decision.

3. Consultation

APRA has consulted extensively on proposed changes to requirements on an ADI's associations with its related entities. APRA undertook a public consultation from July to September 2018, and has met with and discussed the proposed changes with a number of interested parties. APRA received a total of ten submissions from ADIs and industry bodies. Industry has generally supported the need to revise requirements on related entities however some ADIs will be materially affected by the new APS 222. In particular, revisions to the related entity limits and to the ELE requirements are expected to be the most challenging requirements for certain ADIs to implement.

The key concerns raised in submissions focused on:

- the expanded definition of a related entity to substantial shareholders and associates, and the inclusion of a step-in risk entity as a related entity. APRA has made changes to adjust the definition of a substantial shareholder, and remove associates and step-in risk entities from explicitly forming part of the related entity definition;
- revised related entity limits, which APRA has maintained as they are required at the proposed levels to limit contagion risk and the level of capital at risk in a crisis; and
- the amended ELE framework, in particular the removal of certain overseas subsidiaries from being eligible for inclusion. APRA recognises there will be a

¹ Subsection 9A(4) of the Act specifically provides that APRA does not need to consult where APRA is satisfied that doing so could result in a delay in revocation that would be:

- (a) contrary to the national interest; or
- (b) contrary to the interests of depositors with the ADI.

large impact for certain ADIs but has maintained the proposed changes as they are needed to address complexity in ADI group structures, effective supervision of subsidiaries in the ELE, and the potential for resolution to be complicated in the wind-up of an ADI.

APRA has conveyed to industry that, where necessary, transition periods will be considered and determined by APRA supervisors on a case-by-case basis.

4. Regulation Impact Statement

APRA prepared 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*

Banking (prudential standard) determination No. 7 of 2020

The legislative instrument is 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 Instrument

The purpose of the instrument is to revoke *Prudential Standard APS 222 Associations with Related Entities* determined by the Australian Prudential Regulation Authority (APRA) in 2014 and replace it with a new *Prudential Standard APS 222 Associations with Related Entities* (APS 222).

APS 222 sets out requirements for authorised deposit-taking institutions (ADIs) to identify, monitor and control contagion risks arising from their associations and dealings with related entities and those entities where an ADI is likely to provide support beyond any legal obligation. ADIs are bodies corporate that have been granted the authority, under the *Banking Act 1959*, to carry on banking business in Australia. APS 222 does not prescribe any measures relating specifically to the collection or treatment of personal information.

Human rights implications

APRA has assessed the instrument and is of the view that they it does 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 instrument is compatible with human rights.

Conclusion

The instrument is compatible with human rights as it does not raise any human rights issues.