Prudential Standard APS 222

Associations with Related Entities

Objective and key requirements of this Prudential Standard

This Prudential Standard aims to ensure that authorised deposit-taking institutions give due consideration to the risks associated with the corporate group of which they are a member and are not exposed to excessive risk as a result of their associations and dealings with related entities.

The key requirements of this Prudential Standard are that an authorised deposit-taking institution must:

- monitor potential contagion risk between the institution and other members of a conglomerate group of which the institution is a part;
- meet minimum requirements with respect to group risk management, dealings with related entities and certain related matters; and
- adhere to prudential limits on intra-group exposures.

Authority

1. This Prudential Standard is made under section 11AF of the *Banking Act 1959* (**Banking Act**).

Application

2. This Prudential Standard applies to all authorised deposit-taking institutions (**ADIs**) under the Banking Act, subject to paragraph 3.

3. A foreign ADI, within the meaning of subsection 5(1) of the Banking Act, is subject only to the requirements in paragraphs 20 to 31 inclusive.

Monitoring of contagion risk

4. Associations between an ADI and other members of a conglomerate group (defined in accordance with *Prudential Standard APS 110 Capital Adequacy* (**APS 110**)) to which the ADI belongs could give rise to potential contagion risk. That risk refers to the possibility that problems arising in other group members may compromise the financial and operational position of the ADI. In assessing the level of risk of such associations, APRA will have regard to the following factors:

   (a) the financial strength of the group;

   (b) the nature of business conducted in group entities;

   (c) the quality of management and systems and, particularly, risk management across the group;

   (d) the level of financial and operational interdependence across the group, particularly between regulated and unregulated entities;

   (e) whether other members of the group are regulated entities (i.e. any entity directly regulated by APRA or by an equivalent banking or insurance prudential regulator overseas) and the quality of regulation;

   (f) the ratings (where applicable) of unregulated entities in the group;

   (g) badging and product distribution arrangements which might link the ADI to the fortunes of other entities in the group; and

   (h) other relevant factors to be considered on a case-by-case basis.

5. To ensure that contagion risk is kept at a modest level, an ADI must have adequate systems, policies and procedures in place to manage, monitor and control all forms of risks arising from its associations with other members of a conglomerate group, beyond those arising from direct financial dealings with group members. The risks range from reputational risk and legal risk arising from the use of a common brand name (group badging), cross-selling of

products or perception of support provided by an ADI to group members and *vice-versa*, to operational risk arising from the use of common services provided by or to other group members.

Group risk management

6. Paragraphs 6 to 11 of this Prudential Standard apply to an ADI that heads a conglomerate group (refer to *Prudential Standard APS 110 Capital Adequacy* (**APS 110**)). Where an ADI forms part of a conglomerate group headed by an authorised non-operating holding company (**authorised NOHC**), the requirements set out in paragraphs 6 to 9 of this Prudential Standard apply to the ADI and its subsidiaries.

7. For conglomerate groups headed by an ADI, the Board of directors (**Board**) of the ADI is responsible for ensuring that comprehensive policies and procedures are in place to measure, manage, monitor and report overall risk at a group level. To ensure that existing Board-approved policies and the relevant controls remain adequate and appropriate for managing and monitoring overall group risk, the Board or a board committee must review them regularly (at least annually) to take account of changing risk profiles of group entities. Any material changes to group risk management policies must be approved by the Board.

8. The Board of an ADI must ensure that the ADI establishes appropriate policies, systems and procedures to monitor compliance with APRA's prudential requirements on a group basis. To facilitate conglomerate group supervision by APRA, an ADI must:

   (a) provide APRA with the following group information:

      (i) details of group members (e.g. name, place of incorporation, board composition, nature of business and any other additional information required by APRA for a better understanding of the risk profiles of individual group members);

      (ii) management structure of the group (including key risk management reporting lines);

      (iii) intra-group support arrangements (e.g. a specific guarantee of the obligations of an entity in the group);

      (iv) intra-group exposures (refer to paragraph 17); and

      (v) other information as required by APRA from time to time for the effective supervision of the group;

   (b) notify APRA in accordance with s62A of the Banking Act of any breach of a requirement in a prudential standard or a condition of a banking authority (whether by an ADI in the group or by the group) and of any circumstances that might reasonably be seen as having a material impact

and potentially adverse consequences for an ADI in the group or for the overall group;

(c) advise APRA in advance of any proposed changes to the composition or operations of the group with the potential to materially alter the group's overall risk profile (this must include any proposed changes to the ADI's stand-alone operations); and

(d) obtain APRA's prior approval for the establishment or acquisition of a regulated presence domestically or overseas.

9. An ADI must provide APRA with descriptions of its group risk management policies and the procedures used to measure and control overall group risk (including any material changes thereto). The ADI should, as best practice, disclose in the group's full published annual report each year an outline of its group risk management policies, including the policies governing dealings between the ADI and other group members.

10. An ADI must submit a declaration from its chief executive officer, endorsed by the Board, covering the Level 2 group's risk management systems within three months of the ADI's annual balance date in accordance with the declaration requirements in *Prudential Standard APS 310 Audit and Related Matters* (**APS 310**).

11. If an ADI qualifies the declaration in paragraph 10, the ADI must explain the reasons for the qualifications in accordance with the requirements in APS 310 and provide plans for corrective action.

Dealings with related entities

12. For the purposes of this Prudential Standard, all entities controlled (whether directly or indirectly) by:

(a) an ADI (other than subsidiaries that form part of the Extended Licensed Entity (ELE) [1] in accordance with Attachment A of APS 110;[2] or

(b) the ultimate domestic parent of an ADI (including the parent entity itself)

represent a "related entity" of an ADI. Consistent with the definition of a conglomerate group set out in APS 110, a "related entity" excludes the foreign parent(s) of an ADI, the foreign parent's overseas-based subsidiaries and their directly owned non-ADI entities operating in Australia[3]. Where appropriate, APRA may deem that other entities (and their subsidiaries) represent a "related entity" of an ADI.

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1 In this Prudential Standard, 'ELE' has the meaning in APS 110.

2 These subsidiaries are treated as if they were a part of the ADI itself and consolidated with the ADI in determining its Level 1 (i.e. stand-alone) capital adequacy (refer to APS 110).

3 Prudential limits on the aggregate exposure of an ADI to these entities are set out in *Prudential Standard APS 221 Large Exposures.*

13. The Board of an ADI must establish, and monitor compliance with, policies governing all dealings with related entities. The policies, including any material changes thereto, must be provided to APRA if requested.

14. An ADI's Board policies on related-entity dealings must, at a minimum, include:

    (a) a requirement that the ADI address risks arising from dealings with related entities as strictly as it would address its risk exposures to unrelated entities (refer to paragraph 15);

    (b) prudent limits on exposures to related entities at both an individual and aggregate level (refer to paragraph 17);

    (c) procedures for resolving any conflict of interest arising from such dealings;

    (d) requirements relating to exposures generated from an ADI's participation in group operations (refer to paragraphs 27 to 30);

    (e) requirements relating to the transparency of third-party dealings associated with related entities.

        (As a general rule, an ADI should not undertake any third-party dealings with the prime purpose of supporting the business of related entities.)

15. If an ADI applies terms and conditions to dealings with related entities that are inconsistent with the benchmark for unrelated entities, they must be approved by the Board of the ADI with justifications fully and clearly documented in a register. The ADI must make this register available for inspection by APRA if so requested.

16. An ADI must not:

    (a) hold unlimited exposures to related entities either in aggregate or at an individual entity level (e.g. a general guarantee of the obligations of a related entity); or

    (b) enter into cross-default clauses whereby a default by a related entity on an obligation (whether financial or otherwise) is deemed to trigger a default of the ADI in its obligations.

17. The Board of an ADI must, in determining limits on acceptable levels of exposure to related entities, have regard to:

    (a) the level of exposures which would be approved for unrelated entities of broadly equivalent credit status; and

    (b) the impact on the ADI's stand-alone capital and liquidity positions, as well as its ability to continue operating, in the event of a failure of any related entity to which the ADI is exposed.

18. An ADI must satisfy APRA that it has adequate systems and controls in place for identifying, reviewing, monitoring and managing exposures arising from dealings with related entities. APRA may require an ADI to put in place additional internal controls, a more robust reporting mechanism and to maintain a higher Prudential Capital Ratio (PCR)[4] if APRA is not satisfied with the adequacy of the ADI's systems and controls.[5]

Provision of support

19. An ADI may provide support to related entities (and *vice-versa*) provided such support is undertaken in accordance with the prudential requirements set out in paragraphs 14 to 17 in relation to the policies governing an ADI's dealings with related entities.[6] An ADI must not give the impression of ADI support unless there are formal legal arrangements in place providing for such support.

20. A foreign ADI may provide support to its subsidiaries operating in Australia (and *vice-versa*). However, it must avoid giving any impression of support to these subsidiaries unless there are formal legal arrangements in place providing for such support. Where a foreign ADI wishes to give a general guarantee to its Australian subsidiaries, it must be able to demonstrate to APRA that the home supervisor is aware of the obligations and has no objection to the transaction.

Group badging[7]

21. An ADI and other members in the conglomerate group to which it belongs may use a common brand name provided:

    (a) section 66 of the Banking Act governing the use of restricted expressions in Australia by an ADI or by any other person is complied with; and

    (b) the roles and responsibilities of different group members are clearly disclosed (refer to paragraph 23) to reduce the possibility of creating an impression that a non-ADI member of the group is an ADI, or that (contrary to the legal position) a group member is guaranteed or supported by an ADI in the group.

22. APRA may require an entity not to use a particular brand name if that would give rise to a prudential concern having regard to the following factors:

    (a) the presence of appropriate disclosures;

    (b) the type of entities involved (whether regulated or unregulated);

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4 In this Prudential Standard, 'PCR' has the meaning in APS 110.

5 Refer *Prudential Standard APS 110 Capital Adequacy* for further details.

6 Paragraph 19 also applies to provision of support by a foreign-owned ADI to non-ADI entities operating in Australia directly owned by the ADI's foreign parent or by the parent's subsidiaries (and *vice versa*).

7 All paragraphs under this section also apply to foreign ADIs (and their subsidiaries operating in Australia), and to non-ADI entities operating in Australia directly owned by the foreign parent of an ADI or by the parent's subsidiaries.

(c) the manner in which various products and services are marketed; and

(d) the types of customers involved.

23. To enable counterparties to clearly distinguish between dealings with an ADI and those with other non-ADI group entities, the ADI must ensure that financial transactions (e.g. sales of financial products) between unregulated group members and external counterparties are accompanied by clear, comprehensive and prominent disclosure that:

(a) the group member with whom the counterparty is dealing is not an ADI and that the member's obligations do not represent deposits or other liabilities of the ADI in the group; and

(b) the ADI does not stand behind the group member, unless support is provided for in a formal legal agreement (refer to paragraphs 19 and 20). The nature and limit of such support should also be prominently disclosed where appropriate.

24. For group members involved in securitisation, prudential requirements in relation to disclosure and separation are set out in *Prudential Standard APS 120 Securitisation*.

Distribution of products[8]

25. Where an ADI distributes the financial products of other group members (or third parties), the ADI must ensure that the identity of the product provider is prominently displayed in the relevant marketing material and product documentation such that:

(a) there is no confusion created in customers' minds about the respective roles and responsibilities of the ADI and the product provider; and

(b) it does not give any impression that the product is guaranteed or otherwise supported by the ADI, unless a formal legal agreement is in place to this effect (refer to paragraphs 19 and 20).

26. An ADI must ensure that, when other members of the group (or third parties) distribute its products in either an agent or representative capacity:

(a) appropriate disclosures are present detailing the respective roles of the ADI and the other group members or third parties (refer to paragraph 25); and

(b) the other group members (or third parties) do not, unless otherwise agreed with APRA (and supported by appropriate contractual arrangements – refer to paragraph 27), assume any key decision-making function of the ADI (e.g. in relation to creditworthiness) in distributing the ADI's products.

[8] Refer footnote 7.

Participation in group operations[9]

27. An ADI may participate in group operations (e.g. share premises with other group members, centralise back-office functions, outsource services to other group members, etc.) provided:

    (a) dealings with related entities (and other parties) arising from participating in group operations are appropriately documented in written agreements (outsourcing of the ADI's material business activities to a related entity must satisfy the prudential requirements set out in *Prudential Standard APS 231 Outsourcing*);

    (b) such operations do not lead to any confusion in the mind of customers;

    (c) these operations do not impinge on the safety and soundness of the ADI as a stand-alone entity;

    (d) the arrangements covering participation in group operations do not prevent APRA from being able to obtain information required for the supervision of an ADI or pertaining to the group as a whole; and

    (e) there is a clear obligation under the written arrangements for any service provider to comply with any direction given by APRA in relation to the operations of an ADI.

28. An ADI must satisfy APRA that its ability to readily conduct its business in a sound fashion would not be jeopardised should premises or other services (such as computer systems) provided by related entities become unavailable.

29. An ADI must be able to demonstrate that the level of reliance placed on premises, services, etc. provided by related entities, or the provision of services to related entities, does not compromise the ability of the ADI to identify and manage its risks on a stand-alone basis.

30. An ADI's participation in group operations must be approved by the Board. In approving such activities, the Board must:

    (a) have regard to the risks presented to the ADI on a stand-alone basis as a result of its participation in such activities; and

    (b) be satisfied that any exposures to related entities which might arise have been appropriately captured in measures of the ADI's exposures to related entities.

31. The Board of an ADI must establish policies and procedures to address risks arising from the ADI's participation in group operations. The policies must be provided to APRA upon request and any material changes must be advised to APRA as soon as practicable. An ADI must address these risks on the same basis as it would if such operations were undertaken by unrelated entities.

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[9] Refer footnote 7.

Prudential limits on intra-group exposures

32. An ADI, or where applicable an ELE, must ensure that its exposures to related entities comply with the following limits:[10]

    (a) related ADIs (including overseas based equivalents)

        (i) exposure to individual related ADI – 50 per cent of Level 1[11] capital base;[12] and

        (ii) aggregate exposure to all related ADIs – 150 per cent of Level 1 capital base;

    (b) other related entities

        (i) exposure to other individual regulated related entity (i.e. any related entity other than an ADI or overseas-based equivalent banking or insurance prudential regulator overseas) – 25 per cent of Level 1 capital base;

        (ii) exposure to individual unregulated related entity – 15 per cent of Level 1 capital base; and

        (iii) aggregate exposure to all related entities (other than related ADIs and related overseas based equivalents) – 35 per cent of Level 1 capital base.

33. An ADI's (or ELE's) exposure to a related entity, for the purposes of paragraph 32, is the aggregate of all claims, commitments and contingent liabilities arising from on and off-balance sheet transactions (in both the banking and trading books) with the related entity, and

    (a) includes (but is not limited to):

        (i) outstanding balances of all loans and advances;

        (ii) all unused advised off-balance sheet commitments (refer to *Prudential Standard APS 112 Capital Adequacy: Standardised Approach to Credit Risk* (**APS 112**)), whether revocable or irrevocable;

        (iii) the credit equivalent amounts of all market-related contracts (calculated in accordance with APS 112[13]); and

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10 These limits are measured against an ADI's or the (**ELE's**) Level 1 capital base (calculated in accordance with *Prudential Standard APS 111 Capital Adequacy: Measurement of Capital*) as appropriate.

11 In this Prudential Standard, 'Level 1' has the meaning in APS 110.

12 In this Prudential Standard, 'capital base' has the meaning in APS 111.

13 In determining an ADI's (or ELE's) exposure to a related entity, netting by novation and close-out netting are permissible for market-related contracts provided all the requirements set out in APS 112 for netting are met.

(iv) in the case of a regulated related entity (i.e. any related entity directly regulated by APRA or by an equivalent banking or insurance prudential regulator overseas), equity exposure and capital support (excluding the intangible component of investments deducted from Tier 1 capital) provided to the related entity (including off-balance sheet exposure arising from any guarantee of a capital instrument issued by the related entity) that has not been deducted from the ADI's Level 1 capital for capital adequacy purposes;

(b) excludes:

(i) exposures of the ADI to, including equity investments in, subsidiaries that form part of the ELE (refer to APS 110);

(ii) exposures (including equity exposures and capital support) that have been deducted from the ADI's Level 1 capital for capital adequacy purposes (refer to APS 111);

(iii) exposures to the extent that they are secured by cash deposits (subject to satisfying the criteria set out in APS 112);

(iv) exposures to the extent that they are guaranteed by governments, or secured by government securities (subject to satisfying the conditions set out in APS 112);

(v) exposures arising in the course of settlement of market-related contracts; and

(vi) exposures to the extent that they have been written off or specifically provided for.

Approval requirements

34. An ADI must obtain prior approval from APRA for any proposed exposures in excess of the prescribed limits set out in paragraph 32. Such approval will only be granted on an exceptional basis. The ADI concerned must satisfy APRA as to why the proposed exposure(s) might reasonably be expected not to expose the ADI (or ELE) to excessive risk. APRA may impose a higher PCR on the ADI on a Level 1 basis to compensate for the additional risk that may be associated with the proposed exposure(s).

Prior consultation requirements

35. An ADI must consult with APRA before:

(a) establishing or acquiring a subsidiary (other than an entity which is to be used purely as a special purpose financing vehicle for the ADI);

(b) committing to any proposal to acquire (whether directly or indirectly) more than 20 per cent of equity interest in an entity; and

(c) taking up equity interest in an entity arising from the work-out of a problem exposure where:

(i) this exceeds 0.15 per cent of the ADI's Level 2 capital base before deductions (calculated in accordance with APS 111); or

(ii) this will result in the ADI acquiring (whether directly or indirectly) more than 10 per cent of equity interest in the entity; or

(iii) this will result in the ADI's aggregate investment in non-subsidiary entities exceeding 5 per cent of the ADI's Level 2 capital base before deductions (calculated in accordance with APS 111).

Notification requirements

36. An ADI must notify APRA, in accordance with s62A of the Banking Act, of any material breach of the prudential limits on exposures to related entities prescribed in paragraph 32, including remedial actions taken or planned to deal with the breach.

37. An ADI must report any equity investments that are not subject to the prior consultation requirements set out in paragraph 35, in writing, to APRA within three months of undertaking the investment.