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Ms Heidi Richards
General Manager, Policy Development
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Australian Prudential Regulation Authority

Via email: ADIpolicy@apra.gov.au

Dear Heidi

Discussion Paper: Revisions to the capital framework for ADIs

Thank you for the opportunity to provide comment on this February 2018 discussion paper.

COBA speaks for customer owned banking institutions, i.e. mutual banks, credit unions and building societies.

The customer owned banking sector comprises 74 ADIs with total assets of more than $110 billion, 4 million customers and 10 per cent of household deposits. Customer owned banking institutions vary widely in size but all are focused on consumer retail banking and provide important competition and choice in markets for home loans, personal loans and credit cards. All customer owned banking institutions are subject to the standardised approach to credit risk.

Our key points in response to the discussion paper are set out immediately below and we also address APRA's Consultation questions 1.1 and 1.2 in this cover letter but our detailed responses are contained in **Appendix A.**

Key points

COBA supports:

- revisions to the framework that will reduce the competitive differential in regulatory capital requirements between large and small ADIs, improving the competitive position of the latter
- revisions to the framework that address the FSI recommendation that the difference in average mortgage risk weights between the standardised and IRB settings is narrowed
- a floor of at least 72.5 per cent on the amount of total RWA for IRB banks, relative to the amount of RWA that would be calculated using only the standardised approaches
- additional RWA overlays on top of the outputs of the IRB risk-weight function, including both an overlay specifically for residential mortgages and an overlay for total RWA, and
- a simpler approach for small ADIs.

COBA seeks changes to APRA's proposed approach to:

- the implementation period
- the definition and treatment of non-standard loans
- retail exposures, to reduce the capital impost on personal loans
- credit conversion factors, including clarification on the treatment of mortgage redraws, and
- reverse mortgages.

APRA consultation question 1.1 Are there any other potential impacts on the industry or community that should be considered in balancing APRA's objectives?

A major concern of our members and a key factor influencing the competitive capacity of smaller challengers to the major banks is the regulatory compliance burden. The fixed costs of complying with regulation fall more heavily on smaller firms. The regulatory compliance burden provides yet another advantage to major banks because they can spread their costs over a vastly bigger revenue base.

The Productivity Commission's February 2018 Draft Report on Competition in the Financial System found that the Australian banking sector is a strong oligopoly with four major banks holding substantial market power as a result of their size, strong brands and broad geographical reach. This is further supported by regulatory settings which contribute to the major banks' structural advantages. "As a result, the major banks have the ability to pass on cost increases and set prices that maintain high levels of profitability — without losing market share," the Draft Report finds.

These findings have been reinforced by the ACCC in its March 2018 *Residential mortgage price inquiry interim report* which drills into the detail of how the major banks' "accommodative oligopoly" is working against the long-term interests of Australian consumers.

The PC Draft Report calls for prioritisation of reforms that reduce regulatory barriers to entry and expansion in banking.

APRA's capital framework is a critical factor in determining the competitive capacity of customer owned banking institutions in terms of:

- the overall regulatory compliance burden
- the relative position of small and large ADIs, and
- the relative position of ADIs and non-ADI lenders.

COBA urges APRA to keep the above points in mind as it responds to our submission.

APRA question 1.2 What are the advantages of aligning the proposed changes with the Basel Committee's implementation date of January 2022?

COBA supports aligning the implementation date with the BCBS implementation date of January 2022 for standardised ADIs, with capacity to opt in from January 2021.

We are broadly supportive of APRA's proposed consultation plan on these capital proposals outlined in the discussion paper (Figure 2, page 55). However, noting that the final standard is expected to be released in January 2020, with proposed implementation in January 2021, any slippage to this proposed timeframe will lead to an implementation period of less than 12 months.

There are several advantages to extending the implementation period to provide additional time for ADIs to undertake the various activities required to implement a revised capital framework. These activities include:

- modification of systems and processes to measure, monitor and report their capital adequacy position
- accommodating and planning for multiple regulatory changes in the next few years, including the roll-out of APRA's new data collection reporting system, introduction of Comprehensive Credit Reporting, Open Banking and new economic and financial statistics reporting obligations
- planning and executing any necessary capital raisings to rebuild capital buffers if an ADI is required to hold more capital under the revisions, and
- designing and implementing any product changes resulting from the finalised standards.

The impact and cost of these measures will be relatively uncertain until the release of the draft standard, supporting the case to allow for a longer implementation period. There is little prudential risk of extending the implementation period given that ADIs are required to meet the unquestionably strong requirement by 1 January 2020 and would have to continue to do so throughout 2021.

On the other hand, some standardised ADIs may be disadvantaged by a later implementation date if they stand to benefit from the revised framework. These ADIs should be allowed to opt in to the new rules from January 2021.

The most pro-competitive implementation model, that does not compromise prudential objectives, would be for implementation of the revised framework by IRB ADIs from 2021 and for standardised ADIs by 2022 with capacity to opt in from 2021.

Further calibration of risk weights

COBA notes that based on the indicative risk weights and credit conversion factors, several COBA members' initial analysis has indicated that they may be subject to a significant increase in their capital requirements which in some cases would be well above the benchmark of 'unquestionably strong'.

COBA recognises that APRA's paper does not provide definitive quantitative proposals, but rather an indicative set of risk weights to outline the 'shape' of the framework. COBA and its members look forward to the release of these more definitive quantitative proposals.

Please do not hesitate to contact me on 02 8035 8441 or Luke Lawler on 02 8035 8448 to discuss an aspect of this submission.

Yours sincerely,

MICHAEL LAWRENCE
Chief Executive Officer

APPENDIX A

Segmentation of standard mortgages by risk into higher and lower risk

APRA's 'risk' segmentation (page 23) – APRA consultation question 2.2

APRA has proposed to separate its standard mortgages into 'higher' and 'lower' risk mortgages. The 'risk' of these mortgages depends on the loan purpose combined with the repayment structure (principal & interest or interest-only). These mortgages are then subsequently graded by loan-to-value (LVR) ratios.

COBA supports this approach as it is significantly simpler than the BCBS's 'material dependence' approach. COBA notes that the material dependence approach can be highly subjective and may require ongoing verification of customer information over the long term. Similarly, it may be difficult to collect 'material dependence' data for older mortgages.

APRA's proposed approach is a simpler distinction between the two types of loans and the current categories of 'higher' and 'lower' risk mortgages reflects APRA's recent investor lending and interest-only benchmarks.

COBA supports the fixed risk weight table as proposed by APRA (i.e. a calibrated risk weight table) rather than the use of multiplier on owner-occupied P&I loans as this is an administratively simpler approach. COBA believes that any concerns that require a change in the capital uplift can be dealt with on an individual ADI basis.

However, COBA notes that the BCBS calibration is based on the 'material dependence' concept. The 'materially dependent' loans are likely to be subset of 'higher' risk loans,[1] which means that, while administratively simpler, the APRA's proposal is a more conservative than its BCBS equivalent. This should be considered when calibrating the final risk weights.

COBA supports APRA's 'whole-loan' approach for lenders' mortgage insurance (LMI). COBA supports APRA's preferred approach to increase the risk weights for standard loans with an LVR over 80 per cent that do not have LMI, as this would be in line with APRA's existing approach to recognising LMI in the standardised approach. COBA notes that these final risk weights are dependent upon the results of APRA's QIS.

COBA also notes that the 'material dependence' concept remains with respect to commercial property exposures (see Table 17). While COBA members generally do not do much of this kind of lending, further guidance will be required in this aspect.

[1] For example, an investor loan may meet the 'higher risk' category but not necessarily fit into the material dependence category (i.e. an investor loan that does not rely on property cashflows)

Revising the Operational Criteria for Standard Mortgages

COBA provides the following comments on APRA's proposed approach to revise the standard mortgage criteria to align with the BCBS criteria and introduce serviceability criteria.

Aligning with BCBS operational criteria (page 20)

Valuation – retain subsequent revaluation for loan to value calculation

COBA agrees that while the Basel operational criteria is largely aligned with APRA's existing criteria, COBA notes that under the existing APS 112 Attachment D para 5[2], ADIs are able to use "subsequent formal revaluations, where appropriate" to calculate loan to value ratios. This compares to the Basel criteria that: "The property value must maintain the value at origination or be decreased".

APRA should retain its existing approach of valuation at origination for LVR purposes supplemented by the use, where appropriate, of a "subsequent formal revaluation by an independent accredited valuer". This allows incumbent ADIs' the flexibility to retain a customer without subjecting the customer to an additional refinancing process. In terms, of security valuation this would be the same valuation as if the loan were being originated. From a prudential perspective, this can provide a more balanced risk outcome as the incumbent can utilise their existing relationship to more accurately judge the risk of the borrower. COBA notes that the prudential standard or prudential practice guide can provide further guidance on the 'formal revaluation'.

Completed property – including certain 'construction' loans within standard loans

APRA should exercise its supervisory discretion to include certain types of construction loans within the standard mortgage framework provided they meet the other non-finished property criteria.

Both APRA and the BCBS note this discretion and it possible application, with APRA's discussion paper noting that this could include "where a property under construction is to become the borrower's primary residence". Similarly, the BCBS notes two criteria: 1) a one-to-four family residential housing unit, that is not an ADC[3] and 2) where a sovereign has the power to ensure the property will be finished.[4]

This will ensure that construction loans aren't unfairly penalised under the non-standard framework give that the construction periods are generally less than 1 year. This will also lower the relative capital requirements (and subsequently pricing) for prospective owner occupiers constructing property with the intention to occupy which fulfils broader social objectives.

[2] APS 112 Attachment D follows: In order to determine the appropriate risk-weight for a residential mortgage, an ADI must classify the loan as either a standard or non-standard eligible mortgage (refer to paragraphs 6 and 7 of this Attachment) and determine the ratio of the outstanding amount (refer to paragraphs 8 and 9 of this Attachment) of the loan to the value of the residential property or properties that secure the exposure (loan-to-valuation ratio, LVR). For this purpose, the valuation may be based on the valuation at origination or, where relevant, on a subsequent formal revaluation by an independent accredited valuer.

[3] Land acquisition, development or construction exposures which refers to loans to companies or SPVs financing any of the land acquisition for development and construction purposes, or development and construction of any residential or commercial property

[4] See para 60 on page 18 of the BCBS' Basel III: Finalising post-crisis reforms, https://www.bis.org/bcbs/publ/d424.pdf

Serviceability criteria as part of the operational criteria (page 22)

The last four years have seen APRA focus on lending standards, policies and practices. This includes APRA's 2014 guidance on prudent serviceability assessment rates and buffers.[5] These requirements have been embedded in lending policies over the last few years. In line with this, COBA does not object to the inclusion of the following as 'standard' mortgage criteria:

- interest rate buffer of at least two percentage points (APG 223.32)
- minimum floor assessment interest rate of at least seven per cent (APG 223.33), and
- verification that a borrower is able to service the loan on an ongoing basis.

However, COBA strongly disagrees with any proposal to consider mortgages approved outside an individual ADI's loan serviceability policy as a non-standard mortgage.

This proposal is counter-productive to prudential stability as it creates an incentive for ADIs to loosen their individual lending policies to increase the scope of a standard mortgage that would therefore not be subject to the increased capital requirements for non-standard mortgages.

COBA believes that this would be much better dealt with ADIs' override policy and management monitoring. COBA notes that these 'outside policy' mortgages are still subject to the other operational criteria including APRA's serviceability criteria on buffers, assessment rate and ongoing serviceability verification.

COBA notes that there may also need for a transitional treatment for mortgages currently considered standard under the existing framework which were written prior to 2014, when these criteria were introduced.

Consideration of a graduated approach for non-standard loans (page 23)

COBA notes that the existing treatment of non-standard mortgages includes a graduated risk-sensitive approach, with the risk weight increasing with LVR[6]. This compares to the proposed non-standard approach which provides a flat 100 per cent risk weight for all non-standard loans. The BCBS also uses this flat risk weight approach albeit at a lower risk weight of 75 per cent (i.e. the risk weight of a retail counterparty).

COBA accepts that the equivalent non-standard loan should be subject to a higher risk weight than the equivalent standard loan.

However, the proposed framework goes too far and is overly punitive for some non-standard loans.

COBA notes that some of our members, particularly regionally-based ADIs, have a larger proportion of non-standard loans under the existing criteria. This is due to these properties having a lower 'marketability' rating (i.e. lifestyle blocks) which makes them non-standard under the existing criteria (i.e. not meeting criteria (c) of APS 112 Attachment D para 6[7]). There may be other reasons that classify these loans as non-standard (aside from serviceability). This outcome is less problematic under the current framework which has different risk weights based on LVR for non-standard loans. It would become significantly more problematic under the proposed revisions.

[5] See APRA Letter to ADIs on 9 December 2014 Reinforcing sound residential mortgage lending practices http://www.apra.gov.au/adi/Publications/Documents/141209-Letter-to-ADIs-reinforcing-sound-residential-mortgage-lending-practices.pdf
[6] See APS 112 Attachment D Table 4: columns 3 and 4
[7] This criteria relates to being 'Readily marketable'

This can be alleviated by taking a graduated approach to the risk weights for non-standard loans. Similarly, a graduated approach provides greater capital incentive to pursue non-standard loans that have lower LVR rather than higher LVR loans.

Example of non-standard penalty – Owner Occupier principal and interest (Table 15, APRA discussion paper)

	LVR %					
RW%	0-50	50.01-60	60.01-80	80.01-90	90.01-100	>100.01
Standard mortgage	20	25	30	40	50	70
Non-standard mortgage	100	100	100	100	100	100
Non-standard penalty	80	75	70	60	50	30

COBA also notes that APRA proposes to subject all ADIs (including IRB ADIs) to the non-standard loan risk weight. COBA supports this approach as its increases the consistency between the IRB and standardised approaches.

Transitioning from a non-standard to a standard mortgage

COBA notes that existing APS 112 includes a mechanism allow ADIs to reclassify non-standard mortgages as standard if they meet certain conditions. APS 112 Attachment D para 7 allows ADIs to reclassify non-standard eligible loans as standard "where the borrowers have substantially met their contractual loan repayments to the ADI continuously over the previous 36 months". COBA believes that a similar clause could be used to promote a transition towards a standard mortgage treatment for certain types of non-standard loans (i.e. those who do not immediately meet marketability requirements).

Reverse Mortgages (page 22)

COBA notes that APRA proposes to treat reverse mortgages (RMs) as non-standard mortgages and therefore subject to a flat 100 per cent risk weight irrespective of the LVR. This contrast with the current treatment where there is 'two tier' risk weight system based upon whether the LVR is above or below 60 per cent.

COBA believes that APRA should retain the existing approach for reverse mortgages which differentiates between RMs with higher or lower LVRs.

RMs are a niche product for older Australians who are asset rich and cash poor to live out their retirement in comfort. This product may become more important in the future as more and more household wealth is tied up on the family home.

A COBA member's reverse mortgage portfolio has a value-weighted LVR significantly below the existing 60 per cent LVR threshold for a 50 per cent risk weight. These RMs are provided conservatively with 'vanilla' securities with restrictive security conditions and this ADI has not had a default in years of offering this product.

Other retail exposures

Disproportionate impact of increasing the retail exposures risk weight (page 27)

APRA proposes to increase the retail exposure risk weight from 100 per cent to 125 per cent. In contrast, the BCBS outlines a 75 per cent risk weight for the 'regulatory retail exposure' class.

The proposed treatment of personal loans reduces the incentive for ADIs to rebalance their loan portfolios away from the industry's "structural concentration" in mortgages.

COBA believes that the decision to further increase this risk weight to 125 per cent will have a disproportionate impact on the customer-owned banking sector.[8]

APRA justifies the proposed increase on the basis that the retail portfolio experiences the highest potential loss rates relative to capital levels in a downturn under APRA's stress testing. COBA notes that the presence of a security is likely to reduce these loss rates.

If APRA is to implement this proposal, then COBA believes that these should be consideration of a concessional risk weight for other secured personal loans.[9]

COBA provides the following comments on this proposal.

Disproportionate impact on the customer-owned banking sector due to historical reasons

Credit unions were historically formed as vehicles to pool savings and provide personal loans. Most of the customer-owned banking sector has its roots in the credit union sector with our sector, with 60 institutions being former or current credit unions.[10]

While credit unions in Australia have expanded beyond this remit into housing loans, this historical footing has led to relatively larger weightings of personal loans in broader book composition.

Recognising alternative non-housing securities

In terms of the individual personal loan product, there are generally two broad products, unsecured and secured personal loans. Secured loans can be secured against a multitude of securities including residential property and motor vehicles. While APRA's standardised framework recognises the residential property security, it should recognise alternative securities.

APRA should consider a concessional risk weight for secured personal loans. One of the BCBS's credit risk consultation papers notes that with respect to the regulatory retail class that: "the only risk driver that had the potential of enhancing the risk sensitivity of the exposure class was the extent to which an exposure is secured by durable goods."[11]

This treatment would provide a lower risk weight for loans have some form of alternative security, say 100 per cent (assumed a 125 per cent RW for unsecured), which would be in line with the existing approach. This would create additional incentive for lenders to have some form of security against the loan. COBA member feedback notes that a large proportion of personal loans are secured, particularly by cars.

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[8] For example, APRA's Monthly Banking Statistics show individual customer-owned banks generally hold a relatively larger proportion of their books in 'other loans' to households compared to other banks
[9] Noting that personal loans secured by residential property are subject to APRA's treatment under the residential mortgage security framework.
[10] The remainder are current or former building societies.
[11] See page 10 of the BCBS' second consultative document on revisions to the standardised approach to credit risk https://www.bis.org/bcbs/publ/d347.pdf

COBA recognises that this approach introduces some complexity in terms of the security recognition criteria. This is similarly recognised by the BCBS credit risk consultation paper which notes that this could "introduce undue complexity". However, the use of 'simple' criteria could suffice noting that an exposure eligible for this concessional treatment is still, at best, only be subject to the risk weight that is in line with APRA's existing risk weight for these exposures. Additionally, ADIs who do not want this additional complexity could opt to consider all personal loans as unsecured.

COBA notes that APRA intends to recognise alternative securities for SME lending by lowering the general SME exposure risk weight, in the absence of any security recognition criteria. APRA's discussion paper (page 29) notes that: "For SME exposures that are not secured by property, APRA proposes to reduce the 100 per cent risk weight currently applied under APS 112 to 85 per cent. This gives some recognition to the various types of collateral, other than property, that SMEs provide as security."

A proposed alternative security framework would also maintain consistency with the BCBS framework given that the minimum risk weight for both categories is likely to be greater than the BCBS 75 per cent minimum risk weight. This would also address APRA's concerns by increasing capital held in the retail portfolio on the riskier exposures within this portfolio (i.e. unsecured loans).

Introducing a credit card 'transactors' framework (page 27)

COBA supports the introduction of a 'transactors' framework for credit card exposures. This creates an incentive for ADIs to originate credit cards to consumers whose behaviour is more likely to be a transactors rather than a revolver.

The Basel III reforms include a concessional risk weight of 45 per cent for 'transactors' (i.e. credit cards users that have paid their balance in full at each repayment date over the previous 12 months).

COBA notes that APRA has chosen not to introduce transactors category due to concerns about a 'material increase' in RWA in a downturn as the exposures moves from the 'transactors' risk weight of 45 per cent to the 'revolvers' risk weight of 100 per cent. This concern is legitimate given the large gap between the two risk weights.

However, COBA notes there are number of ways to reduce this 'material increase' risk, including through a smaller gap between the 'transactor' and 'revolver' risk weights (i.e. less than the current 55 percentage points), a lower risk weight for 'transactors' undrawn balances or alternatively through a lower CCF factor for transactors.

Unrated ADI exposures

Grading unrated ADIs Exposures (page 60-61, Tables 25 and 26)

APRA's proposal introduces a 'grading system' for exposures to unrated ADIs. Most customer-owned banking institutions are unrated ADIs, so exposures to them will be subject to this approach. COBA notes that the consultation paper does not outline how APRA expects to 'grade' these exposures. However, COBA notes that the Basel Accords outline a Standardised Credit Risk Assessment Approach (SCRA) to undertake this assessment.[12] COBA looks forward to further clarification of these grading requirements, particularly to ensure that any due diligence requirements are proportionate and appropriate.

[12] See page 9 of the BCBS' Basel III: Finalising post-crisis reforms https://www.bis.org/bcbs/publ/d424.pdf

Credit Conversion Factors

APRA's proposed credit conversion factor (CCF) adjustments could lead to significant increases in capital for customer-owned banks, particularly the decision to introduce CCFs by counterparty.[13] CCFs are used to convert off balance sheet exposures into amounts that will be risk weighted under the capital framework.

COBA believes that APRA should consider greater alignment with the Basel framework and greater clarification around their potential application.

COBA has the following comments.

Aligning with the Basel credit card credit conversion factors

COBA notes that APRA proposes to introduce a 50 per cent CCF for credit cards. COBA does not agree with this approach and believes it should be aligned with the minimum 40 per cent risk weight for 'other commitments' under the BCBS proposal (see page 64). This capital outcome will still significantly exceed the BCBS proposal given that APRA proposes a 100 per cent risk weight.

One member notes that this effectively creates a 200 per cent risk weight for the drawn exposure where the drawn balance is approximately 1/3 of the total limit. A high CCF creates an incentive for ADIs to pursue higher risk 'revolvers' rather than 'transactors'. Similarly, high CCFs have the potential to create a competitive disadvantage for APRA-regulated entities vs. non-APRA regulated entities.

Similarly, as discussed below, if these undrawn balances meet the conditions for an unconditionally cancellable commitment then they should be subject to the CCF for those kinds of commitments.

Clarifying the treatment of mortgage redraws

COBA believes that more clarification is required on where an undrawn mortgage redraw facility fits into this framework. COBA notes that APRA proposes a 100% CCF for residential mortgages which is unlikely to be appropriate for this feature.

Mortgage redraws are available to customers who are ahead in payments. Household prepayments (both offsets and redraws) have been increasing over the last 10 years as some households increase mortgage buffers.[14]

Some redraws are unconditionally cancellable by ADIs and should be treated as such. Some other arrangements require approval before a withdrawal which raises questions if and where they fit into the CCF commitment framework (i.e. they may not be considered commitments).

At present, these redraws would be subject to a CCF of 0% or 50% depending on their terms and conditions (i.e. when they exist as unconditionally cancellable or >1 year maturity commitments).

[13] One member estimates that the CCF adjustments based on the indicative risk weights lead to a decrease of up to 70 basis points in their capital adequacy ratio.
[14] See Graph 2.8 https://www.rba.gov.au/publications/fsr/2017/oct/household-business-finances.html

Including the BCBS clause of using the 'lesser' of two CCFs

COBA notes that Basel Paper notes that "Where there is an undertaking to provide a commitment on an off-balance sheet item, banks are to apply the lower of the two applicable CCFs".[15]

This approach includes commitments that would be considered 'unconditionally cancellable commitments' with the footnote 57 of the Basel Accords[16] noting that if a bank has an unconditionally cancellable commitment described in paragraph 84 to issue direct credit substitutes, a 10% CCF will be applied (instead of a 100% CCF for direct credit substitutes).

COBA believes that APRA should take this approach which ensures that exposures that are unconditionally cancellable commitments are not unfairly subject to excessive capital requirements.

[15] See para 85 on page 26 of the BCBS' Basel III: Finalising post-crisis reforms https://www.bis.org/bcbs/publ/d424.pdf
[16]See footnote 57 on page 26 of the BCBS' Basel III: Finalising post-crisis reforms https://www.bis.org/bcbs/publ/d424.pdf

Operational risk capital

COBA supports APRA's proposal to adopt Basel Committee's standardised measurement approach (SMA) to operational risk capital calculation as baseline for all ADIs. COBA also recognises that APRA also proposes to further simplify this approach in the form of a flat rate capital add-on for smaller and simple ADIs.

COBA notes that while further articulation will be needed on the specifics of an Australian SMA, it appears that the SMA based on the calculation of a business indicator would be achievable for most ADIs.

Focusing adjustments on larger ADIs - APRA question 5.1

APRA's consultation paper notes that APRA has chosen to not implement the loss multiplier (LM) component. While COBA recognises the concerns outlined on page 41 by APRA about the use of the LM, COBA believes that the focus of these supervisory adjustments (which effectively replaces the LM) should remain on larger and more complex institutions.

BCBS introduces the LM to account for the various business models and other risks posed by more complex organisations, with BCBS requiring the LM for banks with a business indicator greater than €1 billion.[17] The BCBS provides the discretion of national supervisors to introduce the LM for 'bucket 1' banks (i.e. smallest banks) or alternatively set the LM to 1 for all ADIs (i.e. not implement a LM). COBA notes that APRA has exercised this discretion but has proposed to utilise supervisory adjustments to address this particular issue.

COBA believes that these supervisory adjustments (SA) should be focused on larger and more complex banks given that the SA approach predominately exists in lieu of a LM component. This is in line with the SMA consultation paper[18] which that "significant differences in the risk profile of medium to large banks cannot be fully accounted for by an approach that relies only on financial statement proxies [i.e. the BI approach]".

APRA has opted not to implement the LM but has instead opted to include supervisory adjustments where APRA assesses that these calculation lack 'sufficient credibility'. This judgement is based on an ADI's size, nature and complexity and qualitative and quantitative information. Customer-owned banking sector entities are relatively small, conservative and simple relative to their larger peers within Australia. Similarly, the BCBS approach would have been calibrated on the BCBS sample of internationally active banks – who are likely to more complex than Australia's customer-owned banking institutions.

[17] The business indicator is calculated for all banks based on financial statement information
[18]See para 13 on page 3 of the BCBS' consultative document on the standardised measurement approach for operational risk https://www.bis.org/bcbs/publ/d355.pdf

A simpler approach for small ADIs

COBA supports APRA's proposal for a simplified framework that could be applied to small, less complex ADIs. This recognises that prudential regulation is becoming overly complex, and that there are simpler alternatives that can reach a suitable outcome. The discussion paper recognises this noting, that for certain institutions, "the cost of these measure may outweigh the benefit to prudential safety".

In a recent speech[19], German central banker Andreas Dombret made the following observations:

- appropriate as they are for the global players, the [Basel rules] rules tend to overburden small institutions
- the rules could act as an additional handicap for small banks that are already under pressure from many sides, and
- jurisdictions are free to apply a different set of rules to smaller banks which operate solely within their national market and pose no threat to international financial stability.

APRA's proposal for a simplified framework for smaller ADIs is a welcome first step and we look forward to ongoing discussion about other areas in the prudential framework.

Increasing complexity of regulation

Over the last twenty years, the financial sector has increasingly become complex and global in nature. In response, there has been an increasing complexity in regulation.

The predominant driver of regulation has been the Basel Committee. The Basel II Accord was published initially in June 2004, and implemented prior to the 2007-2009 financial crisis. The extent of this crisis, driven by deficiencies in the financial regulation for internationally active large banks, led to the Basel III reforms. These 2011 and (finally) 2017 Basel III reforms are considered the end of these post-crisis reforms.

The Basel Charter notes that it "expects full implementation of its standards by BCBS members and their internationally active banks". [20] The focus of these standards on large internationally-active banks is clear as these institutions were the source of these problems and key source of the risks that these frameworks seek to address. These international standards seek to minimise broader risks to financial stability, but also to ensure that there is a "level playing field" among internationally-active banks.

Customer owned banking institutions are neither large nor internationally active so a different and proportionate approach is appropriate. Proportionality is about balancing the costs and benefits of regulation. If regulation is disproportionate in relation to its objectives, the costs can exceed the benefits.

Maintaining proportionality

While COBA supports the proposed approach, a broader and permanent commitment to proportionality in regulation must remain a key facet of the prudential supervision framework.

This would ensure that all ADIs are able to benefit from proportionate regulation regardless of whether they fit this 'small and simple' criteria. This not a new concept and nor is one that is inconsistent with APRA's existing activities.

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[19]See speech by Andreas Dombret: International challenges in financial regulation - the view from Europe 29 March 2018 https://www.bis.org/review/r180416a.htm

[20] See Basel Charter para 12 https://www.bis.org/bcbs/charter.htm

For example, APRA has implemented the Standardised Approach to Counterparty Credit Risk (SA-CCR). Recognising that the SA-CCR is too complex for most ADIs with immaterial CCR exposures, APRA has proposed to retain a 'simplified' approach which covers ADIs with immaterial exposures. This creates a proportionate two-tier system. Under the proposed approach in the capital framework, there would be a third-tier of smaller and simple ADIs that would not be subject to CCR capital requirements.

Similarly, the paper notes that "requirements for liquidity, risk management and governance… already allow for proportionate approaches to be applied through APRA's supervision practices. APRA is nevertheless open to industry's views on other areas that might be simplified."

COBA broadly supports APRA's proposed areas to simplify the framework. COBA also welcomes APRA's statement of its openness to consider other areas to simplify.

Support both qualitative and quantitative eligibility criteria

APRA proposes to use both quantitative and qualitative measures to define this 'small ADI'. COBA supports this approach because even a small ADI can move higher up the risk spectrum if it undertakes complex activities.

Qualitative criteria

The qualitative measures proposed by APRA - simple and domestic – are appropriate.

Quantitative criteria

In terms of a quantitative measure, COBA supports APRA's preference to use total assets as the defining criteria, given that it is both a simple and well understood as noted by all stakeholders.

On the appropriate size threshold, COBA considers that this should cover as many customer-owned banking institutions as possible, noting that even our largest members are relatively simple institutions.

Dr Dombret provides some initial thinking about where this boundary could lie in the European context:

> A reasonable threshold under which simpler rules could be applied to an institution would be around the low single-digit billion range, although the level at which this threshold should ultimately be set is up for debate for the time being. Still, if the threshold were set at total assets of €3 billion, for instance, this would affect 82% of all institutions in Germany but only 14% of aggregate total assets. [21]

COBA notes that such a boundary covering 14% of aggregate total assets is likely to include the whole customer-owned banking sector, noting that some ADIs will choose to opt out of this framework (see below).

The Banking Act now has new ADI size thresholds introduced as part of the BEAR and also for use in other contexts (e.g. coverage of mandatory Comprehensive Credit Reporting regime). The Government has set a small ADI threshold at $10 billion. COBA would prefer this threshold to be $20 billion to comfortably cover our entire sector for the foreseeable future.

[21] See speech by Andreas Dombret: Heading towards a "small banking box" - which business model needs what kind of regulation? 29 June 2017 https://www.bis.org/review/r170714a.htm

Supervisor and ADI opt-out powers

COBA notes that APRA proposes for all ADIs meeting this criterion to automatically be subject to the simplified framework. COBA does not disagree with this.

However, there may be situations where an ADI may prefer not to use the simple framework so, like other aspects of the prudential framework, ADIs should have the choice to opt out.

Similarly, we accept that APRA supervisors should have discretion to require a small ADI to use the more complex framework "where appropriate based on the nature of its business". However, APRA must ensure that there is adequate consultation with the affected ADI.

Operational flat capital add-on

COBA member feedback notes that the calibration of this 'flat add-on' should consider that these entities are likely to be simpler and more conservative than the internationally active institutions used to calibrate the BCBS SMA and therefore be set an appropriate level (i.e. towards the lower end).