20 July 2018

Mr Wayne Byres
Chairman
Australian Prudential Regulatory Authority
Email: ADIpolicy@apra.gov.au

Dear Wayne,

Regional Bank Submission
Revisions to the capital framework for Authorised Deposit-taking Institutions

The Regional Banks welcome the opportunity to comment on APRA's Discussion Paper outlining *Revisions to the capital framework for authorised deposit-taking institutions.* We apologise for the lateness of our submission.

We fully support revising the framework to ensure capital estimates are more risk reflective and the framework embodies Australian public policy objectives.

This submission is made on behalf of six banks: AMP Bank, Bendigo and Adelaide Bank, BOQ, ME, MyState and Suncorp Bank.

It is an objective of the Regional Banks to advocate policy changes that will assist in levelling the playing field in Australian banking. The capital framework, given the dual system for estimating risk weights, has been a key focus since the Murray Financial System Inquiry.

We applaud APRA for its effective implementation of the Murray Inquiry's proposed reduction in the residential risk weight gap between standardised and IRB banks. In our view, APRA's effective implementation of that recommendation has materially assisted competition in the market.

At the core of our collective work is the view that the superior customer service of smaller banks and the higher levels of 'trust' in our brands should enable relatively strong growth into the future. But, to assure this, the playing field needs to be as level as possible.

The Regional Banks see this consultation as a good opportunity to improve the capital framework. Indeed, we believe once the capital framework revisions are completed, it may be more than a decade before material revisions are again undertaken. In our view, the changes must both improve risk capital allocation and also support competition.

Key recommendations

Our submission makes six recommendations/comments:

1. Greater use of loan to value ratio (LVR) in calculating the risk weights for 'non-standard' residential loans. The proposed approach is insufficiently granular;

2. APRA to reconsider its proposed approach for the risk weight treatment of loans that fall outside an ADI's loan serviceability policy;

3. Imposition of an Internal Ratings-Based (IRB) Risk Weighted Asset (RWA) floor of 72.5% will improve competitive neutrality. However, the Regional Banks support a higher floor noting that there are differences of opinion amongst Regional Banks as to the optimal level of the floor.

4. Capital treatment of lenders mortgage insurance (LMI) needs further work. Regional Banks recommend a separate working group process;

5. APRA reconsider its recommendation of a credit conversion factor (CCF) of 100% for undrawn mortgage credit and generally align with Basel III proposals; and

6. Closer alignment to the Basel standard with regard to retail exposures.

These recommendations are discussed below:

1. Greater use of LVR in determining risk weights for non-standard loans

The Regional Banks support APRA's proposal to adopt different risk weight schedules for (a) owner-occupied, principal and interest, versus (b) investment and interest-only loans. We also strongly support the reduction of minimum RW to 20%, although we note that for loans with LVR below 50%, the IRB banks will still maintain a capital advantage in the safe end of the market.

Another key issue is the relative risk weight differential between IRB and standardised with respect to residential investor loans. The Regional Banks recommend APRA address this by imposing a correlation factor that will materially close the gap, particularly given the lack of historical data relating to investor loan performance in downturns. An alternative means of closing the gap is through lower risk weights in the standardised schedule.

Non-standard loans

Notwithstanding these two issues, our main concern is with the treatment of 'non-standard' loans in both schedules. Given smaller banks compete against IRB banks and, increasingly, against non-bank lenders, it important for competition that the standardised risk weights are as risk-reflective as feasible.

APRA's proposal of a default risk weight of 100% for non-standard loans, regardless of underlying LVR, is insufficiently risk reflective. It is also considered too punitive to treat these loans with the same RW as a defaulted loan or a mortgage with an LVR above 100%.

In our view, LVR (in conjunction with capacity to service the loan) is the primary differentiator of underlying risk and it should ideally be reflected in the risk weight estimate for all loans.

Accordingly, the Regional Banks propose that APRA use one of two approaches to address this issue.

The first method is through a system of 'scalars' to increase risk weights to reflect risks associated with non-standard and higher risk loan characteristics.

Under this approach, the base risk weight for any loan should be determined by the loan purpose, the LVR and rate applied to a 'standard' loan. The base rate is then increased through use of scalars to reflect defined factors.

By way of example, let's use a 25% scalar and look at an individual borrower who takes out an interest-only loan with an LVR greater than 100%.

The applicable base risk weight on a standard loan is 85%. Assuming the loan has additional risk factor (eg. there is insufficient interest rate buffer) and is therefore classified as 'non-standard', then base rate would be scaled up according to this formula: 85% x (1.25)^1 = 106% and the applicable RW would be 106%. Assuming the loan had two additional risk factors, then it would be scaled by (1.25^2).

The Regional Banks accept this will create additional complexity in the system and for some loans, the applicable risk weight will exceed 100%. The intention is to make the weights more risk reflective, not to engineer a lower level of risk weights overall.

As an alternative to APRA's proposal for non-standard loans, the Regional Banks would also support the Australian Banking Association's (ABA) proposal whereby loans are classified as 'high' and 'low' risk, and subject to a risk weight floor of 50% and a ceiling of 100%, as per the schedule in the ABA submission.

The advantage with the scalar model is it generates greater granularity and more closely tied to underlying risk. The ABA's model offers greater simplicity of implementation.

Without greater use of LVR in determining risk weights, the Regional Banks are particularly concerned about the competitive boost this will give to non-bank lenders as they specialise in loan categories where the minimum regulatory capital is too punitive in relation to the true risk.

2. Loans outside an ADIs serviceability policy

APRA is proposing to expand the definition of non-standard loans to include loans that fall outside a bank's standard serviceability policy. As such, the loan will attract a 100% risk weight.

The Regional Banks believe this is insufficiently risk-reflective and potentially creates some adverse incentives. For example, some banks may respond by loosening their serviceability policy, in preference to strengthening their exceptions policy and procedures. Those banks that do not loosen their serviceability policy, are at risk of losing market share.

While APG 223 sets a baseline for lending standards, it is better that APG is viewed as a 'minimum' standard and banks have incentives to strengthen their serviceability policy.

A further impact of the definition change may be to penalise credit worthy customers that do not have standard sources of income. These include: self-employed, freelancers, people who have recently changed jobs, individuals with high net wealth and low incomes. To the extent the risk weight treatment is insufficiently risk reflective, the policy will be of benefit to non-banks that do not have regulatory capital obligations.

The Regional Banks recommend APRA remove from the definition of non-standard loans, those that fall outside serviceability. A competitively neutral alternative may be to set APG 223 as the determining criteria whether a loan's serviceability characteristics are non-standard, although we note that APG 223 is not applied uniformly across the industry.

The Regional Banks accept that if the non-standard definition does not include loans that fall outside standard serviceability, then clearly banks must demonstrate they have robust exceptions policy, including board-approved risk tolerances. More regular auditing of exceptions policies and processes should be considered as an alternative.

3. Proposed IRB RWA floor of 72.5%

Imposition of an Internal Ratings-Based (IRB) Risk Weighted Asset (RWA) floor of 72.5% will improve competitive neutrality. However, the Regional Banks support a higher floor noting there must remain an incentive for banks to invest in their risk management capability. In relation to the optimal level of the floor it is noted that amongst the Regional Banks there is a difference of opinion.

While the incorporation of the floor will assist with competitive neutrality, the extent of this depends not only on the level of floor, but also on the portfolio granularity to which it applies. For example, although standardised banks will receive a lower risk weighting for mortgages with a lower than 50% LVR, it is acknowledged that the IRB competitive advantage in this segment will remain and likely impact portfolio structures and risk profiles of IRB banks versus standardised banks.

AMP Bendigo Bank BOQ me MyState SUNCORP

4. Further work needed on lenders mortgage insurance

The Regional Banks typically do not have the scale to use captive mortgage insurers and are therefore dependent upon the two commercial operators, QBE and Genworth. Given there are only two suppliers, there is a risk that pricing will result in smaller banks paying more for insurance relative those utilising captives.

A secondary issue is the relative risk weight treatment of LMI in the Standardised Approach versus IRB framework. As a principle, we advocate that LMI has an equivalent risk weight impact in the two approaches.

We note that APRA has based its proposed residential mortgage risk weights for loans with >80% LVR on the assumption of LMI but has not yet specified a treatment for loans not covered by LMI.

APRA is also yet to propose a method for treating LMI in the IRB framework. One possible approach is for APRA to specify separate correlation factors, depending on whether a loan is LMI insured or not.

The Productivity Commission has expressed concerns over the competitive impacts of non-portability of the LMI upfront fee.

Given these issues, the Regional Banks recommend that APRA establish a dedicated working group to further consider the treatment of LMI in the capital framework.

5. Credit conversion factors (CCFs)

APRA is proposing to apply a 100% CCF to the undrawn component of a mortgage loan, even where a contractual right exists for the bank to cancel that undrawn credit. The Regional Banks suggest 100% is not sufficiently risk reflective.

This is likely to have a material impact on the RWA assets of Standardised banks and, therefore, also increase the IRB Bank's RWAs via the proposed floor of 72.5%.

This can be seen in the following stylised example: assume a mortgage loan limit of $500k, $300k is drawn, $200k is undrawn. The applicable risk weight is 35%. By applying a 100% CCF instead of 0% to the undrawn amount, the estimated quantum of RWAs will increase by 67%.

It is clear that a change of this magnitude to 'discretionary' levels of credit exposure will result in a change in bank behaviours. Access to credit lines would be reduced or rationalised, the ability for partial drawdowns could be removed and any benefits provided to customers that prepay could be withdrawn and/or the additional capital costs would be passed on.

The Regional Bank's endorse the ABA's submission recommendation of a broader adoption of the Basel III CCFs, as APRA's proposals are materially higher. This includes alignment of the CCF corresponding to 'Other commitments – unconditionally cancellable' to Basel III's recommended 10%.

6. Retail exposures more aligned to the Basel standard

APRA is proposing to apply a 100% risk weight to credit card exposures, compared to a Basel Committee recommendation of 75%. The Regional Banks endorse the Basel standard as a better representation of risk. The ABA's submission includes some IRB modelling data (from Pillar 3 reports) that broadly align to 75%, with CBA being the exception. According to the ABA submission, CBA uses a different reporting methodology.

For 'other retail', the proposed increase from 100% to 125% is inconsistent with the underlying risk. Once again, we understand IRB modelling suggests the underlying implies a risk weight of less than 100%, albeit the Standardised Approach necessarily involves a more conservative treatment. We recommend keeping 'other retail' at 100%.

Conclusion

The Regional Banks appreciate the opportunity to have input into this consultation. We hope you find valuable our submission and would welcome any opportunity for further engagement.

If you have any questions, please don't hesitate to call.

Regards,

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