Australian Banking Association

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Submission on APRA's revisions to the capital framework for ADI's.

The Australian Banking Association (the ABA) welcomes the opportunity to make a submission on APRA's 12 June 2019 response revisions to the capital framework for ADIs (the response). Further, we thank APRA for holding member workshops during the consultation period.

With the active participation of its member banks in Australia, the ABA provides analysis, advice and advocacy for the banking industry and contributes to the development of public policy on banking and other financial services. The ABA works with government, regulators and other stakeholders to improve public awareness and understanding of the industry's contribution to the economy and community. It strives to ensure Australia's banking customers continue to benefit from a stable, competitive and accessible banking industry.

The ABA notes that APRA has made a number of changes to the previous capital framework in its response and introduced a number of new proposals for the capital framework. The ABA's full response to the June 2019 consultation is attached to this letter. In summary, the key ABA issues are:

- An earlier implementation date for the revised operational risk capital requirements will be difficult and should be optional as ADIs are still waiting on the relevant prudential standards to be finalised by APRA.
- Considerable variability from the international Basel III Standards will make certain types of lending more expensive and reduce supply of lending to key sectors such as first-time home borrowers, SMEs and personal lending. Overpayment of mortgages and the use of LMI is discouraged by these proposals, both of which are key credit risk mitigants.
    - Evidence and analysis supporting the proposed superequivalent measures is not provided by APRA. This is inconsistent with best practice regulatory requirements.
- The impact on the net stable funding ratio (NSFR) of the capital proposals need to be assessed before the requirements are finalised. The proposals could drive an adverse change to the NSFR which is not the intent of the Basel changes.

The ABA looks forward to responding to the future consultation on the final prudential standards expected later this year.

Yours sincerely

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Introduction

The ABA submission is structured into two sections.

- Section 1 outlines the ABA's key issues and concerns and
- Section 2 follows the June 2019 consultation paper structure and provides more detailed ABA feedback on each chapter.

Section 1: Key issues and concerns

Implementation timeline

The ABA welcomes APRA's proposal to align the implementation of the revised capital standards with the Basel Committee's internationally agreed implementation date for Basel III of 1 January 2022.

However, the ABA is concerned about an earlier implementation date for the revised operational risk capital requirements for ADIs currently using an advanced measurement approach for operational risk. APRA is proposing to retain an earlier implementation date of 1 January 2021. While APRA may consider the earlier date advantageous for ADIs, without information on the proposed CPS 230 Operational Risk standards, there still remain uncertainties on the broader operational risk requirements which may impact implementation. The ABA, therefore, requests that the earlier implementation date is optional for ADIs.

With the delay of the release of APS 113, ADIs are also concerned with the time being allowed for implementation, particularly if there are any requirements for a parallel run. With significant changes to systems and data required, the ABA proposes that the minimum implementation timeline should be 18 months and it should commence from the date the final standards are issued.

In addition, given that several of the standards are interconnected (e.g. APS 113 and APS 112), the ABA requests the opportunity to provide further feedback on these in future consultations.

Global comparability

The ABA welcomes APRA's revisions to the proposed capital framework that further aligns the Australian prudential framework with the Basel standards. Global comparability is critical for Australian banks as they compete for capital inflows on global markets. Demand for credit in the Australian economy has consistently exceeded domestic saving and this gap has been funded from offshore investors.

However, there are still significant superequivalant variations to international standards proposed by APRA including:

- SME capital risk weights and collateralisation
- Personal credit/revolving credit risk weights
- Credit conversion factors (CCF)
- Limited discounts for LMI and other credit risk mitigation measures on residential mortgage credit risk weighting.

The ABA questions the need for these superequivalent requirements given that banks are now more resilient. Banks now have with much higher levels of capital, more liquid assets and more stable funding structures. Further, stress test of the banks indicate that they have sufficient capital to withstand double-digit unemployment rates and housing price falls exceeding 30 per cent. [1]

Impacts of APRA's domestic variations from international standards

[1] Reserve Bank of Australia, *Financial Stability Report*¸April 2019, https://www.rba.gov.au/publications/fsr/2019/apr/overview.html

When considering variations to reflect local market conditions the ABA is supportive of APRA's objectives to align capital with risk where necessary. However, any variation will have a significant negative impact on Australian banks being able to compete with international banks, international comparability and the economy. An appropriate transparent assessment of these impacts needs to be made by APRA as part of its policy decision making to ensure there is a net benefit to the community from these proposals. Under the APRA Act, APRA's statutory mandate is, in performing and exercising its functions and powers, to balance the objectives of financial safety and efficiency, competition, contestability and competitive neutrality and, in balancing these objectives, to promote financial system stability in Australia. These impacts are discussed further below.

Disadvantage Australian suppliers competing in global markets

Many Australian banks face competition from global peers who are not bound by similar rules. Higher Basel requirements on Australian banks will mean they are at a distinct competitive disadvantage to those banks regulated by jurisdictions that have adopted the lower Basel requirements. This will effectively create a regulatory barrier to entry and expansion for domestic banks to compete in international financial markets such as institutional banking asset finance. Given this, banks international growth could be restricted.

Disadvantages Australian banks competing for capital

The ABA also notes that as the final Basel standards require all banks globally to prepare capital results based on the standardised approach (SA). It is very likely that these SA results will be used to compare banks globally. As such, any local variations to the SA approach will have particular impact on the comparability of Australian banks to their global peers and will likely mask their relative strength.

The ABA is therefore strongly supportive of aligning both the IRB and SA approach in Australia to the Basel standards.

Detrimental to Australian economy

The ABA considers that any additional capital required above international standards will have a detrimental effect on the Australian economy. At present, Australian economic growth is weak and any further impediments to lending such as increased capital requirements combined with competitive disadvantages in international markets, will have a further negative impact on economic growth when they come into effect. In particular, the higher capital risk requirements for SME and personal credit; as well as the insufficient recognition of LMI for higher LVR loans which are important for first home buyers.

The Council of Financial Regulators recognise that tighter financing conditions have played some role in the recent declining in housing credit and stress the importance of lenders continuing to supply credit to the economy.[2] The Council also noted that higher lending requirements are affecting the number of small business lending applications. Imposing greater requirements than the international standard will further contribute to declines in lending which will impede economic growth.

Overall calibration approach

The ABA notes that the calibration of risk weights provided in the consultation paper is indicative only. These calibrations are based on the first completed QIS and the final risk weights will be determined by the second QIS which will occur in the second half of this year.

However, the concerns raised in our previous submission still remain. As noted in our previous submission, there are a number of regulatory changes coming into effect that may affect the final calibration. APRA's consideration will need to be given other pending changes including Fundamental Review of the Trading Book (FRTB), Credit Valuation Adjustments (CVA) changes and any changes as a result of the review of the capital adequacy framework currently being undertaken by the Reserve Bank of New Zealand. Changes recommended by the BCBS resulting from their review of the regulatory treatment of sovereign exposures would also need consideration.

[2] Council of Financial Regulators, *Financial Stability Review*, October 2018, pp 69–73,

In relation to the standardised risk weight floor that APRA is intending on implementing as part of the finalisation of Basel III, the ABA requests APRA to adjust the calibration where it has introduced super-equivalence into the standardised capital framework.

Impact on net stable funding ratio

The ABA's view is the capital proposals will have a material impact on the net stable funding ratio (NSFR) significantly increasing the stable funding requirements of ADI's. Prudential Standard APS 210 Liquidity (APS 210) refers to Prudential Standard APS 112 Capital Adequacy: Standardised Approach to Credit Risk (APS 112), and changes to the standardised risk-weights will drive an adverse change to the NSFR based on current proposals. The ABA does not believe that tightening the NSFR requirements is the intent of the Basel changes, and request that APRA ensures this is not an unintended effect.

The ABA recommends that changes required to update APS 210 be subject to a consultation process after finalisation of APRA's capital proposals to ensure appropriate recalibration of NSFR models.

Section 2: Feedback on chapters

This section provides feedback on the issues by chapter, which are:

- Credit risk: residential mortgage lending (Chapter 2)
- Credit risk: other standardised exposures (Chapter 3)
- Other amendments to the standardised approach (Chapter 4)
- Operational risk (Chapter 5)
    - Implementation timeline and the finalisation of standards
- Other matters not considered in the consultation paper.

Each of these chapters is discussed below.

Credit risk: residential mortgage lending (Chapter 2)

In this section, the ABA outlines its concerns regarding the following:

- Non-standard mortgage definition
- Revaluation of residential security
- The proposed IRB approach
- Asset class definition
- Capital reductions for LMI
- Difference in standardised and IRB mortgage capital requirements
- Other housing issues

Non-standard mortgage definition

The ABA welcomes providing transitional arrangements for the new definition. The ABA also supports the revisions to require a positive determination, which will allow the use of exceptions process rather than a focus on serviceability alone. This will allow banks to continue to provide services to those customers who have complex arrangements or temporarily have a change in circumstances. Examples include borrowers who are going through family separation and domestic violence where exceptions need to be made to allow families to remain in their homes.

However, the ABA still has concerns on the proposed definition of non-standard mortgages. Of particular concern is the additional of a 2.5 per cent buffer over the loan product rate, rather than over the customer rate, in line with the draft APS220 and APG223. The customer rate is more important than the product rate in determining serviceability requirements and aligns with the Bank's practices in determining whether a customer can afford to repay a facility. The ABA believes that the definition in APS 112 should be amended to align with the draft APS220 and APS 223. However, the ABA still has concerns on the proposed definition of non-standard mortgages. Of particular concern is the additional of a 2.5% buffer over the loan product rate, rather than over the customer rate, in line with the draft APS220 and APG223. The customer rate is more important than the product rate in determining serviceability requirements and aligns with the Bank's practices in determining whether a customer can afford to repay a facility. The ABA believes that the definition in APS 112 should be amended to align with the draft APS220 and APS 223.

Revaluation of security

The ABA has concerns about the narrow opportunities provided to borrowers to revalue their security for both residential and commercial borrowings. The ABA considers the high prescriptive nature of the circumstances when a borrower can revalue security is likely to lead to unforeseen and unwanted policy consequences. This includes higher churn of mortgage products and radical changes to commercial lending.

Residential

The ABA notes that APRA proposes to allow ADIs to revalue the property securing a mortgage where an updated valuation is obtained as part of a "new loan application process". The ABA considers that the situations proposed by APRA in which a revaluation can be undertaken to increase the value of a property for risk weighting are too narrow. A customer may seek a revaluation in order to obtain a lower mortgage interest rate. If the only option is a new mortgage to access a revaluation, this will in turn lead to an increase in the number of new mortgages taken out which incur new application fees. This higher cost is not in the interest of the consumer and it is questionable how this will reduce risk in comparison to current practice.

Commercial

For commercial properties modifications may be made to the contractual arrangements (rather than the property itself), such as adjustments to the lease or quality of the tenant which can increase the value of the property. Other examples, which apply equally to residential property, include changes to zoning or other controls, which in our opinion unequivocally increase the value.

A borrower may wish to revalue the security in these cases to access a lower interest rate and/or alleviate restrictions on their loan. The unintended consequence of disallowing these types of revaluations would be market churn and an increase in short term funding. It also does not appropriately reflect the risk of the exposure.

The proposed IRB approach

APRA is proposing to implement a simpler method for calculating the capital requirements for residential mortgages. Rather than introducing two correlation functions, APRA is proposing to revert to the Basel III correlation of 15 per cent and achieving the targeted calibration through the application of multipliers to RWA (subject to final calibrations).

While ABA welcomes a simpler framework, which is more aligned to the Basel III proposals, it believes that that the multipliers are conservative relative to both the Basel III proposals and the approach outlined in the February consultation. The multipliers do not take into consideration:

- The risk that is already captured through ADI's PDs and LGDs that reflect differentials between the segments;
- The relative risk between owner occupier principle and interest loans and other home loans, which is 1.33 multiplier in the current proposals but was 1.25 multiplier in the prior APRA consultation.

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Given this, the ABA believe that further review of the proposed multipliers is warranted to ensure that the relative calibration reflects the underlying risk.

Asset Class Definition

The ABA has significant concerns with APRA's proposal to exclude from residential mortgage sub-class exposures to non-natural persons (such as family trusts) which have five or more mortgaged residential properties. This definition is narrower than the proposals in the February 2018 consultation. However, material industry-wide developments are required to operationalise this requirement in a way that ensures compliance. Banks are unable to track accurately whether a non-natural borrower has five or more mortgage properties because:

- Banks are not aware of mortgages held with other entities (ADI or non-ADI). Banks are reliant on the borrower's disclosure; and
- Data is not regularly kept and monitored on number of mortgages over the period of the mortgage.

The ABA requests that this requirement be limited to those properties held by the obligor at the ADI level.

Capital reductions for loan mortgage insurance (LMI)

The ABA is concerned about APRA's proposed credit risk weighting for residential mortgages with (LMI).[3] The ABA considers a reduction of between 30-50 per cent for mortgage risk-weights would be an appropriate mechanism to recognise the benefits of LMI, such as:

- a meaningful reduction in loss given defaults (LGDs) for loans which meet the minimum of 40 per cent LMI coverage.
- LMI coverage is less prone to procyclicality; and
- It enables greater competition from smaller banks for high LVR loans.[4]

The ABA is concerned that the proposed discount for LMI for mortgage with an LVR above 80 per cent is too low. It seems that APRA is limiting the discount to around 5-10 per cent compared to the current 15-25 per cent discount on current risk weights. Given LMI providers are prudentially-regulated entities and must hold regulatory capital to withstand a 1-in-200-year stress event, the ABA considers the value ascribed from LMI should not be reduced.

The ABA requests that APRA implement appropriate discounts for LMI and provide the policy rationale for this significant policy change. The reduced benefits for holding LMI seem to be a distinct change in prudential policy and likely to have significant impacts on the amount of credit available to first home buyers. As noted in the Productivity Commission report, almost a fifth of all home loans in Australia are covered by LMI. Given this, the ABA considers that LMI provides considerable benefits for customer and enables many people to buy their first home that would otherwise be unable to do so.

The ABA recommends appropriate calibration of LMI for both IRB modelling and Standardised risk weights to ensure competitive neutrality between the SA and IRB ADI's remains appropriate.

In addition, the ABA recommends the APRA consider allowing a broader range of insurance products, for example, portfolio level first loss insurance to ensure competitive pressure on the existing LMI providers to the benefit of customers.

[3] Lenders mortgage insurance (LMI) is a type of credit protection insurance that protects a lender from losses in the event of a borrower defaulting on a home loan. Lenders choose whether to purchase LMI when extending credit to a borrower, and usually do so when loans have a high loan-to-value ratio (LVR) (usually more than 80per cent). This is because high-LVR loans have a higher risk of default

[4] Productivity Commission, *Inquiry Report: Competition in the Australian Financial System,* page 363 https://www.pc.gov.au/inquiries/completed/financial-system/report/financial-system.docx

Difference in standardised and IRB mortgage capital requirements

The ABA appreciated APRA's workshop presenting its analysis of the cost differences between standardised and IRB capital requirements. The ABA accepts APRA's analysis which finds that the gap is currently 5bps on average. The ABA is aware that the Regional Banks are submitting a more detailed review of the approach described, so will not repeat that commentary here.

The ABA considers that there should be an appropriate incentive (such as the gap above) for banks to seek advanced accreditation. That said, it is important that this gap remain consistent across the different risk levels across a lending portfolio. If there is a high variation for some types of risk then the outcome could be distortionary. In particular, it would be a concern if the variation in the gap was greater for mortgages with lowest risk under the standardised approach given most banks hold a greater proportion of lower risk loans than higher risk loans.

Further, it would be a concern if any variation in the gap could contribute to providing a cost advantage for loans with the lowest risk for more sophisticated IRB banks. APRA would need to consider the possible unintended consequences from incentivising banks with the most advanced risk management systems to focus on low risk mortgages.

The ABA is unable to further comment on variations between risk weights due to the lack of granular information available. Current APRA and Pillar III reporting from IRB banks does not allow for meaningful analysis of variances between banks, and the ABA would encourage APRA to share anonymised data on an LVR basis for comparison. This would improve the overall transparency of the market and enable meaningful competitive analysis by all banks. This analysis is currently only available to IRB banks who have access to both SA and their own IRB based Risk Weight results.

Credit risk: other exposures under the standardised approach (Chapter 3)

In this section, the ABA outlines its concerns regarding the following:

- Eligible collateral for SME's
- Standardised risk weights - SME Exposures
- Credit conversion factors (CCF)
- Risk weights for retail exposures.
- Securities Financing Transactions (SFTs)

Each of these are considered below.

Eligible collateral for SME's

The ABA welcomes APRA's revised proposal which recognises that collateral may act to mitigate losses in the event of default by proposing to allow ADIs to risk-weight SME exposures (as set out in Table 3). Eligible collateral for this purpose includes motor vehicles, commercial property and plant, equipment and machinery.

The ABA understands from the APRA workshop that the standardised approach to the definition of collateral is more simplified than the definition to be used for the IRB approach. APRA told the ABA that the IRB approach will have a broader scope of physical collateral that can be considered for SME's. That said, the ABA recommends that APRA recognises 'other eligible physical collateral' in line with the Basel framework to maintain risk sensitivity, international comparability and competitiveness, and provide appropriate incentives to obtain collateral.

Further, the ABA seeks the inclusion of other business assets such as receivables and licences. The ABA agrees that any such collateral must be marketable, however, the requirement to use the market value is difficult to implement and spot pricing is not available in all circumstances. The ABA notes that such valuation requirements are not used for capital purposes for immovable property where this information is available.

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Further, the ABA seeks the inclusion of other business assets such as receivables and licences. The ABA agrees that any such collateral must be marketable, however, the requirement to use the "market value" is difficult, as "spot" pricing is not available, noting that such valuations are not used for immovable property where this information is available.

SME lending collateralised by residential property

The ABA would like APRA to consider whether residential property collateralisation requirements are suitable for business lending. Under the proposed requirements, business lending that is 'predominately' collateralised by residential property must meet requirements which are in place for retail style personal lending. In particular, any requirement to apply retail-lending based requirements such as APG 223 and the 2.5 per cent buffer. These requirements are not suitable for business lending and the ABA considers that instead business lending policies/requirements should be used.

Standardised risk weights - SME Exposures

The ABA questions the risk-weight of 85 per cent for SME retail compared to the Basel setting of 75 per cent. We question whether this variation, which would result in a further move away from global comparability is justified or necessary. APRA's proposed variation from the global standard will not materially improve financial safety or financial system stability and the deviation increases the complexity of reporting.

Further, APRA is proposing that SME exposures must collateralise loans to achieve the 85 per cent credit risk weighting. This is a further deviation from Basel standard which does not require collateralisations of SME loans.

The ABA appreciates that a move to 75 per cent credit risk weighting will be a reduction compared to the current credit risk weightings under APS 112. However, the Basel international standard is set at a minimum level to ensure that globally systemically important banks can lend in a way that protects internationally financial stability. The ABA questions why non-globally systemically important banks such as Australian banks, need a higher credit risk weighting combined with collateralisation to maintain adequate financial stability.

Further, the ABA understands from the APRA Capability Review that APRA may have limited evidence for this proposal. The review found that "APRA has not undertaken a deep dive risk review for SME and corporate portfolios in several years".[5]

Requiring higher SME credit risk weighting means that SME lending will potentially be unnecessarily more expensive and/or reduce supply of SME lending than what could be the case. This is a key concern for the economy as SME lending is a key driver of economic growth.[6] Economic lending data shows (see above) that SME lending is significantly lower than previous years and is in decline. Continuing credit risk weights above international standards is a missed opportunity for economic growth.

Given this, the ABA proposes that SME lending credit risk weightings proposed by Basel III are implemented. Further increases in the credit risk weighting above the Basel III standard should only be

[5] Treasury 2019, *Australian Prudential Regulation Authority Capability Review at page 58* , https://www.treasury.gov.au/sites/default/files/2019-07/190715_APRA%20Capability%20Review.pdf

[6] Lindgren, E., 'Access to finance: Small and medium enterprises effect on economic growth', Lund University, 2015, https://www.lup.lub.lu.se.

implemented when supported by the outcome or finding from a recent deep dive review of the SME risk portfolio.

Credit Conversion Factors

APRA is proposing to retain the CCF estimates proposed in the February 2019 discussion paper, subject to some minor adjustments.

The ABA still considers that APRA's deviation is materially higher than the Basel III standard and will impact the competitive position of Australian banks relative to international peers. The ABA's recommendation is that APRA adopts the Basel treatment of CCFs.

Further, the ABA consider that there should be consistency in the Credit Conversion Factors (CCFs) applied under both the Standardised and AIRB approaches, as such any revision to CCFs to Residential Mortgages should be equally applicable to AIRB and Standardised ADIs.

Residential exposures

The ABA concerns about residential exposures CCFs outlined in its previous submission were not addressed by APRA's June 2019 consultation paper.

The ABA considers APRA's proposed CCF of 100 per cent is overly conservative as it does not reflect the actual usage of these credit lines. Pre-payments by customers or paying ahead are an effective risk mitigant for individuals. As noted by the RBA, "while household debt is still at a high level, most households appear to be in a good position to service their debt. Many households have accumulated prepayment buffers, which can compensate for temporary loss of income…".[7] This lack of capital relief for overpayment of loans could limit an ADI's ability to provide incentives for the customers to overpay and develop a buffer to support repayments if a loss of income is experienced. This is even more relevant in the current economic context of low wage growth and increasingly high debt levels.

The ABA recognises there is some risk of redraw, but would be supportive of using the 40 per cent proposed by Basel for both IRB and Standardised ADI's. Our members welcome opportunity to discuss calibration of CCF's and provide further detailed analysis.

Short term self-liquidating trade letters of credit

Further, the ABA considers that the CCF category labelled 'short-term self-liquidating trade letters of credit arising from the movement of goods' requires further consideration by APRA. The ABA understands that APRA is proposing to adopt a narrow definition of the Basel wording for this category. However, we would underline that the Basel definition should capture other forms of trade finance that share the same characteristics as "self-liquidating trade letters of credit". In this respect 'open account trade financing structures' arise from the shipment of goods and are used to finance a unique bona fide transactional flow, where the maturity date of the individual financing matches the milestones in the physical transaction (typically be in vicinity of 60-180 days maximum).

An ADI should be able to apply a CCF of 20per cent across trade products (including open account) provided they can evidence an observed CCF over a long run cycle and that they can demonstrate robust controls to preserve the integrity of the trade offering and observed CCF, clearly differentiating it from other forms of clean working capital finance. Equally, based on the short duration risk of individual financing structures (i.e. 60-180 days maximum) and that the draws must be in support of a bona fide self-liquidating flow, the ABA believes 'open account trade financing structures' should be exempt from the one year floor as per proposed treatment for "self-liquidating trade letters of credit".

Risk weights for retail exposures

The proposed risk-weights for retail exposures exceed the Basel standard, and as APRA does not recognise the 'regulatory retail' category or the concept of 'transactors' (those that repay their full credit card balance every month), the increase is significant. The ABA acknowledges APRA's reluctance to consider the concept of 'transactor' accounts, however the ABA considers that increasing the risk

[7] Reserve Bank of Australia, *Financial Stability Report,* April 2019, https://www.rba.gov.au/publications/fsr/2019/apr/overview.html

weight to 100 per cent risk-for these customers is not reflective of the actual risk. The proposed credit risk weight is significantly above the modelled behaviour of these portfolios by IRB banks in Australia. 'Other retail' risk-weights for IRB banks, as per their Pillar III reports, are broadly consistent with the Basel standard of 75 per cent.

For 'other retail', an increase in the risk-weight to 125 per cent compared to the current 100 per cent does not align with risk characteristics and performance experienced by our members for these portfolios. As noted above, IRB ADIs model these exposures at significantly lower risk-weights than 100 per cent, and although the ABA accepts that the SA approach will by its nature be less risk sensitive and therefore more conservative, the increase to 125 per cent is not warranted.

The ABA therefore recommends that APRA aligns to the Basel III category of 'regulatory retail' at 75 per cent risk-weight and retains the current treatment of 'other retail' at 100 per cent risk-weight.

Securities Financing Transactions (SFTs)

The ABA encourages APRA to adopt the Basel framework in order to ensure:

a) global consistency in the Basel III framework; and

b) a level playing field for Australian ADIs.

In relation to APRA's proposed rules for SFTs, the ABA is concerned that Australian ADIs will be placed at a disadvantage where overseas jurisdictions do not implement the minimum haircut floors, as has been recommended by the European Banking Authority (EBA). In addition, if the majority of overseas banks are not subject to the haircut floor, the market practice shift intended by the Basel rules will not eventuate.

The ABA recommends that APRA takes account of global regulatory developments in relation to the minimum haircut floor, and not implement this part of the SFT rules until it has been implemented in jurisdictions with significant market players in this market.

Other amendments to the standardised approach (Chapter 4)

In this section, the ABA outlines its concerns regarding the following

- Commercial property and land acquisition, development and construction (ADC)
- Definition of subordinated debt exposures
- Exposures originated through third parties
- Lease exposures
- Risk weight multipliers with currency mismatch
- Credit risk mitigation
- Project Finance exposures

Each of these topics is considered below.

Commercial property and land acquisition, development and construction (ADC)

Whilst the ABA welcomes APRA's guidance on the assessment of tenancy profile, the ABA recommends the removal of the requirement for assessment one-year post expiry for risk weighting purposes for commercial properties (paragraph 7 of standardised mortgage requirements). This is because the concept ignores the reduced risk benefit of multiple tenancies with staggered lease expiry over a single tenant. It also ignores assets with high probability of tenant renewal, such as a supermarket tenant trading strongly in a desirable location and demography, who would exercise its lease options to protect its business. The inclusion of such a requirement may lead customers to seek short term lending which is unlikely to be the objective of the policy.

When assessing ADC exposures, the ABA seeks more flexibility in applying a 100per cent risk weight. The proposed test based on pre-sales cover is too narrow and does not consider other forms of credit risk mitigation. The test ignores other structural enhancements such as sponsor guarantees or low LVR. It also penalises build to hold developments (applicable for commercial as well as residential developments) that do not have pre-sales. Given this, the ABA recommends that APRA consider a broader test to avoid unintentional consequences which could limit lending for ADC without any significant benefits to financial stability.

Definition of subordinated debt exposures

The ABA is concerned that the definition of subordinated debt exposures in Attachment B will create unforeseen consequences. The current definition is very broad, and a strict reading could mean that exposures that we do not think APRA intends to capture could be subject to a 150% risk weight.

The wording in the draft APS 112 defines an subordinated debt exposure as "any facility that is expressly subordinated to another facility, or is structurally subordinated as the obligor has insufficient cash flows or assets from its own operations to meet its debt obligations (i.e. debt issued by holding companies), or the ADI does not have a priority claim on the obligor's assets in the event of administration or insolvency."

This definition could result in debt issued by a holding company being considered subordinated, regardless of the existence or materiality of creditors ranking ahead of the facility. In addition, almost all facilities could be considered to have a priority claim in the form of e.g. deposits, employee and tax liabilities.

With contractual subordination, the extent of subordination is always clear so more conservative treatment is warranted. However, the effect of structural subordination is far more variable and not suited to the automatic application of a 150% risk weight. For example, in the typical situation of lending to a holding company where the group's assets are in subsidiaries, the structural subordination can be mitigated if the ADI is pari passu for a significant portion of the group's assets. ADIs typically have guidance based on the effective level of structural subordination, and in some cases no/minimal adjustment would be acceptable (eg where the subordination has been effectively mitigated or is immaterial) so a single risk weight covering all possible scenarios is too blunt. As APS 112 is designed to be relatively simple, a similar nuanced approach with several additional risk weights would not be appropriate so APRA recommends for simplicity and consistent application across ADIs and internationally that para 37 should only cover contractual subordination and the para 38-39 rules should stay as drafted.

Exposures originated through third parties

APRA considers that a risk weight higher than that applied to other retail exposures is appropriate and therefore proposes a risk weight of 150 per cent for these exposures.

The ABA understands that these requirements are aimed at addressing the potential lending risks created by peer-to-peer lending. However, the ABA would suggest that APRA further consider the wording of these requirements in the prudential standard to clarify this. The ABA believes the current drafting of this section could have unintended consequences to well established business segments and future lending innovations.

Examples of markets which could be affected are securitisations, subscription finance (capital call facilities) and direct lending to third party lenders. These types of lending expose ADIs to the underwriting/origination abilities of the third party, but these risks are mitigated by due diligence on the underlying assets and retaining recourse on the third party itself, not just to some of its specific underlying assets.

Lease exposures

APRA proposes to retain the current 100 per cent risk weight subject to an ADI's aggregate leasing assets being below a threshold of 10 per cent of Tier 1 Capital. Exposures above the threshold would be required to be risk weighted at 250 per cent which the ABA believes reflects APRA's intention of creating a disincentive for ADIs to have significant residual value risk.

The ABA requests that APRA clarify the standard to capture only operating leases held on balance sheet as part of this requirement, in line with the consultation paper, as the draft standard could be interpreted as applying to both operating and finance lease assets. The ABA suggests that in Table 15, "Risk weight (%) applying to the portion of aggregate lease exposures …" be replaced by "Risk weight (%) applying to aggregate residual risk exposures …". This would tie the higher risk weight to residual risk exposure, rather than to all leases. The 250per cent risk weight for all lease exposures would be disproportionate and inconsistent with the Basel III paper.

Risk weight multiplier for exposures with currency mismatch

As APRA already suggests in APG223 that foreign currency income is discounted, the ABA believes that any such exposures have been originated prudently and recommends that this requirement not be implemented. Should APRA believe that this requirement is warranted, we request that transitional arrangements apply and that the multiplier applies only to loans originated after implementation of the standard.

Credit risk mitigation

Minimum haircut floor

APRA intends to align with the BCBS' revised approach for measuring the exposure related to SFTs. This includes:

a) Recalibration of supervisory haircuts;

b) Introduction of a new formula for exposure calculation; and

c) Introduction of minimum haircut floors.

The ABA recommends that APRA implements points a and b, but delays introducing the minimum haircut floors until there is clarity around how it will be implemented overseas.

While the ABA typically wants APRA to align with the BCBS rules, we are concerned about the potential introduction of minimum haircut floors given how punitive the treatment becomes if the floor is breached (the exposure becomes treated as if it were unsecured). Additionally, the European Banking Authority (EBA) has recommended to the European Commission that they adopt Basel as written, except for the minimum haircut floors.[8] Hence the ABA is concerned that if APRA implement Basel rules then Australian banks will be at a disadvantage from an international comparability/competitiveness perspective.

Eligible financial collateral

The ABA supports APRA's approach to expand the scope of eligible financial collateral and continue to align with Basel, by including certain securitisation exposures and certain units in unlisted trusts. However, we do not think APRA should remove the concession for trading book instruments as eligible collateral for SFTs as:

- SFTs over trading book eligible debt securities are pivotal in facilitating collateral and liquidity management;
- the global bond market is deeply liquid, even at the lower end of the credit curve (e.g. turnover in High Yield corporate bonds reported on TRACE for the last three months was in excess of US$250bn[9]); and

[8] EBA Paper, Executive Summary, page 4, Recommendation 2

[9] TRACE is the Trade Reporting and Compliance Engine operated by FINRA and used by market participants to report OTC transactions relating to fixed income securities. See Bloomberg, TRACE <GO>, TFLO Corporate Bond volume, 3 months to Sept 12, 2019

* historical evidence suggests that the 30per cent haircut applicable to non-main index equities (which has been increased from 25per cent) remains appropriate for trading book eligible debt securities. Even assuming an extended 20-day holding period the largest observed move in the 'Barclays US Corporate High Yield Total Return Index' since 2006 (i.e. including the Global Financial Crisis from 2008-2009), was -28.16 per cent[10].

The ABA recommends that APRA align with Basel and retain the current concession for trading book instruments that would not otherwise qualify as eligible collateral to be recognised as eligible collateral for SFTs.

Project Finance exposures

For Specialised Lending exposures, APRA has proposed to recognise favourable risk weights for operational phase – high quality exposures and penalise pre-operational phase exposures. While the ABA is supportive of the risk differentiation being provided to project finance exposures, it has concerns on the criteria required for recognition of 'high quality' exposures. The criteria significantly limits the exposures that can be recognised as high quality which is not consistent with how banks would typically rate exposures or commensurate with the risk.

The ABA believes the definition of 'operational' is too narrow. Not all debt that completes construction (which is what is typically termed as operational) declines. For some asset's debt can actually remain the same or in fact increase when supported by long term concession and offtake agreements to match the underlying increase or growth in revenue attributable to the long-term concession. As currently defined, we have interpreted sub-paragraph (b) such that assets will not constitute operational phase for years if not decades following completion of construction. What is more relevant to determine operational status is the strength of the credit counterparty, quality and market position of the asset as well as the structural protections that support the increase or bullet nature of the debt outstanding and that debt declines on a notional basis over the life of the asset.

Secondly, the conditions for high quality are highly restrictive and do not consider all risk indicators considered when applying a favourable credit rating, such as gearing, structural and documentary protections, quality of sponsor and quality of product. For example:

* References to "main counterparty" in sub-paragraph (d) ignores the benefits of diversification of source revenue which strengthens the ability to service debt service obligations.
* Lenders benefit from contracted off-take agreements particularly in the sectors of renewables, resources, oil and gas and alternative infrastructure assets such that revenues should not be restricted to regulated, availability and take or pay assets (see sub-paragraph (c)).
* References to a termination payment regime in sub-paragraph (f) is highly restrictive and would only apply to a very small universe of exposures in project finance where the borrower elected to terminate for convenience. Lenders rely instead on structure, gearing and appropriate security to finance large scale projects in oil and gas, resources, infrastructure and renewable sectors with high quality sponsors to support repayment of debt obligations under all likely downside revenue scenarios.
* Pledging of **all** assets and contracts as required in sub-paragraph (g) does not take into account the nature of some asset classes like oil and gas projects that are supported by high quality and strong credit rated sponsors where items, for example production licences or contracts may not be pledged.

Operational risk (Chapter 5)

As noted earlier, a key issue for the ABA is the proposed early implementation of the operational risk requirements. APRA is proposing to retain an earlier implementation date of 1 January 2021 for the revised APS 115 for ADIs currently using an AMA, rather than a 1 January 2022 implementation date

[10] Barclays US Corporate High Yield Total Return Index contains nearly 2000 US Corporate Sub-Investment grade bonds. See Bloomberg, PX_LAST and INDEX_PRICE, LF98TRUU Index and LUACTRUU Index, Date range: 18/08/2006 – 16/08/2019

for the rest of the proposals. The ABA strongly recommends that APRA makes this earlier implementation date optional, not mandatory.

The ABA considers the current timeline of 1 January 2022 to be an ambitious implementation date. Many prudential standards remain to be finalised and consulted on by APRA. These include the final prudential operational risk standard. Based on the current expected APRA policy timetable, the proposed 2021 implementation date for operational risk would leave less than 12 months to implement and operationalise the final standard. This raises significant risks for entities to comply with the early date and is not consistent with better regulation principles for significant implementations.

Under the existing implementation timeline proposed by APRA, revisions to the capital framework for ADIs are effective on 1 January 2022. We appreciate that APRA has previously revised this date to align with the internationally agreed date set by the Basel Committee on Banking Supervision (BCBS). However, we are concerned that, given consultation is now expected to extend into 2020, this timeline will not be sufficient for banks to implement the changes.

The proposed changes, particularly the requirement to calculate RWA under both IRB and standardised approaches, are extensive and involve significant changes to data, systems, models, reporting and controls. Substantial time and investment will be required from banks to implement the revised framework. The full requirements for these changes will not be known until final prudential standards are released. As such, sufficient lead-time is needed after the standards are finalised to implement and embed these changes. Given this, the ABA recommends that the implementation date should be no earlier than 18 months from the release of the final standards, including associated practice guides and reporting standards.

Other matters

Definition of “commitment”

The ABA welcomes inclusion of Basel requirements around commitment. However, the requirement to apply this only to corporate counterparties penalises SME exposures, particularly asset finance, where non-regulated entities enjoy a more beneficial operating environment. The ABA would recommend that APRA review this proposed drafting with a view to making it more competitively neutral.

Asset Class Definitions

APRA is proposing to increase the threshold between SME and Corporate to $75 million; and from Corporate to Large Corporate exposures to $750 million. While these changes would better align to the Basel Standards, APRA need to consider the impact of these changes on the IRB approach, and in particular the capital formulas which allow for correlation adjustments based on size. It would be appropriate to align these so the treatment is more consistent with Basel.