9 November 2018

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[redacted]

Improving the transparency, comparability and flexibility of the ADI capital framework

Thank you for the opportunity to comment on APRA's proposal to improve the ADI capital framework's transparency, comparability and flexibility.

About COBA and its members

COBA is the industry association for Australia's customer owned banking institutions (mutual banks, credit unions and building societies). Collectively, our sector has $113 billion in assets, around 10 per cent of the household deposits market and 4 million customers.

Customer owned banking institutions account for three-quarters of the total number of domestically-owned ADIs operating in Australia.

All our members are standardised ADIs under the ADI capital framework. Our member ADIs predominately fund themselves from retail deposits and are unlikely to have material, if any, international funding sources.

Our sector currently holds $97 billion in deposits, with deposits consisting 93 per cent of our sector's total liabilities. The decision for the vast majority depositors to 'invest' in an institution through deposits is not made in any way shape or form based on the capital ratio. Even if they were, the highly domestic nature of retail deposits means that there is little need for international comparability for our member ADIs.

One member has noted that the absence of internationally comparable capital ratios (ICCR) has not appeared to be a determining factor for them to access international capital markets. This member ADI has credit ratings from major credit rating agencies which is likely to be a more deterministic in this aspect.

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Transparency and comparability are the core policy problems, not flexibility

COBA believes that core issues are the transparency and comparability of the capital framework.

It is clear that APRA does not believe it is transparent enough that its capital framework is stronger than the Basel minimums.[1] A 'hidden' strength in the capital framework would then lead to a possible problem where *internationally active* Australian banks' capital ratios are not comparable with international peers.[2] Assuming these peers compete for the same funding, this then leads to the risk of "undue interruption to the flow and cost of funding to the [Australia] financial system". These are issues of transparency and comparability.

COBA notes that if capital framework flexibility was a 'core issue' then both proposed options would address this issue. They do not, so COBA notes flexibility remains an ancillary issue.

Support for voluntary consistent disclosures to meet the policy problem

COBA supports the APRA's first approach (**Approach 1**) for a consistent disclosure methodology on the condition that these are voluntary disclosures.

COBA recognises that APRA is open to a 'do nothing' approach and that this is viable alternative. However, COBA believes that adopting Approach 1 based on voluntary disclosure is effectively a 'do nothing' approach for ADIs who do not require an ICCR. This is the lowest cost way to address the core policy problems of transparency and comparability.

A consistent APRA-approved adjustment methodology allows ADI to disclose a credible and internationally comparable capital ratio. This meets the 'comparability' policy objective. The 'gap' between this ICCR and the APRA regulatory capital ratio is an indicator of the strength of the Australian framework. A persistent and significant gap across multiple entities (e.g. the major banks and some regionals) would show that both APRA's IRB and standardised framework is 'unquestionably strong'. This meets the 'transparency' policy objective.

Shifting the costs onto those who need international comparability

The key to this approach is that it is optional for ADIs to incur the costs of international comparability. It allows ADIs that do not need an ICCR (i.e. mutual ADIs) to not disclose or calculate this measure. This lowers the implementation costs. This shifts the cost burden of international comparability onto those who seek such comparability, effectively a 'user pays' system. If a mutual ADI, or any ADI, wants to approach international capital markets then it could incur these adjustment costs as part of its international funding program.

APRA notes that these adjustments could be automated as part of normal regulatory reporting processes. However, COBA iterates that while this may be possible, this is still an unnecessary cost for customer-owned ADIs given the negligible benefit of ICCRs. The absence of customer-owned ADIs calculating their own ICCR is clear evidence that there is little use for this metric in our sector.

Similarly, if APRA were to calculate and then disclose this on our member ADIs behalf then it would reduce costs for ADIs. However, it would place costs onto these ADIs to explain this irrelevant metric to our stakeholders. COBA notes there maybe value in APRA disclosing an industry aggregate for benchmarking purposes.

COBA notes that APRA states that it is "not intended that the choice of approach be optional for individual ADIs". COBA's suggested approach meets requirement. While the voluntary disclosure is

[1] See Page 16 Discussion paper were APRA notes that "the degree of relative conservatism within APRA's capital framework is not readily apparent to many investors"

[2] A more conservative framework leads to higher risk weighted assets (denominator), which leads to lower capital adequacy ratio.

optional, the approach is the same. COBA notes that APRA's suggest voluntary disclosure as a potential simplification outlined on page 22.

COBA notes that APRA's paper states that the comparability issue is the greatest for IRB ADIs (i.e. the major banks).[3] As such, the solutions (and subsequent costs) should be focused on these ADIs in this 'user pays' system. These ADIs already perform their own adjustments,[4] so moving towards an APRA-approved methodology is unlikely to be a complicated nor expensive exercise.

Similarly, if most of the variance occurs due to use of the IRB models, then APRA could get these IRB ADIs to also report on a standardised basis for international comparability purposes (noting that this is one of the revised Pillar 3 requirements and likely to a critical part of the post-crisis reform capital floor[5]). This could also potentially control for variances in the conservatism of IRB models.

Importance of simplicity over complexity

As a general principle, regulation must be kept as simple as possible in order to meet its desired objectives, particularly related to transparency and comparability. It is important the regulators do not introduce additional complexity without significant benefits. In line with this, COBA believes that approach 2 introduces excessive and unnecessary complexity.

COBA also notes that the additional complexity of approach 2 has the potential for unintended consequences. Given this adjustment is ADI-specific adjustment and subject to periodic recalculation, it raises the potential of additional and unnecessary complexity for operational forecasting.

COBA welcomes APRA's potential simplifications for standardised ADIs. However, COBA notes that simplest and lowest cost approach is generally no change so the proposal for voluntary disclosure under Approach 1 is the simplest approach.

In the absence of voluntary disclosure, COBA supports the status quo. If this is applied to mutual ADIs in a blunt approach, then this would be a solution looking for a problem, given our sector does not have, or is likely to have in future, significant international funding sources.

COBA has also provided comment on APRA's identified advantages and disadvantages in **Appendix 1.**

[redacted]

Kind Regards

[redacted]

Director - Policy

[3] See Page 12 where the average adjustment for the four largest ADIs was 485 bps

[4] See any of the major banks' half yearly or full year disclosures

[5] See https://www.bis.org/bcbs/publ/d432.pdf BEN2

APPENDIX 1

Addressing Approach 1 advantages

No change to any regulatory capital requirements

COBA and its members both agree with this statement and highlight the importance of minimising any unnecessary change. There is already going to be significant change to the capital framework so keeping as many parts constant as possible is likely to minimise the chances of any unintended consequences.

Improves transparency of APRA's relative conservatism.

COBA notes that this is also the case for Approach 2, so this is not a differentiator between the two approaches.

Builds on the existing practice of larger ADIs self-disclosing comparable capital ratios and adds credibility as the methodology would be determined by APRA.

COBA notes that this is lowest risk approach given that it adds credibility to an existing process rather than dramatically reshaping the capital framework with variable minimum PCRs. This represents a prudent incremental approach.

Lowest cost of the two possible approaches

COBA strongly agrees with this assessment. However, COBA notes that our proposed approach of voluntary disclosure is likely to have even lower implementation costs than Approach 1.

Addressing Approach 1 disadvantages

Confusion may arise from two APRA-endorsed capital ratios for ADIs

COBA notes that investors who unable to distinguish between two capital ratios are unlikely to be sophisticated enough to invest in a bank, particularly in times of stress. Similarly, if they are international investors, then it unlikely to be sophisticated enough to invest in a foreign jurisdiction if they are confused by two capital ratios.

Investors may still focus on the regulatory ratios rather than adjusted ratios.

COBA believes that the risk of an investor focusing on the regulatory ratio should not be a concern to the prudential regulator. Investor's decisions and what they base their decision on is up to individual investors.

COBA notes that a similar problem would already arise under the disclosure of CET1, Tier 1 and Total Capital ratios so this may not be a significant issue. COBA also notes under a voluntary disclosure approach that any 'confusion' would only be incurred by ADIs who opted into international comparability.

Addressing Approach 2 advantages

More effective approach to improving comparability than Approach 1

COBA believes that a necessary level of comparability is met through Approach 1 given that headline capital ratios rather than minimum capital ratios are likely to be more important to investors.

Supports the fact that actual capital strength should be perceived as such.

COBA notes there are alternative ways to show the capital strength of the APRA framework. For example, under Approach 1, this is the gap between the APRA ratio and the ICCR for an individual institution or the aggregate ADI industry gap across groups of ADIs (e.g. IRB and standardised). APRA could also clearly articulate on its website as to why and where it is more conservative than its Basel peers.

Provides opportunity to increase the responsiveness in times of stress

COBA notes that while it does provide this opportunity, there needs to consideration as to the potentially unknown costs. APRA should also consider how often this additional responsiveness is needed with APRA's other tools (or future TLAC buffers).

Addressing the Approach 2 disadvantages

Involves changes to both capital and disclosure requirements.

COBA members have noted this approach is likely to be the most expensive. While the credit risk weights are changing, this is nowhere near as complex as this proposal which would change how capital is managed. This could require some significant changes and is inconsistent with APRA's intention for simplicity in this paper as well as the idea of a 'simple framework' for simple ADIs.

May significantly increase operational complexity for ADIs

COBA agrees and does not believe that the added complexity of a variable capital ratio outweighs the potential benefits. Similarly, there would need to be a significant piece to educate investors about why an ADI's minimum capital ratio is higher than others. The is the same risk that exists with a 'two capital ratios' situations except that rather than being an improve on the status quo (as the majors currently provide these ratios), it would be a step into a completely different and new direction.