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Discussion Paper: Revisions to the capital framework for authorised deposit-taking institutions

COBA welcomes the opportunity to comment on APRA's revised capital framework.

COBA is the industry association for Australia's customer owned banking institutions (mutual banks, credit unions and building societies). Collectively, our sector has $121 billion in assets and 4 million customers. All COBA members are standardised ADIs under APRA's capital framework.

COBA urges APRA, in revising the capital framework, to:

- improve transparency on its consideration of competition in developing and implementing the revised capital framework
- continue to monitor and disclose the differences in the capital framework outcomes between standardised ADIs and internal ratings based (IRB) ADIs, recognising the impact on competition and leaving scope for further adjustments if necessary, and
- improve transparency around the quantitative impact study (QIS) results and the calibration of unquestionably strong capital requirements.

In terms of specific proposed revisions, APRA should:

- reduce the overly conservative proposed credit conversion factor (CCF) on undrawn mortgages,
- ensure that the capital framework maintains incentives for a viable LMI market,
- clarify the treatment for ADI exposures to support mutual ADIs' access to funding, and
- introduce fairer capital treatment for information technology expenses.

Competition in Australia's banking market

The 2018 Productivity Commission (PC) inquiry into Competition in the Financial System found that: "competition is poor in many of the financial markets we have examined".

It also found that regulators largely have the tools to support a competitive marketplace but their focus is tilted towards the stability of the system, with regulatory regimes that are indifferent to, or actively discourage, innovation and competition.

The PC found that:

- competition can support stability, for example, through preventing excessive concentration in the financial system that would otherwise lead to dependency on a very small number of providers,
- regulatory settings and the (actual or perceived) interventions of the Australian Government are having a significant impact on competition in the financial system,
- APRA's approach to risk weights has increased the cost disadvantage for smaller financial institutions and reduced the scope for price competition, potentially harming consumers, and
- creating a regulatory system that supports competitive outcomes will require an explicit recognition of the role regulators play in restricting competition and a cultural shift towards considering pro-competitive action.

Revisions to the capital framework present APRA with a critically important opportunity to improve competition while promoting financial system stability.

Transparency on how APRA has considered competition in this proposal

COBA welcomes APRA's statement that a broader objective of these proposals is to "[ensure] appropriate relative capital outcomes between the IRB and standardised approaches, both on an overall basis and for the residential mortgage portfolio, so as not to create unwarranted competitive distortions". We are asking APRA to increase the transparency around how it has considered competition in its capital framework proposals.

The APRA Capability Review outlined the need for more transparency on competition stating that: "APRA can do more, including publishing a clearer interpretation of its mandate, establishing a strategic position on competition and being held to account."[1]

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 notes that these factors are well within APRA's current interpretation of its mandate which describes the 'competition' aspect as: "Institutions being able to compete with other regulated and unregulated providers through prices and features offered on their products and services".[2]

Excessive capital requirements unnecessarily increase costs on consumers. Differences in capital outcomes reduce standardised ADIs' ability to compete against both IRB ADIs and the rapidly growing non-ADI sector. Ultimately, this decreases consumer choice and competition.

COBA acknowledges that capital requirements have narrowed over recent years as APRA has implemented the Financial System Inquiry (FSI) recommendations.

[1] APRA Capability Review Panel 2019, APRA Capability Review, page xxii. Available online.

[2] APRA 2019, APRA Policy Priorities, page 8. Available online.

These changes include:

- a higher 'unquestionably strong' increase for IRB ADIs of 150 basis points compared to 50 bps on standardised ADIs
- an increase in the average IRB risk weight for residential mortgages to 25%, from 15% (compared to 39% for standardised ADIs)
- announcement of a 3 percentage point increase in total capital requirements by January 2024 for domestically systematically important ADIs.

While the 'gap' in the capital requirements has narrowed, COBA wants to ensure APRA is continually and transparently monitoring the impact of the different capital outcomes.

If this gap is creating competitive distortions, then APRA should address it through mechanisms such as increasing the multipliers on the IRB approach. We recognise that APRA has stated its intention to be vigilant about these potential distortions but we seek transparency on this.

COBA supports the need for risk weight assets floor, however, we believe this should be applied at an exposure level. This limits the benefits to IRB banks of modelling on a 'per-loan' basis. This also allows APRA to dampen the procyclical nature of IRB approach. In benign periods, this exacerbates the risk weight gap. APRA recognises this noting that "the difference between IRB and standardised capital requirements will vary over the credit cycle, as the IRB approach is more procyclical, so the difference will be larger in benign periods and smaller in stressed periods". [3]

The APRA Capability Review has highlighted the 'light touch' APRA has paid to competition in the past noting that "competition was only mentioned in passing in APRA's 2018-2022 Corporate Plan and competition was not a frequently referenced concept within APRA's committees and industry groups".[4]

COBA recognises that there has been a positive shift in APRA's consideration of competition. The APRA Capability Review also highlights this stating "competition in the Australian banking market, and development of APRA's competition analysis framework, was considered by APRA's ADI Industry Group in March 2019."[5]

COBA strongly supports this work. APRA should make this general work, alongside its specific competition considerations for the capital framework, more transparent.

Transparency around comparisons between standardised and IRB ADIs

COBA welcomes APRA's commentary in its response to first-round submissions about the differences between the standardised and IRB ADIs capital requirements. This should continue through adequate and consistent disclosure of major banks' modelled risk weighted assets (RWAs) compared to their RWA as if they were standardised institutions.

These disclosures should have enough detail to allow stakeholders to compare these IRB risk weights versus the alternative standardised risk weights. This would identify where IRB ADIs are receiving a significant advantage. This would also clearly outline areas, if any, where they would be holding more than the standardised approach. COBA also suggests that these differences come with an explanation of the basis of these potential advantages. The Basel Pillar 3 standard outlines this as one of the requirements of its disclosure forms:

[3] APRA 2019, Response to submissions: Revisions to the capital framework for authorised deposit-taking institutions, page 21. Available online.

[4] APRA Capability Review Panel 2019, APRA Capability Review, page 71. Available online.

[5] APRA Capability Review Panel 2019, APRA Capability Review, page 73. Available online.

> "Banks are expected to explain the main drivers of differences between the internally modelled amounts disclosed that are used to calculate their capital ratios and amounts disclosed should the banks apply the standardised approach. Where differences are attributable to mapping between IRB and SA, banks are encouraged to provide explanation and estimated materiality."[6]

COBA suggests that something similar should occur in Australia. This is likely to improve public debate about the IRB approach and its capital outcomes.

Transparency around unquestionably strong calibration (UQS)

A key objective of the capital framework is to incorporate APRA's unquestionably strong (UQS) benchmarks into the capital framework. This leads to an equivalent increase in capital of 150 basis points for IRB ADIs and 50 basis points for standardised ADIs.

COBA has strongly supported this proposal as it narrows the gap in capital outcomes between IRB and standardised ADIs. If calibrated correctly, this narrows the gap in capital outcomes by an equivalent of 100 bps across the system. The quantitative impact study (QIS) data plays an important role in this calibration.

COBA seeks more transparency around the QIS results This will ensure that stakeholders can understand the drivers of this calibration, including the areas where the increase in minimum capital requirements is likely to flow through. This is important as overshooting this target will unnecessarily increase the capital requirements on standardised ADIs. This will reduce their ability to competitively price compared to their major bank peers which will reduce price competition for consumers. This also provides a 'leg-up' for non-ADIs who are exempt from APRA's capital requirements, lending standards, risk management and governance requirements and macroprudential interventions.

COBA notes there may be concerns about confidentiality. However, APRA can address this by confidentialising or aggregating the results.

More transparency around QIS results gives industry greater confidence about APRA's proposed calibration. APRA has noted that these benchmarks represent "average targeted outcome across the industry as a whole, results will inevitably vary across different ADIs depending on their portfolio composition and risk profile." Increased transparency will demonstrate how and if APRA has achieved the benchmark across the system. This is important as it is unlikely that any ADIs will precisely hit this benchmark.

Several COBA members have seen significant implied increases in their capital requirements from the QIS so greater confidence is needed around the system-level calibration.

Support for the simplified framework

COBA supports APRA's proposed simplified framework. We believe that will reduce some of the regulatory burden of the capital framework for smaller, less complex ADIs. COBA supports APRA's intent to prescribe a quantitative threshold at a level to cover all mutual ADIs. However, the proposed $15 billion threshold may not cover all mutual ADIs by 1 January 2022.

In this submission we also put forward an additional proposal to promote investment in information technology for simple ADIs.

COBA provides more specific comments on aspects of the capital framework in **Appendix 1.**

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[6] Basel Committee on Banking Supervision 2018, Consultative Document: Pillar 3 disclosure requirements – updated framework, page 47. Available online.

[redacted]

Yours sincerely,

[redacted]

Chief Executive Officer

Appendix 1: Specific comments on the capital framework

Residential mortgage exposures

Treatment of undrawn mortgage balances

COBA strongly recommends that APRA should revise its proposed 100% credit conversion factor (CCF) for residential mortgages. COBA believes several factors suggest this figure is conservatively set and should be set at an effective level below 100%.

Of APRA's proposed revisions, the proposed 100% CCF will have the greatest impact on mutual ADI capital requirements given the current capital treatment of these redraws.

COBA and its members are willing to work with APRA to explore options that provide a more nuanced approach to these balances. This includes options such as a lower CCF that better reflects the risk of these exposures, retaining the 'unconditionally cancellable' category or tiered CCF arrangements (i.e. where an initial amount has a CCF of 100% and subsequent and less-likely-to-be-drawn amounts have a lower CCF).

A 100% CCF combined with removing the unconditionally cancellable category will increase the risk-weighted assets for standardised ADIs. This is due to the current treatment being either a 50% CCF (maturity more than one year[7]), 0% (unconditionally cancellable[8]) or 0% (not accepted[9]). COBA acknowledges that APRA proposes to apply the same CCFs to both IRB and standardised ADIs, however, given the current treatment this is likely to increase the capital held by standardised ADIs.

It is useful to consider the following two scenarios:

1. Where the loan is drawn but the consumer has repaid more than the contractual repayments and there is a redraw facility present, and
2. Where the loan is approved but not accepted by the customer.

COBA members have also noted that there must be similar considerations for other unconditionally cancellable unused credit limits, such as lines of credit.

Situation 1: Where the loan is drawn but the consumer has repaid more than the contractual repayments and there is a redraw facility present (prepayments)

COBA notes that some of these redraw facilities currently meet the definition of 'unconditionally cancellable'[10] based on the terms and conditions of the loan contract and redraw facility. This means that they are currently treated with a CCF of 0%. Alternatively, any redraw facility that does not meet the definition of unconditionally cancellable, would attract a 50% CCF (based on their maturity).

Given APRA proposes to remove the 'unconditionally cancellable' category these exposures will attract a 100% CCF under the new framework. COBA urgeses APRA must revise the proposed 100% CCF for these situations.

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[7] APS 112 Attachment B Table 1 (10(b)(ii)))

[8] APS 112 Attachment B Table 1 (10)(c))

[9] APRA 2013, Prudential Practice Guide APG 112 – Standardised Approach to Credit Risk. Available online.

[10] APS 112 Attachment B Table 1 (11)

Ensuring a better treatment than an offset deposit account

The clear substitute from a consumer's perspective for a mortgage redraw is the offset deposit account. Under the capital framework, the offset account does not provide any capital benefit. This equates to an effective CCF of 100%. This is equivalent to what is proposed for redraws under APRA's draft APS 112. This redraw CCF should be lower than 100% given that redraws have superior liquidity advantages for ADIs compared to offset accounts.

Offsets are typically more accessible than a mortgage redraw. A customer can withdraw the entire deposit without restriction. For loans with offset deposits, ADIs end up with higher mortgage exposures alongside less stable funding from offset deposits.

COBA acknowledges that restricting a consumer from accessing a redraw is unlikely to occur during normal business activities. However, COBA notes that this regulatory capital framework is aimed at meeting unexpected losses rather than 'business as usual' losses. The flexibility given to financial institutions to activate these clauses have been built specifically to address these circumstances and create a safer banking system. More broadly, these limits are managed across the portfolio. It is highly unlikely that all loans within a portfolio will access their redraw at the same time. Therefore, a lower effective Risk Weight on undrawn balances (through a lower CCF) is more realistic.

More broadly, the capital framework should also incentivise ADIs towards more beneficial prudential outcomes. In the case of a prepayment, from a prudential perspective, the outcomes are likely to be ranked in the following order (from most desirable to least desirable):

1. Prepayment with no redraw
2. Prepayment with redraw (cancellable at ADI discretion)
3. Prepayment into an offset

The capital framework should provide incentives for ADIs to offer more prudent options.

Ultimately the most prudent option is having no redraw. However, this greatly reduces the financial flexibility of those who are 'ahead' in their mortgage repayments. Prudent banks use the 'months in advance' measure to assess macro-level credit trends in their portfolio and a significant change in capital treatment may disrupt this dynamic. Banks may reduce their offerings of redraws to customers, offering only offset account facilities to customers with their inherent limitations for prudent management as previously noted.

The absence of a redraw facility may also push these customers into higher interest and less appropriate credit forms relative to the redraw facilitate (i.e. a credit card or a personal loan). The redraw facility does provide a useful 'sweet spot' between more prudential stability and access to buffered funds for the consumer. It therefore follows that it should have a better capital treatment relative to the offset account.

Ensuring consumers continue to benefit from redraw facilities

A 100% CCF is likely to increase the costs on consumers for loans with redraw facilities. Redraw facilities provide significant value to consumers as the extra effort involved with a redraw facility can provide an element of discipline for consumers that may be tempted to dip into the readily available funds of an offset account. As such, this product should remain accessible to consumers. A lower CCF will assist this.

Reflecting the increasing level of prepayments, including for those well ahead in their repayments

COBA notes that the capital treatment of prepayment must not be set too conservatively given that the total volume of prepayments (balances in offset and redraws) have increased over the last few years.

As noted by the RBA, the “aggregate stock of mortgage prepayments remains large”. Excessive conservatism is likely to be exacerbated in a situation of increasing prepayments.

The latest RBA Financial Stability Review (FSR)[11] notes that these prepayments account for 16.5 per cent of the stock of housing credit. This is the equivalent of two and a half years of mortgage repayments. This compares to 10 per cent of outstanding balances in the 2012 FSR[12].

This increase could be due to households looking to build greater buffers. This is also likely to continue to increase in the current declining interest rate environment, where households do not automatically adjust their repayments in line with the prevailing interest rate . These households would be paying an extra amount beyond required repayment, therefore increasing prepayments.

In addition to the increasing level of prepayments, there are a significant proportion of loans that are well ahead in their prepayments. The latest FSR[13] shows that around 30 per cent of loans are 24 months or more ahead in their prepayments. Around 40 per cent are 12 or more months ahead. It is unlikely that a 100% CCF is appropriate in these situations. While ideally these specific exposures would be subject to a lower CCF, this is likely to be too complex. As such, the overall CCF should be lowered to account for these loans that are well-ahead in their prepayments.

Situation 2: where the loan is approved but not accepted by the customer

COBA notes that these exposures may not be considered to be ‘commitments’ under the revised definition in the draft APS 112[14]. This definition outlines that “[a] commitment is any arrangement that has been offered by the ADI and accepted by the client to extend credit, purchase assets or issue credit substitutes”. Given these loans have been offered by the ADI but not accepted by the customer, they would not constitute a commitment and therefore would not attract any CCF. COBA seeks clarification that this would not be a commitment.

If these are ‘commitments’, then APRA should retain the existing long-standing concessional treatment where these exposures are assigned a 0% CCF as outlined APG 112 para 6. The rationale supporting this paragraph (below) remains valid today.

> “In the case of commitments to provide residential mortgage loans, a long-standing concessional treatment exists since developments in the nature of residential mortgage lending have led to a situation where a significant proportion of the offers made by ADIs is not eventually accepted by customers. To accommodate this specific characteristic of residential mortgage lending, ADIs may assign a zero per cent credit conversion factor (CCF) to a commitment to provide a residential mortgage facility from the moment they issue a letter of offer up until the letter of offer is accepted or signed by the customer.”

A failure to do so will lead to an inefficient situation where excess capital is held against these potential exposures.

[11] RBA 2019, Financial Stability Review, Household and Business Finances, page 28. Available online.

[12] RBA 2012, Financial Stability Review – September 2012, Box B: Households' Mortgage Prepayment Buffers. Available online.

[13] RBA 2019, Financial Stability Review, Household and Business Finances, page 28. Available online.

[14] Draft APS 112 Attachment C para 1

Risk weights for loans with Lenders' Mortgage Insurance

COBA highlights concerns about the narrowed risk weight discount for loans with lenders' mortgage insurance (LMI) compared to those without LMI. This discount has narrowed from the existing APS 112. For 90% LVR loans, the difference is cut from 25 percentage points to 10 percentage points. This has the potential to impact mutual ADIs' ability to compete in the higher loan-to-value ratio (LVR) space. APRA should consider restoring the current discount level for LMI loans by further lowering the risk weighting for loans with LMI.

Table 1: Narrowed discount for LMI loans – difference between LMI and non- LMI

	Loan-to-value ratio					
	<50	50-60	60-80	80-90	90-100	>100
Draft APS 112	0	0	0	10	10	5
Current APS 112	0	0	0	15	25	25

If the LMI 'discount' is too small, it will reduce the incentives for institutions who may be able to self-insure to use LMI. This may impact the longer-term viability of LMI. It is highly unlikely that mutual ADIs will be in the position to self-insure. As a result, mutual ADIs may be subject to a weaker LMI market.

LMI plays an important role in allowing mutual ADIs to transfer the risk of higher LVR loans and compete in these markets. This is clearly articulated by Productivity Commission in its Competition Inquiry report:

> "We consider that the largest value to the Australian community from the risk management aspect of LMI is that it can encourage smaller lenders to more fully compete in the home loan market — particularly for higher LVR loans"[15]

For middle- & high-income Australians, the ability to save a deposit is a greater constraint on home ownership than the ability to service a home loan, particularly in the case of first home buyers[16]. LMI is one of the options that consumers can use to address this issue. LMI allows households to access the financial and non-financial benefits of home ownership sooner than they would otherwise do so.

LMI allows mutual ADIs to service our key markets of first home buyers and owner occupiers. From a consumer perspective, the absence of LMI could limit competition and choice in this segment. The use of LMI in Australia is significant with 23 per cent of owner-occupier loans having LMI (19 per cent for all loans).[17]

Any erosion of smaller ADIs' capacity to compete in the first home buyer market would have significant long-term competitive implications and could exacerbate concentration in the mortgage market.

[15] PC 2018, Competition in the Australian Financial System, page 365. Available online.

[16] Parliament of Australia 2019, NHFIC Amendment Bill 2019, Explanatory Memorandum. Available online.

[17] PC 2018, Competition in the Australian Financial System, page 363. Available online.

Risk-sensitive risk weights for non-standard loans

COBA maintains our view that there should be more risk sensitivity in the treatment of 'non-standard' loans. This should reflect the role that LVR and LMI play in reducing risk.

COBA notes that 'non-standard' loans can still be subject to factors that reduce their risks such as LVR (collateral) and LMI (insurance). The proposed 100% risk weight does not consider any of these factors despite the existing APS 112 framework doing so. This 100% risk weight is also well-above the Basel minimum of 75 per cent (i.e. the risk weight of a retail counterparty). This is likely to increase costs on consumers above the actual level of risk.

COBA acknowledges that these are unlikely to "form a material portion" of an ADI's residential mortgage portfolio. However, this is not a sufficient reason to entirely rule out graduated risk weights. Similarly, while COBA recognises APRA is seeking simplicity in this area, there are other ways to maintain simplicity. For example, limiting the 'tiers' for these graduated risk weights (i.e. like the reverse mortgage treatment). COBA also notes that the current framework has the 'complexity' of LVR and LMI.

There are many reasons for mortgages to sit outside the standard mortgage boundary. One area that has been raised with COBA is the need for a property to be 'readily marketable'. COBA notes that some of our members, particularly regional ADIs, may have a larger proportion of these types of non-standard loans. This may adversely impact the ability for all ADIs to lend in rural and regional Australia.

If APRA has concerns more broadly around non-standard loans, it should consider limiting the graduated treatment to certain types of non-standard loans – i.e. those where enough of the operational requirements are met such that LVR and LMI exist as risk mitigants.

COBA welcomes APRA's proposal to subject IRB ADIs to the same non-standard risk weight. While this reduces the competitive advantage of the major banks in this space, the flat risk weight will reduce the ADI sector's ability to compete against non-ADIs.

Definition of owner-occupier based on loan purpose

COBA support the use of the loan purpose-based definition in line with our submission on 6 June 2018 in response to APRA's query about sectoral views.

COBA members have recorded loan purpose data in line with their existing reporting requirements and may not have security usage data readily available for their existing mortgage books. If there is a change to security usage, these members would need to undertake a costly coding process, in addition to undertaking system and process changes. These changes would lead to marginal benefits but consume resources that could be better utilised in other areas

Other retail exposures

Risk weights on other retail exposures (including personal loans)

COBA recognises that APRA has increased the proposed risk weight on 'other retail exposures' to 125% based on the potential loss rates. This increase is likely to have a greater impact on the mutual ADI sector than the broader banking sector given our history as personal loan providers. COBA acknowledges that it appears that this risk weight is likely to be broadly in line with those seen from IRB lenders. However, COBA would like to ensure that there is transparency around the comparison against IRB lenders' risk weights in this area.

Table 2: Focus of mutual ADIs in the other retail category

	Total Loans ($m)	Other loans to households ($m)	% of total loans as other loans
Credit Union/Building Society/Mutual Banks	101,988	5,084	5.0%
Rest of ADI sector	5,430,906	177,776	3.3%

More broadly, APRA will need to consider about how this increased risk weight may create further incentives for a shift into the lower risk-weighted credit cards, or alternatively into non-ADI products such as buy now pay later products. This increased risk weight will increase the competitive advantage of non-ADIs in this area.

Retail credit cards CCFs

COBA recommends that APRA reduce the retail credit cards CCF further to 40% in line with the Basel standards. Credit card products are already under significant threat from non-APRA regulated providers such as the unregulated 'buy now pay later' sector. APRA should ensure the capital framework does not create a competitive disadvantage for ADIs. This could result in these exposures leaving the ADI system and also moving outside the *National Consumer Credit Protection Act 2009* regime and potentially also the Credit Reporting system.

Risk weights on loans secured by motor vehicles

COBA welcomes the introduction of this new risk weight category for "Loans secured by motor vehicles". However, COBA believes that the current 100% risk weight should be further lowered to 85% in line with an equivalent SME loan secured by motor vehicle [18].

A 100% risk weight treatment appears to be out of line with the IRB approach which could create a competitive advantage for IRB ADIs. Westpac's disclosures[19] show that the average risk weight is 80% for the 'other retail' category. This 'other retail' portfolio includes auto loans, New Zealand credit cards and personal loans. It is likely that based on APRA's proposed risk weightings that this would lead a standardised portfolio of well over 100% RW. Lowering this risk weight will reduce the gap and competitive advantage of IRB ADIs in this space.

A lower risk weight also better aligns with the credit card risk weight of 75%. This risk weight is significantly lower than the proposed risk weight for motor vehicles.

APRA should also consider the competitive advantage given to non-ADI lenders if this risk weight is too high. This is important given the conduct issues arising during the Royal Commission in the area of motor lending.

[18] Draft APS 112 Attachment B page 20 Table 12 Risk weights for unrated SME exposures

[19] Westpac 2018, Westpac Group September 2018 Pillar 3 report, page 49. Available online.

Flexible treatment of third-party lending exposures

APRA has proposed a 150% risk weight for “exposures through third-party lenders”. COBA suggests that APRA exercise some flexibility around this risk weight given that a very high risk weight risks stifling innovation.

APRA outlines the rationale that this increased risk weight is due to “the increased risks involved in this type of lending.” COBA considers that the requirements in APRA’s draft APS 220 and recent letter to ADIs on third party loans[20] will help manage these risks. COBA acknowledges that a higher risk weight is appropriate if these exposures are higher risk than the equivalent underlying loan, however, COBA would consider it more prudent to wait and see.

COBA believes that there needs to be more flexibility in the risk weight treatment to ensure this does not stifle innovation in this area as it may prevent the emergence of future business models that may or may not have these increased risks.

The proposed 150% risk weight also assumes that the underlying loan is an unsecured retail finance exposure. This exposure would normally attract a risk weight of 125%. However, COBA notes that personal loans may not be the only lending market prone to disruptions through these fintech models. Therefore, an unnecessarily high risk weight that is not tied to the underlying exposure could limit innovation in this space.

[20] APRA 2019, Letter to ADIs: Exposure to Third Party Lenders including Peer to Peer Lenders. Available online.

Other non-retail counterparty issues

Treatment of bank exposures – use of short-term ratings for interbank exposures

COBA has concerns about how the short-term & long-term ratings frameworks interact for interbank exposures. This may unnecessarily increase the capital held against mutual ADI exposures. This may make it less attractive for other ADIs to hold short-term exposures with mutual ADIs. This could increase the costs of mutual ADIs' funding options and consequently limit mutual ADIs' capacity to grow. Retaining diversity in funding options is critical given the strong growth in the mutual sector in recent years and the need to maintain these options to provide competitive pressure in the banking market. COBA seeks clarification in this area in the standard.

APS 112 Attachment B Para 11 outlines that an ADI with "an exposure to a bank with a short-term external credit rating" must use the 'short term' rating framework (Table 7), if this risk-weight is higher than under Table 8.

COBA questions whether "short-term external credit rating" is referring to an issue-specific or issuer-specific rating, and what occurs in the case where there is an issuer-specific rating but not an issue-specific rating.

For mutual ADIs with long-term issuer-specific ratings, COBA is not aware of any that do not have a short-term rating. These short-term issuer-specific ratings are at best, in credit grade 2 (A-2/P-2/F-2) while the long-term rating is in credit grade 3 (BBB tier). This means that under Table 7, if these exposures are short-term exposures, they would attract a risk weight of 20%. However, under the short-term framework (Table 8) they would attract a risk weight of 50%. Under para 11, this means that risk weight would be 50% not 20%.

COBA's starting point is that this refers to an issue-specific risk weight given that the Basel reforms refer to "For risk-weighting purposes, short-term ratings are deemed to be issue-specific". [21]

Similarly, the equivalent Basel reference mentions that this is a specific short-term rating:

> "When a specific short-term rating for a short-term exposure to a bank maps into a less favourable (higher) risk weight, the general short-term preferential treatment for interbank exposures cannot be used. All unrated short-term exposures should receive the same risk weighting as that implied by the specific short-term rating." [22]

Physical assets under leases

COBA notes that the proposed treatment of physical assets under leases (i.e. branches) could be an issue for the smallest ADIs.

APRA proposes a risk weight of 250% for the portion that is above 10% of Tier 1 capital. APRA should consider whether there needs to be an exemption for own premises (including branches). COBA notes that these 'own premises' are unlikely to be the aim of this treatment. The 2018 Consultation Paper highlights noting that "Concerns with the current capital treatment of ADIs' exposures to physical assets would also extend to instances where ADIs hold material exposures to fixed assets beyond their own premises."[23] This paper also outlines that these exposures are not the targets noting that "Leases can expose ADIs to the risks of owning various types of physical assets commonly subject to leasing, such as aircraft".[24]

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[21] BCBS 2017, Basel III: Finalising post-crisis reforms, page 32. Available online.

[22] ibid, page 33.

[23] APRA 2018, Discussion Paper: Revisions to the capital framework for authorised deposit-taking institutions, page 38. Available online.

[24] ibid, page 38.

Simplified Capital Framework

General Comments

COBA supports APRA's proposed simplified framework. We believe that this will reduce some of the regulatory burden of the capital framework.

COBA supports APRA's intent to prescribe a quantitative threshold set at a level to cover all mutual ADIs. However, COBA notes that the proposed $15 billion threshold may not cover all mutual ADIs by 2022.

Operational risk capital charge

COBA supports APRA's inclusion of a simplified capital charge for operational risk capital.

This reduces the regulatory burden for simple ADIs with respect to calculating operational risk capital.

COBA believes that APRA should further reduce this capital charge to 8 per cent in order to recognise the simplicity of these organisations.

Risk weighting capitalised information technology expenses for simple ADIs

COBA proposes that APRA introduce an alternative treatment for simple ADIs for capitalised information technology (IT) expenses. Currently, these expenses are a deducted from CET1 capital as they are considered to be 'intangible assets'. This treatment is overly punitive and does not reflect the importance of these assets to modern banking. It also creates a competitive distortion versus non-ADI lenders.

An alternative treatment would act as a carrot to invest in these areas. It is in both APRA's and regulated entities' interests for them to have competitive digital offerings and up-to-date systems. This is increasingly important given expanding regulatory requirements related to IT systems and the need to improve cyber resilience. Failure to provide a more favourable treatment will continue to give non-ADIs a competitive advantage over ADIs in this space.

Banking is a crossroads where there is significant digital disruption. As has been observed in Europe, "software is as necessary as an asset to produce banking services than a factory to produce cars".[25] The challenge of IT investment has fundamentally changed. The prudential standards have not reflected this.

The APRA Capability Review[26] outlines three keys to this disruption:

- ongoing transformation of existing regulated entities' IT landscape
- emergence of new technology-enabled business models, and
- increased competition from niche and scale technology competitors (i.e. 'techfins').

All three factors are driving increases in IT investment from ADIs. In all likelihood, ADIs are going to make these investments to remain competitive. However, the punitive capital treatment will reduce their ability to grow after making these investments. For an institution that is capital constrained this could potentially reduce their ability to invest. APRA Chair Wayne Byres has already acknowledged the need for greater IT investment:

> "Our reviews emphasise that, to facilitate new technology, investment budgets need to be increased, not just reprioritised. They will also likely need to be maintained at a higher level

[25] AFME 2018, AFME Position Paper CRD 5/CRR2: Capital treatment of Software. Available online.

[26] APRA Capability Review Panel, 2019, APRA Capability Review, page 22. Available online.

> than has been the case in the past to allow for a catch up on the backlog of maintenance that is needed."[27]

To mitigate any potential adverse prudential outcomes flowing from giving these investments a different, more favourable capital treatment, the new treatment could be subject to a cap and/or some boundaries around eligible expenses.

APRA would not be the first regulator to consider such treatment. It is already on the agenda in Europe:[28]

> "As a general rule, banks are required to deduct the value of software assets identified as intangible from their capital. This increases their capital needs. The co-legislators have agreed to exclude certain software assets from the scope of assets that need to be deducted from own funds. In order to ensure a level-playing field at international level and to foster the investments in software in the context of an even more digital environment, the European Banking Authority will be mandated to draft technical standards to define those software assets that do not need to be deducted.
>
> This specification is important as software is a broad concept that covers many different types of assets not all of which preserve their value in a winding-down situation. The technical standards should ensure prudential soundness, taking into account the digital evolution, difference in accounting rules at international level as well as the diversity of the EU financial sector including FinTechs.'

COBA is eager to work with APRA to further flesh out this proposal as it could deliver beneficial outcomes in terms of innovation, competition, consumer choice and financial system stability.

[27] Wayne Byres 2019, Peering into a cloudy future, Speech to 2018 Curious Thinkers Conference, Sydney 24 September. Available online.

[28] European Commission 2019, Adoption of the banking package: revised rules on capital requirements (CRR II/CRD V) and resolution (BRRD/SRM). Available online (see 3.4)