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COBA Supplementary Submission on ADI Capital Framework

Thank you for the opportunity to make a supplementary submission on APRA's proposed new capital standard (APS 112).

This submission is focused on proposed paragraph 46 *Exposures through third-party lenders*.

As noted in our 20 September 2019 submission, the proposed 150% risk weight for these exposures risks stifling innovation. We are also concerned the requirements imposed by this new paragraph are unclear and are inconsistent with the well-understood and risk-based capital requirements that apply under Attachment B of APS 112 to 'Corporate Exposures" and "Specialised Lending Exposures".

The use of third parties to originate loans is common practice in relation to all loan/asset types (including home loans, personal loans, motor vehicle loans and an extensive array of commercial lending facilities). In the case of non-retail credit exposures, the applicable capital risk weightings are clearly set out in Attachment B as being referable either to the external credit rating of the counterparty or, in the case of unrated counterparties, to the size of the applicable counterparty – see paragraphs 18 – 32 of the draft APS 112. The scope of the "Corporate Exposures' definition (see paragraph 18) is also very broad, as it includes exposures to "…trusts, funds and other entities that do not meet the definition of any other asset class" and hence applies to an ADI's credit exposures to trusts or structured vehicles even where the underlying exposures are retail in nature (e.g. car loans, equipment loans).

The above requirements in the draft standard are largely unchanged from those in the current standard and ensure that capital risk weightings are appropriately linked to the applicable risk-based factors of the counterparty's credit rating, size and/or the nature of the underlying asset types and security backing. Importantly there is no relevance, under this longstanding approach, to how any underlying credit exposures were originated in the first place.

By contrast, the new paragraph 46 in the draft standard proposes a 150% risk-weighting and introduces several new concepts (or determining factors) that clash with the longstanding approach in Attachment B. It is not clear what is meant by "a credit exposure **through** a third party" or "an online lending platform". Nor is it clear whether the paragraph only applies to retail loan exposures or is also intended to embrace commercial exposures. This uncertain application is not assisted by footnote 10, which says:

"*For the avoidance of doubt, the risk weight prescribed in this paragraph must be applied irrespective of the characterisation of the third-party counterparty or underlying borrower, i.e. an ADI must not risk-weight these exposures as corporate or retail exposures".*

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Does this mean that exposures that would otherwise have their risk-weightings determined under paragraphs 18 – 32 will automatically attract a 150% risk-weighting solely due to the fact that a third party (i.e. not the ADI with the exposure in question) was involved in the initial origination and approval of the loan?

If the approach taken in proposed paragraph 46 is to be adopted in the standard, it must be revisited to:

- clarify what is and is not meant by an exposure “through” a third party,
- clarify what is meant by “an online lending platform”,
- make clear whether or not the new higher risk weighting applies only to retail exposures or also to commercial exposures (and in either case whether it only applies to unsecured exposures),
- ensure that any additional capital required is commensurate with the underlying risks associated with the exposure, and
- ensure any treatment of these exposures does not inhibit innovative and more efficient approaches to loan origination, especially in relation to small business lending.

The current capital risk-weighting approaches under APS 112 and APS 120 are built on the risk associated with the underlying assets and/or the nature and creditworthiness of the counterparty and are not driven by how the relevant loan exposures were first originated (for example, there is no additional capital for home loans originated through mortgage brokers). Changing this longstanding approach has the potential to create significant inconsistencies and unintended consequences, including with respect to well-established securitisation structures.

APRA has previously provided guidance on how ADIs should manage certain types of “third party exposures” in its recent letter to ADIs on third party lending.[1] APRA has also outlined its preferred approach to third party credit assessment and approval in draft APS 220 paras 54 & 55[2]. These measures are likely to increase ADIs’ capacity to prudently manage such risk exposures.

Although APRA’s starting position appears to be that third-party originated credit exposures are automatically riskier, it is important to note that such exposures can arise in many different forms, each with differing risk characteristics and some with significant credit enhancement or risk mitigation features. Given such a diverse risk spectrum, the proposition of requiring additional capital due to “third party” involvement should continue to be considered as an ‘if necessary’. This aligns with the position put forward in APRA’s recent letter to ADIs, which noted that: “[APRA] will actively adjust capital requirements if considered necessary.” [3]

The overly blunt approach proposed in paragraph 46 provides no capital incentive to reduce risk within ‘third party’ loan origination arrangements. The only incentive is to exit third-party exposures. In our view, APRA’s framework should create capital incentives under these third-party approaches.

Clarification about what is considered a third party

Draft APS 112 paragraph 46 establishes three criteria which determine whether a credit risk exposure is subject to the 150 per cent risk weight. These are:

1. Third-party undertakes credit assessment of the underlying borrower,
2. Third-party undertakes credit approval of the underlying borrower, and
3. The above two are based upon the third party’s credit risk policies and processes.

There are a wide range of exposures in this space and APRA would need to clarify what is within scope of this treatment, e.g. does the higher risk-weighting apply to exposures to securitisation

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[1] APRA Letter to ADIs, Exposure to Third Party Lenders including peer to peer lenders, 25 March 2019

[2] Draft APS 220 Credit Risk Management (March 2019)

[3] APRA Letter to ADIs, Exposure to Third Party Lenders including peer to peer lenders, 25 March 2019

structures, as the latter often incorporate underlying loan receivables that have been originated, assessed and/or approved by third-parties?

While it may be clear at the extremes whether or not an exposure fits into a particular category, there are multiple cases in between that may not be considered to be pure third-party exposures (and therefore should not be subject to the higher risk weight).

Category	Description	Borrower relationship	Assessment	Approval	Credit Policy & processes
Not TPE	ADI exposure	ADI	ADI	ADI	ADI credit policy
Not TPE	Third party introduced, but not a TPE	Third party	ADI	ADI	ADI credit policy
?	Third party exposures originated within an ADI's parameters	Third party as agent for ADI	Third party as agent for ADI	Third party as agent for ADI	ADI credit policy, with audit
?	Securitised and rated third-party exposures	Third party	Third party	Third party	Third party lender's credit policy
TPE	Pure third-party exposure	Third party	Third party	Third party	Third party lender's credit policy

Capital impact on types of different types of exposures

For exposures 'within' scope, the proposed approach does not consider the risk from the underlying assets. It assumes that these exposures will always be an unsecured retail exposure. This is not the case in many circumstances (e.g, strata loans, business equipment loans), and this assumption will act as a barrier to innovation. There are already many types of residential property-secured exposures or SME exposures that are initially originated by third parties, rather than by ADIs directly. The table below shows the varying and unnecessary additional capital premium.

Underlying exposure	Proposed draft APS 112 risk weight	Third party exposure risk weight	Third Party additional 'premium'
'higher' risk home loans	25 to 95	150	+55 to +125
'lower' risk home loans	20 to 85	150	+65 to +130
Unrated retail SME	75 to 100	150	+50 to +75
Credit Cards	75	150	+75
Non-standard mortgage	100	150	+50
Secured by vehicle	100	150	+50
Other retail	125	150	+25

Proposed solution(s)

COBA proposes the following alternative solutions to the issue we understand APRA is seeking to address in paragraph 46.

Solution 1

Remove all 'third-party' references in the capital framework. The relevant risks are more appropriately dealt with through supervisory interventions. For example, APRA's revised APS 220 includes discretion for APRA to deal with these situations where "APRA considers that an ADI is taking excessive credit risk relative to its financial or operational capacity to manage or absorb that risk"[4]. Similarly, APRA has outlined in its letter to ADIs that it "will actively adjust capital requirements if considered necessary." [5]

Solution 2

Include a loading system where additional capital is added onto the ordinary risk weight applicable to the underlying exposure (as determined by reference to the type of asset or the creditworthiness/size of the borrowing counterparty). This system creates an incentive for ADIs to improve their credit risk and other due diligence practices relating to these exposures. This would extend as far as to having no additional capital in certain circumstances.

The various types of third-party exposure arrangements could be 'graded' by APRA and then moved up or down based upon supervisory judgements of an ADI's operational capacity or where an ADI works to reduce the potential risk of these arrangements. COBA notes that APRA already has the power to do this through its supervisory framework. This approach would clearly communicate an incentive for ADIs to reduce or mitigate risk with respect to any such arrangements.

	Grade 1	Grade 2	Grade 3
Additional risk weight loading onto underlying risk weight	+0%	+10%	+25%

[redacted]

Yours sincerely

[redacted]

Chief Executive Officer

[4] See draft APS 220 Credit Risk Management para 107 & 108. Para 107: "Where APRA considers that an ADI is taking excessive credit risk relative to its financial or operational capacity to manage or absorb that risk, APRA may set limits on particular exposures or categories of exposures that may be held by that ADI, including but not limited to limits on growth or limits on the share of the ADI's portfolio, or may require the ADI to cease a particular type of lending or credit activity."

[5] APRA Letter to ADIs, Exposure to Third Party Lenders including peer to peer lenders, 25 March 2019