Revisions to the capital framework for ADIs

Review of the APRA response to submissions, 12 June 2019

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Revisions to the capital framework for authorised deposit-taking institutions

Judo Bank Pty Ltd ('Judo Bank') submission to The Australian Prudential Regulation Authority ('APRA') – September 2019

Executive summary

Judo Bank welcomes the opportunity to continue to contribute to the consultation by APRA into the proposed revisions to the capital framework for authorised deposit-taking institutions ('ADI').

In June 2018 Judo Bank (then known as Judo Capital) provided its submission in response to the APRA discussion paper on the proposed revisions (February 2018).

The purpose of this submission is to provide the subsequent considerations by Judo Bank into the responses by APRA (12 June 2019). This submission is to provide the following for consideration by APRA:

1. **Impact of deferring implementation**
   - Capital impositions from the change to the timing for implementing the proposed revisions from January 2021, to January 2022, for SME exposures not secured by property.
2. **Risk Weight models for Small Medium Enterprise ('SME')**
   - Proposed change from 100% Risk Weights for SME, to the proposed average of 85% continues to encourage residential property security; and while the proposed reduction is welcomed it does little to address the issues with the entrenched, industrialised approach to SME lending.
3. **Recognition of core business assets as collateral for SME lending**
   - Opportunity to recognise the value of stock and debtors as core business assets of SMEs and include in the assessment of market value of physical collateral that can mitigate losses in the event of default for the calculation of Risk Weights for SME exposures.
4. **Operational risk capital calculation**
   - Flat-rate capital add-on of 10% increases the variation between Risk Weights for residential property secured lending and SME loans; with a compounding factor to the calculation of capital that is required.

Context

In 2017 Judo Bank provided its response to the APRA Discussion Paper on the proposal for phased licensing for ADIs. Judo Bank remains supportive of enhancements to policy frameworks that stimulates increased competition, and in April 2019 obtained its banking licence to operate as an ADI in Australia's highly-regulated banking system. This recognises the commitment of Judo Bank to contribute to Australia's banking industry where capital ratios are considered unquestionably strong, providing Australia's SME businesses with competitive alternatives.

Through its own progress to operations with an ADI licence and its focus on Australian SMEs, Judo Bank has gathered significant insights into policy development, and the practical application of policy.

There are considerable benefits to Australian SMEs from the effective deployment of capital, with the business banking market estimated at $760 billion of outstanding loans (excluding lending to financial institutions) of which approximately 40 percent ($300 billion) is in SME lending. Compared with bank lending to the household sector which in 2018 reached $1.8 trillion, of which $1.68 trillion is to residential mortgages.

The SME Banking Insights Report for 2018, commissioned by Judo Bank, found almost two thirds of respondents (63.1%) to the Insights Report (responses from 1,752 SME owners and managers), said they planned to borrow money in the next 12 months. The average sum sought is $700,000, with new borrowings predominantly intended: to support cash flow and relieve working capital constraints (61.0%); and the acquisition of business equipment/plant (36.6%).

The SME Banking Insights Report for 2019, found the finance gap for businesses with a turnover of up to $20 million has ballooned over the past 12 months from $83 billion to $90 billion.

Judo Bank contributed to the consultation into the revisions proposed in the APRA Discussion Paper dated 14 February 2018 ("Discussion Paper") to the capital framework. The Response to Submissions by APRA dated 12 June 2019 is another opportunity for Judo Bank to contribute its observations and the learnings gathered in practice to the exchange of information with APRA and other regulators to enhancements to policy frameworks.

There are four key areas identified by Judo Bank that should be addressed by the proposed revisions to the capital framework. The benefits of the recommended approach is: allocation of credit to Australian SMEs; Risk Weight models that supports the effective deployment of capital; and increased competition.

1. Impact of deferring implementation to January 2022

1.1 Judo Bank acknowledges that time is required to prepare for new and changed regimes. However, the proposed deferral by 12 months burdens ADIs focused on Australian SMEs by retaining the capital impositions from the inability to access the proposed Risk Weights for SME exposures not secured by property (ranging from 100% to 75%, expected to average 85%).

1.2 There is an urgency to addressing this practical impediment to the efficient allocation of lending to the productive SME sector, and the ability of Australian SMEs to deploy those funds in productive business investment. Encouraging the deployment of capital and funding to the SME segment of the economy is beneficial in the current economic conditions, and as one step to addressing the decline in the stock of SME lending declined as a share of GDP while household debt has soared.

2. Risk Weight models for SME exposures

2.1 The proposed reduction to SME exposures not secured by property is set out in section 3.2, Chapter 3 – Credit risk: Other exposures under the standardised approach. The development of the range between 100% and 75% that is now proposed is supported.

2.2 It's noted the expectation of APRA that considers an average Risk Weight of 85%. This maintains an expected variation from the 75% Risk Weight that will apply under BIS Basel III standards ('Basel III'). In its submission dated June 2018, Judo Bank raised a question about this variation with the Risk Weight that will apply under Basel III. Judo Bank believes the Risk Weights proposed in Basel III are appropriate, particularly given the ability for APRA to impose Prudential Capital Requirements specific to the business model pursued by each ADI.

2.3 It's noted in Canada and the United Kingdom the retail risk weighting of 75% is assigned to SME lending not secured by residential property (subject to conditions and a maximum value). SME loans not meeting these conditions are assigned a 100% risk weighting (Productivity Commission Inquiry Report Competition in the Australian Financial System No. 89, 29 June 2018).

Australian SMEs applied for $800,000 in new credit on average (Judo Bank SME Banking Insights Annual Report – Sept. 2018). Mirroring the Canadian or UK approach with 75% risk weighting to a limit of say $1,000,000 may provide an efficient method of applying the revisions proposed for Australian SMEs, and to then step up risk weightings to 85% and 100%. All proposals require analysis to ensure the facts and data support the intended outcomes set out in the APRA Response (12 June 2019, Chapter 3 section 3.2 'SME exposures') and avoids any unintended consequences,

2.4 The data and analysis from the results of the second Quantitative Impact Statement ('QIS') will be important to assess the proposed tiered approach to SME exposures, and the stated requirement to allocate an additional 10% in regulatory capital to that which is proposed in Basel III to achieve the proposed average Risk Weight of 85%.

2.5 The proposed reductions to Risk Weights for SME exposures not secured by property maintains the considerable incentivisation for lending secured by residential property. Judo Bank consistently comments on this systemic issue, notwithstanding its business model is designed to support Australian SMEs. Most recently, Mr Joseph Healy, Co-CEO, presented on SME Financing at the Monash University Business School's Australian Centre for Financial Studies Conference (22 July 2019) on the Hayne Royal Commission: Implications for the Australian financial sector. In Mr Healy's paper, presenting on some of the key issues impacting SMEs, the need for more public policy intervention was argued.

3. Recognition of core business assets as collateral for SME lending

3.1 Recognition of assets as collateral that may act to mitigate losses in the event of default can be extended to include: Stock; and Debtors. These are core business assets of many Australian SMEs and excluding Stock and Debtors is prohibitive in supporting the growth in lending to this productive segment. The assets recognised as collateral in the proposed in the APRA Response (12 June 2019, page 25, 26) are physical assets. Debtors hold value and as core business assets their inclusion is supported. In Advanced IRB risk models, LGD values extended to these assets (particularly Debtors) is favourable from a capital allocation perspective and exclusion of this from the revised capital framework would continue to maintain a material structural separation in capital allocation between Advanced IRB ADIs and Standardised ADIs in SME lending.

3.2 Applying value to these asset classes, i.e. Stock, Debtors, is another mechanism to enhance the deployment of capital through recognition of the market value of the collateral provided by SMEs as a percentage of the exposure.

4. Operational risk capital calculation

4.1 The flat-rate of the proposed 10% capital add-on to RWA for Operational risk is, on face value, an effective method to apply a simplified framework.

4.2 However, this sustains the variation between property and non-property collateral used as security:

- Residential-property secured debt, the range is between 20% and 85%;
- SME lending, the proposed range is 75% to 100%.

The impact is evident when comparing the effect of the 10% capital add-on to the different Risk Weights. The inadvertent effect of this simplified approach is to disproportionally increase capital requirements on higher risk weighted assets (such as SME lending) compared with the current standardised approach to operational risk capital. Where an ADI has a focus on higher risk weighted lending (such as SME loans) we request that there is consideration to normalise this impact.

To illustrate, for a single loan of $1,000,000 the impact on RWA for Operational risk as the level of security varies is presented in the tables below.

Table 1: Indicative risk weights for residential mortgage exposures under the revised capital framework and standardised approach; Owner-occupied principal-and-interest mortgages; no LMI.

	Owner-occupied principal-and-interest mortgages				
LVR	<=50%	<=60%	<=80%	<=90%	<=100%
Risk weight assets ($)	200,000	250,000	350,000	550,000	700,000
Operational risk RWA ($)- Revised Capital Framework	20,000	25,000	35,000	55,000	70,000
Operational risk RWA ($)- Standardised (Current APS 114)	52,500	52,500	52,500	52,500	52,500

Table 2: Indicative risk weights for $1,000,000 SME exposure under the revised capital framework and standardised approach;

		SME Loan	
LVR	<=60%	<=100%	>100%
Risk weight assets ($)	750,000	850,000	1,000,000
Operational risk RWA ($)- Revised Capital Framework	75,000	85,000	100,000
Operational risk RWA ($)- Standardised (Current APS 114)	65,625	65,625	65,625

While conscious of the benefit of simplicity, Judo Bank does not believe there is an inherent direct connection between lending RWAs and operational risk exposure.

In summary.

Judo Bank welcomes the opportunity to continue to contribute to the consultation by APRA into the proposed revisions to the capital framework for authorised deposit-taking institutions ('ADI').

While there is not one solution that will remedy access to capital by Australian SMEs, there is an urgency to build momentum in the changes to the efficient allocation of capital. It's important to note that Judo Bank views this as opportunity for greater public policy intervention on matters such as creating an even playing field amongst lenders; and increasing competition, which is badly needed given industry structure.

Judo Bank considers that it is filling a market gap by basing credit assessment of SMEs on all of the four C's of Credit, compared to the incumbent approach of looking primarily to residential property security as collateral. As such, Judo projects a significant reduction in credit RWAs on the implementation of the revised capital framework. The 12 month delay in implementing the revisions presents a challenge for Judo Bank and other ADIs aiming to address this gap by looking beyond residential security, as such institutions will be left with two unpalatable options for managing through this period:

1. Raise significant amounts of additional capital during 2021 and drop back to an over-capitalised position upon the introduction of the revised capital framework in 2022.
2. Defer growth in non-residential secured lending until the revised capital framework is introduced.

It should be noted that there is no guarantee that capital markets will support Option 1, leading to ADIs defaulting to Option 2 and the gap in credit availability remaining at its current level.

About Judo Bank.

Built by some of Australia's most experienced bankers - Judo Bank is a purpose-built Challenger (and not a Fintech) that has come to market to address the growing dissatisfaction with, and the gaps inherent in the offerings of the incumbent banks.

The objective in forming Judo Bank is to build a unique banking offering that delivers the best aspects of genuine relationship banking coupled with a strong culture of risk management.

Judo Bank gained the banking licence in April 2019. For Judo Bank, a banking licence is seen as a privilege that will allow it to not only compete as a bank, but also to present the strength of its unique, alternative offering to the marketplace and add genuine value to the Australian SME market.

Details on Judo Bank can be found at www.judo.bank