CUSTOMER OWNED BANKING ASSOCIATION

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Dear

APS 111 Capital Adequacy: Measurement of Capital

COBA appreciates the opportunity to provide a submission to the APRA's APS 111 consultation.

COBA is the industry association for Australia's customer owned banking institutions (mutual banks, credit unions and building societies). Collectively, our sector has $128 billion in assets, around 10 per cent of the household deposits market and more than 4 million customers.

This submission makes the case to change the treatment of capitalised information technology software costs in APS 111 to better balance all of APRA's objectives in today's operating environment for banking. This builds on the proposal raised in our 20 September 2019 submission on revisions to the capital framework for ADIs and in a subsequent discussion with APRA.

Reducing barriers to invest in software

COBA proposes that APRA should commit to implementing a less punitive capital treatment for capitalised software expenses.

Given these assets are currently identified as intangible assets, they are deducted from Common Equity Tier 1 (CET1) capital. This in practice leads to a risk weight of 800% to 1250% compared to a fixed weight of 100% if they were a tangible asset. Essentially, every dollar in software investment needs to be funded by an additional dollar in regulatory capital (equity). This is a disincentive to invest in these types of assets given that capital is a limited resource. Capital is critical for ADIs in today's environment as it is needed to underpin the additional loan growth to reach scale efficiencies or offset declines in the net interest margin.

As APRA has noted[1], operating models in banking are being transformed as entities embrace automation, digitisation and the internet to achieve efficiencies, improve information exchange and enhance customer experience. For smaller players, such as customer owned banks, technology offers the possibility of greatly enhanced competitive capacity.

The rapid pace of technological change includes a massive increase in the availability of, and the ability to process, data. These developments also enhance APRA's supervisory capacity.

[1] APRA Chair Wayne Byres' speech to COBA2017 Individual challenges and mutual opportunities (23 October 2017). Available online.

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Investment in technology can improve resilience (e.g. managing cyber risk), efficiency and competition. The punitive capital treatment of software investment is a barrier to such investment.

Requiring ADIs to deduct software assets from CET1 suggests that such assets hold no value when they could be the ADI's most valuable assets. Currently, a piece of furniture is given more value than critical software.

This outcome is driven by the capital framework's assumption that the exit of an ADI is via liquidation. We propose that the likelihood of other means of resolution should be factored into the treatment of capitalised software costs. Software that is critical to banking operations is likely to be valuable in the resolution of an exiting bank by merger with another bank.

In the European Union, this has been recognised by banking regulatory policymakers. The EU is working on new rules acknowledging that due to the evolution of the banking sector in the digital environment, software is becoming a more important type of asset. The EU is proposing that certain prudently valued software assets should not be subject to the deduction of intangible assets from Common Equity Tier 1 items.

By taking similar action, APRA has the opportunity to promote competition and efficiency while preserving the financial safety of institutions and the stability of the Australian financial system.

COBA believes that a risk-weighted approach for software assets is more appropriate than deduction.

A more favourable treatment would act as a carrot to invest in these areas. COBA members have noted that the current treatment limits their pace of investment in this area. It is in the common interests of APRA, consumers and ADIs for ADIs to have competitive digital offerings and up-to-date systems. This is increasingly important given expanding regulatory requirements related to IT systems, reporting and data management obligations, and the need to improve cyber resilience. Regulatory barriers to these investments should be lowered or removed. A failure to provide more favourable treatment will continue to give non-ADIs a competitive advantage over ADIs.

If APRA wishes to proceed cautiously, it has the following options:

- restrict eligibility for the new treatment to standardised ADIs or an even smaller category, such as ADIs with assets of less than $25 billion
- impose a hard cap on the impact on an individual ADI's regulatory capital, and/or
- impose a relatively high risk weight (e.g. 200%).

A changing operating environment

Everything a bank does is now dependent on its software. As noted above, the requirement to deduct these expenses from capital suggests there is no value in these assets. However, this is not correct as this software is essential to the operation of the bank, and arguably has significantly more value than any of the bank's physical assets.

The importance of software in banking is evident with the recent proliferation of new 'digital' start-up banks. None of these models involve significant physical assets, but rather proprietary software and other technological advantages. The customers of a bank built from 'first principles' engage with their bank without anything more than using an application interface on their phone.

An amended framework would recognise that rapid technological change is a given and provide ADIs, particularly smaller ADIs, with the flexibility to continue to invest to be part of this technological change. The APRA Act Explanatory Memorandum outlines the needs for 'flexibility' in the interpretation of its mandate:

> This flexibility is considered to be of particular importance at a time when the financial system is, and will continue to be, subject to rapid change arising from such factors as globalisation and technological change.'[2]

This statement was written more than 20 years ago. If it was true in 1998, it is even more so in 2020 where the pace of technological change has exponentially increased.

Increasing need for software investment in banking

Investing in software and information technology is critical for a bank to remain competitive in a digital first world. In fact, it now underpins the strategies of nearly all the new competitors. Deloitte notes that "Consumers around the globe expect their banks to act and interact more like top technology brands."[3] Consumers now expect a digital first experience.

It is unsurprising that the neobanks are self-prescribed as 'digital' banks'. This outlines the primacy of technology in the banking sector. For example:

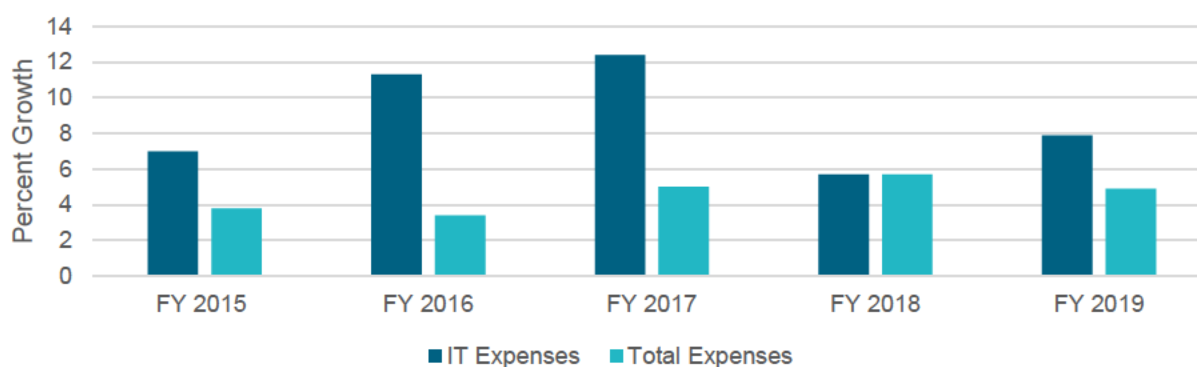
- 86 400 describes itself as a "challenger digital bank"
- Archa outlines its offering as a "new digital account that you can manage through a beautiful mobile app and debit card "
- BNK has the tag line of "digital banking for everyday Australians"

Technology investment in financial services is significant and it is expected to continue to grow at an exceptional rate with Gartner noting that "Technology spending in the banking and securities sector in Australia is expected to reach A$18.5 billion in 2020, an increase of 5.2% from 2019"[4]. In fact, globally the banking sector spends the most of all sectors on information technology products and services.

Increasing information technology investment in the customer owned banking sector

The customer owned banking sector is subject to growing pressure to increase technology spending (see Chart 1). Our sector is subject to the same customer, efficiency and compliance factors that drive the technological investment in the broader banking sector. In nearly all the last five years, information technology expenses growth has exceeded total cost growth.

Chart 1: Customer-owned banking sector information technology expenses[5]



[2] Australian Prudential Regulation Authority Bill 1998, Explanatory Memorandum, clause 4.10.

[3] Deloitte 2018 Accelerating digital transformation in banking: Findings from the global consumer survey on digital banking. Available online.

[4] Gartner 2019 Gartner Forecasts Australian Banking and Securities IT Spending to Grow 5.2% in 2020. Available online.

[5] Note these figures include all IT expenses and not just those capitalised as assets. Data is sourced from KPMG Mutual Industry Review publications since 2015.

COBA expects investment in these areas to increase as customer-owned banks undertake digital transformations to improve customer experience and reduce cost-to-income ratios. A KPMG survey identifies “Technology and transformation of business” as the biggest opportunity for the mutual sector to improve their performance.[6]

S&P Global ratings this month said that technological developments will require the greatest investment over the next two years for mutual ADIs, both to meet regulatory requirements (e.g. Open Banking & Comprehensive Credit Reporting) and to remain agile with respect to the evolving digital requirements of their customers.[7]

In terms of the potential quantum of intangible software assets on the sector’s balance sheet, COBA estimates around $110 million in these assets (net of amortisation) for our largest members.[8]

Capital deductions are particularly punitive to smaller ADIs due to their fixed costs and reduced ability to raise capital. While mutual ADIs now have enhanced capacity to raise equity capital, many information technology projects would not be able to meet the necessary return on equity hurdle to be able to justify a costly capital issuance (particularly if they are driven by regulatory compliance requirements).

Increasing regulator expectations

Alongside the increasing consumer and industry expectations, regulators have also started to increase the expectations of technology investment. While an ADI’s ability to undertake this investment depends upon its individual circumstances, reducing any barriers in the regulatory framework will assist with this investment task. ADIs are entitled to a consistent approach from regulators, i.e. if regulators require greater investment in technology, they should reduce barriers to such investment.

APRA Chair Wayne Byres has highlighted the need for the quantum of investment to increase rather than just be reallocated:

> “A concern for APRA is that the understandable desire to invest in new technology-enabled products and services, coupled with the necessary investment in cyber security and risk mitigation, comes at the expense of ongoing maintenance of existing technology platforms. This is particularly problematic given the legacy infrastructure on which many institutions are currently operating, often a patchwork of systems that have been bolted together over many years. “How should we allocate our investment’’ is an important question, but a more important precursor is: “How much do we need to invest?”[9]

These regulator expectations are not just limited to the risk management and cybersecurity spaces and have flowed onto the need to automate reporting systems. Undoubtedly this is likely to provide efficiencies for both ADIs and regulators. However, where these investments sit in terms of the ‘allocation’ priority list based on the rate of return is likely to be towards the lower end. This creates a need to increase the quantum of investment in order to meet regulatory expectations.

> “APRA’s recent survey of reporting entities showed that around three quarters of entities still complete their submissions manually, despite the availability of alternative file-based submission methods in D2A. APRA considers that this will need to change when data collections are updated in the future, and entities will need to take the opportunity to increasingly automate their reporting as manual reporting will not be sustainable.”[10]

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[6] KPMG 2019. Mutual Industry Review 2019: Maintaining trust and transforming for the future. Page 18.

[7] S&P Global Ratings 2020. Australia’s Mutuals To Grind Through Tough Operating Conditions *(*19 Feb 2020)

[8] COBA estimates based on COBA member FY2019 Annual Reports.

[9] APRA Chair Wayne Byres’ speech to the 2018 Curious Thinkers Conference (21 September 2018). Available online.

[10] APRA Email: Update on APRA’s new Data Collection Solution (29 October 2019). Available online.

This automation goes hand-in-hand with an expanded data collection scope given that "APRA plans to collect more granular, detailed data in the future." This could mean further changes to systems. APRA is not the only regulator looking towards a more technology-enabled future. ASIC has outlined strong sentiments around the potential of technology, particularly regulatory technology.

> "ASIC considers that the regulatory technology (regtech) sector has enormous potential to help businesses build a culture of compliance, identify learning opportunities, and save time and money relating to regulatory matters"[11]

Prudential benefits of software investment

At first glance, any proposals to reduce the capital held against these assets could be seen as a 'weakening' of the prudential standards. However, this view does not consider any of the benefits (including to financial safety and stability) arising from increased technology investment as a 'going concern'.

There are clear benefits of more technology investment for smaller ADIs.

Investment	Benefit
Customer-facing technology	Improves an ADI's ability to grow and its sustainability
'Back office' efficiency technology	Reduce cost-to-income ratios and improves an ADI's sustainability
Cybersecurity technology	Reduces cyber risk
Risk management technology	Reduces compliance risk and helps an ADI address regulator demands
Regulatory reporting technology	Increases the quality of information available to APRA for supervisory purposes, which should then reduce risk of a disorderly failure. Improves information to ADIs for management purposes.

Prudential costs of capitalised software investment

Given these assets are currently identified as intangible assets, they are deducted from Common Equity Tier 1 (CET1) capital. This in practice leads to a risk weight of 800% to 1250% compared to a fixed weight of 100% if they were a tangible asset. Essentially, every dollar in software investment needs to be funded by an additional dollar in regulatory capital (equity). This is a significant disincentive to invest in these types of assets given that capital is a limited resource. Capital is critical for ADIs in today's environment as it is needed to underpin the additional loan growth to reach scale efficiencies or offset declines in the net interest margin.

This is an issue for all banks, where software investment is treated as an intangible asset.

European Banks have been at the forefront of action on this issue. Similar to Australia, these assets are also treated as intangible assets for regulatory capital purposes and hence deducted from capital.

[11] ASIC Regtech initiative series 2018-19. Available online.

The European Banking Federation's Gonzalo Gasós outlines these concerns:

> "Banks contribute to the digitalisation of the EU economy. They need to invest in software development to remain competitive and to strengthen their cybersecurity. Many MEPs are aware of this fact and have tabled amendments to remove the deduction from capital. The Council should put this crucial issue over the table as soon as possible. This cannot be ignored.
>
> "Some argue that software might not have value in liquidation. I don't agree with that. Let me explain: there are 3 tools to resolve a bank: the bail-in, the bridge bank and the sale of business.
>
> "The main goal of the bail-in and the bridge bank, is to maintain the critical functions after the resolution without disruption; software is precisely that: a critical function. You may agree with me that a bank can't operate without its software. Yet, how come in current legislation more value is given to a lifeless table than to vital software. Up to 12 times more value in terms of cost of capital. This needs to be fixed as soon as possible.
>
> "As to the sale of business in resolution, let me give you a clear example: a bank that was resolved by the Single Resolution Board 10 months ago is still using the same software. Do we need more evidence?"[12]

In response to these concerns, the European Commission and European Banking Authority have outlined a clear policy position:

> "Due to the evolution of the banking sector in an even more digital environment, software is becoming a more important type of asset. Prudently valued software assets, the value of which is not materially affected by the resolution, insolvency or liquidation of an institution, should not be subject to the deduction of intangible assets from Common Equity Tier 1 items."[13]

The EBA is expected to consult guidance around these risk weighted software assets in Q2/Q3 2020.[14]

COBA believes that such a position on risk weighting should be taken in Australia. For simplicity's sake, we would prefer a broader definition of 'software' assets, rather than the EU's very specific formulation, noting the significant benefits and value that these assets generate outside of resolution, insolvency or liquidation.

It is not only customer owned banks that would benefit from such an approach, with neobank 86 400 raising this issue in its submission to the current Senate Fintech Inquiry.

> "The net effect of the regulation is that we are forced to raise additional regulatory capital for every investment we make in our proprietary technology. 86 400 achieves a better capital outcome for investment in a $100 office chair than it does for $100 in software development. This is a significant disincentive for start-up ADIs to invest in the technology needed to drive better customer outcomes and better competition in the industry."[15]

Why is the capital framework so punitive?

The prudential framework is heavily skewed towards the assumption of liquidation. There is an assumption that there is no value to intangible assets in a wind up. While this could be true for some

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[12] EBF Gonzalos Gasós' speech to Banking Package Review Event (11 April 2018). Available online.

[13] European Parliament 2018. Regulation (EU) 2019/875 (20 May 2019) para 27. Available online.

[14] European Banking Authority 2020. The EBA 2020 Work Programme. Page 16. Available online.

[15] See 86400 submission to Fintech Senate Issues Paper. Page 7 (24 December 2019). Available online.

types of intangible assets, software should be treated differently. Software is now critical to a bank's operations.

> "The prudential standards of the capital adequacy framework however, is biased more heavily towards a liquidation basis, which seeks to ascribe a realisable recognition and measurement basis for assets and capital supporting an ADI's operations"[16]

COBA believes that this 'liquidation' assumption is too narrow. It is highly unlikely that an ADI (particularly a smaller ADI) would be able to get to a situation where a liquidation would occur. APRA has recently been given additional tools to intervene more proactively if an ADI is heading towards this path. COBA also believes that an institution that has invested in software systems is likely to be a more attractive merger or acquisition prospect if it does come to that point.

Addressing concerns about capitalised expenses as 'tangible' assets

COBA notes APRA's concerns articulated in its 2003 Policy Position Paper:

> "APRA has been monitoring the growth in the recognition of capitalised expenses by ADIs over a number of financial years and is increasingly concerned about the potential growth in value of these assets relative to regulatory capital and the consistency of accounting treatment across ADIs."

These concerns are not insurmountable and COBA believes there are ways to design a regime that can addresses these concerns if they remain valid today.

Consistency of accounting treatments across ADIs

COBA members have noted that the accounting treatment of software is determined by the relevant Australian Accounting standards in terms of what is defined as an intangible asset and what is able to be capitalised. These updated and audit requirements should reduce any concerns about the consistency of the accounting treatment across the ADI industry.

Potential growth in value of these assets relative to regulatory capital

If APRA retains any concerns about the potential growth in these assets relative to regulatory capital, then APRA could apply a cap to provide a 'backstop' on this treatment. This could be pegged at a percentage of regulatory capital. This would allow the risk weighting of these assets (i.e. treating them as tangible) up to a certain point beyond which they would be deducted (i.e. treated as intangible). COBA notes that a similar approach was used for equity exposures to the Australian Business Growth Fund. Like intangible assets, equity investments are also fully deducted from CET1.

> "An ADI that invests in the ABGF will be able to apply a risk weight of 250 per cent to their investment. This compares to the current capital treatment of a full deduction from Common Equity Tier 1 (CET1) Capital for these investments. This revised treatment recognises the wider financial system benefits from increasing access to financing for SMEs."
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> "To ensure that risks to ADIs of investing in the ABGF are contained, an ADI will only be able to invest up to 2 per cent of its Level 1 CET1 Capital in the ABGF."[17]

This approach would address APRA's 2003 concerns where "the relevant items comprise up to and exceed 10% of the ADI's regulatory capital base. APRA does not consider it prudentially appropriate for such material proportions of capital to be represented by capitalised expenses."[18]

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[16] APRA 2003. Policy Position Paper on the Prudential Treatment of Capitalised Expenses. Page 5.

[17] APRA 2019. Capital treatment of investments in the Australian Business Growth Fund. Available online.

[18] APRA 2003. Policy Position Paper on the Prudential Treatment of Capitalised Expenses. Page 3.

Thank you for the opportunity to provide a submission. Please contact , Director – Policy, on or , Senior Policy Manager, on if you have any questions.

Yours sincerely

Chief Executive Officer