1 April 2021

General Manager Policy Development
Policy and Advice Division
Australian Prudential Regulation Authority
GPO Box 9836
Sydney NSW 2001

By email: ADIpolicy@apra.gov.au

Dear ,

Revisions to the capital framework for authorised deposit-taking institutions

The Australian Financial Markets Association (AFMA) welcomes the opportunity to make comment on APRA's proposed revisions to the capital framework. We acknowledge APRA's key objectives for the reform of the ADI capital framework:

- To strengthen the capital framework to incorporate 'unquestionably strong' capital benchmarks, and
- Ensure adherence with the internationally agreed Basel III framework.

We note APRA has acknowledged that ADIs are already meeting the 'unquestionably strong' benchmarks, and that it is not seeking to further increase the overall level of capital in the banking system. This notwithstanding, any internal reallocation of capital within ADIs will invariably have a negative impact on certain business lines, and this has been raised as a concern for our domestic bank members engaged in the delivery of retail margin lending products.

These members are concerned that as currently drafted, APS 112 has the potential to require the application of a 40 per cent credit conversion factor (CCF) to the undrawn portion of client's notional credit limit. This is a material change from current regulation, where retail margin loans receive favourable treatment relative to the broader class of securities financing transactions (SFTs). This current treatment reflects the view of members that, in practice, the product displays the characteristics of uncommitted and discretionary lines of credit, where a facility limit doesn't reflect a near term "plan of use" on the part of the client, and where, absent satisfaction of the lender's collateralisation conditions precedent, the latter is not obliged to allow drawdown.

It is noteworthy that since the introduction of legislation in 2011 mandating margin lending as a regulated financial product under the Corporations Act, historical loan losses (and particularly of ADI lenders) have been demonstrated to be immaterial, a testament to the effectiveness of credit risk mitigation techniques used by the ADI lenders.

Australian Financial Markets Association
ABN 69 793 968 987
Level 25, 123 Pitt Street GPO Box 3655 Sydney NSW 2001
Tel: +612 9776 7955 Fax: +61 2 9776 4488
Email: info@afma.com.au Web: www.afma.com.au

This submission seeks APRA's consideration of, as the optimal outcome, maintaining the current exemption from the application of the CCF on the undrawn portion of the lending cap, or, in the event APRA is not inclined to accommodate this, applying the CCF to the maximum accessible unutilised portion of the margin lending facility after taking into account the notional credit limit, the lendable value of eligible collateral held and the drawn balance.

AFMA's arguments as to why this consideration should be given are detailed hereunder.

Off-balance sheet treatment as an uncommitted facility

The borrowing capacity of the client is recorded as an off-balance sheet notional credit limit, this being the maximum amount of funds available to the client without additional authorisation or approval, and reflects the maximum that the client may draw down based on the loan conditions, ie the notional credit limit and the maximum allowable loan-to-valuation ratio. AFMA contends that retail margin lending facilities display operational characteristics more representative of an uncommitted facility and generally lack the justification to be now assessed as a commitment to lend. The following are relevant to this argument.

Client's discretion as to use of funds

Unlike the case for committed and working capital facilities, the margin lending client is not required to submit a detailed commercial or personal finance 'use of funds' business plan incorporating cash flow commitments that are generally attendant in the former.

Rather the facility is provided to the client with discretion as to how and when it will be availed of, this generally being to take advantage of financial market aberrations from which the client seeks to take advantage, ie by it dealing in a financial product, or when the combination of prevailing interest rates and expected investment returns looks attractive.

Due to the discretion as to use afforded to the client, margin lending facilities have tended to remain largely unutilised, particularly regarding any use to raise cash. Rather, facility access is generally to institute an investment strategy should the opportunity present itself, and where the target investment is then pledged to the lender as collateral. Loans are then repaid from proceeds of the client's sale of the security, as opposed from the client's cash flow.

Constraining factor on client access to the facility: Over-collateralisation of all drawdowns

The over-collateralisation of amounts to be advanced is a condition precedent and constraining factor of any drawdown under the margin lending facility. This condition precedent establishes that absent its satisfaction the ADI is not obliged to provide loans to the client. This being the case, the total funding commitment of the ADI to the client, and therefore the counterparty credit risk, is effectively managed and controlled by the value of the eligible collateral held.

Absence of Facility fees

As is the general rule for uncommitted facilities, currently there is no fee assessed on margin lending arrangements. The lender's income is entirely sourced from interest earned on the drawn amount.

Credit Risk Management

Unique level of collateral control

In addition to meeting APRA's requirements for eligible collateral, the security used by a retail margin lender is under complete control prior to the release of any loan funds. Any new loan security acquired with borrowed funds is delivered directly into the control of the margin lender. This provides absolute certainty that any increase in exposure is instantly collateralised, with no opportunity for delay or a gap in coverage. It also provides the control required to liquidate assets in the event of default.

The maximum accessible unutilised portion of a margin lending facility is an important dynamic when determining the credit risk embodied in the facility. A client can only increase their exposure above the current drawn amount to the lower of the credit limit and the maximum lending value derived from the collateral posted with the lender. Where a client is in default, as a result of a decrease in the valuation of their collateral, no additional lending will be provided, and the client's total credit exposure will be limited by the current drawn amount.

Independent collateral valuation.

At the inception of the arrangement, the borrower agrees that, in the event of default, the liquidation of eligible collateral is the primary mechanism to repay a drawn exposure. The independent and accurate valuation of loan security is the first priority of retail margin lenders, as this is the basis for every decision to release any funds. It is also the basis for the calculation of margin call, and for the quantum of corrective action required.

Any realised exposure, irrespective of when it occurs, is completely collateralised. This serves to fully mitigate the need to compensate for the future use of the facility with a CCF factor of 40%. AFMA contends that there should be scope for a retail margin lender, which restricts its approved security list to the defined classes of eligible collateral, to be exempt from applying a CCF factor to unused portion of the facility.

Current market value of collateral position

The collateral posted under margin lending agreements is generally in the form of equities although this may also be in the form of securities, managed funds, or cash. As exchange traded and OTC markets exist from which the current market value can be readily determined on any business day, ADIs invariably have the capacity to determine the current value of the client's collateral position, and therefore the status of any existing or contemplated advance in terms of its collateralisation. This, combined with the application of the condition precedent of over-collateralisation for any further advance, effectively nullifies the ADI's counterparty credit risk on the unutilised portion of the facility other than that portion representing the lendable value as determined by the collateral LVR.

Loan-to-valuation ratio - LVR

The application of an LVR, which is in every instance is required to be less than 100% is a key element of the constraining factor on the maximum lendable value, ie the amount that can be advanced, and its maintenance thereafter within this boundary is required to keep the loan in a performing state. A loan where the LVR is not maintained and left

partially unsecured would be deemed to be in default, and the unutilised lending cap on borrowings suspended or cancelled depending on the circumstance, meaning that the facility cannot be further accessed in circumstances where the collateral is inadequate.

Total commitment as defined under APS 113 Capital Adequacy: Internal Ratings-based Approach to Credit Risk

The objectives and key requirements of APS 112 provide that an ADI may reduce the credit risk capital requirement for its on- and off-balance sheet exposures where the exposure is covered by eligible lenders' mortgage insurance, or an eligible credit risk mitigation technique.

We note that APS 113, Attachment B, paragraph 29 relating to the CCF applicable for off-balance sheet exposures provides that:

> *'CCFs may be applied to the lower of the value of the unused committed credit line and the value of any other constraining factor on the availability of the facility, such as the existence of a ceiling on the potential lending amount that is related to a borrower's reported cash flow or its external credit rating. If the lower value is used, an ADI must have sufficient line monitoring and management procedures to support using the lower value for Regulatory Capital purposes.'*

It is acknowledged that the exception to this is where it exposes an ADI to counterparty credit risk against a committed facility. AFMA contends that, as access to funding under a margin lending facility is pre-conditioned by the over-collateralisation of the lendable value, there is no commitment to lend other than to the lendable value of the surplus collateral held. As such, under APS 113 the value of the constraining factor (the lendable value of surplus collateral held) is the maximum amount against which the CCF can reasonably be applied.

This being the case, AFMA contends that under APS 112 a similar interpretation of the application of the CCF should be used, ie the value of the constraining factor (the lendable value of surplus collateral held) is the maximum amount against which the CCF can reasonably be applied.

Risk weight applicable to retail margin lending facilities

As currently proposed, the risk weight of unavailed 'empty' facilities with a notional credit limit is 100%, which suggests that consideration is not being given to the fact that any use of the facility is pre-conditioned with the requirement for the potential exposure to be secured by eligible collateral. While it is acknowledged that the lender has no precise indication as to the quality of the future loan security, the condition precedent of exposure collateralisation with eligible collateral clearly has value as a credit risk mitigation technique and does not exhibit the risk characteristic of a loan secured by 'other collateral', as indicated by a 100% risk weight.

AFMA suggests that APRA recognise this and apply a 20% risk weight, potentially on the condition that the ADI attests that the future collateral it would accept would only be of the 'eligible' variety. It is acknowledged that, should the ADI be unable to attest to this, it may need to default to the conservative risk weighting ie 100%.

If implemented as drafted, APS 112 will, by virtue of the application of a 40% CCF and 100% risk weight on unavailed facilities, result in a materially increased risk RWA component for margin lending facilities, thereby significantly increasing the capital costs on a retail-oriented product. This would not serve retail client best interests.

An unintended and unnecessary consequence, and most likely outcome, will be either the cancellation of inactive and/or underutilised retail lending facilities or the application of an unutilised facility fee on retail margin lending activities in order to recoup the increased capital costs attributed to the ADI's business unit, an unwarranted increase in costs for investors. This potential increase in RWA is considered an unnecessary burden on industry and its investor clients given APRA's acknowledgement that ADIs are already meeting the 'unquestionably strong' benchmarks.

Recommendation

AFMA recommends that APRA continue to treat ADI margin lending facilities as uncommitted, and therefore not require the application of a 40% credit conversion factor on the credit limit.

In the event APRA is not inclined to regard ADI margin lending as in the nature of an uncommitted facility, AFMA recommends that APRA only apply the CCF to the maximum accessible unutilised portion of the margin lending facility (where lendable value is defined by the LVRs applied to the collateral held by the loan issuer) and not to the unused amount recorded under the facility notional credit limit. The formula to derive this is presented as:

a. Where a client's lendable value > drawn balance:

Maximum accessible unutilised portion = Min(Credit limit, lendable value) – drawn balance

and

b. zero where lendable value < drawn balance, representing a default or margin call situation where the lender prohibits any further increase in exposure to the counterpart.

AFMA further recommends that APRA apply a 20% risk weight for unavailed 'empty' facilities as the practical means of recognising the risk mitigation value provided by the condition precedent that drawn amounts be fully secured with eligible collateral.

For more information, or if you have questions in relation to this letter, please contact me at [redacted]

Yours sincerely

[redacted]

[redacted]
Director Markets and Rates