CUSTOMER
OWNED
BANKING
ASSOCIATION

16 April 2020

[redacted]
General Manager – Policy Development
Australian Prudential Regulation Authority

Via email: Policy.Development@apra.gov.au

Dear [redacted]

**Discussion Paper: Consultation on a more flexible and resilient capital framework for ADIs**

COBA welcomes the opportunity to respond to APRA's December 2020 Discussion Paper: Consultation on a more flexible and resilient capital framework for ADIs.

COBA is the industry association for Australia's customer owned banking institutions (mutual banks, credit unions and building societies). Collectively, our sector has $146 billion in assets and more than 4.5 million customers. Customer owned banking institutions are simple retail banking businesses, and all are subject to the standardised approach to credit risk. Our member institutions range in size from less than $200 million in assets to over $15 billion. Given the current size of individual COBA members, it is unlikely that any of our members will become internal ratings-based (IRB) ADIs in the foreseeable future. The majority of COBA members are also likely to remain subject to the proposed simplified capital framework in the long run.

The design and implementation of the capital framework is critical to allowing for a competitive, contestable, and diverse banking market.

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

1. That the standardised capital framework is a genuine competitive alternative to the IRB framework.
2. That the calibration of overall capital requirements does not increase capital on standardised ADIs.
3. There is genuine transparency for comparisons of capital between standardised and IRB ADIs.
4. It remains committed to addressing the 'too big to fail' problem with total-loss absorbing capital.
5. The efficient delivery of the 2023 implementation timeline.

**Ensuring the standardised capital framework remains a competitive alternative**

COBA welcomes APRA's statement that the proposed capital adequacy framework changes will enhance competition by "limiting some of the differences between standardised and IRB capital outcomes". It is critical that APRA adequately consider and address any unintended impacts on competition when calibrating its capital framework. Ensuring a correctly calibrated framework is of paramount importance given the framework is likely to be locked in for at least another decade.

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COBA recognises that APRA's proposals include several features that may enhance competitive outcomes between standardised and IRB ADIs:

- a capital floor for IRB ADIs to limit the overall difference in risk weighted assets between the standardised and IRB approaches
- different regulatory buffer requirements for IRB ADIs, and
- a commitment to ensuring the average pricing differential between the standardised and IRB approaches attributable to capital requirements does not widen.

To fulfill the intent regarding the 'gap', APRA should outline the flexibility/mechanisms in the framework that would allow it to narrow this gap if it were to widen once it finalises the capital framework. In considering these potential responses, 'narrowing' mechanisms should not just be based on increasing capital requirements on IRB ADIs/D-SIBs but should include options to reduce capital requirements on standardised ADIs.

Ultimately, an uncompetitive standardised capital framework will harm consumer choice and competition. Ensuring that the standardised credit risk framework remains a viable alternative to the more complex advanced models is critical as smaller ADIs continue to consolidate and the limited success of encouraging new entrants. If you characterise competition by new entrants and growth by existing incumbents, the standardised framework plays an important part given that the vast majority of ADIs are subject to the standard framework. Existing ADIs who make the transition to IRB status are few and new entrant IRB ADIs are non-existent.

The current Australian banking market is starting to see increasing consolidation with the exit of two neobanks[1] and the proposed acquisition of a mid-tier bank by another (ME & BOQ). There is increased speculation about parent financial services companies divesting their subsidiary ADIs. This hollowing out of the 'middle' and the consolidation of smaller ADIs reduces diversity in the banking market and raises questions about competition and choice.

Given the capacity to lend is a function of capital, the standardised capital framework provides the risk-based constraint to excess leverage. APRA must ensure that minimum standardised requirements are calibrated to be as low as possible. In line with this, APRA should consider further reducing the standardised risk weights for housing, including on mortgages redraws, to further enhance the competitive position of standardised ADIs. We acknowledge that APRA prefers not to go below Basel minimums, however, there are certain areas where APRA's more conservative approach could be adjusted, e.g., high LVR loans, LMI and interest-only treatments.

COBA notes that previous APRA analysis has outlined a 'small' pricing gap based on capital requirements: "In this analysis, APRA concluded that the average pricing differential that could be reasonably attributed to differences in capital requirements was in the order of 5 basis points". While this could be seen as an inconsequential amount, APRA should consider this five-basis point gap in the context the currently historically low net interest margins of 1.5 to 1.8 per cent[2]. Other factors can also heighten this capital benefit such as the too big to fail (TBTF) funding advantage.

COBA remains concerned around the competitive advantage of IRB ADIs for exceptionally low-risk loans. While APRA has introduced a minimum risk weight floor of 5 per cent, the minimum risk weight under the standardised capital framework remains at 20 per cent. This difference provides an advantage for IRB ADIs over their standardised competitors for the low-risk loans, which incentivises IRB ADIs to chase these low-risk loans at the expense of standardised ADIs. While the Basel minimum remains 20 per cent, as noted above, there are other areas where APRA could reduce capital requirements on residential mortgages.

[1] Xinja as a return of deposits and 86 400 as a merger with major bank NAB.

[2] Based on APRA's Quarterly ADI Performance Statistics

## Ensuring capital framework calibration does not increase capital on standardised ADIs

COBA believes it is critical from a competition perspective that any calibration does not increase capital on standardised ADIs. Any disproportionate increase on standardised ADIs will further erode the competition-enhancing benefits from reducing the gap.

Excessive capital requirements unnecessarily increase costs on consumers. Any differences in capital outcomes can create distortions in different ADI groups' ability to compete. For example, any excessive capital requirements on standardised ADIs will reduce their ability to compete against both IRB ADIs and the rapidly growing non-ADI sector who hold no regulatory capital against their lending. In addition, when ADIs are required to hold capital above the minimum requirements, i.e. due to their PCR setting, this could accentuate any over-calibration of the standardised capital framework.

One of APRA's core objectives is to incorporate APRA's unquestionably strong (UQS) benchmarks into the capital framework to implement the 2014 FSI's first recommendation. Outlined in APRA's 2017 UQS paper[3], these benchmarks are an equivalent increase in CET1 capital of 150 basis points for IRB ADIs and 50 basis points for standardised ADIs. APRA's Discussion Paper reiterates that it is not seeking to further increase the banking system's overall level of capital.

## Supporting transparency around comparisons between standardised and IRB ADIs

COBA welcomes APRA's decision to require IRB ADIs to "publish their capital ratios under the standardised approach"[4]. This will help stakeholders compare the capital requirements of standardised and IRB ADIs and provide more transparency on the benefits of IRB model.

These disclosures will allow all stakeholders to better understand the capital position of all ADIs and the advantage available to IRB ADIs. COBA welcomes APRA's statements that "these incentives [to IRB ADIs] should not be unlimited" and the that "the regulatory framework may have an unintended impact on competition in the financial system". Transparency about the IRB advantage flowing from regular disclosures will also act as the 'canary in the coal mine' for APRA to act if the gap begins to widen again in future.

In formulating these disclosures, COBA notes that ADIs do not just compete on aggregate capital ratios but rather within product exposure groups. APRA should ensure that disclosure occurs at a level where stakeholders can understand the advantages in each exposure group, particularly in residential mortgages where nearly all Australian ADIs compete. Aggregate figures could mask situations where higher capital in other areas of the portfolio are cross subsidising significantly lower capital outcomes in the mortgage portfolio. 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:

> "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."[5]

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

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[3] APRA announces 'unquestionably strong' capital benchmarks

[4] APRA Discussion Paper, page 5.

[5] Basel Consultative Document: Pillar 3 disclosure requirements – updated framework, page 47. Available online.

### Committing to addressing too big to fail with total-loss absorbing capital

APRA should remain committed to the implementation of the total-loss absorbing capital (TLAC) regime.[6] Implementing this regime will fulfil recommendation 3 of the 2014 Financial System Inquiry and seek to mitigate the 'too big to fail' (TBTF) funding advantages of the major banks that arise due to their perception of implicit government support.

Addressing the TBTF problem is critical given there remains the perception that the Government will support the major banks in a failure event. A recent FSB study noted that "in some jurisdictions such as Japan, Singapore and Australia, credit rating agencies (CRAs) do not judge the framework to be fully effective, because of what they judge to be the state's propensity to support". This perception gives ADIs that already have a significant scale advantage an unfair further advantage which reduces their funding costs.

In July 2019, APRA stated that it would require the major banks to lift Total Capital by three percentage points by 1 January 2024. APRA should recommit to this timeline to give non-major banks the certainty that it will address the TBTF funding advantage in a timely manner. Any delays will continue to tilt the playing field in favour of the major banks.

### Retaining the current proposed 2023 implementation timeline

COBA supports APRA retaining the proposed implementation date for the revised capital framework of 1 January 2023. We acknowledge that the challenges of bringing forward commencement probably outweigh the benefits and as a general rule ADIs should have at least a one-year implementation period for significant changes to any prudential standard.

Assuming the relevant standards are finalised by the end of 2021 and implementation set for 2023, APRA will need to engage closely with ADI stakeholders on reporting standards and prudential practice guides.

This is a significant change to a foundational element of the prudential regime.

COBA appreciates APRA's engagement so far on the proposed capital framework. COBA members look forward to this continuing throughout the implementation phase, particularly given the final standards are likely to be released with just over one year remaining to the implementation date.

COBA members have also noted APRA must finalise certain aspects of the capital framework (for example, definitions, criteria, and classifications) as soon as possible and communicate these as final to allow ADIs to start implementing these reforms. These reforms will require system changes that cannot be done if standards remain in the draft form. An inability to get these done as soon as possible could lead to potential inconsistency and comparability issues.

### Aligning implementation of credit risk reporting and credit risk capital reporting

APRA should align the implementation dates of the credit risk reporting suites together to reduce the implementation costs on ADIs.

The revised capital framework will require credit risk capital reporting changes from the proposed APS 112 implementation date. APRA has already flagged more granular credit risk reporting requirements[7] through its new ARS 220 currently proposed for implementation on 1 January 2022. APRA's draft ARS 220 letter outlines that: "data collected by ARS 220.0 will form the basis of an ADI financial instrument data model which will be extended at a future date to include topics such as capital adequacy for credit risk amongst other areas of interest." Given the explicit alignment with the ARS 112, COBA supports moves to unite the implementation of these reporting standards to allow ADIs to implement them in a

[6] APRA responds to submissions on plans to boost the loss-absorbing capacity of ADIs to support orderly resolution

[7] APRA letter on draft ARS 220

single project to minimise project costs.

**Further engagement on operationalising the simplified framework**

COBA welcomes the simplified framework which is expected to cover all mutual ADIs based on the criteria outlined in the draft APS 111.

This simple framework includes several simplified prudential requirements that are likely to reduce the burden on smaller ADIs, particularly the exemption from the proposed APS 117.[8] We recognise that this provides a significant benefit to smaller ADIs.

COBA notes that APRA and industry must resolve several issues before the implementation of the framework such as:

- the process for notifying ADIs well ahead of time of their status in terms of qualifying for the simplified framework
- outlining ADI opt-out procedures
- clarifying the potential scope and extent of APRA's partial opt-out power, and
- outlining a clear transition process for ADIs moving onto the 'full' capital framework.

COBA and COBA members would welcome further engagement with APRA and its policy and supervisory teams to further understand and shape the operation of the framework to ensure that it aligns with its regulatory burden reducing intent.

COBA provides more detailed comments on the standardised credit risk framework in **Attachment 1** and on the simplified capital framework in **Attachment 2**.

If you have any further questions or queries, please contact [redacted].

Yours sincerely,

[redacted]

[redacted]
**Chief Executive Officer**

[8] APS 117 Interest Rate Risk in the Banking Book

# Attachment 1: Standardised credit risk

## Property Exposures

### Calibrating the capital framework to lower capital on standardised ADIs

COBA believes it is critical from a competition perspective that any calibration does not increase capital on standardised ADIs. Any increase in capital on standardised ADIs (even offset in aggregate by the system) will erode the competition-enhancing benefits from this capital framework.

COBA welcomes APRA's proposal to reduce the credit conversion factor (CCF) for mortgages to 40 per cent. This is a significant reduction given the proposed increase to a 100 per cent CCF in the previous draft July 2019 standard. COBA also recognises that this is a positive deviation for standardised ADIs from the CCF applied to IRB ADIs. However, APRA must recognise that even this revised CCF remains a significant increase for ADIs who have structured their mortgage redraws as "unconditionally cancellable" (UCC)[9]. This means that at an individual level and potentially at a system level there could be higher absolute minimum capital requirements across the system for standardised ADIs. APRA should consider this in the context of an expected 7 per cent RWA reduction across standardised ADIs.

COBA notes that the absence of a UCC category remains an area of APRA conservatism given the Basel Framework retains the UCC concept with a CCF of 10 per cent. APRA should introduce a lower CCF, i.e. below 40 per cent, for mortgage commitments given the significant level of pre-payments seen in Australia.

COBA also notes that loan-to-value ratios (LVRs) under the revised capital framework will be higher across the board compared to the current framework. This difference is due to undrawn commitments now forming part of the numerator for LVR calculations.[10] This leads to loans with large undrawn balances having higher LVRs under the revised framework compared to the current APS 112. COBA members note this is akin to 'double counting'. It is critical to consider the impact of this change in the context of reducing RWAs on standardised ADIs to ensure that there is not an over-calibration of the capital framework that increases capital on standardised ADIs.

COBA acknowledges that in this calibration that APRA wants to adhere to the Basel standards, including minimum settings. However, there are certain areas, such as higher LVR loans, that are above Basel minimum. APRA could also reduce risk weights for LMI-insured standard loans or seek a more granular approach to non-standard loans. While APRA notes the rationale for limiting LMI benefit is due to the view that for the largest ADIs "it would be imprudent to encourage them to build a significant reliance on a lower-rated counterparty.". However, COBA notes that for standardised ADIs this is not true as the counterparty could have a higher rating.

[9] Current APS 112 Attachment B Table 1

[10] Draft APS 112 Attachment A para 10

## Treating bridging loans as standard loans

COBA believes that bridging loans should fit into the standard loan framework i.e., standard interest-only (IO) loans given their unique and short-term circumstances. COBA notes the current definitions could inadvertently capture these loans.

Bridging loans are a specific type of finance, generally interest-only loans, used to cover the gap between buying a new property and selling a customer's existing property. They are generally very short-term loans of between six to 12 months. These loans are not repaid on an amortisation schedule but have capitalised interest until the existing property is sold.

Bridging loans could be caught as non-standard loans, as opposed to standard interest-only loans, due to the following: "Where an ADI's assessment does not result in a positive determination of the borrower's ability to meet their repayment obligations, an ADI must classify the loan as non-standard."[11] This view arises if ADIs interpret the 'repayment obligation' as one based solely on ongoing repayments rather than one that factors in the intended property sale.

The incoming APS 220 also clouds this: "An ADI must assess credit risk primarily on the strength of a borrower's repayment capacity. The ADI must not place undue reliance on collateral provided by the borrower as a substitute for a comprehensive credit assessment."[12] This paragraph suggests that repayment capacity is related to ongoing repayments. COBA suggests that the clearly planned property sale represents meeting a 'repayment obligation' and 'repayment capacity' in the context of a bridging loan, and subject to meeting the other standard loan criteria there would not be 'undue reliance' on this as a substitute for a comprehensive credit assessment. Any exemption would need to clearly avoid capturing reverse mortgages given that they clearly fit in the non-standard category.

## Removing the interest-only loan six-month seasoning requirement

APRA must remove the 'seasoning' requirement that prevents IO loans from being treated as principal-and-interest (P&I) loans until six months after conversion.[13] This requirement adds unnecessary complexity and has the potential to disadvantage incumbents.

These increased capital requirements are unnecessary given that ADIs are required to assess interest-only loans on a post-IO P&I basis given the standard notes:

> "for interest-only loans secured by residential property, an assessment of serviceability for the specific term over which principal-and-interest repayments apply, excluding the interest-only period".[14]

This requirement unnecessarily increases the standard's complexity and compliance task as ADIs will need to track the historical nature of all mortgages. For simplicity's sake, APRA should remove this requirement as it adds little given that the higher risk weights are only applied for an additional six months and the post-IO repayment assessment outlined above. This requirement would also only increase the capital on owner-occupied (OO) loans that are shifting to P&I given that investor loans would be remaining in the same 'other' risk category.[15]

This capital treatment can also create competition issues where an incumbent will have a capital advantage from originating a P&I loan that is not subject to an IO risk weight. More broadly, there is

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[11] Draft APS 112 Attachment A para 5

[12] Incoming APS 220 para 41, effective 1 January 2022

[13] Draft APS 112 Attachment A para 14(b)

[14] Draft APS 112 Attachment A para 5(c)

[15] Draft APS 112 Attachment 1 Table 1

the potential that this competitor will be able to take advantage of a better LVR treatment (i.e., lower LVR) if there is house price appreciation which could compound this disadvantage.

| | IO period | 6 months period | After 6 months |
|---|---|---|---|
| **Repayment Type** | IO repayments | P&I repayments | P&I repayments |
| **Incumbent** | | | |
| **House Value** | At origination | At origination | At origination |
| **Capital Treatment** | IO RW | IO RW | P+I RW |
| **ADI Competitor** | | | |
| **House Value** | NA | Most recent | Most recent |
| **Capital Treatment** | NA | P&I RW | P&I RW |

*Interaction with short-term interest-only loans*

The presence of short-term interest-only periods amplifies the above issue. If APRA retains this treatment, then it must exclude all forms of short-term IO loans. For example, construction loans are only expected to have interest-only period of up to 12 months but will be subject to an elevated capital requirement for a period equal to at least half its IO term. There is an overly complex and punitive treatment for a short IO term given it has already been assessed that the customers can service a larger fully drawn loan on a P&I basis.

## Removing non-standard treatment of interest-only loans with more than 5 years of IO

COBA's view is that APRA must remove this five-year IO period requirement[16] given that it adds unnecessary complexity, is administrative burdensome and unnecessarily increases churn. If retained, it would need to have clear carveouts for investor loans and home equity lines of credit (HELOCs). Even if this is the case, this solution remains complex to essentially deal with a limited P&I IO problem.

At minimum, investor loans should be standard loans irrespective of the above timeframe. COBA suggests that if APRA retains this disincentive for longer IO term treatment, then it must limit it to owner-occupied housing with term IO periods to target the risks of long-term IO loans. This also reflects APRA's current view in APG 223 – "APRA expects interest-only periods offered on residential mortgage loans to be of limited duration, particularly for owner-occupiers."[17]

The draft APS 112 currently outlines ADI consider the following to be non-standard loans: "interest-only loans with an interest-only term of greater than five years, excluding any exposures that are predominantly for business purposes."[18]

COBA believes investor loans should fit into the standard loans definition given the structure of Australia's taxation system and investment housing markets. APRA already broadly proposes to exempt loans predominately for business purposes. These loans would be subject to extended interest-only terms for the same reason as property investment – increasing cashflow for other purposes. COBA notes that in terms of IO policies there is generally a limit of five years IO at origination. Any extensions to this are contingent on a full reassessment of P&I serviceability over the shortened remaining life of the loan (i.e., assess ability to meet P&I for 20 years if a customer requested an additional five-year IO term after the first expired). COBA understands this is broad industry practice. Similar to the 'seasoning' issue, these loans are also already assessed on a P&I

[16] Draft APS 112 Attachment A para 19(a)

[17] APG 223 para 49

[18] Draft APS 112 Attachment A para 19(a)

basis for the residual repayment over the remaining non-IO term.

It is quite common for investment loans to roll over interest-only periods beyond five years. This is not necessarily a measure of risk but rather to minimise cashflow requirements while maximising taxation deductions. The current drafting presents an issue where if an incumbent lender had five years on the loan, any extension to this period would lead to them requiring to risk weight it as a non-standard loan.

This treatment means that a new ADI competitor has a capital advantage if it pursues long-term IO investor loans from an incumbent ADI. This provides a pricing advantage. For investors to get the optimal capital treatment, they would need to churn between two or more ADIs every five years. Alternatively, this could create a competitive advantage for non-ADIs who are not subject to APRA's capital requirements.

| | Up to 5 Years | Years 6-10 |
|---|---|---|
| **Incumbent** | | |
| **Capital Treatment** | Standard Loan & risk sensitive | Non-Standard |
| **ADI Competitor** | | |
| **Capital Treatment** | NA | Standard Loan & risk sensitive |
| **Non-ADI competitor** | | |
| **Capital Treatment** | NA | NA |

COBA also notes there are expected to be data challenges on capturing a cumulative five years if there are several periods of interest-only.

**Home equity lines of credit**

Home equity lines of credit (HELOCs) are also captured under the proposed IO 5-year treatment. This is due to these loans having indefinite or no specific interest-only periods. HELOCs are therefore subject to a 100 per cent risk weight rather than a risk-sensitive risk weight based on their LVR. The punitive non-standard risk weight treatment compounds the inclusion of unconditionally cancellable undrawn amounts into the numerator of LVR calculations. We acknowledge that these products do not have the same risk profile as traditional P&I products, as outlined in APG 223, however, their classification at a flat non-standard risk weight is inconsistent with similar products within the capital framework such as credit cards and reverse mortgages. The HELOC provides an option for customers to borrow lower costs funds against their existing home equity for various purposes. From a credit risk perspective, while it is not an amortising loan, it is secured against a residential mortgage.

COBA notes that for ADIs to continue to be able to offer this product that these loans should have a more risk sensitive treatment whether this is under the standardised framework as an IO, or as a non-standard loan under a more risk sensitive framework that considers LVR.

| | Risk Weight | CCF% | Security |
|---|---|---|---|
| **HELOC** | 100% | 40% | Secured |
| **Reverse Mortgage >60%** | 100% | 40% | Secured |
| **Reverse Mortgage ≤60%** | 50% | 40% | Secured |
| **Retail Credit Cards** | 75% | 40% | Unsecured |

## Interactions between six-month seasoning and five-year non-standard treatment

COBA notes that if APRA intends to retain these requirements more clarification is needed to ensure correct risk weights are used when the IO period greater than five years and six-month IO seasoning requirements overlap. Given that ADIs will use systems to implement these requirements, they need to be able to be coded to a set of logic-based rules that a system can run. It is highly unlikely that ADIs will classify these manually as this will increase unnecessary operational risk and is unlikely to lead to consistency and comparability across ADIs.

One example is the case of a standard investor IO with LMI and an IO period of three years and LVR of 75 per cent (risk weight of 45 per cent).

- If this loan converts to P&I at the end of the three-year term the risk weight should remain as 45 per cent RW for the first 6 months at least,
- If it gets an extension to its IO term of a further three years, it will become a non-standard loan risk-weighted at 100 per cent. However, if it converts to P&I after it is 6 years of IO, should it be treated as non-standard for the first six months or can it be treated as a standard IO loan with LMI and an LVR of 75 per cent, i.e. risk-weighted at 45 per cent?

## Granularity of non-standard home loans

COBA maintains our position that there should be more risk sensitivity in the treatment of 'non-standard' loans. The risk weights 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 per cent risk weight does not consider any of these factors despite the existing APS 112 framework doing so. This 100 per cent 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.

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.

COBA acknowledges APRA has removed the explicit requirement for these properties to be 'readily marketable'. This could provide additional flexibility about defining rural and regional properties as standard noting that this would already be incorporated into valuations.

## 'Additional serviceability criteria' for standard vs. non-standard mortgages

COBA's view is that APRA should remove the 'additional serviceability clause'. This clause adds unnecessary complexity to the capital framework due to the uncertainty around its application and the potential for inconsistent application of the additional serviceability criteria. The draft APS 112 includes APRA discretion on serviceability criteria for determining the boundary between standard and non-standard loans.[19]

If retained, APRA should provide more information about these 'additional serviceability criteria'. These additional criteria could have significant data and capital implications. APRA should also outline the circumstance under which it would use this power, consultation periods and the expectations on ADIs. For example, would this mean that ADIs would be able to take on APRA-judged 'lower serviceability' loans as long as they were willing to take the extra capital hit?

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[19] Draft APS 112 Attachment A para 5

COBA notes that APRA can already address these issues via the supervisory limit powers in APS 220 paragraphs 110-111.

# Non-property exposures

## Flexible treatment of third-party lending exposures

APRA has retained its proposed 150 per cent risk weight for “exposures through third-party lenders”. COBA continues to hold the view that APRA should exercise some flexibility around this risk weight given that very high-risk weights risk stifling innovation.

COBA looks forward to APRA’s guidance on how ADIs should be interpreting and applying this requirement in the revised APG 112 given the potential that any uncertainty around this definition could further stifle innovative lending models.

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 future business models emerging that may or may not have these increased risks.

## SME exposures

### Assessment of dependence on rental income

The draft APS112 Attachment A paragraph 5b states that “where the repayment of a commercial property loan is dependent on the cash flows generated by the property through rental income, an assessment of the tenancy profile relative to the maturity of the loan” is required to classify it as a standard loan.

COBA members note that the average tenancy (estimated to be 3-5 years) is likely to be much shorter than the maximum loan terms that ADIs currently offer. These loan terms are more akin to residential loan terms. COBA is concerned if the tenancy length is interpreted as the ‘profile’ that may limit ADIs’ ability to provide loans with maturities that do not align with the underlying tenancy agreement’s term.

### Aligning classifications of counterparties with EFS

COBA notes that the classification of corporate counterparty exposures through the definitions of SME Corporate and SME Retail differ from those currently used to classify business counterparties under the existing Economic and Financial Statistics collections.

COBA members have suggested that consideration should be given to aligning the classification of corporate counterparty exposures with the EFS standards given that most mutual ADIs have very few loans that would be classified as SME Corporate.

# Clarifications

## Calculation of natural hedges for currency mismatches

COBA members require clarification around the 'loan amount' regarding the calculation of natural hedges[20]. Any exposures that have currency mismatches without the presence of financial or natural hedge are subject to a 1.5 risk weight multiplier[21]. COBA suggests that APRA amend the below wording to align with loan instalment, e.g. repayments rather than loan amount to align with the Basel standards[22].

> For the purpose of the application of the multiplier, an ADI may only treat an exposure as hedged where the natural or financial hedge covers at least 90 per cent of the **loan amount**[23].

In terms of assessing the hedge, COBA suggests that this calculation does not include haircuts for rental property income as per APG 223. COBA believes that Basel does not intend to include the haircut given that the Basel 20.93 refers to "normal operating procedures", i.e., which suggests that in the case of an investment property that it would tenanted.

> A natural hedge exists where the borrower, in its normal operating procedures, receives foreign currency income that matches the currency of a given loan (e.g., remittances, rental incomes, salaries).

COBA suggests for simplicity's sake that this calculation be based on gross rent, actual repayments (i.e., not buffered repayments) and with no haircuts applied to rental income. These three factors, as well as haircuts to foreign income sources, are already considered conservatively in the credit risk assessment, if they are then applied in the context of foreign currency risk then it would be overkill.

COBA also notes that the presence of natural hedge is only likely to be able to be calculated at origination and it is not possible as an ongoing requirement.

## Scope of Land Acquisition, Development and Construction (ADC) exposures

COBA members are concerned that investor construction loans could be captured under the ADC category[24] . COBA seeks clarification that this is not the case given the Basel specifically defines Land ADCs as below noting emphasis on the key aspect regarding lending to companies or special purpose vehicles:

> 20.90: Land ADC exposures refers to loans to companies or SPVs financing any of the land acquisition for development and construction purposes, or development and construction of any residential or commercial property. ADC exposures will be risk-weighted at 150 per cent, unless they meet the criteria in CRE20.91.[25]

In the absence of this clarification, all ADIs that are currently providing investor construction loans will need to update lending policies to include definitions of qualifying pre-sales and qualifying development costs as well as an assessment process for pre-sales. While this may be appropriate for major developments such as apartment blocks or unit complexes, this seems quite excessive for a situation where a non-company/SPV borrower is building a house to rent out. There may also be an

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[20] Draft APS 112 Attachment B para 44

[21] Draft APS 112 Attachment B para 43

[22] See Basel 20.93 notes "only these natural or financial hedges are considered sufficient where they cover at least 90% of the loan instalment".

[23] Draft APS 112 Attachment B para 44

[24] Draft APS 112 Attachment A para 28(b)

[25] See Basel 20.90

unintended consequence where customers will provide false indications that they expect to occupy the property to avoid the corresponding increased interest rate from this capital treatment.

## Credit card undrawn exposures treatment

COBA suggests that APRA clarify the treatment of retail credit cards given the updated draft APS 112 no longer refers to a specific retail credit card category. COBA assumes that this is included in “other commitments” category at a CCF of 40 per cent. Members have queried whether it fits into the ‘revolving underwriting facility’, however, this is unlikely given the following D2A definition.[26]

[26] See the definition of revolving underwriting facility

# Attachment 2: Simplified framework

## Clarifying the eligibility criteria

COBA understands that APRA intends to take a principles-based approach to small ADI eligibility. While this approach provides flexibility, ADIs will need some clarity to provide certainty on eligibility. Any uncertainty about eligibility may create unintended consequences around ADI behaviour or suboptimal outcomes that may run contrary to the expected benefits of the simplified capital framework.

### Supporting an appropriate assets threshold that covers all mutual ADIs

COBA supports the proposal to expand the eligibility threshold for the simplified framework to $20 billion in total assets, noting that "APRA expects that the $20 billion threshold will cover all mutual ADIs, and provide sufficient scope for ADIs to continue to grow without needing to transition onto the broader capital framework".

Given that the capital framework will be implemented by 1 January 2023, APRA should ensure that the proposed threshold remains appropriate to meet this 'covering all mutuals' expectation. COBA members have also queried as to how often APRA expects to review the $20 billion assets threshold.

### Clarifying the offshore funding criteria

COBA submits that all our members clearly operate under 'domestic activities' part of this criterion. However, COBA notes that 'offshore' funding has the potential to capture a broad scope of funding options. [27] APRA needs to provide more guidance on the specific risk that this requirement is looking to target. COBA assumes this exists due to increased rollover risk from offshore funding arising from 'home bias' and foreign currency funding.[28] A potential unintended consequence of a lack of clarity is that ADIs may be reluctant to pursue more diverse funding given the risk that APRA could consider them to be 'off-shore' and their use would trigger an unintended transition to the 'full' capital framework.

COBA also provides some situations below for APRA to consider in the context of 'off shore' funding. COBA and its members are also willing to discuss further situations regarding offshore funding.

| Situation | |
|---|---|
| **Foreign residents investing in AUD denominated domestic issuance of an Australian based ADI (e.g., senior unsecured, securitisation).** | Our view is that this is not in the definition given that the funding is denominated in Australian dollars.<br><br>Considering this to be 'offshore' would also impact mutual ADI's ability to pursue securitisation while remaining eligible for the simple capital framework. |
| **Prepaid card programs where funding is sourced from Australian residents even if float accounts are located overseas for settlement purposes.** | Our view is that this is not within the definition given that the funding is sourced from Australian residents but held overseas so there is an absence of home bias. |

[27] Draft APS 110 para 9b iv

[28] See RBA The Nature of Australian Bank's Offshore Funding

## Clarifying expectations around immaterial derivative exposures

COBA notes that the draft standard outlines that small ADIs must have "immaterial non-centrally cleared derivative exposures"[29].

Some COBA members are interested in views on 'immaterial' given that there is the potential for COBA members to utilise non-centrally cleared derivatives. Given the cost of central clearing for swaps, most mutuals' derivatives contracts would be non-centrally cleared. To effectively manage the interest rate risk of the banking book considering both earnings and valuation risks, it is necessary to use interest rate swaps. Natural physical hedges within the balance sheet are generally not sufficient to maintain exposure within risk limits. Additionally, interest rate swaps are an important tool when repositioning the balance sheet to take advantage of the rate cycle. The notional value of these swaps can therefore easily become quite large.

As a broad policy position, COBA would not expect such activity to exclude an ADI from the simple framework given it is a relatively straightforward measure to manage risk and is within APRA's prudential safety interests.

[29] Draft APS 110 para 9(b)iii

# Operationalising the simplified framework

APRA should outline in upcoming guidance how it expects to implement the simplified framework to ensure that policy intent of proportionality and regulatory burden reduction is adequately implemented via its supervisory teams.

APRA's Discussion Paper outlines some indication of these operations but COBA suggests this is collected in a single place given that in future it is unlikely that stakeholders will refer to response papers etc for the underlying policy intent. These administrative matters including notification, opting out, APRA's partial opt-outs and the transition process.

## Notifying ADIs well ahead of time of their eligibility status

COBA understands that by default, ADIs will be subject automatically to the simplified framework. Similar to the draft CPS 511 Remuneration, APRA should provide a timeline for when it expects to notify ADIs that they are by default subject to the framework given that the qualitative criteria could be subjective and the significant and very welcome benefits of being in the simplified framework (i.e. reduced regulatory burden, particularly with respect to interest rate risk).

Some COBA members hold concerns that an uncertain status would lead to potential need to have to to prepare for two different regimes, i.e., a simple framework and then also the 'full' capital framework. This dual regime uncertainty can lead to increased regulatory burden costs compared a certainty of knowing that they would have to only prepare for one regime (noting that costs are lower if this one regime is the simple regime).

## Outlining ADI opt-out procedures

APRA's upcoming guidance must include information on the process of opting out of the framework as well as the expected transition times for ADIs. In some cases, small ADIs may want to opt-out of the simplified framework. ADIs would be interested in the process of opting out and the logistics around the time to decide.

These reasons could include market requirements, more advantageous operational risk capital charges under APS 115 and to create certainty around when they expect to transition if they look like they will be doing so anyway.

## Clarifying the potential scope and extent of APRA's opt-out powers

COBA notes that APRA's discussion paper outlines that APRA can transfer a small ADI into the full capital framework or into individual risk categories while retaining some of the benefits of the simplified framework. COBA members would like to understand more about how this is expected to work in practice, given there are multiple degrees of oversight including ad-hoc reporting, application of the reporting standard, application of the prudential standard.

COBA's view is that before applying any prudential or reporting standard that there must be least one year's lead time. COBA members are also interested in how APRA will maintain supervisory consistency across cohort groups when applying this power.

## Clear transition process for ADIs moving onto the 'full capital framework'

APRA should outline further guidance on the timelines for ADIs when they are transitioning into the 'full' capital framework. As noted above, COBA's view is that the before applying any prudential or reporting standard that there must be least one year's lead time.

COBA also understands that ADIs would be subject to the 'full' framework if an ADI opts out. COBA suggests that there are discussions with the ADI before there is any kind of notice regarding an ADI or APRA opt-out given the potential regulatory change resourcing implications of a shift in frameworks.

# Benefits of the simplified framework

## Communicating the benefits of the simplified framework and general proportionality

COBA suggests that APRA outline in a more accessible form the benefits of the simplified framework, in the form of a 'map'. This will ensure that ADIs are able to easily navigate the framework, noting that otherwise ADIs would need to review each individual prudential standard. More broadly, APRA should outline these benefits across its entire prudential framework, including areas such as the liquidity. This will provide more information and transparency around the APRA's efforts on proportionate regulation.

COBA also suggests that in terms of drafting the standard, APRA make it clear regarding which sections apply to small ADIs. The current drafting outlines small ADIs requirements as a subset of standardised ADIs which is somewhat confusing.

## Futureproofed proportionality by default approach

COBA suggests that APRA ensures that future policy consultations consider opportunities to incorporate other requirements into the simplified framework. For example, there could be more proportionate application of future prudential requirements or lower frequency reporting for small ADIs. COBA notes that this would need to consider the implications on any once-small ADIs that have opted out of the simple framework.

## Ensuring the operational risk capital reflects the simplicity of our banking model

COBA supports APRA including a simplified operational risk capital charge for small ADIs. This reduces the regulatory burden for simple ADIs when it comes to calculating operational risk capital and reflects their simple business models.

COBA believes that APRA should closely examine this capital charge and consider lowering it (i.e. to 8 per cent) in order to recognise the simplicity of our member organisations, which are relatively straight forward retail banks with conservative lending criteria.

This simplicity is not just compared to the major banks, but also compared to other standardised ADIs. This operational risk capital charge can be a balancing factor utilised to adjust for this simplicity and lower capital requirements.

Some COBA members have noted the potential that their operational risk capital calculations could be more favourable under APS 115 than under the simplified framework. COBA suggests this situation would arise if credit RWA is growing faster than the APS 115 business indicator measure.

## Simplified approach to market risk

COBA considers that it could be beneficial to allow limited and small value foreign exchange derivative exposures without the need to consider holding capital.

A simplified market risk treatment would enhance small ADIs' ability to hedge non-AUD denominated contracts, providing more options for managing the risk associated with foreign payments, without needing to work through the complexity of APS 116 requirements. COBA considers that as ADIs progress their digital transformation programs it is more likely that they will start utilising providers requiring payments in foreign currencies. Any treatment should focus on hedging service contracts rather than credit exposures.

## 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.

# Clarifications

## APS 180 counterparty credit risk capital requirements

APRA's Response Paper outlines that small ADIs are not expected to be subjected to counterparty credit risk capital or reporting requirements. However, under the draft APS 110, it appears that small ADIs remain subject to the APS 180 risk weighted exposures given that small ADIs are a subset of standardised ADIs. COBA's interpretation is that it appears as through small ADIs remain subject to the APS 180 risk weighted assets component but not to the capital charge arising from APS 180's credit valuation adjustments. As noted above, COBA suggests APRA redraft this relevant section to refer to only outline requirements for small ADIs to improve the drafting clarity.

COBA members query how this simplification works given that there are references throughout APS 112 and other prudential standards to the use of APS 180 for calculations such has bank exposures through derivatives (i.e., RWA). APRA should provide more clarification to both small and standardised ADIs regarding the interactions between APS 180 and the simplified and standardised capital frameworks, including more information on these two components of APS 180 capital.

## Operationalising a non-zero default counter cyclical buffer

COBA notes that APRA's proposal to implement a default non-zero counter cyclical buffer (CCyB) will be a new experience in Australia given that we have not had a non-zero default CCyB. APRA should provide more guidance and information on its operation including on triggers for changes and expected timeframes for ADIs to comply given the greater likelihood of upward and downward movements. COBA notes that APRA expects to "revise the indicator framework that sets out the operation of the CCyB, including articulating APRA's expectation for when the CCyB would move upwards or downwards from its default position."

APRA's Discussion Paper notes that: "The prevailing level of the CCyB may not be set at the new default level at the time of implementation (planned for 1 January 2023), and will depend on APRA's judgement of the economic conditions and the level of systemic risk at the time." While COBA acknowledges the potential for a zero buffer at the framework implementation, APRA must outline more information on the lead-up times to when APRA would expect ADIs to meet any return to a non-zero buffe and how long ADIs would have to replenish this buffer. For mutual ADIs, this timeline is critical to aid in capital planning given that the two most common options for ADIs to rebuild buffer (dividend retention and CET1 issuance) are not options widely available to mutual ADIs.

COBA notes that UK PRA's announcement last year outlined with the respect to the CCyB following:

> "The FPC expects to maintain the 0% rate for at least 12 months, so that any subsequent increase would not take effect until March 2022 at the earliest. To aid with firms' capital planning, the PRA will take the FPC's expectation into account when assessing broader capital plans submitted by firms."[30]

[30] Statement by the PRA accompanying measures announced by the Financial Policy Committee