1 April 2021

General Manager. Policy Development
Policy and Advice Division
Australian Prudential Regulation Authority
1 Martin Place
SYDNEY NSW 2000

Dear ,

Revisions to the capital framework for authorised deposit-taking institutions

Thank you for the opportunity to provide feedback on APRA's changes to the authorised deposit-taking institution (ADI) capital framework. In this letter, I would like to provide two comments for the full draft of Prudential Standard APS 112 Capital Adequacy: Standardised Approach to Credit Risk and Prudential.

Macroprudential concerns for granular residential mortgage risk weights change

It is encouraging to see the proposed risk weight structure is on a more risk adjusted basis. Past literature has shown banks intend to take riskier positions within the asset class of the same risk weight and such risk shifting goes undetected due to this regulatory arbitrage (Duchin & Sosyura 2014). The proposed change could make sure the banks put aside more capital for riskier loans. Within a bank's mortgage portfolio, this proposed change could improve the risk structure of the portfolio and remove the regulatory arbitrage.

However, it would also be important to consider the macroeconomic impact of this proposed change. Specifically, I want to raise two macroprudential concerns. The first concern is related to how this proposed change could further increase Australian banks' exposure on residential mortgages given the low risk weights on low LVR loans. The second concern is related to redistributive effects of this regulation change under the current expansionary monetary policy regime.

- **Impact on Australian banks' residential mortgage reliance**

Risk weights for any mortgages with LVR<=70% will receive a lower risk weight under the current proposed structure. This change could mean that high LVR mortgages (LVR>80%) are crowded out, but it could also crowd out bank's other lending as well. The impact of within mortgage risk weight changes needs further investigation to understand how they could change the bank's reliance on mortgage lending.

As the discussion paper (APRA 2020) correctly pointed out, Australia banks outrank their peers in other countries on the current share of residential mortgages on bank balance sheets. While the proposed risk weight change could lower banks' risk within this exposure, it might expand

this already high exposure even further towards low-risk mortgages by crowding out other lending like business lending and other non-residential mortgage consumer lending. This could impair banks' credit supply role, especially during this crucial period where many households and business may rely on bank lending to recover from the pandemic shock. For example, Martin et al (2021) find that the Spanish housing boom reduced non-housing credit growth during its first years. The combination of lower risk weights on lower LVR mortgages and low interest rate environment could trigger a housing market boom in Australia and reduce non-house credit supplies accordingly. Even the non-housing credit picked up after the initial dip, the combination of financial distress and low credit supply could lead to a notable amount of business closure and personal bankruptcy before non-housing credit could pick up.

- **Redistributive effects of capital regulation**

Past literatures have suggested banks' capital changes and capital regulation could have redistributive effects on banks' different stakeholders (Diamond & Rajan 2000; Carletti, Marquez & Petriconi 2020). For owner-occupied mortgages, young family with limited wealth accumulation would have a stronger demand for high LTV loans. Households with high level of wealth on the other hand would be more likely to borrow low LTV loans. Since the demands for different LTV loans may vary across different income groups, it would be essential to take the redistributive effects of capital regulation into account when APRA want to change the risk weights of different LVR loans. A high level of risk weight granularity could potentially create incentives for banks to disproportionally channel their credit supplies towards high wealth households, when the banks are in favour of the lower risk weight on low LTV loans. Such redistributive effect could be further amplified during the current expansionary monetary policy regime in Australia and would induce economic inequality gaps. Furthermore, lower risk weights for low LTV loans could make First Home Loan Deposits Scheme less attractive for banks to supply credit given the relatively higher capital cost even APRA lowers those loans' risk weight to 35 per cent.

On the other hand, it's important to keep a granular risk weight structure for high LTV investment properties loans to mitigage bank's risk exposures and the redistributive effects of bank mortgage lending under the current expansionary monetary policy regime in Australia.

- **Suggested solution**:

Avoid significant risk weight cuts for low LVR mortgages and increase the high LVR mortgage risk weights. The exact level of risk weight cuts for loans with LVR lower than 80% needs further analysis based on the current positions of banks' loan books. The table below is provided for illustrative purpose only.

Table 1: Proposed risk weights under the standardised approach (Illustrative example)

<table>
<tr><td colspan="2" rowspan="2">LVR</td><td colspan="7">Risk Weight %</td></tr>
<tr><td>≤50</td><td>≤60</td><td>≤70</td><td>≤80</td><td>≤90</td><td>≤100</td><td>>100</td></tr>
<tr><td rowspan="2">Owner-occupied principal-and-interest mortgages</td><td>LMI</td><td rowspan="2">30</td><td rowspan="2">30</td><td rowspan="2">30</td><td rowspan="2">35</td><td>40</td><td>55</td><td>70</td></tr>
<tr><td>No LMI</td><td>50</td><td>70</td><td>85</td></tr>
<tr><td rowspan="2">Other residential mortgages</td><td>LMI</td><td rowspan="2">40</td><td rowspan="2">40</td><td rowspan="2">40</td><td rowspan="2">45</td><td>50</td><td>70</td><td>85</td></tr>
<tr><td>No LMI</td><td>65</td><td>85</td><td>105</td></tr>
</table>

Ineffectiveness of SME loans risk weight changes

The reduced risk weights for small business lending are good incentives to encourage banks providing more credit to small businesses. The lending environment for small businesses have changed in the past decade, but there are still a sizable number of small businesses that feel it is difficult to acquire funding (RBA discussion paper 2018). Furthermore, COVID-19 pandemic worsens the lending environment for small business in Australia (Lewis & Liu 2020).

Nevertheless, changing credit supply for small business by adjusting risk weights would be ineffective. It will be inefficient and unrealistic for regulators to consistently adjust the risk weights for small business lending. In addition, regulation change takes time. Any capital requirement adjustment would be lagged to address shortage in small business loan demand.

- **Suggested solution**:

In 2018 RBA discussion paper (Connolly & Bank 2018), there are some proposals to improve the current small business lending environment in Australia. One of the proposals suggests Australia to adapt the U.S. model where a federal government agency (Small Business Administration (SBA) in the case of U.S.) sponsors a large proportion of the small business loans at a fee. The size of the eligible loans would be generally capped and mainly focus on retail SME. From the capital regulation perspective, the risk weight for sponsored small business lending is 0% in general.

This setting can benefit small business lending (especially retail SME) in the following ways:

(1) **Reduced capital requirement burden**: The capital requirement burden for small business loans on banks will reduce significantly and consequently increase the credit supply incentives. If the agency sponsors 80% of the loans, the effective risk weight for SME retails for the bank could be as low as (1-80%)*75%=15%.
(2) **Development of secondary market**: The low-risk feature of the secured/sponsored small business lending allows the banks to trade those loans on the secondary market and increase the liquidity of those loans. This could further enhance the banks' SME loan supply on the primary market.
(3) **Effective channel for fiscal and monetary policies**: The aggregate credit supply to small business will be more flexible and timelier adjusted. When there is a large demand surge in small business loans, a small business agency can provide more sponsored loans to meet this surging demand in a timely manner. Banks do not have to severely ration credit supplies due to a tough market environment for small business since the government sponsorship would significantly reduce banks' risk exposure. The proposed agent could also provide directly funding support to small businesses as part of the fiscal policy.
(4) **Fees**: To manage the risk exposure of the government agency, the agency can charge lenders a fee (~2%) for the guarantee provided to them.

Thank you for opportunity to comment on APRA's proposal. Please contact [redacted] (Email: [redacted]) to further discuss any matter raised in this submission.

Yours sincerely,

Lecturer
Discipline of Finance
The University of Sydney Business School

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