

1 March 2019

Ms Heidi Richards
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Australian Prudential Regulation Authority

By email: ADIpolicy@apra.gov.au

Dear Ms Richards

Leverage ratio requirement for authorised deposit-taking institutions

COBA appreciates the opportunity to provide feedback on APRA's announcements on 27 November 2018 about the Leverage Ratio, a simplified framework for small ADIs and the broader capital framework.¹

COBA is the industry association for Australia's customer owned banking institutions (mutual banks, credit unions and building societies). Collectively, our sector has \$116 billion in assets, 10 per cent of the household deposits market and 4 million customers.

COBA's key points

- **APRA should use the revised capital framework as an opportunity to narrow the gap between advanced and standardised ADIs, while also reducing model risks**
- **COBA support the introduction of a leverage ratio particularly to act as a backstop for advanced ADIs**
- **COBA support the simplified leverage ratio for standardised ADIs and disclosure for simple ADIs but APRA should consider potential reporting efficiencies**
- **COBA supports the introduction of the simplified regime but the assets threshold should be increased to \$20 billion**

We welcome APRA's leverage ratio proposal. The introduction of a leverage ratio will provide a nonrisk-based backstop that complements the primary risk-based capital ratio measures. This backstop is particularly important for advanced ADIs as it creates a minimum floor that cannot be breached by overoptimistic modelling. The leverage ratio will discourage excessive leverage and protect against the underestimation of risk in IRB models.

More broadly, COBA reiterates that closing the gap between standardised and advanced ADIs' risk weights is a critical measure that APRA can undertake to improve competition. This must be a key consideration when implementing APRA's revised capital framework.

Separately, COBA welcomes APRA's indications that it will introduce a simplified prudential framework. It is now well recognised that the prudential framework has become more and more complex in recent years. A simplified framework is required to apply more proportionate and tailored prudential requirements to smaller and less complex ADIs. The proposed leverage ratio 'disclosure' requirement for small, simple ADIs is a good first step for this concept.

¹ APRA, 2018, *APRA responds to submissions on ADI leverage ratio, and extends timeline for broader capital framework reforms*, Media release, 27 November ([available online](#))

COBA expects the vast majority (if not all) of COBA members to be subject to this framework. Given APRA's 'opt-out' power and the mutual ADIs' simple business models, the indicative threshold for the simplified framework should be extended to \$20 billion in assets (from \$15 billion).

Given the state of the banking market, as highlighted recently by the Productivity Commission, the ACCC and the Financial Services Royal Commission, policymakers should be taking all reasonable opportunities to level the playing field and promote the competitive capacity of smaller competitors to the major banks.

Reducing the unfair advantages of the major banks and reducing the regulatory and reporting burden on smaller ADIs will increase competition in the banking sector without compromising financial stability. For the customer-owned banking sector, this will improve our position as the alternative to the current 'investor-owned' paradigm that dominates the banking market. Ultimately, these changes will benefit consumers.

Support for measures that limit the excessive advantages of advanced ADIs

COBA supports capital framework revisions that will reduce the competitive differential in regulatory capital requirements between large and small ADIs.

While the leverage ratio is not currently a 'binding constraint', it provides a backstop to ensure that these advanced ADIs cannot have excessive leverage.

The policy objective of a leverage ratio is clearly sound. Highly leveraged institutions have smaller buffers to absorb losses before insolvency. While leverage is currently restricted using risk-adjusted capital ratios, the Financial System Inquiry (FSI) highlighted that:

... there are concerns that, in some instances, the risk-weighted approach may lead to insufficient levels of capital. This danger is possible under the standardised or IRB approach, but is greatest for IRB models, as there is potential for 'model risk'. For example, if the historical data are too benign, the models that underlie the risk-weighting system may underestimate the true risk, leading to inappropriately low levels of capital. Concerns have also been raised that banks may have the capacity —and incentive — to manipulate IRB models to achieve a lower capital requirement.²

More broadly, the 'model risk' must be seriously considered given the competitive issues identified in Australia. These models drive the risk weight gap between the major banks and their smaller competitors. The FSI identified the risk weight gap as a significant anti-competitive problem and APRA has since taken interim steps to reduce the gap.

APRA's revised capital framework provides another opportunity to reduce the risks of excess leverage. COBA is encouraged by APRA's statements that "the revised risk weight framework is likely to reduce any competitive differential in regulatory capital requirements between large and small ADIs, improving the competitive position of the latter."³ While COBA recognises that APRA's proposals may reduce the competitive differential, we note that the Reserve Bank of New Zealand (RBNZ) has taken a more

² Financial System Inquiry, 2014, *Financial System Inquiry: Final Report*, 7 December, page 85 ([available online](#))³
APRA, 2018, *Discussion Paper: Revisions to the capital framework for authorised deposit-taking institutions*, 14 February.

procompetition position, adopting a key principle that “where there are multiple methods for determining capital requirements, outcomes should not vary unduly between methods”.

One of the key reforms in the revised capital framework is a floor on the amount of total risk-weighted assets (RWA) for advanced banks, relative to the amount of RWA that would be calculated using only the standardised approaches. This creates a direct link between the advanced and standardised approaches and limits the potential risk weight gap. Another is APRA’s calibration of the IRB scalars. As stated in our revised capital framework submission, COBA believes that APRA should apply this floor at a level of at least 72.5 per cent and supports the use of the IRB scalars including on overall RWA and mortgage RWA. Collectively, how APRA implements these measures can reduce the unfair benefits of IRB models.

Using these mechanisms to further narrow the gap is not unprecedented. In December 2018, RBNZ proposed significant action on this gap through these two mechanisms.

Like Australia, the New Zealand banking system is highly concentrated. The New Zealand banking system is dominated by subsidiaries of the four Australian majors (ANZ, ASB, BNZ, and Westpac) who unsurprisingly are also IRB banks (i.e. banks that can use their own internal models) like Australia’s major banks.

The RBNZ’s Capital Review Paper 4 proposes to:

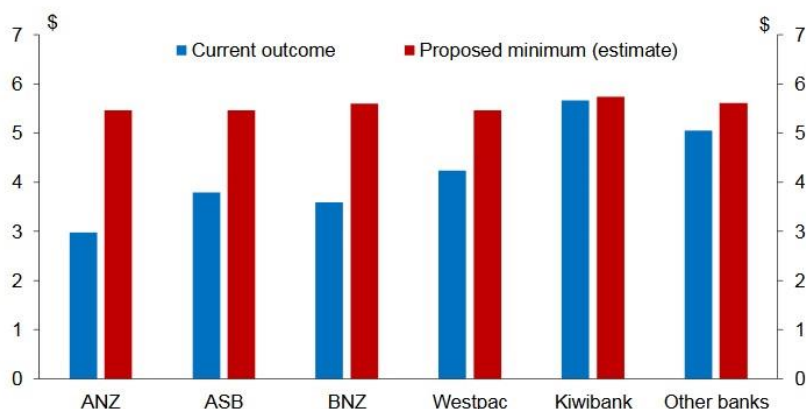
- increase the IRB scalar from its current calibration of 1.06 to 1.2.
- set a floor at 85 percent on RWA for advanced approaches relative to standardised approaches

In aggregate, the RBNZ estimates that these two adjustments will increase IRB banks’ aggregate RWA to an effective level of 90 percent of the standardised capital outcome.³

Figure 1: RBNZ Slide⁴

A more level playing field

- Current Tier 1 capital per \$100 of mortgage lending, Tier 1 capital at proposed minimum ratios (estimate using publicly available data)



The proposed RBNZ outcome is shown in Figure 1 (including its 16% Tier 1 ratio proposal). This significantly reduces the capital advantages of IRB banks on a per \$100 of mortgage lending basis.

COBA welcomes APRA’s intention to retain the IRB scalars and introduce a risk weight floor. However, in light of the RBNZ position, APRA should reconsider whether the level of its proposed risk weight floor and IRB scalar factors are appropriate.

The simplified calculation methodology for standardised ADIs

³ RBNZ, 2019, *Capital Review Paper 4: How much capital is enough?* 25 January ([available online](#))

⁴ RBNZ Deputy Governor Geoff Bascand, 2019, *Safer Banks for Greater Wellbeing*, 26 February ([available online](#)) ⁶

See footnote 4

COBA supports APRA's proposal to provide a simplified leverage calculation method for standardised ADIs using simpler accounting-based measures. This simplification will decrease the costs of calculating and disclosing a leverage ratio (vs. the more complex Basel III calculation).

As noted in APRA's February 2018 consultation paper⁶:

- [the leverage ratio] is not, in most circumstances, expected to constitute a practical constraint for most ADIs
- The overwhelming majority of these [standardised] ADIs have leverage ratios significantly above the proposed 3 per cent minimum requirement, and
- if the minimum leverage ratio requirements were calibrated in the range of 3-4 per cent, the leverage ratio would act as the binding capital constraint on only very low risk-weighted exposures.

There is little prudential risk associated with this approach given that APRA's initial consultation paper noted that the vast majority of standardised ADIs are already well in excess of the 3 per cent leverage ratio minimum.⁵ A more complex calculation methodology is unlikely to derive enough benefit relative to the potential costs.

Simplified prudential framework for small, less complex ADIs but consider reporting costs

COBA supports APRA's proposal for a simplified framework that could be applied to small, less complex ADIs. This recognises that prudential regulation is becoming overly complex and that there are simpler alternatives that can reach a suitable outcome.

APRA's proposal to exempt simple ADIs from the minimum leverage ratio requirement is welcome as the first element of this framework.

In line with this, it is appropriate that the leverage ratio only exists as a disclosure requirement for simple ADIs (noting that this is calculated on the same basis as standardised ADIs).

In general, COBA supports aligning APRA's reporting and prudential requirements with accepted standards or norms as much as possible. COBA members have noted that there has been a proliferation of reporting requirements from regulators over the last few years. Given the 'fixed cost' nature of reporting, reporting costs disproportionately impact smaller ADIs.

A Grant Thornton survey⁶ of mutual ADIs found that:

- Forty-three percent (43%) of respondents indicated that they spend more than one day per week on regulatory reports,
- 24% of respondents said their organisation spends more than 10 hours per week (37.5 hour week) in regulatory reporting, and
- 54% were concerned about increased reporting.

The ADI prudential reporting requirements can form a substantial part of the reporting burden. The introduction of a leverage ratio, even on a disclosure basis, imposes a new reporting form and standard.

In line with this, COBA notes there are two potential developments that could help reduce the reporting burden of this new form:

- whether there is scope for consolidation of forms within broader capital framework reporting standard changes, or
- how APRA's D2A replacement system could improve this collection (give this system should be online by the revised leverage ratio implementation date).

A small, less complex ADI threshold that reflects the Australia market

COBA welcomes APRA's initial indication of a \$15 billion asset threshold for the simplified framework but suggests this threshold should be \$20 billion.

⁵ APRA, 2018, *Discussion Paper: Leverage ratio requirement for authorised deposit-taking institutions*, 14 February (Table 2). However, COBA notes that this could change given that changes to the capital framework are expected by the time of the revised implementation date.

⁶ Grant Thornton, 2018, *A case for proportionate regulation: The cost of compliance*, 16 November ([available online](#)) ⁹ See footnote 4

This higher threshold will better represent the context of small ADIs in the Australian banking market. It will allow more rather than fewer ADIs to be subject to the starting position of a lower regulatory burden with discretion for the regulator on an ‘if not, why not?’ basis.

We note that there are other qualitative criteria proposed in addition to quantitative assets threshold. This will prevent complex ADIs from being subject to a simpler framework.

COBA acknowledges that APRA proposes for all ADIs meeting these criteria to automatically be subject to the simplified capital framework.⁹

Increasing the threshold to \$20 billion is justified on a range of metrics, including the actual distribution of ADIs by size, but also better meets a simple common-sense test of a small ADI. For example, half of one per cent of total resident assets is around \$20 billion which is an appropriate threshold. COBA has articulated its position on size thresholds further in our submission on the BEAR legislative instrument.⁷

Naturally, a higher threshold would cover more ADIs. However, this greater coverage must also be balanced against APRA’s proposal that APRA supervisors have the discretion to require an eligible ADI to use the more complex framework “where appropriate based on the nature of its business” (a position that is supported by COBA). This minimises the risk that an ADI would be inappropriately subject to the simple framework.

This expanded threshold would represent an ‘if not, why not?’ approach, where more ADIs would be subject to simpler and less burdensome requirements until APRA decides that they should not be (or alternatively the ADI does not want to be).

Thank you for the opportunity to comment on this consultation. If you have any questions or comments in relation to our submission, please contact [REDACTED] or at [REDACTED]

Regards,

MICHAEL LAWRENCE
Chief Executive Officer

⁷ COBA, 2018, *Submission on BEAR – Size of an Authorised Deposit-taking Institution – Draft Legislative Instrument*, 20 April ([available online](#))