15 June 2018

Ms Heidi Richards
General Manager, Policy Development
Policy and Advice Division
Australian Prudential Regulation Authority
Level 12
1 Martin Place
SYDNEY NSW 2000
Email ADIpolicy@apra.gov.au

Dear Ms Richards

APRA Discussion Paper: Revisions to the capital framework for authorised deposit-taking institutions

The Australian Banking Association (**ABA**) appreciates the opportunity to provide comments on APRA's Discussion Paper: *Revisions to the capital framework for authorised deposit-taking institutions*, dated 14 February 2018 (**discussion paper**).

With the active participation of its members, the ABA provides analysis, advice and advocacy for the banking industry and contributes to the development of public policy on banking and other financial services. The ABA works with government, regulators and other stakeholders to improve public awareness and understanding of the industry's contribution to the economy and to ensure Australia's banking customers continue to benefit from a stable, competitive and accessible banking industry.

The ABA welcomes the discussion paper which includes proposed revisions to the capital framework resulting from the Basel Committee on Banking Supervision's (**BCBS**) paper, *Basel III: Finalising postcrisis reforms* (**Basel III standards**), as well as other changes to better align the framework to risks, including in relation to housing lending. We also welcome APRA's proposal to simplify the capital framework for small ADIs, which is intended to reduce regulatory burden without compromising prudential soundness.

The ABA notes that APRA is not seeking to increase capital requirements beyond what was already announced in July 2017 as part of the 'unquestionably strong' benchmarks, and strongly support APRA's commitment to undertake further analysis of the impact of these proposed changes on ADIs during the process of consultation. This is needed to ensure capital requirements are aligned with underlying risks. We also look forward to working with APRA on the design potential adjustments to the overall design of the capital framework to improve transparency, international comparability and flexibility.

Our response is structured as follows:

Section 1: Key issues and concerns on capital framework proposals

- Implementation timeline
- Global comparability
- Overall calibration approach
- Impact on net stable funding ratio (**NSFR**)

Section 2: Feedback on specific proposals

- Non-standard mortgage definition
- Corporate and institutional lending proposals - Foundation Internal Ratings based (**F-IRB**) Approach
- Standardised risk-weights
- Definition of 'commitment'
- Customer impact of small- and medium-sized enterprises (**SME**) and qualifying revolving retail exposures (**QRRE**) proposals

Section 3: ABA response to questions contained in the discussion paper

Australian Banking Association

Section 1: Key issues and concerns on capital framework proposals

Implementation timeline

The ABA strongly recommends that APRA's proposed implementation timeline be aligned with the global implementation timeline of the Basel III standards of 1 January 2022, rather than 1 January 2021 as proposed by APRA. The ABA has a number of reasons for proposing this alignment with international standards which will provide all authorised deposit-taking institutions (**ADIs**) with an additional year to implement.

The ABA reaffirms its support for Australian banks to be 'unquestionably strong'. Australian ADIs have implemented strategies to increase their capital strength enabling them to meet, at the latest, APRA's unquestionably strong capital benchmarks by 1 January 2020. Upward adjustments required to the quantum of capital will continue as per the plans developed by ADIs following the July 2017 release of APRA information paper *Strengthening banking system resilience – establishing unquestionably strong capital ratios*[1] (July 2017 information paper). As stated in the discussion paper, APRA do not anticipate an increase in capital beyond the already proposed capital benchmarks needed to reach 'unquestionably strong'.

The recently finalised revisions to the Basel III standards represent a significant change globally for all banks, and the impact analysis is only beginning globally. An early implementation will likely place Australian banks at a disadvantage, as the impact of the new capital standard is not yet fully understood thus an early adoption will likely compound any disadvantage. Aligning the Australian implementation with the BCBS's timeline of 1 January 2022 will not impact prudential or systemic stability and will allow ADIs additional time to implement the vast number of concurrent regulatory reforms.

See question 1.2 in Section 2 for further details on the practical concerns surrounding early adoption of the revised Basel III standards.

Global comparability

The ABA recommends that APRA when finalising the capital framework, aligns the Australian prudential framework with the BCBS's standards, limiting variations to reflect local market conditions only where there is a legitimate or critical need to deviate from international standards given the impact domestic variations can have on international comparability and competitiveness.

Global comparability is critical for Australian banks as they compete for capital inflows on global markets. The Australian economy has been a net recipient of capital inflows since federation. Demand for credit in the Australian economy has consistently exceeded domestic saving and this gap has been funded from offshore investors.

Due to the variation between the current Australian prudential framework and global capital standards, Australian banks are required to prepare additional disclosures to demonstrate to overseas investors and analysts the relative strength of Australian banks when compared to their overseas peers. Table 1 shows recent results with up to 5.6 per cent variation in reported common equity tier 1 (**CET1**) ratios.

Table 1: APRA and Basel equivalent CET1 ratios for the 4 major banks and Macquarie bank

	Date	CET1 Ratio (APRA)	CET1 Ratio (Basel Equivalent)
CBA[2]	31/03/2018	10.1%	15.7%

[1] APRA media release, (19 July 2017), Strengthening Banking Resilience – establishing unquestionably strong capital ratios https://www.apra.gov.au/media-centre/media-releases/apra-announces-unquestionably-strong-capital-benchmarks
[2] CBA Basel III Pillar 3, (9 May 2018), Capital Adequacy and Risks Disclosures as at 31 March 2018 https://www.commbank.com.au/content/dam/commbank/about-us/shareholders/pdfs/2018-asx/asx-announcement_cba_3q18-basel-iii-pillar-3.pdf

ANZ[3]	31/03/2018	11.0%	16.3%
WBC[4]	31/12/2017	10.1%	15.7%
NAB[5]	31/03/2018	10.2%	14.6%
MQG[6]	31/03/2018	11.0%	13.5%

The ABA is strongly in favour of improving global comparability and is of the view that APRA should increase the CET1 capital ratio target, rather than pushing up risk-weights to achieve the 'unquestionably strong' benchmark. Although some Australian banks prepare internationally comparable results, the ABA has always argued it would be a better outcome to rely on a single and consistent published ratio which would enhance the competitiveness of Australian banks in the global debt markets.

APRA's proposals

When considering variations to reflect local market conditions the ABA is supportive of APRA's objectives to align capital with risk where necessary. The ABA would argue against the need for local market variations to the Basel capital standard relating to the non-retail sectors, where banks face competition from global peers who are not bound by similar rules.

The ABA also notes that as the final Basel standards require all banks globally to prepare capital results based on the standardised approach (**SA**), it is very likely that these SA results will be used to compare banks globally. As such, any local variations to the SA approach will have particular impact on the comparability of Australian banks to their global peers and will likely mask their relative strength.

The ABA is therefore strongly supportive of aligning both the IRB and SA approach in Australia to the BCBS's standards.

Overall calibration approach

The Quantitative Impact Study (**QIS**) is essential to inform calibration, and therefore the discussion paper is in itself not sufficient to form a view on an overall calibration approach. The proposals in the discussion paper are an important step in designing the framework, but the overall calibration needs to be looked at from a 'top-down' (ie. quantum of capital) point of view. There are also some critical assumptions in the QIS that will impact the capital calculations and therefore need to be decided before calibration decisions are made. The ABA view on these assumptions are included in this submission.

The ABA notes that there are a number of regulatory changes coming into effect in 2019 that may affect the ongoing calibration of the 10.5 per cent CET1 capital ratio benchmark, established in APRA's July 2017 information paper. These are changes to counterparty credit risk (**SA-CCR**) which is effective from 1 July 2019, and changes to lease accounting (**AASB 16**) which is effective from 1 January 2019. The ABA request that APRA confirm that the calibration of final prudential standards includes the impact of SA-CCR and AASB 16, which are effective prior to 1 January 2021.

Similarly, APRA consideration will need to be given other pending changes including Fundamental Review of the Trading Book (**FRTB**) Credit Valuation Adjustments (**CVA**) changes and any changes as a result of the review of the capital adequacy framework currently being undertaken by the Reserve

[3] ANZ 2018 BASEL III Pillar 3 Disclosure as at 31 March 2018 https://shareholder.anz.com/sites/default/files/anzs_march_2018_pillar_3_disclosure.pdf
[4] Westpac 2017 interim financial results https://www.westpac.com.au/content/dam/public/wbc/documents/pdf/aw/ic/WBC_1H17_Presentation_and_IDP.pdf
[5] NAB 2018 half year results, Investor presentation. https://www.nab.com.au/content/dam/nabrwd/About-Us/shareholder-centre/documents/2018half-year-results-investor-presentation.pdf [6] Macquarie Group FY18 Result Presentation https://static.macquarie.com/dafiles/Internet/mgl/global/shared/about/investors/results/2018/Macquarie-Group-FY18-result-presentation.pdf

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Bank of New Zealand. Changes recommended by the BCBS resulting from their review the regulatory treatment of sovereign exposures would also need consideration.

The APRA discussion paper states that "The specific quantitative risk weight calibrations will not be finalised… until after completion of a quantitative impact study". The ABA strongly requests that any discussions on overall calibrations are reconsidered after the international comparability paper is published.

Some further details on this issue is included in our response to question 7.1.

Impact on net stable funding ratio

The ABA's view is the capital proposals will have a material impact on the net stable funding ratio (**NSFR**) significantly increasing the stable funding requirements of ADIs. Prudential Standard APS 210 Liquidity (**APS 210**) refers to Prudential Standard APS 112 Capital Adequacy: Standardised Approach to Credit Risk (**APS 112**), and changes to the standardised risk-weights will drive an adverse change to the NSFR based on current proposals. The ABA does not believe that tightening the NSFR requirements is the intent of the Basel changes, and request that APRA ensures this is not an unintended effect.

The ABA recommends that changes required to update APS 210 be subject to a consultation process after finalisation of APRA's capital proposals to ensure appropriate recalibration of NSFR models.

Section 2: Feedback on specific proposals

The issues identified below are those of highest priority to our members. A summary of the industry's views is included in this section, and further detail is provided in Section 3: APRA's questions. The issues addressed below are:

- Non-standard mortgage definition
- Corporate and Institutional Lending Proposals - Foundation Internal Ratings-based (**FIRB**) Approach Standardised risk-weights
- Definition of "commitment"
- Customer impact of small- and medium sized enterprises (**SME**) and qualifying revolving retail exposures (**QRRE**) proposals

Non-standard mortgage definition

The ABA has significant concerns on the proposed definition of non-standard mortgages, a classification that impacts both SA and IRB approaches. The ABA's view is that a non-standard classification should be limited to residential lending that is of significantly higher risk. In the ABA's view, the APRA proposed definition is too broad. It captures a very wide range of loans in the nonstandard classification and the broadness of the definition will misalign risk with capital and reduce the overall risk sensitivity of the capital framework.

APRA has proposed that any loans which are approved outside of an ADI's serviceability standards would be classified as non-standard, and the ABA does not agree that all such loans are significantly higher risk. There are occasions when it is reasonable for an ADI to approve a loan outside traditionally serviceability criteria for individuals such as freelancers, self-employed people, those taking temporary parental breaks or those who have non-standard sources of income. In our view, it is preferable for ADIs to continue to have a controlled exceptions process to manage this and still have the loans classified as standard. The ABA believes this approach would be aligned with APRA's framework and expectations for sound residential mortgage lending as detailed in their letter dated 28 April 2018 to ADIs[6] which stated, "prudently managing overrides to lending policies, with risk tolerances set by the Board on the extent of exceptions to serviceability policy (negative serviceability) and serviceability verification waivers". The ABA also notes that any use of internal bank serviceability standards will lead to inconsistency and deviation across the industry as the assessment of serviceability will rely upon a bank's own policy decisions and risk appetite.

The broad definition of 'non-standard mortgage' is not competitively neutral and may also limit credit to customers who do not meet the 'standard' definitions. This puts those individuals at risk of having less choice and facilitating the movement into non-ADI lenders who are not subject to the same level of prudential oversight, and may ultimately increase systemic risk within the system.

In April 2018, the Reserve Bank of Australia stated[7], "tighter prudential framework for the regulated banking system over recent years may induce lending activities to migrate to less regulated, non-ADI lenders."

The ABA appreciates and supports APRA's objective of increasing the role of underwriting principles in the prudential framework, but believes incorporating principles directly into the capital standards is not an effective way of achieving this. Underwriting standards are principles which are best met by prudential supervision and not through standards. Addressing underwriting through guidance and APRA's ongoing review and supervision process allows for a more flexible and responsive regulatory approach to achieving systemic stability without any unintended consequences and tailored application for banks.

The ABA's view is that APRA's objectives in relation to underwriting standards can be achieved through updates to the Prudential Practice Guide APG 223 Residential Mortgage Lending, and the enforcement of underwriting principles through APRA's annual review process. The combination of all or some of these regulatory tools allows APRA to meet its policy objectives without the need to embed underwriting standards within the capital framework.

The ABA therefore recommends that:

- Underwriting principles are included in APG 223 and not in APS 112 and 113
- Guidance for banks is explicitly included in APRA's annual reviews, allowing APRA to ensure compliance as well as refine the approach for individual ADIs

The ABA further recommends that the framework includes mechanisms to enable the reclassification of loans from non-standard to standard. We propose that the current approach in APS 112 is a suitable start. APS 112 allow an ADI to reclassify a loan as a standard mortgage for a borrower who has demonstrated an ability to substantially meet their contractual loan repayments over a 36-month period.

The ABA has provided further feedback in Section 3, question 2.1 (Underwriting standards), 2.2 (Standard approach), 2.3 (Large/Multiple property investors) and 2.5 (IRB approach).

Corporate and institutional lending proposals (F-IRB)

The ABA is concerned that the current proposals, as they stand, will leave the corporate and institutional lending of Australian ADIs at a competitive disadvantage to international peers due to the divergence from international Basel standards. APRA's proposals will have a detrimental impact on both local and global non-retail lending. Local non-retail borrowers can access foreign banks operating branches here in Australia, who are not subject to APRA's super equivalent capital standards. These foreign banks will have a lower capital cost and therefore be able to offer better pricing. When

[6] APRA letter to ADIs, (28 April 2018), Embedding sound residential mortgage lending practices https://www.apra.gov.au/sites/default/files/LetterEmbedding-Sound-Residential-Mortgage-Lending-Practices-26042018.pdf
[7] Reserve Bank of Australia, Financial Stability Review (April 2018), page 40, http://www.rba.gov.au/publications/fsr/2018/apr/pdf/financialstability-review-2018-04.pdf

competing for global non-retail business, Australian ADI's will face a significant competitive disadvantage thereby lessening competition in the Australian jurisdiction.

To minimise the negative competitive impacts on corporate and institutional lending, the ABA has made a number of recommendations for the maturity assumption, APRA's loss given default (**LGD**) proposals, the treatment of physical collateral and the definition of large corporate.

Maturity assumption

The ABA has concerns about the possible application of a 2.5 year (six months for repos) fixed maturity for both bank and large corporate exposures.

This approach is not risk sensitive and results in overstating the risks of short positions and understating the risk of longer dated positions. There is no current indication that maturity is a source of material difference across the banks, and effective maturity is closely aligned to pricing models.

The ABA therefore recommends that APRA allows IRB banks to continue using the effective maturity approach. The Basel standard provides an option to use effective maturity for F-IRB exposures and therefore this would not be a variation from the global standards.

Loss given default proposals for senior unsecured exposures

APRA's approach of assuming a 60 per cent LGD unless certain conditions are met is significantly above the Basel standards and places Australian ADIs at a material competitive disadvantage. Any competitive disadvantage is especially acute in the non-retail sector as these borrowers can normally look to a very wide range of local and overseas lenders on a global basis.

The April 2018 Global Credit Data[8] (**GCD**) report stated that the actual average LGD for senior unsecured exposures is 27 per cent. APRA's proposed LGD of 60 per cent (except for some specific exceptions) puts Australian banks at a competitive disadvantage relative to the 40-45 per cent in the Basel standards. In earlier GCD studies, even at period of extreme stress, average corporate LGDs are below 50 per cent.[9]

As per our earlier recommendations, the ABA recommends that APRA adheres to the Basel standard, in this case applying an LGD of 40 per cent and 45 per cent for financial institutions. However, if APRA decides to apply a different treatment, the ABA has provided more feedback in our answer to question 4.1 in Section 3 below.

Eligible collateral

For secured exposures subject to the F-IRB approach (including large corporate and financial institutions) APRA is proposing changes to LGD estimates based upon collateral type. In the discussion paper APRA does not include 'other physical collateral' as an eligible collateral type. Physical collateral is a core part of asset finance and includes aircraft leasing, inventory, equipment, commodities and vehicles all of which provide meaningful loss protection.

Exclusion of 'other physical collateral' will materially impact the competitive position of Australian ADIs relative to international ADIs in secured lending. Basel proposes a F-IRB LGD of 25 per cent for exposures secured by other eligible physical collateral. APRA's proposed 45-60 per cent unsecured LGD will severely restrict the ability of Australian ADIs to price competitively in these secured lending markets.

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[8] Global Credit Data, (9 April 2018), LGD Report 2018 – Large Corporate Borrowers
https://www.globalcreditdata.org/system/files/documents/gcd_lgd_report_large_corporates_2018.pdf
[9] Global Credit Data, (15 November 2017), Downturn LGD Study 2017
https://www.globalcreditdata.org/system/files/documents/gcd_downturn_lgd_study_2017.pdf

The ABA recommends that APRA recognises 'other eligible physical collateral' in line with the Basel framework to maintain risk sensitivity, international comparability and competitiveness, and provide appropriate incentives to obtain collateral.

Definition of large corporate - impact on unsecured and secured exposures

Unsecured exposures

APRA has proposed extending the application of F-IRB modelling to all unsecured non-retail exposures, rather than limiting F-IRB to large corporates in line with the Basel III revisions. The ABA does not consider that this extension is justified. There is sufficient data available to inform LGD models for corporates with turnovers less than AUD$500m. Over the last ten years, Australian and international banks have strengthened efforts to collect and pool loss data relevant for bank lending products across all Basel asset classes.

As of 2017, the GCD database included over 150,000 non-retail defaulted loan facilities from around the world. Based on data provided by GCD to the Basel's Risk Management Group[10] (**RMG**) in 2015, roughly 75 per cent of all collected loss data points in the corporate asset class are for exposures up to EUR500m. External datasets such as the GCD are motivated by banks' desire and ability to model LGDs, and it is only through such large and diverse datasets that banks, supervisors, and academic scholars are now in a much-improved position to identify patterns and risk drivers for this population of loans.

Internally modelled unsecured LGD and credit conversion factors (**CCFs**) allow for more sophisticated risk management and capital allocation decisions. The F-IRB approach lacks granularity and fails to fully recognise risk sensitive decision-making. Further, APRA's proposal alters the need for external data sets which have significant risk management value as it allows Australian ADIs to quickly and confidently gain deeper risk insights for the purpose of decision-making in their economic capital frameworks, pricing or underwriting policies.

Secured exposures

For secured exposures, the Basel standard constrains LGD modelling for secured exposures with revenues greater than €500m, and APRA are proposing AUD$500m for the same boundary. The ABA recommends that APRA applies the Basel €500m boundary at current exchange rates for secured exposures, therefore allowing all banks to use their internally modelled LGDs for corporates up to AUD$800m to avoid unnecessary competitive distortions for transactions in this sector of the market.

Standardised risk-weights

Retail exposures

The proposed risk-weights for retail exposures exceed the Basel standard, and as APRA does not recognise the 'regulatory retail' category or the concept of 'transactors', the divergence is significant. The ABA acknowledges APRA's reluctance to consider the concept of 'transactor' accounts, however applying a 100 per cent risk-weight to credit cards is significantly above the modelled behaviour of these portfolios by IRB banks in Australia. 'Other retail' risk-weights for IRB banks, as per their Pillar III reports, are broadly consistent with the Basel standard of 75 per cent.

For 'other retail', an increase in the risk-weight to 125 per cent compared to the current 100 per cent does not align with risk characteristics and performance experienced by our members for these portfolios. As noted above, IRB ADIs model these exposures at significantly lower risk-weights than 100 per cent, and although the ABA accepts that the SA approach will by its nature be less risk sensitive and therefore more conservative, the increase to 125 per cent is not warranted.

[10] RMG was a task force under the Credit Risk Group, which reported to the Policy Development Group and the Supervision and Implementation Group of the Basel Committee on Banking Supervision: www.bis.org

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The ABA therefore recommends that APRA aligns to the Basel III category of 'regulatory retail' at 75 per cent risk-weight, and retains the current treatment of 'other retail' at 100 per cent risk-weight.

Small- and medium-sized enterprises exposures

The ABA welcomes the recognition of 'collateral' other than residential property for SME loans, but questions the risk-weight of 85 per cent for SME retail compared to the Basel setting of 75 per cent. We question whether this relatively small variation, which would result in a further move away from global comparability is justified or necessary. APRA's proposed variation from the global standard will not materially improve financial safety or financial system stability and increases the complexity of reporting.

The ABA recommends that the 75 per cent risk-weight be adopted for this category.

Commitments

Definition

APRA has adopted the definition of 'commitment' from the Basel III standards, but the standard also allows discretion to exempt certain arrangements from the definition where they comply with specific conditions. The Basel III conditions include a requirement that the ADI reassess the creditworthiness of a customer prior to each drawdown and also requires that the bank receive no fees for setting up or maintaining the facility. The requirements for this exemption are in footnote 53 of paragraph 78[11] of the Basel standard.

Facilities of the type described in footnote 53 protect ADIs from the risk of drawdown and are also designed to facilitate efficient transactions on standard terms should the customer request and the bank subsequently approve funding. In this sense, they are similar to master trading agreements and do not constitute an offer by the bank. It would therefore not be appropriate to capture these as commitments and apply a 20 per cent CCF to such facilities.

The ABA recommends that APRA exercises this discretion to exempt these arrangements, as described in footnote 53[12], from the definition of commitment. If APRA is simply seeking visibility of such facilities and therefore wants to continue to capture them in the definition of commitment, the ABA recommends that a 0 per cent CCF be applied.

Credit conversion factors

APRA has proposed a treatment of CCFs that is materially higher than the Basel III standard and that will impact the competitive position of Australian banks relative to international peers. The ABA's recommendation is that APRA adopts the Basel treatment of CCFs. The ABA position is covered in more detail in our response to question 3.1 in Section 3 below.

Customer impact of SME and qualifying revolving retail exposure proposals

The ABA's response to APRA's SME and qualifying revolving retail exposure (**QRRE**) proposals are included in Section 3, question 4.3. In general, the ABA is not supportive of the APRA proposals. We believe that the proposed changes will have a material impact on lending to the SME sector of the Australian economy. Increasing capital requirements for SMEs are likely to impact small business owners' access to competitively priced credit. Small business plays a significant and integral part of the Australian economy.[13]

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[11] BCBS, Basel III: Finalising post-crisis reforms, (December 2017), Standardised approach, paragraph 78, footnote 53, page 25 https://www.bis.org/bcbs/publ/d424.pdf

[12] BCBS, Basel III: Finalising post-crisis reforms, (December 2017), Standardised approach, paragraph 78, footnote 53, page 25 https://www.bis.org/bcbs/publ/d424.pdf

[13] The Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry, Background Paper 9: The regulatory capital framework for authorised deposit-taking institutions (ADIs), (9 May 2018), Background Paper 12, Financial services and Small and

Similarly, for QRREs the departure from the global standards and the proposed application of higher risk-weights may have an impact on the availability of competitively priced credit card offerings. Credit cards play a key role in transaction and working capital for consumers. If adopted the proposals are likely to have an impact on the availability of consumer credit through cards and may simply result in a shift in systemic risk from regulated banks to non-bank issuers of credit cards.

Section 3: ABA response APRA questions

Chapter 1 – Introduction

1.1 Are there any other potential impacts on the industry or community that should be considered in balancing APRA's objectives?

As discussed in Section 1 of this submission, the ABA is a strong advocate of a globally consistent implementation of the Basel standards with as few local variations as possible, and only where there is a demonstrated difference in the local market requiring the regulator to adapt the Basel standards. A number of APRA's proposals introduce unnecessary variations to aspects of both the SA and IRB approaches. This will result in reduced global comparability and will require ongoing explanation to investors and borrowers which is a barrier to an Australian ADI's ability to efficiently compete in international markets for the necessary funding required by the Australian economy.

Efficiency: The ongoing cost and regulatory burden of having to create multiple versions of capital ratios is not considered in the discussion paper. To ensure orderly access to international funding and capital markets, banks are already creating internationally comparable versions of their capital ratios, and APRA's proposals would result in a need for further disclosures.

Impacted banks will need to prepare multiple versions of the SAs (APRA's SA and the Basel SA) as well as APRA's and the Basel versions of IRB results. As the floor maintains a relationship between SA and IRB, impacted banks therefore must assess the potential impact of the floor under each SA scenario. The Basel SA reporting is likely to become the global benchmark and the Basel SA reports, produced by Australian banks, will increasingly become more of a prominent risk measure used by global investors to compare Australian ADIs with global peers. Many investors do not look beyond the 'headline' ratio to understand jurisdictional variations and this would disadvantage those ADIs as they compete for funding and capital.

Financial stability: In any crisis scenario, lenders in volatile markets will always focus on those lower risk investments, seeking out those banks with high headline capital ratios, rather than spending the time to fully understand the strength of Australian ADIs. The ABA is, and remains, fully supportive of having unquestionably strong Australian ADIs, but APRA, by embedding this strength via increased risk-weights, rather than the CET1 ratios may obscure the fact that Australian ADIs are unquestionably strong when compared to global peers.

Competition: The ABA holds that the super-equivalence that APRA proposes to apply to non-retail exposures will have a particularly significant negative impact on an Australian ADI's ability to compete against banks operating in an environment with less super-equivalence. This hinders the ability of ADIs to effectively compete with international businesses for institutional clients, including an impact on aircraft and shipping corporate customers due to APRA's proposed restrictions on other physical collateral.

Local large corporates have the option to access funds internationally and higher capital charges will place Australian ADIs at a pricing disadvantage when competing for business. This negative competitive impact is compounded by the number of active foreign branches approved in Australia that are not bound by the Australian prudential capital standards.

Medium-Sized Enterprises (SMEs), https://financialservices.royalcommission.gov.au/publications/Documents/financial-services-and-small-andmedium-sized-enterprises-paper-12.pdf

1.2 What are the advantages of aligning the recommended changes with the Basel Committee's implementation date of January 2022?

The ABA notes that for all our members the burden of continual regulatory change is very material, and more so when the time to implement these reforms alongside a significant number of other deeply complex regulatory requirements is so compressed. The impact on regional and smaller banks with more limited resources is particularly acute and the complexity facing those ADIs with a large footprint is challenging. Aligning the Australian implementation with the BCBS's timeline of 1 January 2022 will not impact prudential or systemic stability but will allow ADIs additional time to implement the vast number of concurrent regulatory reforms in a more orderly coordinated fashion.

Section 1 of this submission highlights the ABA's main concern regarding Australian banks implementing the substantial suite of Basel III revisions ahead of other countries. Further practical issues with early adoption are included below.

Capital allocation and business strategy

Any major change to capital allocation methodologies requires an ADI to undertake a detailed review of business strategy. Capital design is intended to drive lending behaviour, so banks will have to review their economic capital, pricing and their cost allocation models. The changes required by APRA's proposals will be extensive, and in most cases, will require modification to customer facing systems, data collection processes, as well as changes to the internal systems used to capture and calculate capital requirements.

The consultation period and finalisation of rules is expected (per APRA policy priorities document) to extend to the end of 2019, leaving only one year for implementation. The ABA believes it is reasonable to give at least three (BCBS's timeline of 1 January 2022) years after final standards are agreed to implement such fundamental global reforms into the Australian prudential framework.

Interaction with other projects

In recent years, APRA has worked diligently to progress the implementation of Basel III and a significant list of other prudential reforms, i.e. FSI recommendations and TLAC, in a speedy but logically ordered fashion. The adoption of the Basel III revisions represents the largest change to the Australian capital framework since Basel II in 2005, and it would be prudent to allow banks the time to assess and understand the changes as well as to adequately resource the projects. Alignment with the BCBS's timeframe of 2022 reduces the risk, and enables banks to integrate other projects with related overlap (such as APS 180, APS 221 and EFS reforms) and to manage costs and minimise risk.

Aligning the Australian implementation with the BCBS's timeline of 1 January 2022 will also allow APRA time to provide further detail on some critical aspects of its proposals which are needed by ADIs to enable efficient planning for implementation of the changes, these include:

- The discussion paper is silent on the principles required for non-standard loans to revert to standard when appropriate. The ABA has previously recommended that APRA allow ADIs to rely on APS 112 Attachment D paragraph 7, which states "loans may be reclassified as standard loans where the borrowers have substantially met their contractual loan repayments to the ADI continuously over the previous 36 months".
- The discussion paper is silent on revaluation of collateral for mortgages. The ABA recommends that revaluation be allowed as per current practice.
- The discussion paper does not provide specific guidance on public housing companies and not for profit associations[14]. The ABA would support a lower risk-weight to provide certainty to social housing sector customers. The current lack of clarity will result in classification as higher risk mortgages to individuals and/or non-retail treatment of the

[14] BCBS, Basel III: Finalising post-crisis reforms, (December 2017), paragraphs 68 (SA approach) and paragraph 21(IRB approach) https://www.bis.org/bcbs/publ/d424.pdf

exposures direct to the housing provider. Neither classification appears to accurately reflect the underlying risk nor recognise community and government support for social housing purposes. This would encourage legitimate social housing support and allow participation by banks in transactions that benefit a disadvantaged sector of the community.

Chapter 2 - Credit risk: residential mortgage lending

2.1: How should sound underwriting be embedded in the capital framework?

The ABA has included our concerns about APRA's proposed classification of any loan that fails serviceability as non-standard (see ABA's earlier comments in Section 2 of this submission). We recommend the inclusion of underwriting principles in APG 223 and have argued that underwriting principles should not be included in the capital standards APS 112 and 113[15].

The ABA has some concerns on APRA's other two proposed operational requirements, interest rate buffer and the verification of positive net income surplus.

1) **Interest rate buffer and floor settings**: Setting minimum interest rate buffers and floors may become restrictive depending on the economic environment, and as such including the 2 per cent buffer and 7 per cent floor into the prudential standards is not appropriate.
2) **Verification of positive net income surplus**: The ABA also believes that the use of positive net income surplus is too subjective and risks increasing inconsistency across the industry. For example, definitions around minimum income verification requirements may vary, as well as what adjustments or haircuts should be applied to different income types. This again, reflects the risk appetite of the bank in question, and may not be applicable across the whole industry.

2.2 Is there a preferred approach between the options to determine higher risk-weights detailed in section 2.3.1?

The proposed risk-weight of 100 per cent for non-standard low risk loans exceeds the Basel standard for low risk non-standard loans, and is non-risk sensitive. In a recent paper prepared by APRA in response to a request from the Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry[16], APRA states that risk-weights should consider three factors: namely loanto-value ratio (**LVR**), operational requirements and lenders mortgage insurance (**LMI**). By setting a 100 per cent flat risk-weight for failure to meet operational requirements the proposals are giving operational requirements primacy and not considering LVR.

The ABA supports APRA's segmentation of the mortgage portfolio into lower-risk and higher-risk exposures. The ABA would recommend using these classifications and apply a 50 per cent uplift for 'low' risk loans, and a 100 per cent uplift for 'high' risk loans, subject to an overall risk weight floor of 50 per cent and a ceiling of 100 per cent.

The below table outlines the ABA's recommended settings.

Table 2: Proposed risk-weights for residential mortgages under the standardised approach

		<50% LVR	<60% LVR	<80% LVR	<90% LVR	<100% LVR	>100% LVR
Standard	Owner Occupied P&I	20%	25%	30%	40%	50%	70%

[15] APRA Information paper: Policy priorities, (January 2018), states that Prudential Standard APS 220 Credit Quality will undergo an update in 2018/19 to incorporate changes in APG 223

[16] The Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry, Background Paper 9: The regulatory capital framework for authorised deposit-taking institutions (ADIs), 27 April 2018, https://financialservices.royalcommission.gov.au/publications/Documents/apra-the-regulatory-capital-framework-for-authorised-deposit-takinginstitutions-adis-paper-9.pdf

	Other Residential	30%	35%	45%	60%	75%	85%
Non-standard	Owner Occupied P&I	50%	50%	50%	60%	75%	100%
	Other Residential	60%	70%	90%	100%	100%	100%

2.3 What level of capital requirement reduction for LMI should be recognised for residential mortgage exposures?

A reduction of between 30-50 per cent for mortgage risk-weights would be an appropriate mechanism to recognise the benefits of LMI, as there is a meaningful reduction in loss given defaults (**LGDs**) for loans which meet the minimum of 40 per cent LMI coverage.

The discussion paper[17] notes that "APRA's preferred approach is to increase the Table 3 risk-weights (as finally calibrated) for standard loans with an LVR over 80 per cent that do not have LMI." The riskweights proposed in Table 3 for standard loans broadly align with the Basel treatment for loans that do not have mortgage insurance, and any increases would move APRA further away from the global Basel standards. The ABA strongly supports aligning Australian capital standards to the global framework.

The analysis of the impact of APRA's proposed changes will be included in individual bank's submissions to APRA on residential mortgage LGDs, which may include analysis of LMI impacts in downturn conditions. The ABA would welcome the opportunity to engage with APRA further on this topic, as APRA continues the significant calibration task ahead.

2.4 How should exposures to individuals with a large investment portfolio be treated under the standardised approach to credit risk?

The ABA does not agree with either of the approaches proposed by APRA.

- *Non-standard* – applying a simple 100 per cent risk-weighting does not reflect the different risk profiles of large investors and ignores the fact that these investors must still meet serviceability assessments and are secured exposures. They are likely earning rental income from a diversified residential portfolio and each portfolio will have different income and collateral characteristics.
- *Commercial property* – the income and security profile of large investors likely resemble retail clients more than commercial clients. Ongoing commercial probability of default (**PD**) assessments may not be possible without changing the loan documentation requirements and increasing the customer's compliance burden.

The ABA recommends that APRA creates a separate risk-weight calculation for these portfolios. For SA banks, this should include consideration of LTV, operational requirements and LMI, consistent with the approach for retail exposures. For IRB banks, these exposures would be treated consistently with other residential mortgages, and adjusted though a specific asset correlation factor.

The ABA further recommends that APRA reconsiders using the number of properties as a method of identifying large investors. This approach is both complex to implement and not effective in identifying higher risk borrowers.

The application of any definition of 'large investment portfolios' that relies on the number of properties or dwelling presents significant operational challenges to implement. Furthermore, given that sophisticated lenders typically utilise different entity structures (such as trust companies etc.), introducing a dwelling

[17] APRA Discussion Paper, (14 February 2018), Revisions to the capital framework for authorised deposit taking institutions, page 24, https://www.apra.gov.au/sites/default/files/Revisionsper cent2520toper cent2520theper cent2520capitalper cent2520frameworkper cent2520forper cent2520ADIs.pdf

test is unlikely to meet the objective of capturing borrowers with a higher reliance on investment income.

Introducing a fixed test, based on a number of dwellings, will result in a cliff effect and is not reflective of higher risk loans in all instances. For example, five small low-LVR investment property loans may be a lower risk due to diversification benefits, i.e. the ability of the investor to absorb the impact of a rental vacancy in one property within the portfolio as opposed to that of a borrower with a single large property.

In our view, ADIs internal limits on the proportion of very high debt-to-income (**DTI**) lending, and existing APRA policy limits on the maximum DTI levels per individual borrower are more appropriate tools for APRA to address any prudential concerns regarding individuals with large investment portfolios.

2.5 Are there alternatives to the proposed changes to the IRB risk-weight functions for residential mortgage exposures that would similarly address APRA's concerns about higher risk lending?

The ABA's view is that the most effective way for APRA to control higher risk lending is via changes in the PD and LGD estimates in IRB models. Risk factors that are already proven to result in higher default or loss rates are already included in the IRB models.

There is a significant risk that niche lending products, such as bridging loans, which have a strong history of low defaults and low LTVs that are both an essential banking product and demonstrably low risk, are being caught up in a non-risk sensitive approach.

The ABA continues to recommend that the definition of higher risk 'non-standard' lending should include those loans where there is an enduringly higher risk of loss, and where adequate statistical data is not available to fully populate IRB models to a sufficient degree of confidence.

The ABA recommends that APRA consults further to identify those loans which are truly on the fringe and higher risk, to avoid penalising loans that are good quality but are considered 'non-standard'.

Chapter 3 - Credit risk: other standardised exposures

3.1 Should CCFs be aligned between standardised and IRB ADIs?

The ABA is supportive of aligning risk-weight outcomes for exposures where underlying borrower behaviour is unlikely to differ, however if a bank can justify a lower or higher CCF as a result of its product design or internal practices, this should be allowed within the framework with appropriate approval and oversight by APRA.

On the topic of CCFs the ABA has a number of observations about the proposals.

Definition

As detailed in Section 2 of this submission, the ABA recommends that APRA exercise national discretion to exempt certain arrangements as described in footnote 53[18] of the Basel III standard from the definition of commitment. The conditions for this exemption are discussed in Section 2.

Credit cards

The ABA supports APRA's proposal to adopt the Basel definition of commitment, and that a CCF must be applied to any credit exposure that has been offered by the bank, and accepted by the borrower, including any unconditionally cancellable arrangement. However, APRA's has specifically included credit cards in the 'Other commitments' category rather than 'Other commitments – unconditionally cancellable', and assigned a CCF of 50 per cent.

The proposal for a CCF of 50 per cent on credit cards undrawn is not consistent with Basel. The ABA would argue APRA's proposed deviation is not necessary as there is no evidence of systemic higher drawdowns prior to default.

The ABA acknowledges that unconditionally cancellable commitments, such as unused portions of retail lines of credit, are not always cancelled in advance of default, due to constraints such as consumer protection laws, risk management, etc. Some customers do draw down some of their undrawn limits before default, i.e. those that default, having drawn down on their other credit facilities, but the ABA would hold that APRA should take a whole-of-portfolio view , which would demonstrate that even in a stressed scenario the small quantum of consumers drawing down would not warrant a 50 per cent CCF. Applying a higher CCF of 50 per cent coupled with a risk-weight of 100 per cent would unfairly penalise these low-risk revolving retail exposures, and the resulting risk-weight does not appear consistent with IRB results for equivalent exposures.

The ABA recommends the credit cards are included in the 'Other commitments – unconditionally cancellable' category as per the Basel standards, and assigned the associated CCF of 10 per cent.

Residential exposures

APRA's proposed CCF of 100 per cent is overly conservative as it does not reflect the actual usage of these credit lines. For standardised banks, CCFs are the only mechanism available to recognise the lower risk resulting from pre-payments. APRA's proposed approach may prevent banks from passing on the risk reduction benefit to customers in the form of reduced cost. This lack of capital relief for overpayment of loans could limit the ability of standardised banks to provide incentives for the customers to continue to overpay. The ABA would hold that this could potentially exacerbate the financial hardship experienced by customers in instances of loss of income.

The ABA recommends alignment with Basel's treatment of 40 per cent. We also recommend that APRA reviews the CCF's currently applied in IRB banks to ensure consistency of treatment.

[18] BCBS, Basel III: Finalising post-crisis reforms, (December 2017), Standardised approach, paragraph 78, footnote 53, page 25 https://www.bis.org/bcbs/publ/d424.pdf

Chapter 4 Credit risk: other IRB exposures

4.1 Are there additional conditions that APRA should consider for unsecured non-retail exposures to be eligible for a lower LGD estimate under the foundation IRB approach?

APRA's approach of assuming a 60 per cent LGD unless conditions are met is significantly above the Basel standards and places Australian ADIs at a competitive disadvantage. This is especially acute in this sector as these counterparties can normally look to a very wide range of banking counterparties on a global basis.

As noted above, the April 2018 GCD reported average LGDs for senior unsecured of 27 per cent.

As per our earlier recommendations, the ABA recommends that APRA adheres as closely as possible to the Basel standard and apply an LGD of 40 per cent (45 per cent for banks and other financial institutions) for senior unsecured exposures. The ABA has also previously made a recommendation (Section 2) that APRA includes 'other physical collateral' as eligible collateral given the loss protection provided.

Should APRA ultimately decide to apply a senior unsecured LGD framework that differs from the Basel III framework, the ABA considers that the Basel standard LGD of 40 per cent (45 per cent for banks and other financial institutions) should be the default LGD, with only those positions that exhibit specific higher loss characteristics receiving a higher LGD.

The ABA considers that exposures where a preferential LGD treatment is warranted should include:

- Short-dated, self-liquidating, senior unsecured trade finance exposures, including import and export loans and letters of credit, performance guarantees and standby letters of credit
- Exposures to essential assets, such as utilities, infrastructure and government facilities[19]
- Exposures to large well diversified property investment vehicles, for example real estate investment trusts
- Exposures secured by a general security interest or that have other bankruptcy protections, e.g. an essential contract that is likely to be assumed in bankruptcy.

In relation to APRA's proposed criteria for segmenting unsecured exposures into different LGD buckets, the ABA has concerns around APRA's proposed approach. These are:

i) The complexity of defining 'readily realisable' ii) The extent to which contractual protections versus other considerations, such as jurisdiction, should be incorporated, and

iii) How leverage could be appropriately incorporated, noting the need to consider sector specific market norms, both in determining the level of leverage and the measurement basis appropriate for the borrower, e.g. debt to assets, debt to earnings or assets to liabilities. The ABA understands that individual banks will be responding to APRA's request and will include within their QIS response further quantitative detail on risk-weights by asset class. Once APRA has reviewed individual submissions and has come to an initial view, the ABA is happy to facilitate further industry engagement on this topic.

4.2 Should APRA allow IRB banks to use an IRB risk-weight function for commercial property exposures or continue with the supervisory slotting approach (assuming overall capital requirements would be comparable)?

The ABA supports the use of an IRB risk-weight function for commercial property. This will enhance risk sensitivity and incentivise better risk behaviours in commercial property exposures.

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[19] Global Credit Data, (9 April 2018), 'LGD Report 2018 – Large Corporate Borrowers https://www.globalcreditdata.org/system/files/documents/gcd_lgd_report_large_corporates_2018.pdf

In relation to commercial property, the ABA recommends no changes to the current treatment of large, well-diversified commercial property entities. The original reasoning for APRA to agree to use the corporate asset class for this cohort of exposures across the banking system has not changed. These entities represent borrowers with significant portfolio diversification benefits which reduce their inherent default risk. Many of these entities borrow unsecured on international lending platforms and can offer tangible security in the case of withdrawal of bank liquidity from asset markets, further reducing their risk of default.

Exposures to the large, well-diversified commercial property entities cohort would see very significant increases in risk-weights given their move to the more conservative commercial property correlation formulae combined with potentially being impacted by a scalar. This in itself would put Australian ADIs at a material disadvantage in competing with foreign banks for Australian real estate investment trusts' business within their home market.

4.3 What would be the impact of removing the SME retail and qualifying revolving retail asset classes from the IRB approach?

APRA's proposals are inconsistent with the Basel framework, and the ABA would query whether there are benefits which outweigh the costs to transparency and comparability. The ABA has articulated our specific concerns about impact on customers in Section 2 of this submission, and include further technical comment here.

SME retail

The ABA would hold that applying the SME corporate treatment to SME retail is likely to result in less risk sensitivity. The separate correlation factor proposed by Basel reflects evidence[20] that small businesses have a lower correlation with the economic cycle than larger businesses, and therefore the ABA would be supportive of keeping this distinct category.

Qualifying revolving retail

APRA's proposal would result in a significant increase in capital for QRRE, which in our view, is not reflective of the actual risk profile of this portfolio. The portfolios tend to have a short duration, and the implied losses from the APRA proposals significantly exceed the maximum loss experiences of Australian ADIs, which they will detail in their individual responses.

The ABA's view is that APRA remains consistent with the Basel proposals.

Chapter 5 Operational risk

5.1 Should the loss component be omitted from the operational risk capital calculation?

The ABA is supportive of removing the operational loss component.

[20] Bank of Japan, (August 2009), Working Paper Series: Asset correlation for credit risk analysis, https://www.boj.or.jp/en/research/wps_rev/wps_2009/data/wp09e03.pdf
Moody's Analytics, (3 March 2008) Asset correlation, realised default correlation, and portfolio credit risk https://www.moodysanalytics.com//media/whitepaper/before-2011/03-03-08-asset-correlation-realized-default-correlation-and-portfolio-credit-risk.pdf

Chapter 6 Interest rate risk and market risk

6.1 Would standardising assumptions for the non-interest-bearing deposits portfolio and the basis and optionality risk calculations significantly reduce the benefit of having an internal model approach for IRRBB?

The ABA supports a framework that allows for consistency across banks, however we note that standardising assumptions will reduce the benefits of internal modelling, and the ABA continues to support the use of internal modelling for interest rate risk in the banking book (**IRRBB**) calculations. It is important that any standardisation of the framework continues to reflect the different ways that interest rate risk can be managed across the banking system. It is important that an appropriate balance is reached between accuracy and simplicity.

In the design of any standardised assumptions the ABA strongly encourages APRA to ensure capital requirements reflect the economic risks that individual banks are exposed to. We would welcome APRA's continued dialogue in this area as further proposals are developed.

Chapter 7 Approach to overall calibration

7.1 *Are there alternative approaches to ensure an appropriate overall calibration of capital requirements?*

As mentioned in Section 1 of this submission, the ABA is of the firm view that the overall calibration of the Australian capital framework should only be finalised following APRA's consultation on the global comparability paper. Without sight of the potential adjustments to the overall design of the capital framework to improve transparency, international comparability and flexibility, it is difficult to take a holistic view of the Australian capital framework.

In principle, our view is that any capital overlays or adjustments are best done at an overall level, rather than at asset class level. To keep the overall quantum consistent, as well as ensure top quartile positioning, the ABA recommends that this review is done holistically.

Scalars at an asset level do not take into account the overall capital requirements of IRB banks. For example, calibrating risk-weights for residential mortgages between SA and IRB banks need to include additional capital held at IRB banks such as IRRBB as well as the impact of regulatory expected loss, both of which arise from the residential portfolio. There is also reduced incentive to invest in market leading risk analytics if the results are scaled to the less risk sensitive SA at an asset level.

The 72.5 per cent floor included in the Basel III framework has also been put in place to address the model risk and measurement error. The ABA's view is that the floor addresses concerns about the relationship between SA and IRB risk-weights, and as such the ABA is not supportive of the additional use of scalars in general, although we acknowledge that APRA may be considering the use of scalars to meet the 2nd recommendation of the Financial System Inquiry[21]. If APRA decides scalars are needed, then the ABA recommends that they are consistent, easily identified in reporting and applicable to all banks.

7.2 *Are there any definitional issues that APRA should consider in the implementation of the RWA floor for IRB banks?*

The ABA believes that APRA will need to confirm which assumptions are to be used in the calculation of the SA and IRB capital ratios before applying the floor. If scalars have been applied to address any disparity between IRB and SA approaches, the ABA seeks confirmation that these are to be removed before determination of the capital floor.

Chapter 8 A simpler approach for small ADIs

8.1 *What is an appropriate size measure and threshold to determine which ADIs may apply the simplified framework?*

8.2 *Are there other prudential requirements that could be simplified for smaller ADIs without compromising prudential safety and soundness?*

8.2 *Does the proposal for a simplified framework raise any competition concerns?*

Our members have no comments on these proposals.

Conclusion

I appreciate the additional time that APRA has provided the ABA to prepare our response to this discussion paper which is critical step as APRA works to finalise and calibrate a number of significant reforms to the Australian prudential framework. The ABA is cognisant of the size and complexity the task ahead for APRA and we look forward continued dialogue to ensure an appropriate implementation of the capital framework for Australian ADIs.

Thank you again for the opportunity to respond to the proposals.

[21] The Financial System Inquiry Final Report, (7 December 2014), recommendation 2 - narrow mortgage risk weight differences, http://fsi.gov.au/publications/final-report/

Yours sincerely

Signed by

Aidan O'Shaughnessy
Policy Director - Industry & Prudential Policy
[redacted]