5 July 2017

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via email: ADIpolicy@apra.gov.au

Dear Heidi

APS 221 Large Exposures Consultation April 2017

Thank you for the opportunity to comment on APRA's proposed revisions to the large exposures regime.

The discussion paper notes that the primary reason for APRA's revisions to APS 221 Large Exposures is to "reflect the internationally agreed framework for the management of large exposures".[1] Customer-owned banking institutions are not internationally active banks and the extension of the Basel regime to our members is at APRA's discretion.

The Basel Committee on Banking Supervision's supervisory framework for measuring and controlling large exposures issued in April 2014 notes:

> "The large exposures framework is applicable to all internationally active banks. As with all other standards issued by the Committee, member jurisdictions have the option to set more stringent standards. They also have the option to extend the application to a wider range of banks, with the possibility – if they deem it necessary – to develop a different approach for banks that usually fall outside the scope of the Basel framework." (page 3)

COBA's supports APRA's decision to implement the Basel large exposures framework under Option 3: 'Implementation with some adjustments', outlined in Appendix 2 of the discussion paper but with further changes to reverse APRA's removal of the "concessionary" exposure limit to another unrelated ADI.

The proposed standard, if unchanged, will negatively impact smaller ADIs without any commensurate increase in prudential safety and stability.

We encourage APRA to implement a slightly different approach to recognise that smaller ADIs have some large exposures that arise from sector-specific liquidity and operational factors and that they require more flexibility under the large exposures framework.

[1] APRA Discussion Paper: Revisions to Large Exposures: April 2017, page 7

From a risk management perspective, smaller ADIs are already required under the proposed standard to provide Board-approved policies on large exposures and risk concentrations, which cover limits of these types of exposures and ensure that they are "commensurate with the ADI's risk appetite, risk profile, capital and balance sheet size".[2]

The concentrated nature of the Australian financial services industry means that there are relatively few service providers for mutual ADIs. Similarly, in terms of highly-rated ADI investments for liquidity purposes, these same service-provider ADIs overlap with this group of highly-rated ADIs. The proposed 25 per cent limit can greatly restrict a smaller ADI's flexibility to invest its liquidity holdings while choosing the most suitable and cost effective service providers.

Furthermore, the revision of APS221 provides the opportunity to revisit the classification of certain types of 'marketplace' lender arrangements as 'large exposures'. This treatment is putting an unnecessary cap on these lending activities and restricting smaller ADIs ability to grow and diversify into this market.

Recommendations

COBA's view is that APRA should:

- retain the 50 per cent limit for 'smaller and less complex' ADIs (i.e. those subject to the MLH regime). This should be done on the basis that they have a liquidity management regime that already diverges from the Basel norm and due to their size they are likely to have large exposures to service providers that are unrelated ADIs.

- take the opportunity of the new standard to clarify that certain marketplace lender arrangements are not a single aggregate exposure but rather a series of unconnected individual exposures. The treatment of these loans as an aggregate exposure creates an inconsistency between ADIs' regulatory and statutory reporting.

Large exposures and the minimum liquidity holdings regime

COBA requests that APRA reconsider its decision to remove the 50 per cent exposure limit to another unrelated ADI. Under the proposed standard, exposures to unrelated ADIs will be subject to the same 25 per cent limit as other large exposures.

This change does not recognise the potential impact on MLH ADIs liquidity management and is it not clear that it will lead to greater prudential outcomes.

COBA members operate under the minimum liquidity holdings (MLH) regime as 'simple and less complex' ADIs. As MLH ADIs, COBA members are able to hold "bank bills, certificates of deposits (CDs) and debt securities issued by ADIs"[3] as part of their MLH requirements.

We recognise that removing this 'concession' aligns with the Basel Committee's 25 per cent limit. However, the Basel standard does not take into account the unique MLH regime that Australia has in place. The Basel standard applies to internationally active banks that are subject to the liquidity coverage ratio as their liquidity management regime.

[2] Proposed APS 221 Large Exposures, clause 12
[3] Attachment B, APS 210 Liquidity

Some COBA members have investments in other ADIs, which along with other exposures to those ADIs, exceed the proposed 25 per cent limit but are within the current 50 per cent limit. The reduction in this limit will disproportionately impact MLH ADIs who hold high levels of liquidity relative to their capital.

One COBA member notes that it uses the 50 per cent limit to spread its significant liquidity holdings across approximately 10-12 institutions. Under the current proposal, this member would have to increase the number institutions it invests in (hence increasing costs) or alternatively take on a large holding in low-return government securities (hence reducing capital accumulation).

Comparison of MLH Assets to Tier 1 capital, March 2017

	MLH Assets	**Tier 1 Capital**	**MLH/Tier1 ratio**
Credit Unions	5,458	2,727	200%
Building Societies	1,946	967	201%

Source: APRA Quarterly ADI Performance indicators

The table above shows that our sector has, on average, relatively high liquidity relative to our capital holdings. While APRA does not publish these figures for the entire mutual sector or mutual banks, COBA expects a similar MLH asset to Tier 1 capital ratio for the broader mutual sector. This illustrates that under the previous 50 per cent limit, a smaller ADI could comfortably manage 4-5 institutions within its liquidity holdings while maintaining a reasonable return on their MLH assets. However, under the proposed 25 per cent limit, this may no longer be the case. Furthermore, the impact on individual smaller ADIs may be more severe as some COBA members hold significant portfolios of highly liquid assets in excess of their MLH requirements.

Some COBA members hold parcels of RBA repo-eligible securities for emergency liquidity requirements. The RBA's policy is that the minimum size for repo approaches is $20 million. Limiting ADI counterparty exposures to 25 per cent of capital could hinder their ability to undertake open market operations with the full range of repo-eligible securities.

Treatment of large exposures to service providers

Several COBA members have large exposures from their contractual requirements with service providers who are also ADIs. As ADIs, these service providers fit into the "unrelated ADI" category and receive favourable treatment under the current regime but do not under the proposed revisions. These exposures to these ADIs are strictly for operational purposes.

Examples of these exposures to service providers include:

- use of third party banks to conduct clearing,
- securitisation collection accounts, and
- security deposits to support payment obligations.

One particular concern that members hold is how the 25 per cent large exposures limit will impact their self-securitisation arrangements with the RBA. Many of these services are provided by the major banks, and there is concern that smaller ADIs may need to reduce their access to contingent funding in order to avoid breaching the proposed limits. This appears to be an unintended outcome.

COBA notes that paper states that "APRA requests views on the need for an alternative approach for some ADIs, such as service providers".[4] While the discussion paper considers service providers' exposures to ADIs, it should also consider an ADI's exposure to a service provider. COBA suggests that APRA consider alternative approaches for smaller ADIs that have exposures to these service-provider ADIs strictly for operational requirements, including retaining the existing 50 per cent limit or exempting operational exposures to qualifying service providers.

Some COBA members currently hold exemptions to cover their large exposures to existing service providers. These members have concerns about APRA's comments in the discussion paper that "APRA is proposing that ADIs will need to re-apply for any exemptions from the revised large exposures framework regardless of existing exemptions held".[5]

COBA members have made contractual arrangements based on these exemptions and these arrangements are critical to the operation of their businesses. The alternative would be to split their business across multiple providers — which is disproportionately costly for smaller ADIs. In some cases, they may not be able to change providers due to contractual agreements. Splitting services in this manner is unlikely to improve prudential stability.

Retaining the 50 per cent limit to unrelated ADIs could reduce the need for some of these exemptions and provide greater certainty.

Some COBA members have exposures to service providers that are larger than the 50 per cent limit and will need these exemptions renewed in the absence of any alternative approach.

COBA requests that APRA explains and manages the exemption application process in a clear and transparent fashion to ensure that ADIs have the best chance at retaining their existing exemptions and maintaining long standing relationships with existing service providers.

Some COBA members have asked that APRA explain how it expects ADIs to manage any transition, including the disposal of excess large exposures, if existing exemptions are not re-approved. COBA notes that the discussion paper states that APRA can provide exemptions based on "whether the approval is requested for a finite period of time"[6] which can be used to provide temporary exemptions to ease any transition.

Large Exposures and marketplace lending

We are prompted by APRA's proposed new treatment of structured vehicles to raise a separate unresolved issue relating to the treatment of ADI funding of loans originated by marketplace lenders. The new large exposures framework may be an opportunity to clarify this issue.

Marketplace lending is a growing area and is used by COBA members to diversify their lending operations in a similar way to mortgage broking networks. It offers ADIs opportunities to grow and enter new markets. During the 2016 financial year, $156 million in loans were written to consumers and SMEs by marketplace lenders with terms typically of three to five years and amounts from $5,000 to $80,000 for consumer borrowers.[7] Customer owned banking institutions generally invest in these marketplace lenders in two ways: as equity investors and/or as funders of loans.

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[4] Discussion Paper, page 26
[5] Discussion Paper, page 26
[6] Discussion Paper, page 25
[7] 17-164MR ASIC survey offers snapshot of marketplace lending in Australia

COBA understands that around 20 customer-owned banking institutions are involved in funding the loans of a particular marketplace lender. Under this arrangement, customer-owned banking institutions provide funds to a trust, which then lends the money to individual borrowers. Once the money is lent, individual exposures are transferred to the funding ADIs. This exposure becomes an exposure to an individual counterparty rather than to the marketplace lender. The ADI's recourse is to the borrower not the marketplace lender. The exposures are no longer 'held' by the marketplace lender.

COBA members have sought external advice on the treatment of these loans. As a result of this advice, COBA members undertake a 'look-through' approach for accounting and management purposes where they monitor and treat each loan exposure individually.

However, due to the novelty of these arrangements, under the existing APS 221, some COBA members report their total loans through this particular marketplace lender as an aggregated exposure to the marketplace lender, with some members reaching the 10 per cent large exposures threshold. These arrangements are being treated and reported as a large exposure when they are not a large exposure. This is putting an unnecessary cap on these lending activities.

We would like APRA to take the opportunity of the new standard to clarify that these exposures are not a single aggregate exposure but rather a series of unconnected individual exposures. The treatment of these loans as an aggregate exposure creates an inconsistency between ADIs' regulatory and statutory reporting.

APRA's revised large exposures framework proposes that ADIs use a threshold approach and adopt the 'look-through' concept for recognising large exposures to structured vehicles. While this proposal is intended to cover genuine large exposures, rather than the arrangements described above, the application of the 'look through' concept is sound prudential practice.

ADIs should have the option to take a 'look-through' approach for the marketplace lending arrangements described above. This correctly recognises their status as unconnected individual exposures rather than as an aggregate exposure.

The change to Tier 1 capital from regulatory capital

Under the proposed APS 221, the denominator for the large exposure measure is now a narrower capital figure in 'Tier 1 capital' instead of 'Regulatory Capital' in order to align with higher quality capital requirements under the Basel standard.

These changes further devalue Tier 2 capital. We would prefer that Tier 2 capital continues to be counted for this purpose. The Basel III capital regime has significantly increased the degree of difficulty for mutual ADIs to issue capital instruments. If a mutual ADI has met these challenges and issued qualifying regulatory capital instruments, whether they are Tier 1 or Tier 2, they should be counted for the purpose of calculating large exposures.

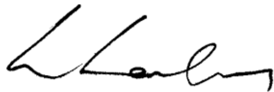
Qualifying central counterparties

COBA notes that the definition of 'large exposures' explicitly excludes "exposures to qualifying central counterparties (QCCPs) relating to clearing activities (where QCCPs are defined in paragraph 9 of *Prudential Standard APS 112 Capital Adequacy: Standardised Approach to Credit Risk* (APS 112))".[8]

COBA suggests that APRA (or alternatively the QCCP co-regulators RBA/ASIC) compile a list of QCCPs in Australia. COBA notes that APRA's previous position was that it "does not intend compiling a list of QCCPs and believes it is for ADIs to make their own determination,"[9] However, a list approach will reduce burden on smaller ADIs and reduce uncertainty about QCCPs.

Please contact Mark Nguyen at mnguyen@coba.asn.au or 02 8035 8443 if you wish to discuss any aspect of this submission.

Yours sincerely



LUKE LAWLER
Head of Public Affairs

[8] Proposed APS 221, clause 18
[9] Response to Submissions Implementing Basel III capital reforms in Australia – counterparty credit risk and other measures, page 10-11