Indue Ltd
Level 3
601 Coronation Drive
Toowong QLD 4066
PO Box 523
Toowong QLD 4066

www.indue.com.au
E info@indue.com.au
T 07 3258 4222
F 07 3258 4211

Indue Ltd
ABN 97 087 822 464

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empowering financial solutions

25 May 2012

Neil Grummitt
General Manager, Policy Development
Policy, Research and Statistics
Australian Prudential Regulation Authority
GPO Box 9836
Sydney NSW 2001

By Email: Basel3capital@apra.gov.au

Dear Neil,

RE: Discussion Paper on Implementing Basel III reforms in Australia

I am writing in response to the above paper released by APRA on 30 March 2012 to outline Indue's views in respect of the key issues from the discussion paper.

Section 4.3 Countercyclical Buffer

Indue made the point in its original submission (dated 30 November 2011) that the stated purpose of the countercyclical buffer (ie: to build up a further capital buffer at times of **excess aggregate credit growth** in anticipation of future losses) did not apply to institutions that will not suffer future losses as a result of excessive credit growth. For this reason, ADIs that do not engage in the provision of credit should not be subject to the countercyclical buffer.

Indue further made the point that if the countercyclical buffer is aimed at buffering increased credit risk then **the most sensible approach is to develop a policy approach that targets those institutions with highest credit growth by applying the countercyclical buffer through increased credit risk weights** (as opposed to a blanket increase in the minimum PCR which impacts capital across all forms of risk).

The Basle III solution to this issue proposed by APRA does not target the problem in as direct a manner as it could through an alternate approach. The current solution proposed will result in there being more capital in the banking system as a whole, but that does not mean that capital is well directed to where it is needed to buffer loss – it is a general approach, not a specific approach. A solution designed around increasing credit risk weights would direct this increased capital to where it is most needed.

APRAs response to this issue in the paper released on 30 March 2012, was to say that its position was consistent with Basle III and was intended to ensure that the banking system as a whole had sufficient capital.

APRA in the response paper acknowledged the issue that was raised in our submission but APRAs response was largely limited to 'APRA sees no reason to depart from the Basle III position' when logical reasons have been presented to APRA to depart from that position.

It is noted that APRAs response (in part) was to refer to the availability of a specialised ADI regime for "purchased payment providers", and such institutions will not be subject to the countercyclical buffer. The fact that 'purchased payment providers' will not be subject to the countercyclical buffer acknowledges that the buffer is not relevant to all institutions. However, the 'purchased payment providers' regime is also very narrow and not aimed at the services provided by Indue (nor the needs of most other ADIs in Australia, evidenced by the fact that there is currently only 1 entity that holds this type of licence due to its very narrow application), so it is not a solution to the issue that we have raised in relation to ADIs that are not credit providers.

Indue submits that if the regulatory framework is flexible enough to acknowledge differences for purchased payment facility providers, then it should also be flexible enough to accommodate organisations such as Indue who are required to hold deposits to provide settlement services, particularly where seemingly logical alternatives are available. Not all ADIs are credit providers and therefore regulatory measures targeting credit providers should apply to credit providers only, not all ADIs.

In terms of impact, the cost to Indue of the countercyclical buffer is the cost of carrying the additional capital to meet the increased regulatory requirement (a buffer of 2.5% would amount to an additional pre-tax servicing cost in the range of 15%-20% of pre-tax profit).

A capital penalty that amounts to 15%-20% of pre-tax profit is excessive in light of the fact that Indue:

- is not a credit provider and will not have contributed to spiralling credit levels in the broader economy;
- will not have received any financial benefits as a result of spiralling credit levels in the economy;
- has presented a sensible alternative approach that directly targets the source of the credit growth and therefore:
  - aligns the increased regulatory capital buffer directly to those institutions who have the increased credit risk; and
  - aligns the increased regulatory capital carrying cost directly to those institutions who have financially benefited from the increased credit levels.

In the case of credit providers it seems reasonable to impose an additional cost upon them in the event that credit growth has spiralled upwards as they will have benefitted financially from the credit growth. In Indue's case we will endure the cost, but will not have gained financially from the credit growth.

Again, a direct linkage approach via the credit risk weightings would most directly target those institutions who have taken on the most credit growth and gained most financially from that growth.

Chapter 5 - Leverage Ratio

We appreciate the revised position that APRA have taken in respect of the leverage ratio. Our arguments in respect of the unfair capital penalty that would apply to certain ADIs by the implementation of this ratio in our initial submission remain and we welcome the opportunity to further consult with APRA in relation to the design and implementation of a Leverage Ratio that addresses this issue.

In particular, we encourage APRA to consider refinements to the definition of 'exposure' for the purpose of calculating the leverage ratio, in that it should exclude 'deposits held with other ADIs/RBA and other Commonwealth Government Securities (CGS)', as these items do not constitute 'leverage' and do not contribute to 'aggregate leverage' in the banking system.

We thank you for the opportunity to put our views forward in respect of the changes to the regulatory regime and we would welcome the opportunity to meet with representatives of APRA to discuss our submission further. If you have any questions in relation to our submission, please contact me on [redacted].

Yours faithfully,

Derek Weatherley
Chief Operating Officer