Response to APRA Discussion Paper “Revisions to the capital framework for authorised deposit taking institutions”

15th June 2018

Judo Capital response to APRA Discussion Paper:

"Revisions to the capital framework for authorised deposit-taking institutions"

Executive Summary

The Judo Capital group of companies, collectively referred to as "Judo Capital", welcomes this opportunity to contribute to consultation by the Australian Prudential Regulation Authority ("APRA") into the proposed revisions to the capital framework for authorised deposit-taking institutions ("ADIs").

Judo Capital has stated its objective to apply for a banking licence to operate as an ADI in Australia's highly-regulated banking system. This recognises the commitment of Judo Capital to contribute to Australia's banking industry where capital ratios are considered unquestionably strong, providing Australia's SME businesses with competitive alternatives.

Judo Capital continues gathering insights into the assessment of policy and its practical implementation into operations in a prudential regulatory environment, including capital and its treatment through the diligence and preparation essential to apply for an ADI licence. Insights include the balance between participating as a new entrant to increase competition, while maintaining stability, and the associated treatment of capital.

Judo Capital has reviewed the revisions proposed in the APRA Discussion Paper, dated 14 February 2018 ("Discussion Paper"), in the context of its SME focused business model, and as such has only commented on components that pertain to this area.

Judo Capital assesses the principles of the proposed revisions outlined in the Discussion Paper:

1. Aligns with and advances the enhanced policy framework designed by APRA to attract new entrants and increase competition in banking (as outlined in the recently introduced Phased Licencing approach);
2. Recognises and makes some progress towards reducing the gap for SME risk weighted assets ("RWA") between standardised and the internal ratings-based ("IRB") approach to capital adequacy;
3. Are positive for new entrants choosing to develop an SME business model and generate the investment necessary to establish prudential and commercial operations in the Australian banking sector. However, there is potential for further reforms that encourages new competitors in the SME business sector as opposed to the retail/consumer sector;
4. Recognises the need for a simplified approach for small ADIs; noting the complexities that exist in practice when defining "small" and "new entrant" does not necessarily correlate to "unsophisticated" or "inexperienced management", as examples.

These are the key areas identified in the assessment by Judo Capital of the proposed revisions in the Discussion Paper and addressed with this response.

The policy revisions as assessed make some progress towards genuine reform. However there remains a fundamental issue from the proposed revisions. This issue is the significant variation in SME capital requirements that remains between the standardised and IRB approaches to capital adequacy.

There is further opportunity to extend the reforms and recognise the performance of those ADIs who demonstrate excellent management and the capabilities to deliver optimal performance in risk management.

Maintaining stability AND promoting genuine competition through reforms

The opportunity offered through this process of consultation is identifying the convergence of a number of stated objectives; namely, achieving unquestionably strong capital ratios, establishing alignment with Basel III reforms, and attracting new entrants.
There is an opportunity to close the gap between standardised and IRB approaches. This recognises banks in the Australian context have "…traditionally been well capitalised to withstand the risks they have faced" (source: p5 Discussion Paper dd Feb. 2018).

The proposed revisions to risk weightings for Retail SME corporate exposures (ref. Discussion Paper, p58, Table 20) from 100% to 85% is another welcome proposal. Noting the Basel III risk weighting of 75% applied to this segment, it is of interest whether there is appetite, and/or data, that demonstrates the benefits of the proposed reduction to 85%, and not to 75% in line with Basel III.

New entrants to banking and small ADIs can work with the regulators supervisory regime to maintain stability and recognise performance in risk management. Based on the assessment of performance an appropriate change in capital treatment can be applied to mirror the risk profile.

Other reforms underway will deliver data and greater insights into portfolio health and performance, for example Comprehensive Credit Reporting.

Collectively, this provides a more sophisticated segmentation of the standardised approach to capital, recognising the variation of participants and prospective participants subject to the standardised approach to capital adequacy. There are benefits with the lack of relative scale of the individual and collective participants who apply standardised treatment, when compared with the concentration in relatively few participants who can apply IRB treatment.

The key is maintaining the balance between the unquestionably strong capital position and the application of higher capital ratios due to higher RWA calculations, that for smaller participants could prove punitive when applied in practice.

Stability and competition are not mutually exclusive

Enabling the efficient utilisation of capital, that is appropriately matched to the risk profiles of individual ADIs, has the potential to attract new entrants and increase competition, while maintaining stability of the banking sector.

The value of competition and stability as sustainable drivers of change within the banking industry cannot be overstated.

There is evidence that post GFC competition in Australian banking was greatly reduced when "challengers" such as BankWest and St George effectively exited the industry. This adds to an argument that regulatory policy can both encourage competition and maintain stability.

It's also notes that a number of new or prospective ADI licensees operate in the consumer segment. Many competitors in the SME business segment are in the unregulated sector. There is benefit to the system for more of the participants in banking services to operate within the highly regulated ADI licence under prudential supervision.

There should be no trade offs between the need for the regulatory environment to continue to be supportive of competition as well as maintaining stability of the banking sector.

Policy supported by data

It's noted in the Discussion Paper that further quantitative analysis is to be undertaken to calibrate the proposed revisions.

With the analysis pending, this response is designed to address the principles contained within the Discussion Paper, and to contribute to the exchange of information with the benefit of the practical insights gathered by Judo Capital in its preparation to operate as an ADI in a highly regulated, prudential environment.

Judo Capital welcomes the opportunity to participate and contribute to this analysis, providing a combination of criteria:

- Scale – Judo Capital will sit between the major banks and smaller or specialist providers of financial services such as Fintechs; and
- Risk - the risk profile of SME businesses that is the target lending market for Judo Capital.

It's a sound principle that policy enhancements are designed to deliver long term, sustainable outcomes, and take into consideration appropriate data and evidence. In this way, policy changes are likely to deliver practical outcomes that can be implemented against clear objectives, likely responses can be modelled, and policy changes can be measured against the stated objectives. This aligns with an assessment of macroprudential interventions in the Productivity Commission draft report on Competition in the Australian Financial System (p12 of the draft report dd Jan. 2018).

Note: Judo Capital contributed to the Productivity Commission draft report, “Competition in the Australian Financial System”.

Other matters

Judo Capital has not provided commentary on matters identified in the Discussion Paper that are outside its core proposition.

Background

In November 2017 Judo Capital provided its response to the APRA Discussion Paper on the proposal for phased licensing for ADIs. APRA has now formally adopted the approach to phased licensing of ADIs, and Judo Capital remains supportive of enhancements to policy frameworks that stimulates increased competition.

Through its own progress to the initiation of an ADI licence application, Judo Capital has gathered significant insights into policy development, and the practical application of policy. Judo Capital welcomes the opportunities presented by this Discussion Paper and others, to contribute key observations and the learnings gathered in practice to the exchange of information with APRA and other regulators to enhance and improve new policy frameworks.

About Judo Capital – ‘Banking as it used to be; banking as it should be’

Built by some of Australia’s most experienced bankers and modelled in part on the UK Challenger Banks - Aldermore (www.aldermore.co.uk); Shawbrook (www.shawbrook.co.uk); and Oaknorth (www.oaknorth.co.uk) - Judo Capital is a *purpose-built Challenger* (and not a Fintech) that has come to market to address the growing dissatisfaction with, and the gaps inherent in the offerings of the incumbent banks.

The objective in forming Judo is to build a unique banking offering that delivers the best aspects of genuine relationship banking coupled with a strong culture of risk management.

Judo Capital has initiated its application for a banking licence in 2018. For Judo, a banking licence is seen as a privilege that will allow it to not only compete as a bank, but also to present the strength of its unique, alternative offering to the marketplace and add genuine value to the Australian SME market.

Details on Judo Capital can be found at www.judocapital.com.au

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