SUBMISSION

Productivity Commission draft report: Competition in the Australian Financial System

29 March 2018

Contents

Executive summary

APRA welcomes the opportunity to respond to the Productivity Commission's draft report on *Competition in the Australian Financial System* (draft report).

Over the long term, financially sound competitors, within a stable financial system, are central to competitive and efficient financial services markets, and deliver benefits to the Australian community more broadly. While prudential requirements may impact individual competitors in regulated industries by imposing differential prudential costs, other factors - such as scale, business models, operating and funding costs and importantly broader economic conditions – are likely to have larger impacts on the competitiveness and long term viability of individual institutions.

APRA's initial submission outlined its role in the financial system, its approach to balancing financial safety with competition and indicators of competition within the industries that APRA supervises. This submission responds to the findings and recommendations in the draft report that specifically relate to APRA and its role within the financial system. In particular, this submission covers: APRA's mandate, the role of the Council of Financial Regulators (CFR), APRA's actions relating to residential mortgage lending practices of authorised deposit-taking institutions (ADIs) and responses to other draft recommendations relating to APRA.

APRA's mandate requires it to balance the objectives of financial safety and efficiency, competition, contestability and competitive neutrality and, in balancing these objectives, to promote financial system stability in Australia. APRA strives to appropriately balance these objectives for the benefit of the Australian community over the long term. Evidence suggests that the costs to business and the community of an unstable financial system are high. APRA's pursuit of system stability, even if it at times may, at the margin, reduce competitive pressures, is predicated on delivering the important community benefit of a stable financial system. APRA is committed to transparently explaining how it pursues its mandate, and does so through a range of methods.

APRA's objectives in taking action with respect to residential mortgage lending practices of ADIs have been to reinforce sound lending standards and reduce the build-up of systemic risks. In pursuing these objectives, APRA has taken into account the effects on competition and determined, on balance, that setting clear prudential expectations for lending growth benchmarks and other measures were timely and appropriate to mitigate risk in an environment of high household debt, high house prices, subdued income growth and strong competition playing out through reduced lending standards. APRA does not agree with the Productivity Commission's suggestion that APRA should have been more prescriptive in directing ADIs' business decisions in how to meet its prudential expectations.

APRA notes that changes to the legislative status of the CFR are matters for Government. As currently constituted, the CFR functions well as a key component of APRA's prudential policy-making process. The input from other regulators and Treasury is an important test in understanding the broader effects of APRA's proposed policies, including the impact on competition in the financial system.

The final chapter of this submission provides a response to the findings and recommendations in the draft report that relate to APRA. APRA is on track to finalise a number of the recommendations outlined in the draft report, including a phased approach to licensing new entities and reviewing the risk weights for ADIs' residential mortgage exposures and exposures to small- and medium-sized enterprises.

Glossary

ACCC	Australian Competition and Consumer Commission
ADI	Authorised deposit-taking institution
APRA	Australian Prudential Regulation Authority
ASIC	Australian Securities and Investments Commission
Basel Committee	Basel Committee on Banking Supervision
CFR	Council of Financial Regulators
EFS	Economic and Financial Statistics
FSI	Financial System Inquiry
IRB	The internal ratings-based approach to calculating regulatory capital requirements for credit risk as set out in *Prudential Standard APS 113 Capital Adequacy: Internal Ratings-Based Approach to Credit Risk*
LVR	Loan-to-valuation ratio
NSFR	Net stable funding ratio
PPF	Purchased payment facilities
RBA	Reserve Bank of Australia
Standardised approach	The standardised approach to calculating regulatory capital requirements for credit risk as set out in *Prudential Standard APS 112 Capital Adequacy: Standardised Approach to Credit Risk*
SME	Small- and medium-sized enterprises

Chapter 1 – APRA's approach to regulation

APRA's mandate

APRA's core mission is to establish and enforce prudential standards and practices designed to ensure that, under all reasonable circumstances, the financial promises made by the institutions it supervises are met within a stable, efficient and competitive financial system. In carrying out this mission, APRA needs to balance what are sometimes competing objectives. APRA's mandate is not entirely unambiguous – at times, it requires a careful balancing act.

In the draft report, the Productivity Commission assesses APRA's performance in balancing the objectives under its legislated mandate and finds that APRA favours system stability, even if it might result in a significant cost to competition. To address this issue, the Productivity Commission proposes that the regulatory architecture be adjusted to designate a 'competition champion' to provide additional input and challenge to regulatory-decision-making.

APRA recognises that regulation imposes costs, both directly on regulated institutions and, ultimately, the Australian community. However, experience indicates that the costs to the community of an unstable financial system, particularly in times of crisis, are significant.[1] Regulation which protects against this is, therefore, not without benefits, although it is unclear how the Productivity Commission has taken this into account in reaching its draft conclusions.

Ultimately, the appropriate balance between financial stability and other objectives for the financial system is a matter for Government. In this regard, the Financial System Inquiry (FSI) recognised that as the banking sector is at the core of the Australian financial system, its stability is of paramount importance.[2] The FSI observed that financial system stability in Australia is underpinned by the continued strong financial performance of the banking system, however, a more resilient financial system is in the interests of individuals, businesses, the economy, taxpayers and the Government and the benefits of greater resilience outweighed the associated costs.[3] The recommendations that followed from this conclusion – in particular, that all ADIs should have stronger capital requirements, notwithstanding that APRA had already implemented a robust capital framework – were endorsed by the Government.

In responding to the FSI recommendation that APRA set capital standards such that Australian authorised deposit-taking institutions' (ADIs') capital ratios are unquestionably strong, APRA has pursued an objective of improved financial system stability, consistent with the core objective of its mandate. In doing so, however, APRA has not ignored other policy

[1] See Basel Committee on Banking Supervision, *An assessment of the long-term economic impact of stronger capital and liquidity requirements*, August 2010.

[2] FSI, *Final Report*, November 2014, p. 34.

[3] FSI, *Final Report*, November 2014, p. 31.

considerations, including the impact of its requirements on competition.[4] As detailed in APRA's Information Paper on establishing unquestionably strong capital ratios, for example, a higher amount of additional capital was required for larger, more sophisticated ADIs relative to the amount required for smaller, less complex ADIs.[5] This responded to concerns that existing differences in capital requirements were perceived to be creating competitive advantages for the largest institutions over their smaller competitors. APRA has also sought to make prudential requirements more sensitive to risk, which should improve the allocative efficiency of the prudential framework, another important consideration in APRA's mandate.

Through its prudential policy and supervisory interventions, APRA seeks to find an effective and appropriate balance between stability and competition considerations. As detailed in Attachment A, APRA's current policy priorities encompass all aspects of APRA's legislative mandate and are intended to strengthen APRA's prudential framework and reflect important measures to enhance efficiency and competition, taking account of external considerations such as Government priorities and international banking regulatory developments.[6]

As discussed in Chapter 2, APRA's residential mortgage lending actions were specifically designed to temper competitive outcomes that were not consistent with long-term community benefit. This involved evaluating trade-offs between stability and competition as well as other aspects of APRA's mandate, including examination of a range of alternatives in order to find the best means to achieve APRA's objectives. But it was unavoidable, where strong competition was in part being manifested in poor lending practices, that some tempering of competition would occur.

More broadly, APRA's regulatory decisions may impact the relative position of individual competitors, or a particular industry sector, with flow-on impacts to other parties, such as customers. However, to the extent there are costs to competition, APRA considers these are outweighed by the significant public benefits that result from curtailing unsustainable financial industry activity and ensuring the financial system is more resilient to deal with future systemic challenges.

Competition in the financial system typically increases in times of economic expansion and prosperity, but may be unsustainable in the long term. The experience of the global financial crisis is a case in point: a number of active competitors operated with non-viable business models and ultimately had to be acquired by existing incumbents. Short-term competitive benefits were ultimately lost, leading to a more concentrated financial system. APRA seeks to ensure, in line with community expectations that their investments in prudentially regulated institutions are safe from loss, that the financial system as a whole is adequately prepared to weather a downturn. Over the long term, financially sound competitors within a stable financial system are central to competitive and efficient financial services markets, and the benefits that they deliver to the community more broadly.

In considering the potential impact of regulatory proposals on competition, APRA seeks to assess whether they will result in unnecessary regulatory costs that could impact on the

4 Productivity Commission, *Competition in the Australian Financial System – draft report*, January 2018, p. 18.

5 APRA Information Paper (July 2017), *Strengthening banking system resilience – establishing unquestionably strong capital ratios*.

6 See APRA Information Paper, *APRA's policy priorities,* 31 January 2018.

competitiveness of entities within the relevant industry. APRA does not interpret its mandate as requiring it to assess the potential impact of a regulatory proposal on the ultimate price paid by consumers for financial products. Consistent with an outcomes-based approach, it is preferable that individual entities determine how to attribute costs from regulatory requirements; for example, the costs to consumers of product pricing changes resulting from higher (or lower) capital requirements or shareholders through capital raisings or profit/dividend decisions.

A sustainable balance between stability and competition is desirable, and a strong and evolving prudential regime will assist in delivering robust financial institutions. In turn, robust financial institutions are most likely to be viable long-term competitors, willing providers of financial services and attractive options for funding to the benefit of the Australian community.

The designation of a 'competition champion' is a matter for the Government **(draft Recommendation 17.1)**. However, regardless of any decision on this matter, APRA believes that the most effective means to establish a stronger 'voice' for competition within APRA's regulatory decision-making will be to strengthen the working relationship between APRA and the Australian Competition and Consumer Commission (ACCC). Until recently, the level of engagement between the two agencies has been relatively limited, at least compared to that with Australian Securities and Investments Commission (ASIC) and the Reserve Bank of Australia (RBA), reflecting in part that the ACCC has not had a dedicated team focussed on the financial services sector. Now that the Financial Services Unit has been established, APRA and the ACCC are pursuing opportunities to strengthen the operational connections between the two agencies at all levels.

Transparency in decision making and assessing performance

APRA is committed to appropriate transparency in the pursuit of its mandate, and does so through a number of methods, including publications, reporting, speeches and appearances before Parliament. To give greater visibility to these mechanisms, APRA recently set out an overview of its accountability requirements on its website.[7] Key publications with respect to APRA's activities include its Annual Report, Corporate Plan and Annual Performance Statement and APRA's assessment against the Government's Regulator Performance Framework.

While confidentiality considerations in relation to s56 of the *Australian Prudential Regulation Authority Act 1998* constrain APRA's ability to detail specific supervisory actions, APRA has demonstrated that it will communicate and explain actions that have broad community interest. This is the case, for example, with APRA's thematic reviews across all regulated industries, and the supervisory measures to address ADIs' poor residential mortgage lending practices which are specifically detailed in Chapter 2 below.

Further, in recent years APRA has made a number of changes that are intended to provide greater clarity on its broader prudential policy-making, balancing of its mandate and policy priorities. For example, APRA has commenced publishing an annual information paper on its policy priorities, and identifies those that are primarily targeted at improving prudential

[7] http://www.apra.gov.au/AboutAPRA/Pages/ReportingandAccountability.aspx

outcomes, enhancing competition and efficiency or that are externally driven. In addition, all policy consultation papers now include a summary of the balancing of APRA's objectives and consideration of alternatives to the proposed policy. This provides an opportunity for stakeholders to comment on these issues and raise any specific concerns as to whether the benefits of any reform outweighs the likely costs.

The Productivity Commission's draft report suggests APRA should provide more analysis on the impact of its policy actions in relation to mortgage lending risks (draft Recommendation 17.3). APRA will consider how to enhance its current communications to provide additional information on this issue. For example, APRA annually publishes an information paper on the setting of its only truly macroprudential tool - the countercyclical capital buffer. This includes summary information on a range of core indicators of systemic risks associated with the financial cycle.[8] Given the obvious connection between APRA's mortgage lending interventions and financial stability risks, this annual information paper could potentially be expanded to include a broader discussion of APRA's considerations and actions on matters related to financial stability, including APRA's assessment of the impact of its actions on competition (and the other elements of APRA's mandate).

Countercyclical capital buffer

The countercyclical capital buffer was introduced in Australia in 2016 following recommendations of the Basel Committee on Banking Supervision (Basel Committee). The buffer is intended to be used to protect the banking system from periods of excess credit growth and is designed to be responsive to changing conditions. It does this through raising banking sector capital requirements in periods of excess credit growth associated with the build-up of systemic risk. Conversely, this additional buffer can be released during periods of economic and financial stress, to reduce the risk of the supply of credit being hindered by regulatory capital requirements.

The countercyclical capital buffer operates as an extension to the capital conservation range and is included in *Prudential Standard APS 110 Capital Adequacy*. The buffer can be set between zero and a maximum of 2.5 per cent of risk-weighted assets, and the total countercyclical capital buffer that an ADI is required to hold would reflect both the level of the Australian jurisdictional buffer applied to Australian exposures and any buffer requirements in effect in other jurisdictions to which the ADI also has exposure.

Decisions on when to increase or decrease the countercyclical capital buffer involve an assessment of whether, and to what degree, there is excessive credit growth and rising systemic risk. APRA's overall approach to setting the level of the buffer in Australia was outlined in the first information paper released in late 2015, including the key indicators it will utilise to assess systemic risk.[9] The buffer is currently set at zero, which reflects APRA's approach to address current systemic risks (e.g. housing lending practices) through other regulatory tools.

[8] APRA Information Paper, *Countercyclical capital buffer*, 7 December 2017.

[9] APRA Information Paper, *The countercyclical capital buffer in Australia*, December 2015.

Importance of consultation to APRA decision-making

Consultation is a central component of APRA's prudential policy-making process and obtaining feedback from external parties is essential to ensuring that APRA achieves its policy objectives, including understanding the competition effects and estimated additional regulatory costs.

APRA, in most cases, will provide extensive timeframes for public comment, often up to three months for major reforms, and formally addresses feedback received through the publication of response papers which explain how APRA has addressed feedback received. Beyond written submissions, consultation also occurs through bilateral meetings with impacted entities, industry associations and other stakeholders. Where major policy proposals are being developed, industry workshops and quantitative impact studies may also form part of the consultation process. As a result, the policy development process is transparent and involves significant, often ongoing engagement with affected entities.

APRA often modifies proposed prudential policy in regulated industries based on feedback received from the consultation process. Two examples are provided below to highlight where APRA has made material changes to policy proposals in response to industry consultation. APRA also observes that many of its policies and interventions are discussed at length in many fora, including in mainstream media, and this subjects APRA's proposals to robust public scrutiny.

Consultation examples

Consolidated Prudential Standard CPS 220 Risk Management (CPS 220)

In 2013 and 2014, APRA consulted on proposals to update and consolidate risk management prudential requirements for ADIs and insurers into one cross industry standard CPS 220. The proposals sought to support the improvements in risk management practices in response to the global financial crisis and create a common approach to compliance to entities operating across regulated industries.

A key issue raised by industry was APRA's proposal to have a designated independent Chief Risk Officer (CRO). Smaller entities expressed concerned about cost and staff resourcing implications of mandating a separate CRO with limited other responsibilities. In response to these submissions, APRA revised CPS 220 to address these concerns by providing smaller entities with an opportunity to implement arrangements that were better suited to their size and scale.[10]

[10] APRA Response to Submissions, *Harmonising cross-industry risk management requirements*, 31 January 2014.

Net Stable Funding Ratio (NSFR) for ADIs

In 2016, APRA consulted on its proposal to implement the NSFR. The NSFR was a key post-crisis reform designed to strengthen the funding profiles of ADIs, thereby promoting a more resilient banking system.

APRA elected not to impose the NSFR on smaller entities, believing the costs associated with the measure did not generate sufficient prudential benefit. While industry feedback was supportive of the overall objective of the NSFR and APRA's approach, a range of technical issues were nevertheless raised. One such example related to the amount of longer term funding ADIs would be required to hold for residential mortgage exposures held as collateral to access a liquidity facility with the RBA. ADIs argued that APRA's proposal was overly conservative and inconsistent with the original intention of the liquidity facility with the RBA. APRA considered the arguments made in submissions in the context of the international and domestic funding environment and amended its original proposal to allow a lower amount of longer term funding to be held for these exposures.[11]

[11] APRA Response to Submissions, *Basel III liquidity – the net stable funding ratio and the liquid assets requirement for foreign ADIs*, 29 September 2016.

Chapter 2 – APRA's actions relating to residential mortgage lending

As highlighted by the draft report, the approach APRA adopted to influence the growth in investor and interest-only lending by ADIs followed an outcomes-based regulatory approach. As recognised by the draft report, this is considered best practice for regulatory interventions as it outlines the outcomes that are sought and leaves it to industry to decide how best to achieve those outcomes.

Objectives

APRA's objective in its intervention in the residential mortgage lending market has been to re-establish and reinforce sound lending standards, which had been eroded by strong competition amongst lenders for growth and market share. However, re-establishing sound lending standards is a difficult task without enforcing heavily prescriptive requirements which would dampen the future dynamics of the mortgage lending market. Improvements were also considered and assessed as to their impact on the flow of credit, in an environment in which a sudden contraction in credit could have created considerable damage to the property market and the economy more generally.

As a result, and after taking into account the advice of the other members of the CFR, APRA chose to act through a range of means designed to carefully recalibrate lending standards. It did so by, amongst other things, establishing:

- benchmarks designed to limit growth in high risk lending; and
- minimum interest rate buffers within borrower serviceability calculations, alongside more conservative treatment of income and expenses.

ADIs were given time to adjust their lending activity such that they operated in accordance with these expectations or, if they chose not to do so, would face higher capital requirements to reflect higher risk. Most, though not all, ADIs chose to moderate their lending to adhere to the new benchmarks, and to improve their serviceability assessments.

Although often popularly (albeit somewhat erroneously) termed 'macroprudential' in nature, APRA's actions were primarily reflective of fundamental (micro)prudential concerns – that lax lending posed a risk to the financial health of lenders and, *in extremis*, to depositors whose money was funding the lending activity.

Because the measures were not implemented through regulation, but rather through supervisory letters to ADIs, there was no formal regulation impact assessment. However, that does not mean that the costs and benefits of the intervention were not considered. There was consideration of these factors within APRA, and during APRA's discussions with the CFR. By using its supervisory rather than regulatory powers, APRA was not obliged to disclose its actions. However, APRA recognised the importance of the actions it was taking, and that they were likely to have impacts on the community that needed to be understood. APRA therefore adopted a strategy of being transparent about its actions and benchmarks, and has used a range of public statements, speeches and other means to regularly update the community on its thinking.

The cost of intervention

Although the draft report discusses the private and public costs of the intervention, it does not explicitly consider the counter-factual scenarios. In particular, given the emerging financial stability risks that were increasingly evident in an environment of high household debt, high house prices, subdued income growth and strong competition playing out through reduced lending standards, it is possible that, without APRA's actions, other policy action – including through monetary policy – may have needed to be called upon.

The draft report also provides an estimate of the fiscal costs of higher interest rates for investors, who are able to generate additional tax deductions to offset some of their higher interest costs. APRA does not, and should not be required to, consider fiscal impacts and tax policy settings in considering its prudential policy settings; it is accepted practice that APRA not explicitly consider the flow on effects to tax revenue from regulatory actions. Just as the RBA does not consider the tax revenue implications of changes to the cash rate target, APRA excludes such considerations from its assessment when calculating the costs and benefits of a particular supervisory action.

Targeting interventions

The draft report considers whether APRA's actions could have been more targeted and notes a number of alternative approaches.

APRA should have influenced lending standards

The primary objective for APRA was to strengthen industry lending standards. Understanding that changes to lending standards would take time to mitigate underlying risks, APRA sought to introduce temporary benchmarks to subdue high-risk lending (investor and interest-only loans) while these changes were introduced. APRA also made it clear in its communication with industry and the public that these benchmarks were temporary measures to mitigate risks to overall financial stability.

APRA undertook a range of measures aimed at improving lending standards both prior to and following the introduction of the benchmarks. In the year prior to the introduction of the ten per cent investor lending benchmark in 2014, APRA introduced measures aimed at strengthening residential mortgage lending standards with the aim of ensuring that ADIs better understood and monitored risks within their residential mortgage portfolios through:

- establishing minimum expectations for parameters used to assess serviceability; notably interest-rate buffers and floors; and

- issuing a prudential practice guide on sound risk management practices, which incorporated explicit quantitative parameters that APRA considers prudent practice for assessing borrower serviceability.[12]

The letter to ADIs in March 2017 announcing the benchmark on the flow of interest-only lending on new residential mortgage lending also specified further expectations aimed at improving lending standards, including that ADIs:

- ensure there was strong scrutiny and justification of any instances of interest-only lending at loan-to-valuation ratios (LVRs) above 90 per cent;

- review and ensure that serviceability metrics, including interest rate and net income buffers, were set at appropriate levels for current conditions; and

- continue to restrain lending growth in high risk segments of the portfolio (e.g. high loan-to-income loans, high LVR loans and loans for very long terms).[13]

Thus, the benchmarks on investor and interest-only lending were introduced as complementary measures in an environment where ADIs were already making significant changes to their lending standards and the manner in which they assessed new loans in response to APRA's expectations.

APRA should have been more specific about how to limit lending

The draft report suggests that to meet the investor and interest-only benchmarks, APRA could have directed institutions to implement specific measures to limit demand that did not require raising interest rates. Some examples include:

- ceasing lending across their portfolio, or in specific postcodes where there has been strong demand growth;

- tightening lending standards; and

- limiting discounts for new borrowers.

As noted above, APRA sought to set the desired outcome (slowing the rate of growth in these classes of lending) rather than dictate exactly how that should be achieved. This approach recognised that for different institutions, different approaches will be more or less suited. The approach adopted by APRA allowed ADIs to assess the various trade-offs for each approach and pursue what was most efficient and effective for their specific circumstances.

ADIs could have complied with the benchmarks by limiting lending to particular postcodes or regions, but APRA has no data or experience by which to calibrate such requirements, which would need to be extremely prescriptive. Further, for APRA to impose such a directive across all ADIs could be interpreted as directing the flow of credit throughout the country, and it would have been administratively burdensome and costly for ADIs. The experience of

[12] Letter to all ADIs: Reinforcing sound residential mortgage lending practices, 9 December 2014.

[13] Letter to all ADIs: Further measures to reinforce sound residential mortgage lending practices, 31 March 2017.

overseas prudential regulators has highlighted that limiting lending in particular geographic areas can result in the 'spread' of the targeted restriction to areas outside of those targeted.[14] It also would have suggested that sound lending was only warranted in some geographies, whereas APRA was firmly of the view that lending standards had deteriorated across the board and needed to be lifted generally.

Another potential option would have been to only apply the benchmarks to the major banks and not to smaller ADIs. APRA deliberately decided to apply the benchmarks to all ADIs so as not to undermine the impact of the measures. It is likely that application of the constraints only on selected ADIs would have resulted in a transfer of high risk loans from large institutions to small ADIs, rather than address the primary concerns being poor lending standards and the volume of high-risk loans within the market.

APRA also sought to avoid creating an environment where smaller ADIs had incentives to underwrite a disproportionate volume of high-risk loans in an environment of already heightened risks. Doing so may have negatively impacted their risk profile, created a need to hold additional capital, and threatened their ongoing viability should economic conditions deteriorate.

Alternatively, APRA could have potentially imposed restrictions on ADIs to limit investor and interest-only lending by using supervision powers to impose tailored directives for individual ADIs. However, this approach would have been opaque with no public view as to what was being required of the industry. The approach would have also taken longer to implement and at the time of the interventions, timeliness in addressing possible stability risks was viewed as being of significant importance by the CFR.

APRA should have explicitly required no action that impacts existing lenders

Finally, the draft report notes that APRA could have explicitly required ADIs to take no action that affected their existing borrowers.

As a general principle, APRA does not seek to set or regulate prices charged by financial institutions for their services. It is far from clear that APRA has the authority to issue such a directive, given it would not have an obvious prudential basis.

More specifically, the proposal seems to view ADIs' decisions to increase interest rates as being solely attributable to APRA's benchmarks, and without regard to a range of factors in the internal and external environments of ADIs. While APRA agrees that the announcement of the benchmarks may have been the trigger for changes to interest rates, it does not consider the benchmarks to have been the sole driver.

Indeed, in the case of investor lending, ADIs did not increase interest rates immediately after APRA introduced the ten per cent benchmark for investor lending growth in December 2014. ADIs initially endeavoured to use other measures – including APRA's preference for tighter lending standards – to achieve slower rates of growth, and only began using pricing as the lever after those other mechanisms proved ineffective to achieve APRA's expectations in a

[14] See the Reserve Bank of New Zealand's consultation on nationwide restrictions on high loan to valuation residential mortgage lending, available at: https://www.rbnz.govt.nz/news/2016/07/reserve-bank-consults-on-new-nationwide-investor-lvr-restrictions.

timely manner. Moreover, when interest rates for investor loans were materially increased by the major banks in the latter part of July 2015, it coincided with APRA's announcement, a couple of weeks earlier, of the impending introduction of higher risk weights under the internal ratings-based (IRB) approach to credit risk, and hence the need to service higher levels of capital in the future.

Similarly, over the past year, APRA has been foreshadowing the potential for higher capital requirements flowing from the FSI recommendations. In particular, APRA indicated to the ADI industry that an increase in capital requirements was likely to be applied to residential mortgage lending. This change on the regulatory horizon was more than likely to have also been considered by ADIs when making decisions about interest rates: indeed, two of the four major banks announced increases to interest-only interest rates prior to APRA announcing the introduction of the 30 per cent benchmark on 31 March 2017.

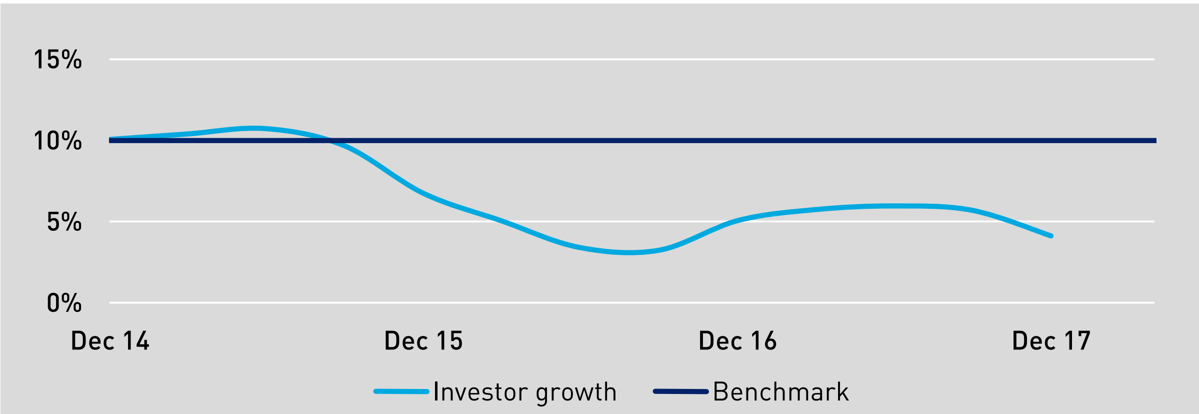
Given the range of factors impacting on bank pricing, the suggestion that APRA should have directed ADIs to take no action that affects their existing borrowers, even if such authority existed, would have been highly problematic. ADIs make decisions on their interest rate settings taking into account a number of factors, and it would be extremely difficult to isolate decisions that were being implemented in response to APRA's benchmarks from those that flowed from other regulatory and market considerations.

Is competition constrained in the market?

The draft report states that the benchmarks removed competitive tension in the market for investor lending.

Chart 1 highlights the level of investor lending growth among all ADIs and shows that investor loan growth has hovered around five per cent since December 2015. Opportunity for competitive tension remains as many ADIs are operating well below the benchmarks and therefore have capacity to expand their share of the market if they wish to.

Chart 1: Investor loan growth, year on year



A breakdown of the investor loan growth between major banks, other large and medium ADIs and small ADIs (Chart 2) demonstrates that with the introduction of the benchmark in December 2014, year-on-year growth in investor loans was markedly different between the three classes of ADIs. This reflected APRA's supervisory approach – while the benchmarks were applied to all ADIs, greatest supervisory attention was given to ensuring the largest lenders adjusted most quickly. APRA took a more pragmatic approach with smaller ADIs, agreeing on time horizons to reach the benchmarks within a reasonable timeframe given each ADIs' mortgage portfolio size and historical growth. Data on cumulative growth in investor loans (Chart 3) demonstrates this point – with a marked difference apparent in the cumulative growth of small ADIs compared to that of major banks and other large and medium ADIs over the same period.

Chart 2: Investor loan growth, year on year by ADI size

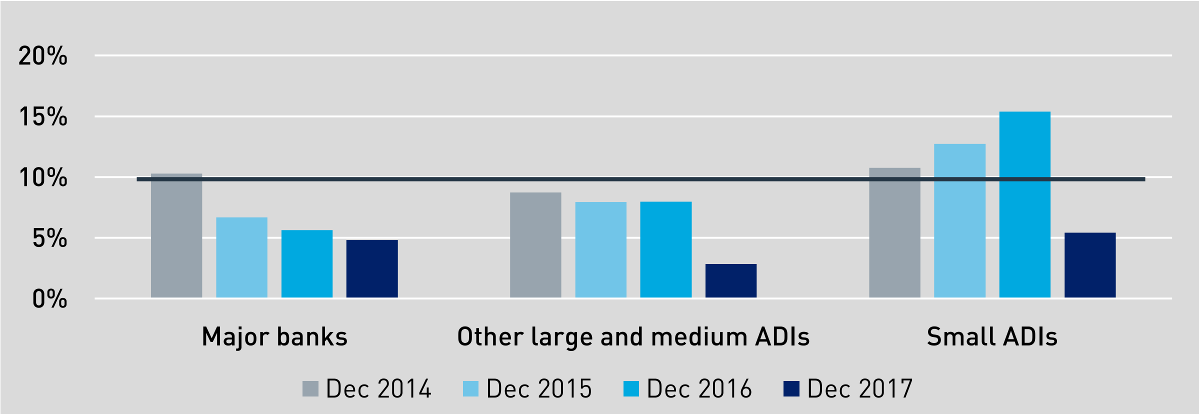
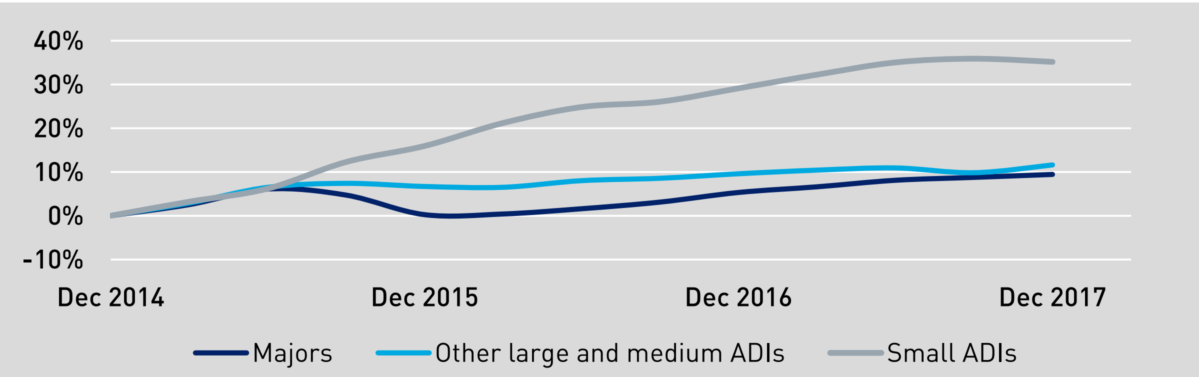


Chart 3: Cumulative Investor Loan Growth by Asset Size



Chapter 3 – Council of Financial Regulators

The draft report proposes that the remit of the CFR be expanded to specifically review and assess the competition issues associated with regulatory decisions. This expanded role would, in effect, be facilitated by an existing regulator (the draft report suggests ASIC or the ACCC) acting as 'competition champion'.

Any changes to the legislative status of the CFR are a matter for Government (draft Recommendation 17.1). However, as currently constructed, the CFR would not be an appropriate forum for the formal analysis and review of the competition impacts of particular regulatory reforms. As a non-statutory body, the CFR does not have legal decision-making powers and acts solely as a central co-ordination and information sharing body.

In its current form, APRA has found that the CFR functions well as a key source of advice for APRA's prudential policy-making and significant industry-wide supervisory measures, where significant proposals can be tested in the context of the efficiency and effectiveness of financial regulation and the impact on stability and competition in the Australian financial system. The Treasury, in particular, plays an important role in this process through assessing the regulatory proposals and providing feedback from a whole-of-Government policy and community perspective. Given this role, it is not clear why the Productivity Commission has not considered Treasury as a candidate to provide the 'voice of competition' within the CFR.

APRA would be concerned if the CFR was to take on a role as a decision-making body, as this may impede and conflict with the independence and statutory mandates of each of the participating regulators. This, in turn, may further blur regulatory responsibility and accountability for the consideration of competition (and other) issues under individual mandates, with resulting negative impacts on decision making and transparency. Publication of the minutes of CFR meetings, as proposed by the draft report, would likely add to uncertainty about regulator responsibility and would be unlikely to be informative to public understanding of decision making. Transparently communicating the basis for a particular decision, including competition considerations, is the responsibility of the relevant regulator.

Regardless of any decision regarding the membership and role of the CFR, APRA is working to strengthen its bilateral collaboration with the ACCC, via the ACCC's newly-established Financial Services Unit. This should assist in enhancing APRA's ability to appropriately consider financial system competition issues as part of its decision making. This heightened collaboration could include information sharing on policy priorities, working plans and consultation on significant policy projects. Further, APRA considers that the ACCC could provide a helpful source of input into post-implementation reviews of material prudential policy changes.

Chapter 4 – Response to other significant issues

This chapter responds to the draft recommendations that specifically refer to APRA.

Reducing barriers to entry and expansion

The Productivity Commission proposes that APRA should finalise and implement its phased approach to licensing for ADIs and revise its policies and guidelines for removing restrictions on the use of the term 'bank' **(draft Recommendation 4.1).**

APRA expects to finalise its framework for a phased approach to licensing of ADIs in the second quarter of 2018.

With regards to the legislative amendments that have been made to section 66 of the *Banking Act 1959*, APRA has commenced a review of its guidelines, consistent with the amendments to use of the term 'bank', and intends to finalise this review shortly.

A proportionate approach to risks non-ADIs pose

The Productivity Commission proposes that the new prudential standard for securitisation be revised and limited in its effect to warehouse funds provided to ADIs **(draft Recommendation 7.1).**

In 2014, APRA commenced a review to simplify the prudential approach to securitisation, including clarification of the treatment of warehouses and other similar structures.[15] The review of the securitisation framework was also aimed at addressing capital requirements for securitisation exposures that were considered insufficient by APRA and other jurisdictions during the global financial crisis. In this regard, the Basel Committee, the international committee charged with developing the capital adequacy framework for internationally active banks, determined that capital requirements for exposures of the highest quality/lowest risk were clearly insufficient, and a two-fold increase was warranted.

APRA's principal objective in reviewing the treatment of ADIs' exposures to warehouses was to address capital 'leakage'. That is, neither the warehouse funding provider nor ADIs selling assets to the warehouse were holding sufficient capital to cover the risks associated with their exposures.

APRA's original proposal was to allow a continuation of the existing concessional capital treatment of warehouses, but to limit this treatment to a period of one year. ADIs did not generally support this proposal. Acknowledging this feedback, APRA instead proposed a principles-based approach which would provide that warehouse structures be subject to the same requirements as other securitisations.[16] In addition, APRA explicitly asked the industry to suggest viable alternative proposals that adequately addressed the risks associated with

[15] Available at http://www.apra.gov.au/adi/Pages/April-2014-Consultation-Securitisation.aspx.

[16] Available at http://www.apra.gov.au/adi/PrudentialFramework/Pages/Revisions-to-the-Securitisation-Framework.aspx.

warehouse arrangements, consistent with the principle that capital requirements remain commensurate with each ADI's underlying risks and opportunities for regulatory arbitrage were limited. Industry was not able to provide an alternative that addressed the deficiencies in the existing framework.

In reviewing its proposals relating to warehouse structures, and taking into consideration the Basel Committee's revised capital requirements for securitisation exposures, APRA was aware that the cost of warehouse funding lines would increase for ADIs and other unregulated financial institutions that used this structure to fund credit exposures. However, it would not be appropriate to have a different capital treatment for ADIs versus non-ADIs, as suggested in the draft report, as the risks to the funding provider are the same. Any difference could also create a competitive and cost advantage to non-ADIs over ADIs.

APRA consulted directly with non-ADI mortgage providers and subsequently amended its proposals to ensure that the increase in regulatory capital requirements was not disproportionate to the risks the proposals were seeking to address. Since then, feedback to APRA has been that the new capital framework has not caused material disruptions.

Capital for exposures to small and medium sized enterprises

The Productivity Commission proposes that APRA should apply a broader schedule of capital risk weights under the standardised approach to credit risk to small-and medium-sized enterprises (SME) lending (draft Recommendation 9.1).

In APRA's recently released discussion paper, *Revisions to the capital framework for authorised deposit-taking institutions*, APRA has commenced consultation on revisions to *Prudential Standard APS 112 Capital Adequacy: Standardised Approach to Credit Risk* (APS 112), taking into account the changes proposed by the Basel Committee.[17] For SME exposures, APRA has proposed to reduce the risk weight for exposures not secured by residential or commercial property from 100 to 85 per cent. This recognises the various types of collateral, other than property, that SMEs provide as security. For SME exposures secured by property, APRA is proposing that risk weights vary depending upon the LVR of the relevant security and other operational criteria.

APRA is open to considering a more granular approach to risk weights for SME exposures not secured by property under the standardised approach to credit risk. In this regard, the proposed risk weight of 85 per cent represents, on average, a sufficient amount of regulatory capital to absorb losses from the portfolio as a whole. If a more granular approach was implemented, for example taking into account additional types of security, APRA would still seek to achieve broadly the same risk weight for the SME portfolio as a whole. This would mean that, while some exposures may benefit from lower risk weights, others (particularly unsecured exposures) would have higher risk weights.

[17] Available at http://www.apra.gov.au/adi/PrudentialFramework/Pages/revisions-capital-framework-and-leverage-ratio-Feb-2018.aspx.

Use of own data in determining regulatory capital for credit risk

The Productivity Commission proposes that APRA should consider proposals by ADIs for variations to the standardised risk assessment for business lending, based on ADIs' own data and risk management systems (draft Recommendation 9.1).

The IRB approach to credit risk allows an ADI, subject to approval from APRA, to use its own data and assessment of risk to determine regulatory capital requirements for credit exposures. The use of an ADI's own data and risk management systems for regulatory capital purposes is, necessarily, subject to a substantial range of minimum requirements, such as data maintenance and validation requirements, to ensure the overall integrity of an ADI's ability to provide prudential inputs into capital calculations.

With a view to making it easier for ADIs to achieve accreditation without weakening the overall standards that accreditation requires, APRA has introduced modifications to its process including a staged approach to accreditation and decoupling operational risk modelling from IRB accreditation.[18] In this regard, the Government's recent open banking and comprehensive credit reporting initiatives may also improve the ability of standardised ADIs to further distinguish between risks so they can apply for approval from APRA to use the IRB approach.

Standardised risk weights for residential mortgages

The Productivity Commission proposes that APRA should review the standardised risk weights for residential mortgages under the standardised approach to credit risk (draft Recommendation 16.1).

APRA has commenced consultation on proposals for a more granular approach for determining the regulatory capital requirement for residential mortgage exposures under the standardised approach to credit risk, including for exposures with an LVR ratio less than 80 per cent. The proposed risk weights for residential mortgage exposures, as detailed in Table 1, closely align with those of Basel framework.

[18] APRA's letter to ADIs, *Internal Ratings-Based (IRB) Approach to Credit Risk: Accreditation Process*, 16 December 2015, available at: http://www.apra.gov.au/adi/Publications/Pages/IRB-Approach-to-Credit-Risk-Accreditation-Process.aspx.

Table 1 APRA's proposed risk weights for residential mortgage exposures

	RW %					
LVR %	≤ 50	≤ 60	≤ 80	≤ 90	≤ 100	> 100
Owner-occupied P&I	20	25	30	40	50	70
Other residential mortgages	30	35	45	60	75	85

Regulation of purchased payment facilities

The Productivity Commission recommends that APRA should design, by mid-2019, a tiered prudential regime for purchased payment facilities (PPF) to reduce barriers to growth (draft Recommendation 16.1).

APRA is open to participating in a review of the current regulatory framework for PPF providers. In this regard, preliminary discussions have commenced, with other relevant parties (the RBA, ASIC and Treasury), on the regulatory regime for PPFs. However, given APRA's current priorities, the introduction of a new regime for PPFs by mid-2019 is unlikely to be feasible.

Collection of home loan interest rate data

The Productivity Commission proposes that APRA should, as part of the Economic and Financial Statistics (EFS) collection, collect monthly data from mortgage lenders on median interest rates for different categories of new residential home loans (draft Recommendation 8.3).

In 2017, APRA, in conjunction with the RBA and the Australian Bureau of Statistics, consulted on changes to a series of reporting standards known as the EFS collection. As part of this collection, additional data will be collected on housing credit stocks, flows and weighted average interest rates for some of the categories proposed in the Productivity Commission's draft report. These data will be collected from July 2019.

APRA sees benefits in considering, as part of the EFS collection, the collection of loan and interest rate data for different types of residential mortgage loans as proposed by the Productivity Commission, noting that the time necessary to develop new reporting forms can be lengthy and resource intensive for both the agencies and the entities that have started building the necessary systems for the new collection. In addition, reopening the EFS collection risks delaying the delivery of other important data that have already been agreed upon. Alternatively, more timely data may be available if mortgage lenders themselves published the data proposed in the draft report.

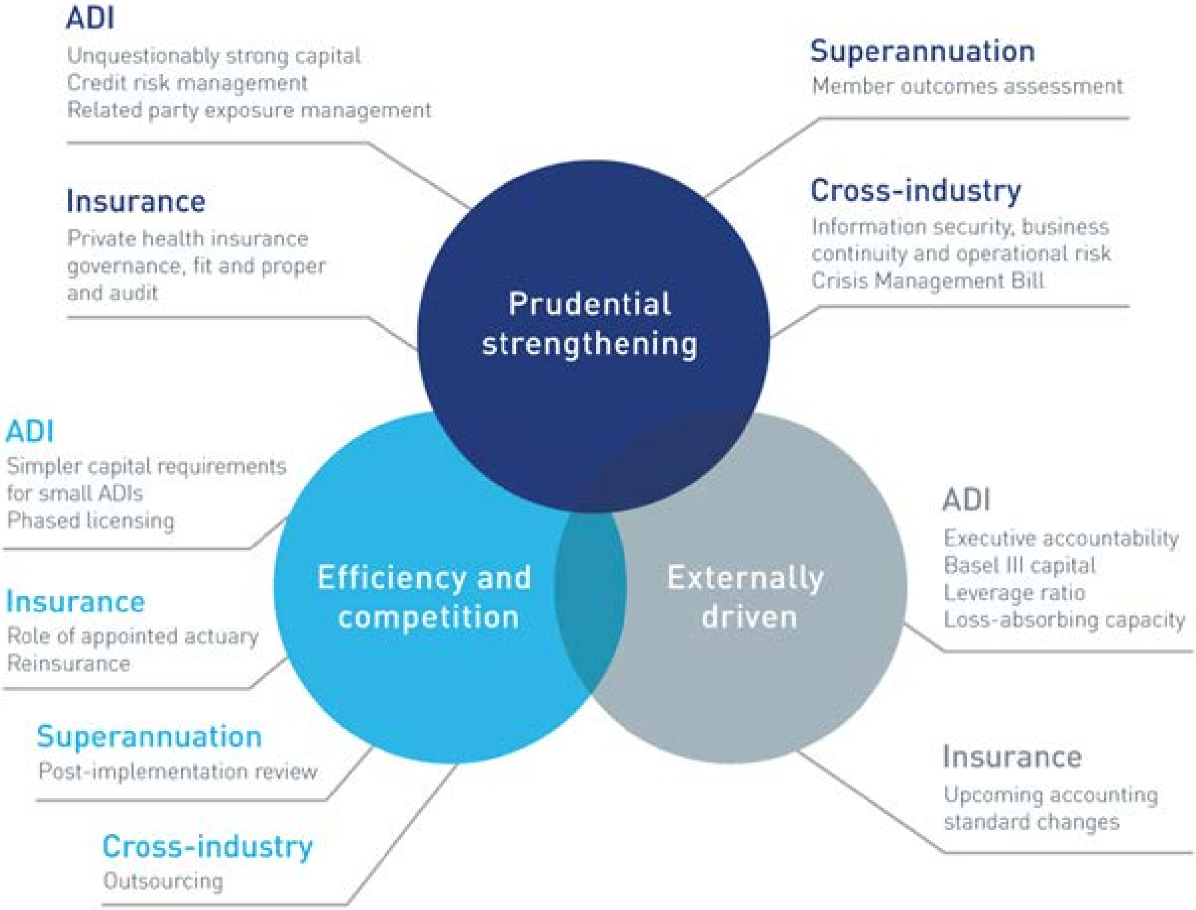
Interest rate transparency for home loans

The Productivity Commission recommends that APRA should publish the proposed interest rate data in a way that is accessible to third parties so that these parties are able to develop comparator websites if there is a commercial benefit in doing so (draft Recommendation 8.4).

APRA would support working with ASIC to improve the access to, and usability of, collected home loan data by consumers. In this regard, APRA has commenced a data transformation program which encompasses a comprehensive modernisation of how APRA collects, stores, analyses and provides access to data. The 'Access to Data' stream of the program is focused on delivering the capability to produce analytics outputs that deliver data and insight to stakeholders. This includes the modernisation of APRA's public dissemination of non-confidential data, including, online access to data and data sets.

APRA would be happy to brief the Productivity Commission further on this program of work.

Attachment A – APRA policy priorities for 2018, by primary driver



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