CUSTOMER OWNED BANKING ASSOCIATION

www.customerownedbanking.asn.au

LEVEL 11, 35 CLARENCE STREET, SYDNEY NSW 2000 GPO BOX 4686, SYDNEY NSW 2001

27 March 2015

William Coen
Secretary General
Basel Committee on Banking Supervision
Bank for International Settlements
Centralbahnplatz 2
4051 Basel
Switzerland

By email: www.bis.org/bcbs/commentupload.htm

Dear Mr Coen

Proposed revisions to the standardised approach to credit risk

COBA welcomes the opportunity to comment on the BCBS's consultative document proposing revisions to the standardised approach to credit risk.

COBA is the industry body for Australia's credit unions, mutual building societies and mutual banks. Collectively, the institutions we represent have more than AU$90 billion in assets and serve more than 4 million customers. The customer owned model is the proven alternative to the listed model, delivering competition, choice, and consistently market leading levels of customer satisfaction. Residential mortgages are the most important asset class for customer-owned banking institutions, generally representing 66-75 percent of member balance sheets.

Prudential regulation in Australia

All of Australia's banks, building societies and credit unions are classified as Authorised Deposit-Taking Institutions (ADIs) and are regulated by APRA, our prudential regulator, under Australia's *Banking Act 1959*. All Australian ADIs are subject to the same prudential framework.

In Australia, the five largest banking institutions (Commonwealth Bank, National Australia Bank, Westpac, ANZ and Macquarie) use the IRB approach to calculate risk weights. All other Australian banking institutions, including customer owned banking institutions, use the standardised approach.

The BCBS proposal

COBA supports the BCBS statement that "Increasing overall capital requirements under the standardised approach for credit risk is not an objective of the

Committee; rather, capital requirements should be commensurate with underlying risk."[1]

However, COBA is concerned that the proposals put forward by the BCBS will actually significantly increase the aggregate amount of capital required to be held by Australian customer owned banking institutions. Preliminary analysis of our members' balance sheets suggests risk weights on their residential mortgage portfolios would increase by around 5 to 10 per cent,[2] depending on the exact composition of each member's portfolio. Similarly, we estimate that the reported capital adequacy ratios would fall by around 0.5 to 2.5 per cent.

More broadly, we note that the Australian Government has recently completed an independent inquiry (the FSI[3]) looking at our financial system, which identified the significant disparity between IRB and standardised risk weights as a competitive neutrality concern.

In Australia, the average risk weight applied to residential mortgages is 18 per cent under the IRB approach, but 39 per cent under the standardised approach.[4] This is a significant difference, which undermines competitive neutrality and has implications for the sustainability of competition in the Australian banking sector. The current requirement for customer-owned banking institutions to hold more than twice as much capital as the major banks, (and for the same loans) is particularly perverse given that we have significantly lower rates of arrears and non-performing loans. The chart below highlights the difference in arrears between the major banks and "CUBS" (credit unions and building societies).

Comparison of mortgage arrears – 90+ days[5]

[1] BCBS, *Revisions to the Standardised Approach for credit risk,* December 2014, p. 2.
[2] That is, average residential mortgage portfolio risk weights would move from the high 30s to the mid-high 40s.
[3] See: fsi.gov.au for details
[4] Murray, *FSI Final Report*, November 2014, p. 61.
[5] Source: S&P's RMBS Arrears Statistics – Australia (Excluding Non-Capital Market Issuance) Dec 2013

The FSI Report said that: "In the Inquiry's view, the relative riskiness of mortgages between IRB and standardised does not justify one type of institution being required to hold twice as much capital for mortgages than another. This conclusion is supported by the findings of APRA's recent stress test, which found regulatory capital for housing was more sufficient for standardised banks than IRB banks."[6]

The FSI Report went on to call for the government to: "Raise the average internal ratings-based (IRB) mortgage risk weight to narrow the difference between average mortgage risk weights for authorised deposit-taking institutions using IRB risk-weight models and those using standardised risk weights."[7] In determining how far IRB risk weights for residential mortgages should be raised, the FSI said that it "...considers a range between 25 and 30 per cent to be appropriate."[8]

COBA is very concerned that implementation of the BCBS proposals would actually achieve the opposite outcome, increasing average risk weights for standardised ADIs and further widening the gap between IRB and standardised ADI capital requirements. Such an outcome would further undermine competitive neutrality in Australia's banking sector.

Residential mortgage risk weights

The current Basel standard assigns residential mortgages a risk weight of 35 per cent under the standardised approach, "provided that there is a substantial margin of additional security over the amount of the loan based on strict valuation rules."[9] COBA agrees with the BCBS's statement that "The recent financial crisis has demonstrated that the current treatment is not sufficiently risk-sensitive and that its calibration is not always prudent."[10]

However, COBA notes that APRA has already introduced a risk sensitive matrix for standardised banking institutions' residential mortgages.[11] Under this approach, residential mortgages are divided into twenty discrete categories, based on the following three risk drivers:

- The loan to valuation ratio (LVR);
- Whether or not there is lender's mortgage insurance (LMI); and
- Whether or not the loan is "standard" or "non-standard."[12]

Using these three risk drivers, a residential mortgage is assigned a risk weight of anywhere between 35 and 100 per cent. While COBA agrees with the BCBS view that "...a 35% risk weight may be too high for some exposures..."[13] we note that risk weights of below 35 per cent are not currently permitted by the Basel framework.

[6] Murray, *FSI Final Report*, November 2014, p. 61.
[7] ibid. p. 60.
[8] ibid. p. 65.
[9] BCBS, *Revisions to the Standardised Approach for credit risk,* December 2014, p. 15.
[10] ibid.
[11] See APRA's APS 112 – Attachment C
[12] See APRA's APS 112 p. 29. for definitions of "standard" and "non-standard"
[13] BCBS, *Revisions to the Standardised Approach for credit risk,* December 2014, p. 15.

COBA notes that the risk sensitive approach adopted by APRA has proven itself effective and resilient. Where banking sectors in other countries struggled during the global financial crisis, Australia's banking sector weathered the storm. In particular, Australia's customer-owned banking institutions continued to experience very low rates of impaired loans both during and after the crisis.

Impaired facilities as a percentage of total loans[14]

Given that Australia already has an effective and risk sensitive framework in place which is well suited to domestic conditions, it is not clear what benefit would be gained by replacing this with a new framework that utilised a different set of risk drivers. While we acknowledge that the approaches to residential mortgage risk weights in many other jurisdictions lack risk sensitivity, this is no reason to make changes to the settings in Australia. It would be unfortunate if, in an attempt to improve the sensitivity of risk weight settings in other countries, the BCBS forced Australia to replace its current approach with something less effective. This would truly be a case of "throwing the baby out with the bathwater."

While international standardisation is valuable aspirational goal to strive towards, it is difficult to achieve in practice, particularly given the economic, demographic, financial and legal differences between countries. For this reason, we believe it is more appropriate for the Basel framework to provide overarching direction while giving national regulators the flexibility they need to appropriately tailor the standards to their own jurisdictions.

In addition to our general concern about the necessity and appropriateness of replacing Australia's current risk weight matrix, COBA raises the following specific concerns about aspects of the BCBS proposal:

[14] Source: APRA, Quarterly ADI Performance, Dec 2013

Use of a Debt Service Coverage (DSC) ratio

Under the BCBS proposal, residential mortgages with a DSC above 35 per cent would face higher risk weights. This raises a number of concerns:

Firstly, most Australian banking institutions do not collect or use a DSC as part of their mortgage assessment process. The far more common metric used in Australia is a net income model, whereby a number of fixed deductions are made from a person's income to estimate living and other expenses, and a binary assessment is then made of whether or not amount left over is sufficient to meet mortgage repayment (after factoring in appropriate interest rate buffers and floors etc). The net income approach is generally considered to be a more effective risk assessment tool than a DSC. Introducing a DSC calculation would require Australian banking institutions to either replace or duplicate their existing systems with this new approach. There is also no effective way for many banking institutions to assess the DSC ratios of residential mortgages within their existing portfolio. It is not clear how the BCBS would propose to treat these loans. It would be very concerning if a punitive risk weight was applied to existing mortgages where DSC information is not available.

Secondly, we note that the BCBS proposes that rental income from the residential property would not be included in the income calculation underpinning the DSC. This is not the current practice in Australia; instead rental income derived from an investment property is factored into assessments of serviceability. Feedback from our members indicates that few investment property loans would meet serviceability requirements if the rental income from the property was excluded. Certainly, almost none of them would achieve a DSC ratio below the BCBS proposed threshold of 35 per cent.

Rental income is a stable source of income in Australia. Vacancy rates for residential real estate are generally very low, and tenancies are stable. The national vacancy rate is currently 2.2 per cent,[15] and has sat steadily in the 1-3 per cent range for more than a decade. This is in stark contrast to residential vacancy rates in the US, which currently stand at 7 per cent, and which historically have been higher than this.[16] COBA believes that individual jurisdictions should have the flexibility to include rental incomes in any DSC calculations where it is prudentially sound to do so.

No accommodation of LMI

LMI is commonly used by Australian banking institutions. Under APRA's current prudential standard, a lower risk weight is applied to residential mortgages with an LVR of above 80 per cent if LMI is also held against the loan.

In addition to providing a risk weight concession, the use of LMI makes prudential sense, particularly for mortgages with higher LVRs. We estimate that approximately 85 per cent of all residential mortgages held by our members with an LVR of more than 80 per cent have LMI.

---

[15] SQM research, *Residential Vacancy Rates*
[16] US Census Bureau, *Housing Vacancies and Homeownership (CPS/HVS),* Fourth Quarter 2014

APRA's provision of a risk weight concession where lenders use LMI makes good prudential sense, as higher utilisation of LMI supports financial sector stability. As APRA notes: "The regulatory capital framework for ADIs has long reflected the risk-mitigating properties of lenders mortgage insurance (LMI) in determining the amount of capital necessary to support insured residential mortgage exposures."[17]

Were this concession to be removed, it is likely that the use of LMI by banking institutions would decline, leading to poorer prudential outcomes. Certainly, a number of our members have indicated that APRA's regulatory treatment of LMI is one of the factors considered in determining whether to hold LMI against a particular mortgage.

It is important that national jurisdictions retain the flexibility to provide concessional risk weights for residential mortgages covered by LMI.

The fixed nature of LVR and DSC assessments

The BCBS proposes that "…when calculating the LTV ratio, the value of the property will be kept constant at the value measured at origination…"[18] and is considering "…whether the DSC ratio should be measured only at loan origination (and not updated) for regulatory capital purposes."[19]

Mortgages in Australia are commonly written for 30 years, and property values and income levels are likely to chance significantly over that period. Over the last decade, the average house price has increased by 67 per cent[20] in Australia, and the average income has increased by 134 per cent over the last twenty years.[21]

While we agree that excessive recalibration of property valuations and income levels could be pro-cyclical and undesirable from a prudential perspective, we also note that such an approach would be unlikely to be in the interests of banking institutions. Frequent recalculation of these values would be administratively time consuming and expensive, and would also be likely to cause frustration to banking customers.

However, completely eliminating reassessment of these variables is equally inappropriate, and would lead to other undesirable outcomes. In particular, COBA is concerned about the competitive neutrality implications of such an approach. For example, where property valuation and income figures are well out of date, a competitor may be able to refinance the loan with a lower risk weight, given their capacity to update these figures as part of the refinancing process. Such an outcome undermines competitive neutrality, and is likely to lead to inefficient and excessive mortgage "churn."

We believe that a more appropriate middle ground would allow for these figures to be updated after a sensible timeframe had passed. This would help to protect against pro-cyclical outcomes while also supporting competitive neutrality.

---

[17] APRA, *2nd round submission to the FSI,* August 2014, p. 15.
[18] BCBS, *Revisions to the Standardised Approach for credit risk,* December 2014, p. 36.
[19] ibid., p. 16.
[20] ABS, *6416.0 Residential Property Price Indexes,* December 2014
[21] ABS, *6302.0 Average Weekly Earnings,* November 2014

Bank exposure risk weights

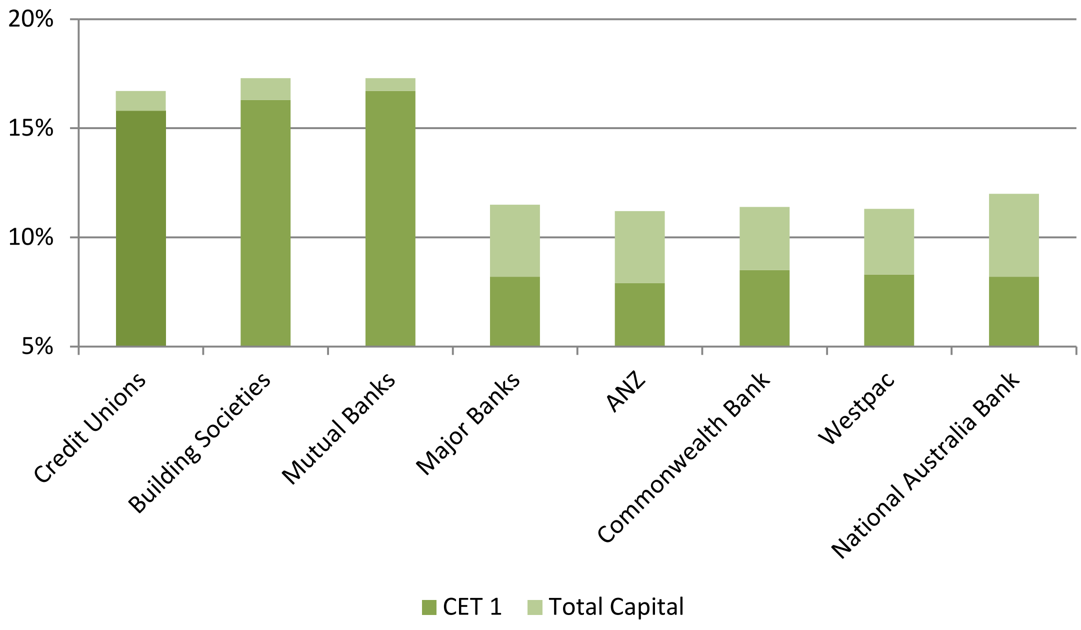
The BCBS paper notes that "The Basel framework's current standardised approach prescribes the use of external credit ratings to determine certain exposures' risk weights. The Committee is investigating the suitability of substituting references to ratings with a limited number of risk drivers that provides a meaningful risk differentiation."[22]

The BCBS paper also notes that "the hard-wiring of external credit assessments into standards, laws and regulations may often lead to mechanistic reliance on ratings by market participants, resulting in insufficient due diligence and poor risk management on the part of lenders and investors."[23]

COBA agrees with the BCBS suggestion of moving away from credit ratings as tool to determine risk weights for bank exposures, given these are not always the best indicator of the riskiness of an institution.

In principle, COBA sees capital adequacy and asset quality as appropriate risk drivers to replace credit ratings. In this regard, we note that customer owned banking institutions generally outperform Australia's major banks on both of these indicators. COBA would support a framework that appropriately recognises the safe and secure nature of the institutions in our sector.

Capital Adequacy[24]



While broadly supporting the shift away from credit ratings, COBA does have two potential concerns with the proposal.

---

[22] BCBS, *Revisions to the Standardised Approach for credit risk,* December 2014, p. 1.
[23] ibid., p. 3.
[24] Source: APRA, Quarterly ADI Performance, Dec 2013; Major Bank Basel III Pillar 3 Disclosures, Dec 2013

Firstly, we note that under the proposal, the lowest risk weight that can be achieved for a bank exposure is 30 per cent, which is materially higher than the 20 per cent currently applied to low risk bank exposures under Australia's prudential standards. COBA questions why the BCBS is proposing such a significant increase in the risk weight for this asset class, particularly given the very low risk of these exposures. Many of our members hold a significant proportion of their assets as low-risk bank exposures, and this change would have a substantial impact on their overall risk weighted asset calculation.

Secondly, we are concerned about the potential interaction between this proposal and existing liquidity requirements in Australia. Customer owned banking institutions must hold must hold their liquidity portfolios in a range of eligible assets determined by APRA. In determining the eligibility of instruments issued by banks, APRA's has placed an emphasis on the credit rating of the issuer. This potentially creates a conflict, with APRA's approach encouraging institutions to hold instruments held by the major banks (with the highest credit ratings), while the BCBS standard would give more favourable risk weights to exposures to smaller banking institutions.

In order to improve the alignment of these two approaches, we would recommend that APRA reconsider its approach to liquidity for customer owned banking institutions in light of the BCBS proposal, and in particular whether the current reliance on credit ratings remains appropriate.

BCBS proposals on operational risk

COBA notes that the BCBS has also released a discussion paper regarding operational risk under the standardised approach.[25] COBA is currently reviewing this proposal to determine the potential impact on Australia's customer owned banking sector.

Please contact me (llawler@coba.asn.au) or Micah Green (mgreen@coba.asn.au) to discuss any aspect of this submission.

Yours sincerely

LUKE LAWLER
Acting Head of Public Affairs

[25] BCBS, *Operational risk – Revisions to the simpler approaches,* October 2014