

10 March 2016

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

Revisions to the Standardised Approach for credit risk – second consultation paper

COBA welcomes the opportunity to comment on the BCBS's December 2015 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 sector we represent has AU\$97 billion in assets and serves more than 4 million customers.

The customer-owned model is the proven alternative to the listed model in the Australian banking market, delivering competition, choice, and consistently market leading levels of customer satisfaction.

Prudential regulation in Australia

All of Australia's banks, building societies and credit unions are Authorised Deposit-Taking Institutions (ADIs) and are regulated by APRA, our 'national supervisor', 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 internal-ratings based (IRB) approach to calculate risk weights. All other Australian banking institutions, including customer-owned banking institutions, use the standardised approach (SA).

In its role as a national supervisor, APRA supports the Basel standards and generally applies these standards as minimum benchmarks. APRA has adapted and modified the BCBS standards in certain areas to suit Australian market conditions. APRA's approach

is to present '[Australian] banks to the world as being regulated and supervised to a level materially higher than the global minimum expectation'.¹

It is important to retain some flexibility for national supervisors, particularly given the BCBS standards are targeted at internationally-active banks but in the Australian market are applied to all ADIs, from the largest listed bank to the smallest credit union.

The BCBS Proposal

COBA supports the broad BCBS intention to increase risk sensitivity under the SA. However, Australia already has a risk sensitive framework. COBA is concerned that some aspects of the BCBS proposal may increase capital requirements for residential mortgages for Australian ADIs. Residential mortgages are the most important asset class for customer-owned banking institutions, generally representing 66-75 percent of member balance sheets. Due to their high exposure to residential mortgages, higher capital requirements could significantly impact Australian customer-owned banking institutions and competition in Australian banking.

An increase in capital requirements for SA institutions reduces their competitiveness against IRB institutions. The recent Australian Financial System Inquiry (FSI) identified the disparity between IRB and standardised risk weights as a significant competitive neutrality concern:

"In the Inquiry's view, the relative riskiness of mortgages between IRB and standardised banks 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.

"The gap between average IRB and standardised mortgage risk weights means IRB banks can use a much smaller portion of equity funding for mortgages than standardised banks. Because equity is a more expensive funding source than debt, this translates into a funding cost advantage for IRB banks' mortgage businesses to the extent that the riskiness of mortgage portfolios is similar across banks.

"Given that mortgages make up a significant portion of the assets of almost all Australian ADIs, competitive distortions in this area could have a large effect on their relative competitiveness. This may include inducing smaller ADIs to focus on higher-risk borrowers. Restricting the relative competitiveness of smaller ADIs will harm competition in the long run."²

The Australian Government and APRA have accepted the FSI recommendation to reduce this disparity. APRA has begun this process by raising the average risk weight of the residential mortgage portfolios of IRB ADIs to at least 25 per cent as an "interim" step. The current average risk weight of SA ADIs in Australia is 39 per cent.

If the BCBS proposals were to be implemented as they stand, this could undo APRA's work to narrow the gap between SA institutions and IRB institutions. This would harm competition without delivering any overall systemic prudential benefit.

¹Speech to the APRA Finsia Workshop Sydney by Charles Littrell, Executive General Manager, APRA, *APRA's Basel III Implementation: Rationale and Impacts* on 23 November 2011.

² Financial System Inquiry, Final Report, November 2014.

A recent IMF report argues that banks in advanced economies should have capital levels equivalent to 15-23 per cent of risk-weighted assets.³ Beyond that level, however, the benefits of adding even more capital “decline rapidly”. Australian credit unions and building societies already hold this level of capital at 16.3% and 18.7% of risk-weighted assets respectively.⁴ The average capital ratio across the customer-owned banking sector in Australia, i.e. also including mutual banks, is an estimated 17.8%.⁵

Limited national discretion

COBA recognises the BCBS desire to minimise the use of national discretion and promote a ‘level playing field’ across jurisdictions. However, discretion is critical to enable supervisors to deviate from a ‘one-size fits all’ approach and reflect the ‘jurisdictional specificities’ mentioned in the consultation paper, particularly in the case of residential mortgages. This allows supervisors to create prudential regimes which accommodate national housing policies, taxation regimes, legal frameworks and competition concerns. COBA believes key areas for national discretion include allowing risk weight ‘discounts’ for lenders’ mortgage insurance and a national-level definition of ‘materially dependence’.

Accommodating mortgage insurance

COBA proposes the specific inclusion of a national discretion clause for residential mortgages to account for risk-reducing products such as lenders’ mortgage insurance, which are commonly used in Australia.

COBA also seeks clarification from the BCBS that the proposed weights relate to uninsured mortgage exposures. This will ensure a ‘level playing field’ treatment across regulatory jurisdictions. Without this, some regulators may apply the proposed BCBS weights to uninsured exposures and provide discounts for insurance, while more conservative regulators may apply these weights to insured exposures and add a premium for uninsured loans.

Mortgage insurance products, in particular Lenders’ Mortgage Insurance (LMI), are commonly used by Australian banks with more than one quarter of Australian loans having LMI.⁶ In Australia, while mortgage insurance is not mandatory, many lenders require LMI where the loan to value ratio (LVR) is above 80%. LMI protects lenders against a prescribed level of loss in the event that a borrower defaults on their home loan. Under a risk-sensitive approach, this protection should reduce the risk weights for these exposures.

APRA currently takes a risk-sensitive approach where, under certain situations, standardised ADIs can apply risk weight discounts for residential mortgages with LMI. This reflects the fact that risk decreases because insurance is held. This is not limited to Australia with several other jurisdictions providing similar incentives for insured residential mortgages, including Canada, Hong Kong, New Zealand, the Netherlands, United Kingdom and the United States.

Without national discretion, COBA is concerned that supervisors may not be able to provide lower risk weights for insured mortgages. Such a move will increase the difference in risk weights between standardised and advanced banks. Several COBA members have commented that without a risk weight discount for mortgage insurance,

³ IMF Discussion Note– Benefits and Costs of Bank Capital, March 2016

⁴ APRA’s Quarterly Authorised Deposit-taking Institution Performance, December 2015

⁵ KPMG’s Mutuals Industry Review 2015

⁶ RBA’s Financial Stability Review: Box C: Lender’s Mortgage Insurance, September 2013

the cost of lending may be prohibitive. This could lead to some banking institutions exiting the high LVR market (e.g. first home buyer market).

In relation to this point, a COBA member commented: "This effective risk mitigation should be taken into consideration for risk weightings as it provides the appropriate level of capital for the risk being undertaken, whilst also supporting the focus of customer-owned organisations to help people move into their first home."

Without explicit recognition of LMI in the prudential framework, it is likely that the use of LMI by banking institutions would decline, leading to poorer prudential outcomes.

National-level definitions of 'materially dependent'

The introduction of the BCBS paper outlines the following intention:

"A more conservative treatment for exposures secured by real estate where repayment is materially dependent on cash flows (i.e. rent/sale) generated by the property".

COBA notes that the BCBS consultation paper does not have an indicative definition of 'materially dependent'. COBA believes that, while this term must be well-defined at a national level, any global definition must allow supervisors to adapt the definition to reflect the 'jurisdictional specificities' mentioned in the paper.

Australia's current standardised regime uses the same set of risk weights for both investor and owner-occupied residential exposures. The BCBS paper introduces the concept of material dependence which would essentially provide for differentiated risk weights depending if the loan was to an owner-occupier or investor.

COBA understand that the premise of the BCBS distinction is on a direct link between loan repayments and cash flow generated by the property. However, Australia's tax regime allows investors to deduct mortgage interest expenses against total income, blurring the lines between rental income and other types of income such as salary and wages. This has led to a difference in the nature of Australian property investment compared to the rest of the world. Australia has a significant number of individual property investors with one in five tax-filing Australians reporting rental income.⁷ Australia's policy settings create a more tenuous link between loan repayments and rental incomes which may not fit a globally-set definition of 'materially dependent'.

Many other considerations can lead to divergent interpretations of 'materially dependent'. These include whether to consider net or gross rental cash flow, interest only or principal repayments, as well as other income sources such as salary or other investment properties.

In order to ensure a 'level playing field', and take into account local market conditions, 'materially dependent' should be defined at the national level to ensure consistent treatment across institutions.

The BCBS proposed risk weights for 'materially dependence' are excessive, particularly for LVRs less than 80%, given Australia's current prudential practice. For example, lenders in Australia are encouraged by APRA to make adjustments to expected rental income for non-occupancy and other costs.⁸

⁷ Australian Taxation Office *Taxation statistics 2012-13* - 2.7 million Australians reported rental income with 12.8 million Australians lodging tax returns.

⁸ APRA's *Prudential Practice Guide APG 223 Residential Mortgage Lending* para 37.

In relation to this, a COBA member commented: "The BCBS appears to be focused on those residential real estate loans primarily funded by rental income, however we do not necessarily see a difference between investor and owner-occupier risk weights based on the historical performance of our portfolio, where we see no significant differences in loss rates across these segments."

Furthermore, COBA believes that the set of 'materially dependent' risk weights should have the same level of granularity as for non-'materially dependent' weights (six rather than three categories). This would increase the level of risk sensitivity. The lack of granularity creates a problem where the 'risk premium'—the difference between materially and non-materially dependent weights—contains significant level shifts between the three categories. Not only could this encourage clustering at certain LVR points, it also increases incentives to not report as materially dependent.

Value of property to be 'measured at origination'

COBA is concerned that the BCBS proposal to limit property value measurement to the point of origination will result in competitors 'cherry picking' older loans. For example, once a loan has been paid down for a number of years, other banking institutions would be able to offer to refinance the loan at a new LVR with a lower risk weight. Such an outcome undermines competitive neutrality for no prudential benefit.

In the last decade average house prices in Australia have increased by 81 per cent.⁹ In Sydney, Australia's largest real estate market, the average house price has increased by 53 per cent over the last three years.¹⁰

COBA proposes that the BCBS allow discretion to maintain Australia's current approach of valuation at origination for LVR purposes supplemented by the use, where appropriate, of a "subsequent formal revaluation by an independent accredited valuer".¹¹ This allows incumbent ADIs' the flexibility to retain a customer without subjecting the customer to a costly refinancing process. From a prudential perspective, this can provide a more balanced risk outcome as the incumbent can utilise their existing relationship to more accurately judge the risk of the customer. Furthermore, COBA also notes that any proposal made by the BCBS should provide a competitively neutral treatment with respect to IRB banks.

On behalf of our member institutions, we look forward to engaging with you on this submission. In Australia, standardised institutions, including customer-owned banks, play an important role to provide an alternative to the larger IRB banks. Therefore it is important the SA allows the appropriate discretions for national supervisors to both reflect jurisdictional specificities and to promote a strong and competitive banking sector.

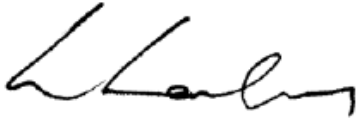
⁹ *Australian Bureau of Statistics 6416.0 Residential Property Price Indexes*, Weighted average of eight capital cities, September 2015.

¹⁰ *ABS 6416.0 Residential Property Price Indexes*, Sydney, September 2015.

¹¹ *APRA's APS 112 Capital Adequacy: Standardised Approach to Credit Risk*: Attachment D – 28.

Please do not hesitate to contact me on +61 2 8035 8448 or Sally MacKenzie on +61 2 8035 8450 to discuss any aspect of this submission.

Yours sincerely

A handwritten signature in black ink, appearing to read 'L. Lawler', with a stylized, cursive script.

LUKE LAWLER
Head of Public Affairs