

28 June 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

Reducing variation in credit risk-weighted assets

COBA welcomes the opportunity to comment on the BCBS's March 2016 consultative document outlining constraints on the use of internal model approaches.

COBA is the industry body for Australia's credit unions, mutual building societies and mutual banks. Collectively, the sector we represent has AU\$99 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.

The use of internal models in Australia

All of Australia's banks, building societies and credit unions are Authorised Deposit-Taking Institutions (ADIs) and are regulated by the Australian Prudential Regulation Authority (APRA), our 'national supervisor', under Australia's Banking Act 1959.

In Australia, the five largest banking institutions (Commonwealth Bank, National Australia Bank, Westpac, ANZ and Macquarie Bank) use internal models to calculate their risk based capital requirements. These advanced institutions have around 80 per cent of the home loan market. All other Australian banking institutions, including customer-owned banking institutions, currently use APRA's standardised approach.

COBA supports the BCBS's proposed measures to reduce the excessive variation in the credit risk weighted assets (RWA) of advanced banks. Reducing this variation restricts the advantages that optimistic modelers have over conservative modelers and, in turn, their advantage over standardised ADIs. A more comparable and consistent modelling approach reduces the risk of overly optimistic modelling and supports the standardised approach to credit risk as a viable and competitive alternative.

More broadly, a range of concerns have been raised about the appropriateness of advanced approaches including undue modelling optimism, model specification and

incentive-compatibility risks.¹ These concerns were echoed by the BCBS, who "...confirmed that there are material variances in banks' regulatory capital ratios that arise from factors other than differences in the riskiness of banks' portfolios".²

A number of regulatory bodies have expressed a lack of confidence in the outputs generated by the internal models used by advanced banks. For example, APRA Chairman Wayne Byres has said there was "an increasing lack of faith in the use of internal models for calculating risk weights".³

The current approach allows advanced ADIs to use modelling assumptions which produce risk weights that are too low, and result in the ADI holding inadequate amounts of capital. APRA's 2014 housing risk stress test found regulatory capital held by advanced ADIs insufficient to cover losses incurred under the scenario.⁴

These lower risk weights also create a funding cost advantage for advanced ADIs over standardised ADIs. Australia's Financial System Inquiry (FSI) found that the average mortgage risk weight for standardised ADIs is twice that of advanced ADIs. The FSI found that "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".⁵

The Australian Government accepted the FSI's recommendation to narrow the gap in average mortgage risk weights between advanced and standardised ADIs and introduce a leverage ratio to act as a "backstop" for internal ratings based (IRB) ADIs. APRA has raised the average IRB mortgage risk weight from 18 per cent to at least 25 per cent by 1 July 2016, effectively forming a 'output floor' on the average IRB mortgage risk weight.

APRA also set a 20 per cent floor in 2008 on the loss given default (LGD) parameter for mortgages to ensure advanced ADIs were not overly optimistic when estimating mortgage portfolio losses due to the absence of data on an Australian housing downturn. This is above the 10 per cent floor prescribed by the BCBS.

COBA believes that output and parameter floors are useful tools to increase the capitalisation of IRB ADIs and reduce the excessive funding advantages from advanced modelling approaches. COBA supports the BCBS's proposal to implement parameter floors as well as the BCBS's future work on capital floors based on standardised approaches.

COBA notes that the BCBS proposes to replace internal models with the standardised approach for risk exposures to other banks. COBA believes that these changes could increase capital requirements for IRB banks, which would be passed through to the other banking institution. This could have broader system impacts by increasing the cost and reducing the availability of funding to other banking institutions, including customer-owned banking institutions. COBA believes that the BCBS should carefully weigh up these impacts before removing the use of the internal models and consider whether other options such as parameter or capital floors are more appropriate.

On behalf of our member institutions, we thank you for the opportunity to provide comment. In Australia, standardised ADIs, including customer-owned banking institutions, play an important role providing competition and an alternative to the larger IRB ADIs. It is therefore important that advanced approaches are credible and

¹ BCBS Consultative Document - Capital Floors: the design of a framework based on standardised approaches

² BCBS Reducing excessive variability in bank's regulatory capital ratios

³ Speech to RMA Australia CRO Forum, *Perspectives on the Global Regulatory Agenda*, Wayne Byres, Sydney, 16 September 2014

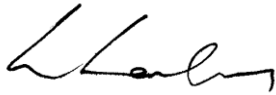
⁴ Speech to AB+F Randstad Leaders *Seeking strength in adversity: Lessons from APRA's 2014 stress test on Australia's largest banks*, Wayne Byres, Sydney, 7 November 2015,

⁵ Financial System Inquiry Final Report November 2014, page 61.

consistent to ensure that they do not create an excessive advantage over standardised ADIs.

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