



**Abacus**  
Australian Mutuals

Association of Building Societies and Credit Unions

24 September 2007

Mr Joe De Pietro  
Senior Specialist, Basel II  
Policy, Research and Statistics  
Australian Prudential Regulation Authority  
GPO Box 9836  
SYDNEY NSW 2001A

Dear Mr De Pietro,

**Draft Standards – APS 112 and APS114  
Standardised Approach to Credit Risk and Operational Risk**

Thank you for the opportunity to comment on APRA's Response to Submissions and revised draft standards for credit risk and operational risk for ADIs using the standardised approaches under Basel II.

Abacus – Australian Mutuals is the industry association for all of Australia's credit unions and mutual building societies. There are 148 mutual ADIs in Australia that collectively have more than \$60 billion in funds under management and more than 4 million members nation-wide. Credit unions and mutual building societies are a diverse range of ADIs, ranging in asset size from around \$10 million to more than \$5 billion and with industrial, geographical and community bonds. Mutual ADIs in Australia are dedicated to putting their members first and to providing real competition and choice for Australians in banking services.

Abacus was established on 1 July 2006 as a joint venture between the Credit Union Industry Association and the Australian Association of Permanent Building Societies. On 1 May 2007, credit unions represented by the National Credit Union Association also joined Abacus, finally giving mutual ADIs a single voice with our industry's regulators and the Government.

Mutual ADIs have had a long involvement with the development of the Basel II framework in Australia. Whilst supporting the principles of the Basel II Accord, mutual ADIs are more aware than most of the impact of excessive regulation. Accordingly, our focus as an industry has been to ensure that the implementation of the Accord has benefits that clearly outweigh the costs of compliance and system changes, and to ensure that the Accord does not unfairly disadvantage smaller ADIs compared to the largest banks.

We have reviewed the latest draft of the proposed standards and highlight the following issues of concern to the mutual sector.

## **APS112 – CREDIT RISK**

### **Other retail exposures**

The mutual sector remains concerned that APRA has decided to exercise its discretion not to apply the reduced risk-weight to other retail exposures, apparently because internal modelling conducted by the largest banks does not indicate that such a reduction is warranted.

Of most concern is the lack of transparency on this issue. APRA has not provided any of the evidence on which it based its decision, so the mutual sector and others have no capacity to judge the decision on its merits. Furthermore, the decision is based on the internal modelling done by large banks – these institutions do not have the same risk profile as mutual ADIs and it is questionable why APRA would be relying on their work to justify its regulation-making decisions.

Like many others, the mutual sector participated in a lengthy quantitative survey process with APRA on the basis that aggregated information would be made available to the sector. Whilst understanding the need to protect confidential information, this must be balanced with the need for transparency in regulation setting. The mutual sector is unable to judge this decision on its merits, simply because this information is not available.

In our view, this is unacceptable and inconsistent with the principles recently laid out in the Federal Government's *Best Practice Regulation Handbook*<sup>1</sup>, particularly in relation to transparency and accountability. The Basel II framework is a significant change to the regulatory landscape for ADIs and yet does not appear to have been subjected to the sort of regulatory assessment and/or cost-benefit analysis that would meet the Government's stated aims of effective and efficient regulation.

The mutual sector also has concerns about the relativity of risk-weights under the standardised approach. For example, a mutual that makes a loan that is secured against commercial property will be required to risk-weight that loan at 100%, notwithstanding the size of the exposure relative to the security, or the creditworthiness of the counterparty. By comparison, an ADI that makes a low-doc loan to a first time borrower may only be required to hold half that amount of capital depending on the LVR.

This is an inconsistent approach to risk, and provides considerable disincentive to ADIs to undertake prudent lending to commercial lending to small and medium sized enterprises. Abacus is concerned that arbitrary risk-weights will create an inequitable barrier preventing mutual ADIs from entering into commercial lending in appropriate circumstances. Abacus encourages a review of the potential impact of these risk weights and the possible competitive restrictions that their application could create.

### **Risk-weights for residential mortgage loans**

Mutual ADIs are generally supportive of the reduced risk-weights proposed for some eligible residential mortgage lending – our sector believes that the lower risk-weights and greater granularity more accurately reflect relative risks than the current framework.

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<sup>1</sup> Commonwealth of Australia, *Best Practice Regulation Handbook*, August 2007

Mutual ADIs do not have significant exposures to non-standard loans and generally have a conservative lending profile. Mutual ADIs are prudent lenders and regularly require members to take out lenders mortgage insurance for loans with LVRs in excess of 80%. Abacus does not oppose higher risk-weights for non-standard lending.

Mutuals are aware of attaining the right balance between providing risk diversity and maintaining the simplicity of the standardised approach. There has been much discussion in recent months about the appropriate recognition of LMI as a risk mitigant. There is no question that LMI remains an important tool for mutual ADIs to reduce the risk of exposures in particular circumstances.

It is also clear, however, that there have been important social benefits provided to the community through the ability of ADIs to allow people broader access to the home market. Of loans over 80% LVR, the majority of loans covered by LMI are now in the 90 – 95% LVR bracket. Whilst it is clear that loans with higher LVRs require greater capital backing than low LVR loans, it is important that the relative risk-weighting recognises the mitigating effect of LMI.

It would be a perverse and adverse outcome for the community if smaller ADIs were forced to turn away first home buyers that under the current arrangements would be solid credit risks (assuming the loans are appropriately assessed in terms of security and capacity to repay). It would be particularly perverse if these typically younger and often more naïve borrowers were forced to use the unregulated banking sector to access funding given the unregulated sectors' recent poor record in terms of responsible lending.

Abacus and mutual ADIs believe that the role of LMI in promoting stability and competition in the residential mortgage sector needs to be reassessed and that appropriate incentives should be implemented to recognise the benefits of LMI.

### **Impaired residential mortgage loans**

Abacus supports APRA's revised treatment for past due or impaired residential mortgage loans that are covered by LMI. Retaining the original risk-weight on these loans after impairment is an appropriate recognition of the risk mitigating impact of LMI. However, we note with some concern that APRA is proposing to restrict this concession so that the total of such loans cannot exceed the ADIs large exposures limit.

This seems an unnecessary and unfair penalty on smaller ADIs, unrelated to risk and the principles underpinning the Basel II regime. APRA has informally indicated to Abacus that it was of the view that this limitation was appropriate because a breach of the large exposures limit would indicate that there may be some systemic lending issues within the ADI.

This argument however does not apply to small ADIs that may easily reach their large exposure limit with a small number of loans. Whilst the impairment of these loans would of course be a serious concern, the fact that a small number of impaired loans cumulatively breach the large exposures limit does not alter the likelihood of loss arising from the individual loan. Abacus has a strong view that there is no justification for penalising the smallest institutions merely because of the issues created by the size of their balance sheet.

APRA also suggested that in the smallest ADIs the removal of this treatment would recognise the concentration risk faced by smaller bonded mutuals. Whilst recognising the importance of concentration risk, Abacus notes that such risk factors are explicitly covered under the Pillar Two requirements – including them under Pillar One in this way is an unnecessary and unjustified impost.

Abacus encourages APRA to remove the artificial link between large exposures and risk-weights for LMI-covered impaired loans given the excessive impact on smaller ADIs.

### **Investments with other ADIs**

APRA is proposing to base the risk-weight for inter-ADI exposures on the external ratings grade of the counterparty. Currently, inter-ADI deposits are risk-weighted at 20%. Under APRA's Basel II regime, the risk-weights for such exposures to unrated ADIs would be increased to 50% where the investments have a maturity date in excess of three months.

The vast majority of mutual ADIs are unrated due to the significant costs of the ratings process. Mutuals generally access wholesale markets through a range of different aggregated service providers. There is a significant amount of deposits made by ADIs within the mutual sector and accordingly, this change to the risk-weights will have a marked impact on some Abacus members. In our view, the increase of these risk-weights is simply not warranted and will have a significant impact on the costs of funds for smaller ADIs, whose risk profile will not automatically change as of 1 January 2008.

Abacus seeks urgent review of this approach and would welcome the opportunity to discuss impacts and alternate approaches to mitigate undue capital impacts for mutual ADIs.

### **Margin Lending**

There is little if any exposure in the mutual ADI sector to margin lending. Accordingly, APRA's proposed approach to margin lending is unlikely to have any material impact. However, Abacus notes with some concern that the proposed approach appears somewhat arbitrary. Again, Abacus is concerned about the lack of transparency around the regulation making process (eg APRA's consultant's report was not released in whole or in part).

## **APS 114 – OPERATIONAL RISK**

### **Definition of 'gross income'**

Abacus welcomes APRA's attempts in this draft of the standard to clarify definitional issues surrounding the Basel framework's gross income terminology. The new definition of "adjusted gross income" is an improvement although there do appear to be some anomalies within the definition, particularly with respect to the deduction of certain transactional fee income. For example, fees from ATM networks is specifically included as an adjustment but it is unclear whether fee income from other payment channels (eg EFTPOS) is to be treated the same way as ATM fees. Abacus and its members seek clarification from APRA of this issue.

Further, APRA has indicated that there is to be some adjustment to the treatment of extraordinary income items and we look forward to further information in this regard.

### **Aggregation of business lines**

APRA's decision to move away from its earlier position and disaggregate retail and commercial banking lines is welcomed. Mutual ADIs do not have significant commercial lending portfolios and would have been significantly disadvantaged under this approach.

**Requirement for audited figures**

Abacus welcomes APRA's decision to revise its requirement for the reconciliation of quarterly returns to audited financial statements within 20 days of the end of the relevant reporting period. This is a pragmatic and logical approach that will reduce unnecessary compliance costs for mutual ADIs.

**CONCLUSION**

Abacus welcomes the opportunity to participate in the consultation on the Basel II Capital Accord. We are supportive of the aims of the Accord and the role of APRA in determining the discretions that will apply in Australia. In summary, Abacus is seeking:

- > A review of the decision to apply a 100% risk-weight to other retail exposures and greater transparency in the decision-making process;
- > More appropriate recognition of the risk mitigating impact of LMI for residential mortgage loans;
- > A review of the impact of higher risk weights for inter-ADI lending, and
- > Further clarification of the definition of adjusted gross income in APS114.

Abacus and a range of ADIs that will implement the standardised approach are scheduled to meet with APRA Basel II Program Director, Mr Bernie Egan on 26 August 2007 and we look forward to discussing these issues with him at that time.

In the meantime, if you have any questions, please do not hesitate to contact Louise Petschler on (02) 8299 9050 ([lpetschler@abacus.org.au](mailto:lpetschler@abacus.org.au)) or myself on (02) 8299 9053 ([mdegotardi@abacus.org.au](mailto:mdegotardi@abacus.org.au)).

Yours sincerely,

**MARK DEGOTARDI**

Senior Adviser, Policy & Public Affairs