Australian Banking Association

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General Manager, Policy Development
Policy and Advice Division
Australian Prudential Regulation Authority
Level 12
1 Martin Place
SYDNEY NSW 2000
By email ADIpolicy@apra.gov.au

Dear Sir/Madam

Discussion Paper: Leverage ratio requirement for authorised deposit-taking institutions

The Australian Banking Association (**ABA**) appreciates the opportunity to provide APRA with comments on the Discussion Paper: *Leverage ratio requirement for authorised deposit-taking institutions* (**discussion paper**).

With the active participation of its members, the ABA provides analysis, advice and advocacy for the banking industry and contributes to the development of public policy on banking and other financial services. The ABA works with government, regulators and other stakeholders to improve public awareness and understanding of the industry's contribution to the economy and to ensure Australia's banking customers continue to benefit from a stable, competitive and accessible banking industry.

Australian authorised deposit-taking institutions (**ADIs**) have been reporting the leverage ratio since 2015. The ABA strongly opposes the early implementation of a revised leverage ratio requirement prior to the finalisation of APRA's revisions to the capital framework, which have a significant and material impact on the operation of the leverage ratio requirement framework, as proposed by APRA. This submission will highlight a number of material concerns with APRA's proposed leverage ratio framework, and will also make a recommendation on a way forward to ensure Australia continues to meet, and exceed, international standards.

APRA, in proposing a 2019 implementation date for the leverage ratio requirement has not fully considered the interaction of their proposed revisions to the capital framework and how these will interact with their proposed leverage ratio requirement framework. For example, the APRA capital framework revisions discussion paper[1] proposes changes to the treatment of credit conversion factors (**CCFs**) under Prudential Standard APS 112 Capital Adequacy: Standardised Approach to Credit Risk (**APS 112**). These CCF proposals will increase the leverage ratio exposure measure, which in itself, will require internal rating-based (**IRB**) ADIs to hold additional leverage ratio requirements. Such interactions between the capital framework and the leverage ratio framework compound the existing conservatism in the Australian prudential framework and such consequences have not been drawn out in the discussion paper.

[1] APRA, (Feb 2018), Revisions to the capital framework for authorised deposit-taking institutions, http://www.apra.gov.au/adi/PrudentialFramework/Pages/revisions-capital-framework-and-leverage-ratio-Feb-2018.aspx

ADIs are currently undertaking a vast number of projects to comply with a large number of concurrent regulatory reforms, including implementation of the recently finalised Prudential Standard APS 180 Capital Adequacy: Counterparty Credit Risk (**SA-CCR**). The commencement date of APS 180 is 1 July 2019 and APRA's proposed changes to the leverage ratio framework would require ADIs to apply a modified version of SA-CCR. The ABA notes APRA's intention to consult on a revised APS 110 and APS 330 to give effect to the proposed leverage ratio requirements in the second half of 2018; this timeline only gives ADIs a short six-month timeframe to implement a modified version of SA-CCR. The ABA would argue that six months is too short a timeframe for such a complex change and would place unnecessary regulatory burden on the resourcing of all ADIs, which are implementing the changes required for the implementation of SA-CCR by 1 July 2019.

The ABA also questions the need for the proposed changes to the leverage ratio requirement which deviate from the Basel Committee on Banking Supervision's (**BCBS**) standard and the International Financial Reporting Standards (**IFRS**). The ABA would hold that the proposed reforms to the leverage ratio requirement, which is a backstop measure to the risk-based capital framework, adds unnecessary complexity and reduces international comparability. The ABA would also hold that APRA has not clearly evidenced the prudential benefit of these proposed changes nor explained the need to deviate from the BCBS's standards.

ABA recommendation

Cognisant of the need to ensure Australia continues to progress the timely adoption of international standards and thresholds, the ABA would recommend that APRA considers setting the minimum leverage ratio for IRB ADIs at 3.5 per cent from 1 July 2019 rather than 4 per cent (refer discussion below). The ABA also recommends that the leverage ratio continues to be measured under the current framework. APRA could then finalise and align the implementation of a revised leverage ratio requirement framework with the BCBS's implementation date of 1 January 2022. In adopting a transitional approach, a number of the technical issues outlined later in this submission would be resolved, thereby preserving international comparability and minimising the regulatory burden with no risk to systemic stability.

In adopting a transitional approach, as APRA has previously done for unquestionably strong CET1 ratios and large exposure thresholds, this will ensure banks are obligated to meet and report their leverage ratio from the earliest date and APRA will minimise the regulatory burden on banks by aligning changes in the capital framework with the leverage ratio framework.

In addition, the ABA would recommend under the above transitional approach, that APRA allow ADIs to apply the SA-CCR exposure at default (**EAD**) measure for the leverage ratio calculations from 1 July 2019 until the BCBS's implementation date of 1 January 2022. This would reduce the regulatory burden on banks, which would otherwise be required to concurrently calculate the leverage ratio using the current exposure method (**CEM**) and the SA-CCR EAD method for regulatory capital requirements.

International comparability

The ABA notes that APRA intends in 2018 to consult on approaches to improve transparency, international comparability and the flexibility of the Australian capital framework. Noting that Australian ADIs currently report leverage ratios lower than their international peers due to conservatism with regards to APRA's definition of Tier 1 Capital, the ABA would suggest aligning any changes to the leverage ratio framework with the revisions of the capital framework, and any proposed approach to improve transparency and international comparability as the optimal approach.

APRA's proposals deviate from the BCBS's leverage ratio framework standard and as a consequence Australian ADIs will move further away from international comparability. Recommendation 7 in the 2015 Financial Services Inquiry Final Report[2] stated that, "The minimum leverage ratio should be comparable with Australia's global peers".

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[2] FSI, Final Report, (7 November 2014), Recommendation 7, available at: http://fsi.gov.au/publications/final-report/chapter-1/leverage-ratio/

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Proposed 4 per cent minimum for IRB ADIs

Should APRA adopt a 4 per cent minimum, the IRB ADIs will have a minimum in excess of the majority of global systemically important banks (**G-SIBs**). The BCBS advocates a minimum of 3 per cent with an additional buffer for G-SIBs equivalent to 50 per cent of their CET1 buffer. As at November 2017 G-SIB buffers ranged from 1 per cent to 3.5 per cent.

The ABA recognises the systemic importance of domestic systemically important banks (**D-SIBs**) in Australia versus the majority of other Australian ADIs, who are subject to the 3 per cent minimum. However, it is the ABA's view that a 1 per cent leverage ratio buffer an excessively large buffer to address APRA's stated view that the true level of Australian IRB ADIs' leverage is less certain.

When proposing the 4 per cent minimum for IRB ADIs, the ABA notes that key to APRA's concerns are exposures to off-balance sheet (**OBS**) items, and in particular, to derivative exposures. Derivatives make up less than 3 per cent of the Australian D-SIB's exposures, compared to 11 per cent for those G-SIBs that have a leverage buffer of 1 percent or more. Therefore, APRA's proposed minimum of 4 per cent is not commensurate to the OBS risk inherent in the IRB ADIs balance sheet when compared to international calibration.

	Australian Major Banks						G-SIBS (Bucket 2 and higher) - Leverage Buffer > 1%						
Exposure ($m)	**ANZ**	**CBA**	**WBC**	**NAB**	**Total**	**Total (%)**	**BAML**	**Deutsche**	**Citi**	**HSBC**	**JP Morgan**	**Total**	**Total %**
On BS	752,347	882,089	794,443	696,733	3,125,612	85%	1,958,220	973,000	1,565,533	1,963,400	2,167,252	8,627,405	70%
Derivatives	31,469	28,051	23,376	24,245	107,141	3%	280,728	197,000	308,522	128,700	413,797	1,328,747	11%
SFT	28,598	18,108	6,969	49,816	103,491	3%	245,553	157,000	276,895	237,600	317,938	1,234,986	10%
Off BS	96,765	84,255	78,705	85,447	345,172	9%	271,625	93,000	282,421	227,400	305,476	1,179,922	10%
Total Exposure	**909,179**	**1,012,503**	**903,493**	**856,241**	**3,681,416**	**100%**	**2,756,126**	**1,420,000**	**2,433,371**	**2,557,100**	**3,204,463**	**12,371,060**	**100%**

Note:

1) As at 30 Sep 17 for ANZ, WBC and NAB and 31 Dec 17 for CBA; 2) As at 31 Dec 17 for G-SIBS; 3) In AUDm for Australian Major Banks and USDm for G-SIBS

On an international comparison, APRA's proposed buffer of 1 per cent would be commensurate with only 5 out of 30 G-SIBs under the BCBSs recommendation in November 2017[3]. Therefore, the remaining 25 G-SIBs would be subject to a leverage ratio buffer smaller than the 1 per cent proposed by APRA for Australian D-SIBs. The ABA notes that during the period of APRA's open consultation on the leverage ratio, the US Federal Reserve commenced a leverage ratio consultation[4] to tailor 'enhanced supplementary leverage ratio' requirements for G-SIBS. The US Federal Reserve is proposing a 3 per cent minimum plus 50 per cent of the G-SIB buffer, previously a 2 per cent buffer was held.

Given the above, the ABA strongly recommends a 3.5 per cent leverage ratio minimum consisting of a 3 per cent minimum plus 50 bps which represents half of the current D-SIB buffer (1 per cent). The ABA considers 3.5 per cent an appropriate buffer reflective of the systemic importance of Australian D-SIBs and maintains consistency with the BCBS's framework.

Implementation timeframe

The ABA is heartened by APRA's recognition of the significant number of regulations and reforms (not just prudential) that Australian ADIs are required to implement in the coming years. Australian ADIs have been reporting on the leverage ratio since 2015 and have invested heavily in processes, systems and technology to comply with the existing leverage ratio requirements as well as global accounting standards such as IFRS. As stated above, the ABA does not support the proposed changes which add unnecessary complexity, and distorts international comparability and takes the opportunity to again

[3] Financial Stability Board, 2017 list of global systemically important banks. http://www.fsb.org/2017/11/2017-list-of-global-systemically-important-banks-g-sibs/

[4] US Federal Reserve: Rule proposed to tailor 'enhanced supplementary leverage ratio' requirements. 11 April 2018, https://www.federalreserve.gov/newsevents/pressreleases/bcreg20180411a.htm

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highlight to APRA that all ADIs, regardless of size, are struggling to implement a vast number of regulatory reforms in the coming years. The ABA would hold that for clarity, certainty and cost-efficiency APRA should align with the BCBS's implementation date of 1 January 2022.

Derivative exposures

Regarding APRA's proposed changes for derivative exposures for IRB ADIs, and in particular the collateral and cash variation margin changes proposed in section 3.2.3 of the discussion paper, the ABA has a number of comments.

Collateral and cash variation margin changes

The ABA believes that the proposed modifications to EAD derivatives for the purposes of the leverage ratio will add complexity to the exposure measure. Removing the recognition of cash variation margin (**CVM**) from the calculation of the exposure measure will require ADIs to calculate different versions of EAD for APRA Prudential Standard APS 110 Capital Adequacy purposes compared to APRA's Prudential Standard APS 180 Capital Adequacy: Counterparty Credit Risk.

Removing the recognition of CVM would result in a divergence from the approaches taken internationally and may place Australian ADIs at a relative disadvantage to international peers. The ABA would hold that adjusting the CVM would provide a more accurate representation of the replacement cost associated with derivative transactions.

Securities Financing Transaction exposures

With reference to APRA's proposed changes for Securities Financing Transaction (**SFT**) exposures for IRB ADIs as detailed in section 3.2.4 of the discussion paper.

ADIs currently apply netting for certain SFT receivables and payables with the same counterparty for statutory accounting purposes where this meets accounting standard requirements. The ABA believes that the balance sheet exposures (after any allowable netting) provide the best reflection of the exposure measure for SFTs. Furthermore, the proposed exclusion of the netting provision would not achieve any reduced complexity; given in practice this would require an adjustment to the statutory accounting netting adjustments when calculating the leverage ratio.

The reporting of gross exposure would also create a distorted and uneconomic perception of the bank's position. The ABA recommends an alignment with the BCBS's approach.

Interaction with capital framework proposals

The OBS component of the leverage ratio exposure measure calculations are influenced by CCF requirements under APS 112. APRA proposes applying the CCFs under APS 112, thereby aligning the calculation of non-market-related OBS exposures with the risk-based capital framework and reducing regulatory burden on ADIs, which are already required to apply such CCFs in calculating credit risk-weighted assets.

The ABA notes that APRA, in their discussion paper Revisions to the capital framework for authorised deposit-taking institutions[5], proposes to increase the CCF for Other Commitments. APRA has also proposed changes to APS 112 CCF for Other Commitments to Other Counterparties (from 20 per cent for <1 year and 50 per cent for >1 year to 100 per cent for both, versus 40 per cent under Basel) and Commitments Cancellable without Notice (from 0 per cent to 20 per cent, versus 10 per cent under

[5] APRA, (Feb 2018), Revisions to the capital framework for authorised deposit-taking institutions, http://www.apra.gov.au/adi/PrudentialFramework/Pages/revisions-capital-framework-and-leverage-ratio-Feb-2018.aspx

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Basel). APRA's proposals are more conservative than the current BCBS's requirements and if implemented, those proposals will have a material impact to the leverage ratio calculations should the CCF factors be made consistent with the risk-based capital framework, and therefore should be an important input into APRA's calibration of the minimum leverage ratio requirements. The ABA believes that this further supports a minimum of 3.5 per cent for IRB ADIs relative to APRA's proposed 4 per cent.

ABA response to questions contained in the discussion paper

Chapter 2 – Overview and minimum requirement

2.2 Should APRA apply a higher minimum leverage ratio requirement to IRB ADIs? What would be the impact of applying a 4 per cent minimum requirement?

> Please see our earlier comments under the heading 'Proposed 4 per cent minimum for IRB ADIs'

Chapter 3 – Exposure measure

3.1 Does offsetting between cash receivables and payables under a trade-date accounting approach have a material impact on the leverage ratio? What would be the impact of removing this provision?

> Removing the ability to offset would add operational complexities as it diverges from accounting treatment (IFRS). Removing accounting offset under the IFRS accounting framework and not allowing the offset criteria set out in the current BCBS's requirements, would increase leverage exposure measures and also fluctuate quarter-on-quarter depending on trade volumes.

3.2 Would omitting the cash pooling treatment provided in the revised Basel III leverage ratio framework have a material impact on the leverage ratio?

> The ABA would welcome APRA's clarification on the definition of 'treasury products' that would be subject to the proposed revised treatment in the discussion paper. As an example, is it APRA's intention to remove cash pooling treatment in its entirety or only on the exception allowed in paragraph 31 of the revised Basel III leverage ratio framework whereby cash pooling is allowed under Basel for accounts where transfer of credit and/or debt do not occur daily.
>
> In general, to the extent that cash pooling arrangements are in place with customers and there are legal rights and an intention to set off, this reduces an ADIs credit exposure to counterparties, and the ABA would hold that has a prudential benefit.

3.3 Does the offsetting of commitments to pay for unsettled purchases and cash to be received for unsettled sales under a settlement-date accounting approach have a material impact on the leverage ratio? What would be the impact of removing this provision?

> The ABA has recommended that APRA considers making a leverage ratio (3.5 per cent for IRB ADIs) a binding obligation under the current framework by 1 July 2019, and to also defer any decision on changes to the leverage ratio methodology until APRA finalises and calibrates the changes to the capital framework resulting from Basel III revisions. Noting the above, that APRA proposes to apply the CCFs under APS 112 in place of the existing CCFs under APS 110, the ABA would not support the proposal to exclude netting of receivables and payables in unsettled financial assets purchased. The ABA would support APRA's proposal to align the CCFs under APS 112. This proposed change would align the calculation of non-market-related OBS exposures with the risk-based capital framework. The ABA is supportive of APRA's aim to reduce complexity and regulatory burden on ADIs.

3.4 What would be the impact on the leverage ratio of not recognising CVM in calculating the replacement cost of derivative exposures?

The ABA does not agree with the proposal and would recommend an approach consistent with the Basel framework. Not recognising CVM in calculating the replacement cost of derivative exposure would have a material impact on computation of derivative exposure for leverage ratio and may negatively impact the derivative activity of Australian ADIs depending how leverage is allocated internally across an ADI.

This provision is currently restricted to CVM that can be assimilated to a form of pre-settlement (daily margining, full mark-to-market offset, CVM in the same currency as the settlement, etc.) which is consistent with the absence of leverage.

As a result of the finalisation in September 2013 of the BCBS-IOSCO Margin requirements for non-centrally cleared derivatives, and the September 2017 release of APRA's Prudential Standard CPS 226 Margining and risk mitigation for non-centrally cleared derivatives, the number of collateralised counterparties has improved greatly with significant progress and effort made to ensure the robustness of the collateral management process.

It is not consistent from a regulatory perspective to require increased collateralisation for the ADI's derivative exposure while penalising the ADI's leverage ratio for CVM posted and received. While the ABA understands that the provision may add some complexity to the calculation for some ADIs, the ABA recommends that provision be made optional (rather than excluded) and it should be left to the ADI to assess the cost/benefit of implementing it.

3.7 What would be the impact of not permitting netting of cash payables and cash receivables in SFTs with the same counterparty?

Please see our earlier comments under the heading 'Securities Financing Transaction Exposures'

3.9 Should APRA adopt a simplified exposure measure calculation for standardised ADIs? Are there other approaches that would promote simplicity without jeopardising financial safety objectives to limit leverage?

The ABA recommended that APRA considers making a leverage ratio (3.5 per cent for IRB ADIs) a binding obligation under the current framework by 1 July 2019, and to also defer any decision on changes to the leverage ratio methodology until it finalises and calibrates the changes to the capital framework resulting from Basel III revisions.

Noting the above, the ABA is supportive of APRA's proposed simplified approach for standardised banks, although we would prefer some exceptions be allowed where those do not contribute to leverage. Specifically, the ABA considers that assets subject to bilateral netting and pooling arrangements should be excluded. The ABA would also support the exclusion of cash balances held with the RBA on the basis such balances contributing to leverage could be counterintuitive in a volatile or stressed environment and may impact the efficient operation of the payment system.

If you would like any further information, please contact me on 02 8298 0408.

Yours faithfully

Signed by

Aidan O'Shaughnessy
Policy Director - Industry Policy
02 8298 0408
aidan.oshaughnessy@ausbanking.org.au