Australian Banking Association

Review into Small and Medium-sized Banks

Council of Financial Regulators

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Australian Banking Association

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Key Points

- **Competition** from small and medium-sized banks is vital for better consumer outcomes, driving innovation, and providing a wider range of options. Given that, it is imperative that regulatory frameworks are designed in a way where they do not impair the ability for smaller players to both **compete effectively** and **deliver sustainable returns** for their shareholders.
    - **Specialised and targeted products** are offered by small, medium-sized and international banks, benefiting various community segments, including regional areas.
    - The **regulatory burden** on smaller banks is a significant challenge, consuming resources and limiting their ability to invest in innovation.
- **Proportional regulation** is crucial, ensuring that the regulatory burden is commensurate with the risk posed by different banks.
    - The ABA recommends **a three-tiered regulatory system** to better match regulation with risk, similar to the approach in New Zealand. This would provide a more appropriate matching of regulation and risk.
- In respect to **capital** settings the ABA:
    - asks whether there is sufficient justification for the credit risk weights applied to vanilla mortgages and small business loans to be noticeably different only because of the originating banks.
    - recommends that APRA adopt a simplified phased implementation approach to IRB accreditation.
- In respect to **funding** the ABA:
    - recommends increasing the issuance limit for covered bonds from 8 per cent to 12 per cent of total assets.
    - does not support the introduction of a Canadian Mortgage Bonds scheme in Australia as unlike Canada, Australia has a well functioning and efficient private securitisation sector.
    - suggests the CLF would help smaller and mid-tier banks, especially in the context of upcoming APRA liquidity reviews and proposed changes to liquidity standards for minimum liquidity holdings (MLH) banks.
- The ABA recommends **reducing unnecessary data collections** and reporting requirements to ease the burden on smaller banks.
- The ABA opposes the idea of a **pre-funded Financial Claims Scheme (FCS)**, as it would impose an additional $8bn in costs that would be incurred by depositors and have the perverse consequence that the burden of mid-tier and smaller banks will be increased.

Australian Banking Association

Policy Lead: **Craig Evans** (Policy Director) craig.evans@ausbanking.org.au

About the ABA

The Australian Banking Association advocates for a strong, competitive and innovative banking industry that delivers excellent and equitable outcomes for customers. We promote and encourage policies that improve banking services for all Australians, through advocacy, research, policy expertise and thought leadership.

Australian Banking Association

ABA submission to Council of Financial Regulators

The Australian Banking Association (ABA) welcomes the Council of Financial Regulators (CFR) Review into Small and Medium-sized Banks. The Review must ensure that Australia's small and medium-sized banks are supported by appropriate regulatory settings that allow them to thrive and do not reduce their ability to compete and succeed. Relatedly, the ABA welcomes the participation of the ACCC in this review and recommend that the ACCC is incorporated into the CFR on an ongoing basis as a permanent member agency.

The Issues Paper released by the CFR, in conjunction with the ACCC, provides a welcome opportunity to comment on the key issues and challenges facing the sector. The ABA looks forward to ongoing engagement with the Review throughout this process to achieve a thriving mid-tier banking sector that will benefit Australians.

1. Benefits of competition

Having successful small and medium-sized banks in Australia is vital for the Australian banking system, as they provide for competition and choice, leading to better outcomes for Australian consumers. The ABA's small and medium-sized banks make a substantial contribution to the Australian economy, serving millions of customers, employing tens of thousands of Australians and providing hundreds of billions in credit to Australian homebuyers, small businesses and other consumers.

They are also active in their communities through substantial philanthropic contributions, as well as initiatives like those that allow employees to take paid volunteer leave to work in the community. The presence of a diverse range of financial institutions benefits consumers in several ways, noting that the below discussion is not exhaustive.

Increased competition drives innovation and allows for better consumer choice, experience and pricing. Competition encourages innovation and ensures that resources are used efficiently and costs are minimised for customers. Multiple strong banks allow for fierce competition not only through price, but also through product and service innovation that will improve customers' experience (see Box).

Box - The benefits of a varied banking industry
A diverse banking industry drives dynamism and innovation resulting in a more competitive environment for the benefit of Australian consumers. Small and medium-sized banks have contributed and often initiated developments in banking service offerings to the Australian community. **Bendigo and Adelaide Bank** pioneered the Community Bank branch model around Australia with more than 300 branch locations[1]; Bendigo has Australia's fourth largest branch network with over 51 per cent of branches located in regional and remote areas.

The **Bank of Queensland** developed a distinctive strategy through a multi-brand approach, focusing on specialised relationship banking in health, property, agriculture, professional services, and diversified target segments.[2] BOQ plays a valuable role in supporting Australian communities by providing critical financing across regional and urban areas, particularly with their strong Queensland presence; **MyState Bank** has deep regional banking heritage having served the Tasmanian community for more than six decades, offering customer and community focused banking services across the country. **Bank Australia** was one of the first banks to offer green lending product options for their customers. **AMP Bank** has launched a digital-only SME specialist bank to service Australia's micro and small business market.

[1] https://www.bendigobank.com.au/community/community-bank/
[2] https://www.boqspecialist.com.au/

International banks operating in Australia have leveraged the strength of their parent banks in delivering benefits to Australia. **ING Bank** changed the way Australians bank 25 years ago by launching the country's first branchless bank and has continued to innovate. International banks can deploy parent company capital and capital from within their global networks. For example, ING Australia finances Vena Energy's Wandoan South Battery Energy Storage System, Queensland's largest battery. **HSBC** has invested capital and knowledge in Australia since 1965 and has led with innovative solutions such as digital trade finance[3] and delivered significant global sustainability linked bonds on a local and global basis[4]. **Rabobank** has utilised its extensive global knowledge of the agriculture sector to develop specialist service offerings for the Australian sector. **Arab Bank**, and **Bank of Sydney** at inception in Australia, introduced culturally sensitive and appropriate banking services in recognition of the multicultural diversity of the nation.

While having multiple banks offer products will lead to downward pressure on interest rates and fees, a competitive banking environment also provides consumers with a wider range of options, allowing them to choose the services that best meets their needs. It also provides for ongoing investment in employment and the economy more broadly by those entities.

Small and medium-sized banks are uniquely positioned to provide specialized and targeted products to various segments of the community, including those in regional areas. Additionally, foreign-owned banks operating in Australia can leverage innovations and insights from global markets to introduce new and innovative products to local customers and small- to medium-sized businesses.

Given the critical role that small and medium-sized banks play in delivering positive outcomes for consumers, it is imperative that regulatory frameworks are designed in a way where they do not impair the ability for smaller players to both compete effectively and deliver sustainable returns for their shareholders through varying economic conditions.

While the ABA acknowledges that APRA's implementation of 'unquestionably strong' capital levels has ensured that the Australian banking system is among the safest in the world, it is always prudent to ensure that the overall regulatory environment is effectively balancing stability and competition.

Australia has not suffered a bank collapse in several decades and our banks have successfully navigated the Global Financial Crisis, Covid-19 and various US and European bank turmoil. This is in part a reflection of the strong practices of its regulators. However, at the same time there has been a noticeable consolidation of the sector over the past two decades. In December 2005, there were around 220 Authorised Deposit-taking Institutions in Australia, in December 2024 there were around 130.

Part of the driver of this consolidation has been the challenges small and medium-sized banks have faced in securing sustainable returns above the cost of capital. Achieving these returns is necessary to attract capital from investors, both domestic and international. Small and medium-sized banks in Australia need to be able to invest in product innovation and growing the business, rather than investing in duplicated systems and processes to meet domestic regulatory requirements. They are likewise particularly sensitive to regulatory imposts and levies, which can have an outsized impact on their returns.

The material difference in capital requirements between the standardised and advanced regimes combined with the pace and scale of regulatory change is also a key challenge for smaller institutions – requiring more capital for the same loans, reducing returns and consuming resources (financial,

[3] https://www.about.hsbc.com.au/news-and-media/hsbc-launches-innovative-digital-trade-finance-solution-in-australia
[4] https://www.about.hsbc.com.au/news-and-media/hsbc-helps-deliver-goodmans-first-ever-sustainability-linked-bond

technological and human) and leaving less capital available for investing in product or technological innovation to improve the customer experience, especially given smaller banks face a challenging competitive environment. As such, to enable a reasonable playing field it is crucial that the regulatory burden is proportionate to the institution's risk profile and not excessive.

The costs that small and medium-sized banks have had to incur in recent years to meet the growing compliance burden has been proportionally immense, given that there are noticeable fixed costs for meeting the standards that banks will have to incur regardless of size. Analysis by the ABA of our mid-tier members showed that they spent around $900 million implementing and managing regulatory projects between FY19 and FY23. Since then, continued on-going costs have been joined by substantial investment in preparation for CPS 230 and other regulatory changes.

The ABA acknowledges the need for this investment in areas of clear consumer benefits and strengthened resilience, such as the scams framework, or to meet AML/CTF requirements. However, mid-tier banks have invested hundreds of millions in meeting other requirements, such as investing $300 million so far to adhere to the Consumer Data Right (while customers registered to use it remains very low at just 0.15 per cent) where a clear consumer benefit or strengthened resilience does not emerge. Indeed, the Strategic Review into the Consumer Data Right Strategy found that “Competition within the banking sector is being negatively impacted as Mid-Tier banks (which have lower overall capacity for technology delivery) incur disproportionately higher relative costs compared with Major banks (more than twice the cost per customer sharing their data)”.[5]

Given the challenges that mid-tier banks are facing, regulators should not exacerbate these issues through unnecessary or overcomplicated regulatory burden. Further discussion of the regulatory burden will occur in the next section.

One of the main challenges that smaller banks face in competing in the Australian market is that banking is, in many ways, a scale business. Larger banks benefit in several ways from their scale. They can achieve greater cost efficiencies through spreading their fixed costs over a larger base. Larger banks have greater resources to invest in technological innovation, to enhance the customer experience and achieve operational efficiency. Similarly, they have more resources available to ensure compliance with regulatory requirements.

As the issues paper noted, including through Graph 18, the larger the bank, the more efficient and lower cost-to-income ratio they operate on, helping drive their profitability. This in turn helps them access cheaper funding through correspondingly higher credit ratings. In contrast, a structurally high cost-to-income ratio that is driven by the high fixed costs of regulatory compliance can be a burden for small and medium-sized banks.

Considering the significant challenge of achieving scale in the Australian banking sector, it is important to explore ways to support smaller banks in this area. Collaborative efforts on back-office services and outsourcing can help achieve efficiencies. Small and medium-sized banks should be allowed to have discussions to identify joint operational efficiencies without facing overly costly and time-consuming delays due to competition laws. Currently, the high costs associated with compliance make such discussions prohibitively expensive.

In addition to what has been discussed above, two issues – the need for more proportionate regulations and the ability to have a more competitive cost of funding – are the main challenges for small and mid-tier banks. The rest of this submission will discuss these in more depth and propose some solutions to those challenges.

[5] Accenture (2024), ‘Consumer Data Right Strategic Review, p3.

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2. Proportionate regulation

The ABA welcomes the Review's focus on proportionality in regulation. In particular, we welcome the Issues Paper's statement that "Importantly, proportionality is about ensuring regulation is commensurate to risk". While we strongly agree with that sentiment, we believe that it is not always implemented in practice in Australia.

The Issues Paper notes that APRA's approach to proportionality is tied to its delineation between Significant Financial Institutions (SFIs) and non-SFIs, with SFIs being all locally incorporated banks with domestic assets greater than $20 billion. We believe this is too broad a distinction. Graph 2 of the Issues Paper illustrates the point starkly. There is a clear distinction between the size and impact of the largest institutions and the small and medium-sized institutions. Indeed, some banks deemed SFIs are classed as small within that grouping and will face a similar regulatory burden as the major banks, despite clearly having a substantially lower impact on the broader financial system.

Size is one matter of distinction, another is the complexity of the portfolios of the institutions, with many smaller and medium-sized banks having comparatively simple lending and trading books at a Group level, with a focus on serving domestic retail and SME lending. While to some extent, this is accounted for by these institutions not requiring internal ratings-based (IRB) accreditation for their credit or other risks, in other areas, such as operational risk, proportionality is not sufficiently incorporated.

Without a systematic approach to incorporating proportionate measures into prudential oversight (this includes regulation, supervision, and reporting frameworks) the resultant regulatory burden on mid-tier banks, which comes with comparatively high fixed costs, will be to the detriment of market-based, dynamic competition.

A recent review on proportionality in South African banking regulation noted: 'Proportionality serves the public good in ensuring that the cost of regulation is calibrated to the benefits. A key public benefit of regulation is a safe and stable financial system. However, unnecessarily burdensome regulation constrains market activity, leading to less competition and innovation in delivering on policy objectives, including expanded access to financial services".[6]

The ABA acknowledges the importance of system strength and stability. However, a well-functioning and diversified banking system must balance sustainable competition and ADI financial resilience with a robust regulatory regime. This balance is critical for fostering a dynamic and innovative banking system. The current approach to bank prudential oversight and regulation in Australia is broadly 'one size fits all'.

We believe the current prudential approach is baselined to the systemic risks of the largest ADIs. Without regulatory nuance, the actual systemic risks posed by mid-tier banks are overstated and the regulatory burdens on these entities are excessive.

As noted above, the distinction between SFIs and non-SFIs in prudential regulation is too binary. Instead, the ABA recommends a move to a three-tiered system (like the one recently introduced in NZ), which would provide a more appropriate matching of regulation and risk.[7]

Our proposal would see three tiers of regulation:

[6] Intellidex (2022), 'Proportionality in Banking Regulation and Supervision. A study of South African Banks', p6.

[7] Reserve Bank of New Zealand (2024), Proportionality Standards For Developing Standards Under the Deposit Takers Act, https://www.rbnz.govt.nz/-/media/project/sites/rbnz/files/regulation-and-supervision/dta-and-dcs/the-proportionality-framework-under-the-dta.pdf.

- Tier 1 institutions with domestic assets greater than $200 billion and/or institutions that are more complex in structure and business practice.
- Tier 2 institutions with domestic assets between $20 billion and $200 billion. These institutions are larger than the non-SFIs and but do not approach the size or complexity of the larger institutions.
- Tier 3 institutions with domestic assets below $20 billion. This would reflect the existing non-SFI pool (notwithstanding the upcoming review of the SFI definition, there remains a distinction between the nature of the smallest institutions and the existing mid-tier of banks).

It is important to note, as the RBNZ do in their Framework, that having different tiers "does not necessarily mean reducing the strength of any particular standard". What it will do though is require regulators to balance the costs and benefits of regulatory requirements in relation to different types of banks.

It also does not mean that regulations will necessarily be different between Tiers. There will be many cases where it will be appropriate for all Tiers, or perhaps Tiers 1 and 2 to be treated similarly. What we would like to see though is regulators being required to consider whether the treatment should be different and to explain why they have decided to either treat different Tiers similarly or not, after weighing whether the regulation is proportionate to the risk faced.

For example, while the ABA acknowledge that APRA introduced an element of proportionality into the implementation of CPS 230 Operational Risk Management through its updated prudential guidance following consultation, this came at the end of the process and after smaller institutions had already made substantial investments to try to meet the standards in the originally announced timeframe. Better practice would be to incorporate this consideration of proportionality at the start of the process and a formalised Tiered approach would assist with this.

The risk of broader systemic impact is different between the Tiers. For example, the impact of issues at a smaller institution, for example a Tier 3 institution, will not have the same impact on customers, markets and the financial system as that at a Tier 1 bank, notwithstanding the risk of contagion.[8] Similarly, not all prudential standards have the same risk of consumer harm, so there will be cases where proportionate regulation is more appropriate than in certain key standards. For example, proportionality could include a fairer capital playing field (see section 2.1 below), extended timing of rollout of new regulatory initiatives and reduced reporting requirements for Tiers 2 and 3.

There is also a key distinction in how the 3-tiered approach should be implemented in Australia compared to New Zealand. In New Zealand, the approach was introduced under a broader reform of the regulatory regime through the Deposit Takers Act 2023. This meant that new standards were being designed and proportionality was being incorporated into these new standards. In Australia, we are not calling for a new stock of prudential standards. Instead, it would be appropriate for these considerations to be incorporated in updates to the existing prudential standards. With APRA's practice of generally reviewing existing standards within 10 years, this will provide a baseline for proportionality to be incorporated throughout the regulatory framework.

The introduction of a Regulatory Grid in Australia (which the ABA strongly welcomes and supports) provides a further opportunity for proportionate regulatory practices to be embedded in the framework, particularly with respect to **a staged implementation of regulatory changes**.

Small and medium-sized banks (ABA's proposed Tier 2 and Tier 3 banks) would strongly benefit from being able to implement major regulatory changes over a longer time period, as it allows them to fund

[8] Contagion risk can be mitigated through pro-active government planning. APRA have already introduced APS 190 and APS 900 to ensure preparedness for bank failure. It could also be mitigated by ensuring that there are clear lines of communication from government to industry and consumers in the case of an event. To date, contagion risk has not formally been incorporated into planning.

the transition over a longer period, while also not having to compete for resources to implement the changes at the same time as the larger banks.

As such, **regulators should commit to applying proportionality in new consultations and regulatory changes** where appropriate. Within the Regulatory Grid, they should include details on the implementation and timing of measures depending on the size of institution (for the banking sector, this could be the 3-tiered approach outlined above or the existing SFI/non-SFI distinction).

As outlined earlier, we agree that regulation should be applied proportionate to the risk. While that is true for the overall framework, as outlined above, it should also be applied in specific cases outlined below – specifically on capital, funding and reporting issues.

2.1 Capital issues

The ABA acknowledge APRA's implementation of 'unquestionably strong' capital levels has ensured that the Australian banking system is among the safest in the world. Similarly, as outlined above, we agree that regulation should be proportionate to the level of risk. As such, it is worth investigating whether Australia's prudential capital requirements introduce challenges in ensuring a competitive funding mix.

The challenge is the discrepancy between the required capital risk weights under the standardised approach to capital and the IRB approach. The potential issues are two-fold. First, the difference between the amount of capital required to be held under the different methods. Second, the cost and difficulty of achieving IRB model accreditation.

2.1.1 Capital differential between IRB and Standardised methods

This section reflects the views of only the ABA's small and mid-tier member banks.

In terms of the capital differential in the two models, we begin with some initial observations. Following the policy principle that regulation should be proportionate to the level of risk, we note that the nature of the portfolios and operations of the smaller and mid-tier banks are such that they are more frequently dealing with homogenous, well-known products. This is apparent particularly in the prevalence of standard mortgage credit on many smaller loan portfolios.

Following that principle, the question becomes whether there is sufficient justification for the credit risk weights applied to vanilla mortgages and small business loans to be noticeably different only because of the different capital methodology that an originating bank uses, especially given the implications of this difference on competition, profitability and the ability to attract capital.

The Issues Paper notes APRA estimates that the IRB price advantage for residential mortgage loans is around 5 basis points. This estimate reflects an initial estimated difference in risk weights of 14 percentage points (an average credit risk weight of 36 per cent for standardised banks and 22 per cent for IRB banks). That means that standardised banks are proportionately holding 64 per cent more credit risk-weighted assets than IRB banks.

APRA outline that "there are other differences between the two approaches that mean the real difference between IRB and standardised capital requirements is much narrower than implied by a simple comparison of headline risk-weights".[9] APRA's analysis suggests the difference in IRB and standardised risk-weights after adjusting for many of those differences is 6 percentage points higher for

[9] Coleman A and Thavabalan N (2024), 'Demystifying credit risk capital requirements for housing loans', Information paper, March.

standardised banks (i.e. that they are proportionately holding 20 per cent more), which leads to the pricing differential of five basis points.[10]

The paper describes this differential as "relatively small", which understates the impact that it can have on small and medium-sized banks. The pricing analysis assumes that the cost of debt and the cost of equity are fixed, which then implicitly assumes that any pricing impact from additional capital requirements is passed onto consumers.

In reality, market forces (including the widespread use of the broker channel) set prices and the cost of equity (or Return on Equity (RoE)) changes to compensate for pricing changes. In Australia, the IRB banks have the vast majority of market share. As the Productivity Commission has noted "other institutions generally behave as market 'followers' and mirror the major banks' pricing decisions. As a result, prices for banking products tend to cluster".[11]

Accordingly, market prices will be calibrated off IRB capital requirements with standardised banks earning lower RoE's as a result of the higher capital requirements. As mortgages are low risk assets, there is a relatively low proportion of the asset funded by capital, meaning seemingly small impacts to pricing differentials can have a significant impact to RoE.

Thinking of the same analysis a different way, if one were to assume that the price of mortgages were fixed (instead of there being a five basis point difference), standardised banks would earn a post-tax RoE of 9 per cent compared to IRB banks earning 10 per cent.[12] This is a 10 per cent difference in shareholder return due to capital requirements. As discussed above, ensuring sustainable returns for shareholders is necessary for the ongoing viability of the mid-tier sector and their ability to provide an alternate offering to consumers.

Furthermore, the paper may understate the true difference in practice. For example, in terms of the capital buffer APRA appear to have calculated the impact of this buffer in the paper through dividing additional buffer by the minimum prudential capital requirement per the standards. However, all banks hold capital levels well above the minimums in the prudential standards, meaning the denominator in this calculation is larger than what APRA have used.

As such, the narrowing in the gap between approaches may be less than what APRA have presented. Similarly, the analysis assumes that the cost of debt funding is fixed, where in practice smaller banks have higher funding costs. Further analysis from APRA could take into account these considerations.

We note that, particularly for the larger mid-tier banks, there are similar expectations from APRA, auditors, Board and Executives to manage risks in the same way as IRB banks in terms of:

- Maintaining credit risk grading systems, similar to IRB approaches. This is a regulatory requirement for more complex banks (APS 220 paragraph 67).
- Managing Interest Rate Risk in the Banking Book (IRRBB) using similar risk management frameworks and measurement approaches as IRB banks. Again these are regulatory requirements for more complex banks (APS 117 Objective and Key Requirements and Definitions 9.(j))
- Participating in APRA's industry stress testing exercises, which requires complex models, similar to IRB models.

[10] This amount is consistent with the 18 per cent differential in CET1 presented by APRA in a briefing to the ABA membership.

[11] Productivity Commission (2018), Competition in the Australian Financial System – Productivity Commission Inquiry Report, p97, June.

[12] Based on assumptions presented by APRA in a briefing to the ABA membership.

- Maintaining automated decisioning approaches for retail and retail SME products.
- Having similar credit risk provisioning capabilities as IRB banks.
- Managing liquidity risk using the Liquidity Coverage Ratio (LCR) and Net Stable Finding Ration (NSFR), which only applies to the larger banks, including mid tiers. Smaller ADIs utilise the Minimum Liquidity Holding (MLH) approach.
- Maintaining model governance policies which mandate monitoring and validation requirements.

These requirements add cost burdens, but do not receive the same financial benefits of that cost base that IRB accreditation does.

We also note that APRA have stated that there needs to be "in-built safeguards to ensure that any capital benefit to IRB banks is not excessive and does not unfairly disadvantage standardised banks".[13]

There still remains the question of whether there should be a substantial differential at all, especially for lower risk products such as low-LVR loans. If regulation is to be proportionate to risk, is the risk in these scenarios worthy of placing smaller banks at a competitive disadvantage? And even if so, is the size of the differential appropriate?

The ABA do not propose that any differential should be reduced through increasing the capital requirements of IRB banks, given that Australian banks are already unquestionably strong. But perhaps there could be consideration in an adjustment in other bank's required capital weightings or buffers.

Potentially, the response should align to the tiered regulation scheme outlined above. For example, for Tier 2 banks, perhaps the best way to provide relief would be to ensure a cheaper, faster and more transparent IRB accreditation process (as outlined below). Relief could also be considered through allowing banks more flexibility to calculate LVRs under APS 112 with updated property valuations. The ABA is happy to work with the CFR on the best way of providing relief as part of ongoing consultation on this issue.

2.1.2 Cost and difficulty of achieving IRB model accreditation

In terms of IRB model accreditation, APRA has previously acknowledged that "IRB accreditation may not be cost-effective for some smaller banks given their lack of scale and diversification".[14] However, given, as the Issues Paper acknowledges, IRB banks "generally hold slightly lower levels of capital", there remains an incentive for those that can potentially seek IRB accreditation to do so.

While APRA notes their engagement plans with banks on IRB accreditation, and the recent enhancements to APS 113 and APG 113, many smaller and mid-tier members remain hesitant and uncertain about the accreditation process and material investment required, with requests for greater transparency about the pathway to accreditation and greater collaboration with APRA as an active partner throughout the accreditation process. It is striking that in the decade since the Financial System Inquiry, which suggested that APRA could make the accreditation process less resource intensive, there has been only one additional bank that achieved IRB accreditation despite others trying, which questions whether the changes have achieved their objective of making accreditation more accessible.

Furthermore, members note that IRB accreditation is a process and that they should not have to reach gold standard on day one to achieve accreditation. The bar has been lifted to where IRB banks are today rather than when they first received IRB accreditation. Indeed, allowing members to use the

[13] Coleman A and Thavabalan N (2024), 'Demystifying credit risk capital requirements for housing loans', Information paper, March.
[14] Coleman A and Thavabalan N (2024), 'Demystifying credit risk capital requirements for housing loans', Information paper, March.

benefits of IRB accreditation to further invest and improve their models will lead to a continuous improvement, as has been seen in the larger banks continued development since initial accreditation.

Members welcome the permitting of a phased rollout as outlined in APG 113 Appendix D, although a number of the requirements there indicate that the phased approach may not simplify accreditation for smaller banks, notably some of the use expectations contained within APRA's qualifying management system and expectations regarding data management practices.

The ABA recommends a simplified phased implementation approach which would:

- Recognise smaller resourcing pools for smaller banks and enable a phased model development, validation and implementation approach.
- Enable use of IRB models in capital calculations in a phased manner along with the associated benefits.
- Allow phased capital relief through the program, which will provide shorter-term incentives to the accreditation process and enable banks to increase capital expenditure on advanced modelling capabilities, which will improve the quality of IRB approaches and accelerate model development projects.
- Allow banks to embed IRB models and capital outcomes in strategic planning processes and performance measurement only after accreditation is achieved and capital held under the IRB approach. If these elements of the qualifying management system are used in strategic planning processes prior to accreditation there will be a disconnect between financial planning and actual capital outcomes.
- Allow banks to mature data management practices throughout and after the accreditation process. For example:
    - Rather than expecting an independent sign off on data quality and controls, requiring that banks will perform an independent review with recommendations and business plans to align to CPG 235 expectations and better practice through time.
    - Where appropriate the independent reviewer could also opine on appropriateness of conservatism in models to account for known data quality issues.
    - Delineating between data expectations for historical data used to develop models, which naturally will have a higher degree of data quality issues, and production data used to calculate capital requirements.
- Allow maturing of the end-to-end IRB implementation through time, with clear expectations of what is required at initial accreditation and what may mature through time. Additional guidance on APRA's expectations related to materiality of portfolios that could remain on a standardised approach and minimum expectations for default and loss experience required to develop models would ensure banks only develop models which are likely to achieve accreditation.
- Provide some certainty on a successful accreditation process, including reasonable timeframes and costs to achieve accreditation.

2.2 Funding issues

The ABA notes the section on funding costs in the Issues Paper, particularly the conclusion that although the paper found that some smaller banks have costs comparable to those of larger banks, this does not reflect the marginal cost of new funding which is required to grow. Instead, it reflects smaller

bank reliance on deposits as a funding source. However, usage of wholesale funding from capital markets is a vital tool to expand and grow (and meet APRA capital requirements) and here smaller banks are at a disadvantage for the reasons that are outlined in the Issues Paper.

One way to provide increased funding flexibility and to reduce costs would be to increase the issuance limit for covered bonds. Covered bonds are a form of bank financing that sees specific assets allocated to back up a specific debt obligation. Currently, the assets securing covered bonds can be no more than 8 per cent of the value of a bank's Australian assets.[15] If this ceiling were raised, it would allow banks to access a greater proportion of their funding through covered bonds. This would help banks to lower funding costs, with covered bonds typically priced below that of other forms of wholesale funding. Everything else being equal, lowered cost of funding could help banks allocate more funds to price competition and/or capital expenditure on innovation.

The ABA recommend increasing the issuance limit for covered bonds should be increased from 8 per cent to 12 per cent of total assets.

Another proposal that has been raised in some quarters has been for the introduction of funding along the lines of the Canadian Mortgage Bond program, whereby Canadian RMBS are purchased by the government to provide cheaper funding to Canadian lenders (with those purchases financed by government guaranteed bonds).

Australia would have to undertake a radical restructure of its funding markets and the role of government to set up such a system here. It is not apparent that such an intervention is warranted. Australia has an efficient and well-functioning private sector RMBS market, which would likely be crowded out by a government RMBS program.

Furthermore, it is likely that the biggest beneficiaries of the adoption of such a model would be lenders not regulated by APRA who would have access to cheaper funding without necessarily having the same lending standards and capital requirements, effectively it would act as a government subsidisation of the unregulated sector.

Similar outcomes in terms of reduced funding costs could be achieved through utilising existing mechanisms rather than creating a new system. For example, a reintroduction of a small allocation of the Committed Liquidity Facility (CLF) would also help smaller and mid-tier banks, especially in the context of the upcoming APRA liquidity review and the proposed changes to liquidity standards for minimum liquidity holdings (MLH) banks. It would transparently maintain the CLF as part of the market infrastructure, assist with the transition of small ADI's Liquidity portfolio's to HQLA1 assets and provide enhanced liquidity for smaller ADI's debt instruments and assist with access to funding.

If, however, the CFR were minded to pursue any support programs like the CLF, the ABA encourages it to give greater consideration to the impact on competition within capital markets and between regulated entities when designing measures.

2.3 Reporting issues

A key area where proportionality can be applied while limiting the risk of consumer harm is through reducing the burden of regulatory reporting. While some welcome steps have occurred, such as APRA's December 2023 announcement on ceasing some ad-hoc data collections, there are still substantial data requests that require significant resources to meet.

Reducing unnecessary data collections and questions and removing duplicative reporting are key steps that should be taken to reduce the burden. Of note, APRA's reporting thresholds determine which

[15] Prudential Standard APS 121 Covered Bonds, Paragraph 39.

Economic and Financial Statistics (EFS) reporting forms are applicable for banks, with certain forms being either inapplicable or provided in a reduced format if they fall below the reporting threshold. One suggestion for easing the burden on small, medium-sized and international banks may be for APRA to review these reporting thresholds or consider reducing the frequency of data reporting (such as moving from monthly to quarterly reporting).

Further examples of where reporting could be simplified include:

- Stocks and flows, cost of funds and value of funds that create a substantial volume of granular reporting:
    - Stocks and flows included in ARFs 742 and ARF 743 require operationally intensive monthly submissions.
    - Cost of funds reported monthly in ARF 742, ARF 744 and ARF 746 involve various dimensions such as business size, SESCA, loan purpose and exposure category.
    - Value of funds reported monthly in ARF 747 and ARF 748 involve various dimensions such as deposit type, SESCA, residual term and exposure category.

These data are both complex and time consuming to report.

- We note the reporting threshold for an ADI to determine applicability of the ARF 748 reporting form is $25b of deposits based on the value reported in item 14 of reporting form ARF 720.0.
- ARF 747 includes numerous dimensions for monthly reporting of deposits at a granular level, which is also complex and time consuming. The applicability of this form could be switched from standard to reduced reporting format or submitted quarterly.
- Through the COVID pandemic, APRA required additional reporting forms ARFs 923.0, 923.1, 923.5. Noting that business conditions have largely returned to normal, APRA may consider ceasing these returns.
- Reporting thresholds may be beneficial for International Exposures reporting forms (ARF 731 series) commensurate with risk.
- Finally, there are also several overlaps across data collections that APRA may consider addressing in the design of new data collections to reduce duplication of costs and resources. For example,
    - Days past due, provisions and non-performing are reported across various forms.
    - Data reported in ARF 923.5 is a duplication of report data in ARF 744 at a more granular level.
    - Income and expense information is reported across both ARF 330 and ARF 730.

Another way to ensure that the burden is matched to the risk would be to introduce or lower materiality thresholds for some reporting, in particular ASIC breach reporting (or reportable situations) would benefit from a clear materiality threshold.

ASIC should consider a comprehensive review of the reportable situations regime to:

- Explore additional ways to provide relief to licensees from reporting insignificant breaches, which can reduce regulatory burdens and costs. For example, in 2023 ASIC excluded certain

misleading conduct breaches from reporting – this was a significant driver of a 27% drop in the number of breach reports between October 2023 and June 2024.[16]

- Explore applying a materiality threshold for determining material loss or damage when licensees must decide if a breach is significant. Regulatory Guide 78.43 and the Explanatory Memorandum to the reportable situations regime legislation require that material loss or damage be determined according to the individual's circumstances. This adds a significant hurdle to standardising breach reporting, as each case necessitates a manual assessment of the individual's circumstances to establish whether the breach results in material loss or damage, thereby deeming it significant for the reportable situations regime.

Recent reform proposals for reforming Australia's anti-money laundering and counter-terrorism financing regime (AML/CTF) include proposed reforms to improve the quality and consistency of international funds transfer instructions data reported to AUSTRAC. While we are obviously supportive of the need to provide better information, the burden on smaller reporting entities could be disproportionately onerous unless appropriately managed.

Finally, many foreign banks operate under broadly equivalent regulations in their home jurisdiction and are often required to set up a new reporting system to prove their compliance in Australia. This 'substituted compliance' is adding an additional burden without achieving any uplift in standards. This is not about these banks not meeting the Australian prudential standards, but rather if they already have reporting systems set up that demonstrate compliance to an equivalent standard, those reports should be sufficient for the domestic regulator. For example, executives subject to, and demonstrating proof of compliance with, the Senior Managers Regime in the United Kingdom should not necessarily have to subsequently provide separate proof of meeting the Financial Accountability Regime in Australia.

3. Financial Claims Scheme (FCS)

The ABA note the reference on page 19 of the Issues Paper that the "Review could consider changes to FCS arrangements, such as to funding, depositor coverage or speed of access to insured deposits". The ABA is comfortable with the current scope of the FCS and is happy to work with regulators constructively on practical ways to ensure that access to deposits is as efficient as possible, particularly given technological developments since the FCS was introduced such as the New Payments Platform.

However, if the reference to funding is with respect to changing the design of the FCS to be pre-funded, then the ABA opposes this measure. As was noted in the 2011 Post-Implementation Review and Regulation Impact Statement on the Financial Claims Scheme, such a system "would impose costs on depositors and ADIs", given the cost of the fee would be passed on to customers through lower deposit interest rates.[17]

We also note the finding of the 2011 review that "An FCS fee would have a negative impact on ADIs; the effect would be greater for smaller ADIs", which would be a perverse outcome for a Review designed to make a more competitive banking system. The challenges would be two-fold, smaller banks raise more of their funding through FCS-covered deposits and they are in a weaker competitive position to be able to pass on the costs.

The Review also said "In a country where failures have been rare, the costs of a fee are likely to outweigh the benefits." Given that since this review Australia has had no bank failures, and APRA have

[16] ASIC Report 800 – Insights from the reportable situations regime: July 2023 to June 2024, October 2024, page 8 https://asic.gov.au/regulatory-resources/find-a-document/reports/rep-800-insights-from-the-reportable-situations-regime-july-2023-to-june-2024/

[17] The Treasury (2011), Post-Implementation Review and Regulation Impact Statement – Financial Claims Scheme, Paragraph 216.

also introduced Prudential Standards CPS 190 Recovery and Exit Planning and CPS 900 Resolution Planning to ensure an orderly process for banks in times of distress, as well as requiring banks hold an "unquestionably strong" level of capital, this observation is even more true today.

Additionally, the 2011 Review noted that "In the absence of a fee, these funds remain on ADIs' balance sheets and can be used to support the flow of credit into the real economy or to bolster ADIs' capital positions. The creation of a fee would reduce these benefits. By contrast, the special purpose fund would need to be invested conservatively, in assets which would remain liquid in the adverse market conditions which would likely accompany a failure. This means that the fees would likely be invested more efficiently by ADIs than by the fund." This suggests that pre-funding would lead to worse outcomes not only for customers and ADIs but also the broader economy.

Imposing an additional levy of at least $8 billion on depositors over the period of the fund build up (assuming a similar charge to the 0.8 per cent fee used in New Zealand) would not be in the interests of Australian households.