Elevate Your Fixed Income

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Australian Prudential Regulation Authority
Authorised Deposit Taking Institutions Policy
Via email: *adipolicy@apra.gov.au*

Dear Sir / Madam,

We appreciate the opportunity to provide feedback on the proposed changes announced on November 15, 2023. Although Curve Securities is not an ADI (Authorized Deposit-taking Institution), we occupy a unique position to offer guidance and insight. Our primary role involves assisting the banking sector, particularly MLH banks, in sourcing wholesale funding through the issuance of Term Deposits (TD) and Negotiable Certificates of Deposits (NCD). Additionally, we indirectly support MLH banks by actively participating in the secondary market for their bond issuance, thereby ensuring liquidity in their paper.

As intermediaries, we also facilitate investors in placing their funds with MLH banks. Specifically, our involvement with NCDs amounts to over $1 billion per month. Notably, the majority of investors are other MLH banks, as referenced in your proposal. With this context, we present our submission from the perspective of being at the heart of the flow of funds between MLH banks. Below, we outline several key points for your consideration.

Interest Rate Risk in MLH Banks.

Most MLH banks manage their MLH liquidity requirements through investments in shorter dated NCDs and Floating Rate Notes (FRN). Their interest rate exposure is therefore to floating rates with limited exposure to the higher volatility that comes with longer duration. The proposal recommends a shift to Australian Commonwealth Government Bonds (ACGB) or Semi-Government securities (Semis). ACGBs are all fixed and Semis offer a limited supply of floating paper. So much so that they should be discounted as a viable alternative to NCDs and bank FRNs for MLH banks.

Increased Interest Rate Exposure

- If MLH banks are required to transition to fixed bonds (such as ACGB), their portfolio duration will lengthen markedly and their exposure to interest rate

- volatility will increase significantly. They will be exposed to a risk they have hitherto had limited exposure to.
- We can illustrate this with an example: Imagine a 4% upward move in yields (approximating recent market conditions). If a $10 million ACGB 3% bond due on November 21, 2033, were unhedged, its capital value would drop from $12,766,000 (at 0.143% yield) to $9,090,200 (at 4.143% yield), resulting in a loss of $3,675,800 (almost 30%).

Hedging

- Hedging these bonds is clearly crucial particularly in a mark-to-market paradigm.
- Many MLH banks currently don't have the capability to effectively hedge these assets and don't have enough long liabilities to offset the interest rate risk.
- Introducing the requirement to hedge as a by-product of investing in fixed bonds comes with significant burdens for smaller community owned banks. Paramount is education but also capabilities around reporting, execution, managing, monitoring, and accounting. This is relevant for swaps or futures and comes with a significant lift in costs. One problem / risk is being replaced with new problems and risks.
- MLH Banks must also establish credit lines and ISDAs (International Swaps and Derivatives Association agreements) in order to hedge and that may be a difficult task for smaller banks to convince the larger banks to go through this exercise.

Liquidity Risk – Repo Eligibility

- SVB was forced to sell their unhedged fixed bonds to fund outflows thereby realising losses.
- In Australia MLH banks, exposed to minimal interest rate risk, are able to sell their holdings of bank FRNs to the market to provide additional liquidity if required.
- Capital losses and the funds they receive in this case are largely restricted to a move out in credit margins rather than an outright move up in yields.
- In periods where there are no bids the banks have a stop-gap through a repurchase agreement with the RBA (via OMO or the Exceptional Liquidity Assistance window).
- The RBA repo facility reduces the need for a bank to lock in damaging losses. They can use their securities to access liquidity and 'ride out the storm'. They typically hold to maturity so in this scenario they are already well placed to absorb stress as intended regardless of their mark to market value and they will receive the face value at maturity.

Funding

- By shifting MLH banks away from investing in bank NCDs and senior bank debt an important source of funding is being eroded.
- The reduced market demand will lead to a marked increase in funding costs as banks shift to more expensive term deposits or lift their NCD margins to entice new buyers.
- FRN margins will also lift and secondary liquidity will be reduced due to the shrinking numbers of buyers. This will compound in greater difficulty issuing new paper – greater difficulty in sourcing funding.
- The increased costs will have a direct impact on profitability and capital retention (see below)
- Funding is the lifeblood of any bank and any constriction here will invariably have knock on effects to loan origination, credit creation and viability.

Earnings / Profitability / Viability

- MLH banks are for the most part mutuals. They are community owned banks. A key source of capital and capital growth for them is retained earnings.
- The measures proposed, will have many direct and indirect impacts on profitability through significant increases in costs.
- While some larger banks will be able to absorb these costs the smaller banks will struggle and, in all cases, will hamper their efforts to recycle profits into capital and grow.
- As community owned banks many play an important role in their respective communities. In many small towns they are the only bank left. The increased costs put this all at risk.

Reduced Flexibility in Liquidity and Cash Flow Management

- MLH banks, by the nature of their smaller size, need to actively manage and fine tune their liquidity and cash flow. For instance, a large new loan will have a significant impact on their ratios, as will a large deposit or redemption.
- The ability to issue, or buy NCDs to bring their liquidity ratios back into balance is an important part of the day to day operations of a bank treasury.
- To fine tune ratios where the bank needed to sell fixed bonds they would also be required to unwind a partial hedge (unwind the hedge just on the portion of bonds sold – say $1m of a $10m swap) This would also lock in potential profit / loss and the basis risk from the associated hedge.
- If they needed to raise funds, rather than issuing an NCD that can be done in a matter of minutes, they would need to tap alternative funding markets such as term deposits. On top of the increased costs of this route it may take a number of days.

The preceding discussion highlights some of the high-level concerns that Curve, on behalf of its banking clients, holds regarding the proposed changes. We appreciate the initiative to conduct workshops and engage in discussions about these proposed modifications. This collaborative process is crucial for ensuring the ongoing strength of the Australian banking system. While we acknowledge the inherent risks in the current system, where bank's exposures are interconnected, any adjustments must adopt a holistic perspective that carefully considers ripple effects and unforeseen consequences.

Curve remains committed to actively participating in this process and contributing to workshops.

[redacted]

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Chief Executive Officer

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