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8 March 2024

General Manager, Policy
Australian Prudential Regulation Authority

Via email: adipolicy@apra.gov.au

Dear Sir/Madam,

Re: Targeted changes to ADI liquidity and capital standards

Goulburn Murray Credit Union Co-Operative Limited (GMCU) would like to thank the Australian Prudential Regulation Authority (APRA) for the opportunity to provide a submission in relation to the proposed targeted changes to authorised deposit-taking institution (ADI) liquidity and capital standards that were released on 15 November 2023.

We acknowledge that the proposed changes are being pursued in an attempt to strengthen individual ADIs and the domestic financial system overall should an ADI specific, domestic or global financial risk event occur, however it is our belief that some unintended consequences may result if the proposed changes are implemented in their current form.

Proposal 1 outlines the requirement for MLH ADIs to use market value to measure liquid assets for the MLH ratio.

Noting that APRA incorporates a proportionate approach to its application of the prudential framework, commensurate with the size and complexity of ADIs, many smaller MLH ADIs will potentially need to introduce additional systems and resources to accommodate the expanded administrative burden relating to the regular valuation and maintenance of records specifically attributable to the measurement of assets at fair value. If required, the selection and implementation of new or expanded systems to accommodate fair value measurement and reporting requirements could be a lengthy and costly process, which may not be achievable for many ADIs ahead of 1 January 2025.

With regard to the proposed deduction of unrealised losses from capital, it would be appreciated if APRA could clarify whether the capital charge is to be applied at the portfolio level (with netting of gains and losses on individual securities accepted), or on an individual security basis whereby unrealised losses attributable to individual securities will act as a deduction to capital.

Proposal 2 relating to the formalisation of requirements for access to exceptional liquidity assistance with the RBA is acknowledged.

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Proposal 3 deals with the reduction of contagion risk by strengthening the composition of MLH liquid assets.

As part of this proposal, APRA is targeting the removal of ADI securities as MLH qualifying liquid assets. Doing so will essentially force MLH ADIs to migrate a significant portion of their existing liquidity portfolio to predominantly long-term fixed rate Government securities.

As is the case with many small MLH ADIs, long-term fixed rate Government bonds are not easily incorporated into what are relatively short duration portfolios dominated by floating rate securities.

If obliged to invest in long-term fixed rate Government securities in order to satisfy liquidity requirements, MLH ADIs will likely experience an increase in interest rate risk, due to the presence of increased fixed rate asset exposures. It should be noted that many MLH ADIs are not easily able to organically hedge long term fixed rate exposures, with a majority of retail deposit liabilities sitting within maturity buckets of 12 months or less.

Further exacerbating the situation, small MLH ADIs may also be restricted in their ability to enter into formal hedging arrangements for a number of reasons, including:

- Not having or being able to access an ISDA agreement sufficient to meet their hedging requirements.
- Not having adequate capabilities or resources to undertake hedging.
- Not having access to formal treasury systems, required to maintain and report on hedging arrangements that may eventuate if the two above items are satisfied.

As a result of the proposal, we may find that MLH ADIs who do not have the ability to hedge, potentially having to tighten their level of fixed rate lending in order to remain within IRR appetite. Such a move would essentially act to restrict part of the core lending operations of mutual ADIs, and potentially work against the ACCC's goal of promoting and maintaining competition in the financial services industry.

As acknowledged by APRA, this proposal will likely dampen the earnings of MLH ADIs.
As a smaller MLH ADI with a diversified portfolio of ADI securities greater than the 60% average referred to by APRA in its letter dated 15 November 2023, the potential impact of this proposal is not underestimated.

Mutual ADIs operate with the intention of putting profits back into their products and services, supporting their customers and the communities within which they operate. By effectively reducing the profitability of these ADIs through a forced reduction in the income generated by liquidity portfolios, APRA's proposal will potentially act to reduce this value proposition and the competitiveness of these ADIs.

Although not the desired approach for MLH ADIs or their customers, ADIs carrying higher levels of liquidity may be forced to reduce their excess liquidity balances and operate at slightly lower MLH ratios in order to partially mitigate the impact of this proposal and to ensure their operations remain economically viable. For smaller MLH ADIs who don't actively participate in wholesale funding activities, these excess liquidity amounts currently also provide an additional safeguard to operating cashflows in times of liquidity stress.

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A potential reduction in the profit generated by MLH ADIs will also act to suppress the ADI's ability to generate capital, which is ultimately required for the ADI to grow and strengthen its operations. Again, it is the smaller MLH ADIs who will be hardest hit in this respect, noting retained earnings are their primary source of capital, with little or no access to wholesale capital markets due to the size of their operations.

Removing the eligibility of ADI securities as MLH qualifying assets will also have direct consequences for ADIs who are partially reliant on wholesale funding from other ADIs. With reduced demand for ADI securities expected, those ADIs who currently rely on wholesale funding will need to investigate other funding avenues. This may include expanding their level of funding via retail channels, which in turn could drive up competition and the cost of retail deposits for all ADIs. This increased battle with the very ADIs that previously provided much of the wholesale funding to other MLH ADIs could prove detrimental to the net interest margins (NIMs) of all parties concerned.

There are also potential indirect consequences of APRA's proposal on small and / or unrated ADIs who currently raise additional funding via the issuance of non-MLH qualifying wholesale term deposits. These ADIs may find it difficult to source wholesale funds due to increased competition within non-MLH qualifying funding markets from larger and / or higher rated ADIs, whose securities will essentially be treated in the same manner as wholesale term deposits for MLH purposes.

Noting the points that have been raised above, an alternative option that could be considered by APRA in relation to the mix of MLH qualifying assets is to allow MLH ADIs to continue holding a specific percentage (such as 50%) of their qualifying assets as investment grade RBA repo eligible ADI securities on an ongoing basis.

It should be recognised that neither the repo of the abovementioned securities with the RBA, nor their sale via secondary markets will have a direct cashflow impact or risk of contagion for the issuer of the security at the time of repo or secondary market sale.

GMCU looks forward to receiving APRA's feedback on submissions relating to the proposed liquidity and capital standard changes to further enhance the resilience of the Australian Banking System.

Regards,

[redacted]

Chief Financial Officer

[redacted]

Treasury & Regulatory Reporting Manager