SWSCU's Submission
to
APRA's Proposed changes to Liquidity and Capital Requirements for Authorised Deposit-taking Institutions.

29 February 2024

Table of Contents

1. Executive Summary:

SWSCU Submission

This submission has been prepared with reference to APRA's letter to Minimum Liquidity Holding (MLH) authorised deposit-taking institutions (ADIs) dated 15 November 2023 "Targeted changes to ADI liquidity and capital standards", and the proposed updates to APS 210: Liquidity.

Whilst South West Slopes Credit Union (SWSCU) understand APRA's reaction to the global banking turmoil, in particular the overnight loss of liquidity from Silicon Valley Bank (SVB), First Republic Bank, Signature Bank and the like in the USA and SVB's eventual collapse, SWSCU would like to put forward the following **four** areas of discussion for APRA's consideration:

- Interest Rate Risk in the Banking book (IRRBB) – this new proposal will make management of IRRBB less efficient and more difficult for MLH ADI's.
- Liquidity of Fixed Assets – the eventual effect of the proposal is counter-intuitive to its intent.
- Reduction in investment income – the proposed amendments will directly reduce wholesale investment income for MLH ADIs.
- Treatment of Assets: FRN's vs Bonds – assets with similar functionalities being treated disparately for legislative purposes.

Discussion of the above follows the introduction pertaining to SWSCU below.

About SWSCU:

South West Slopes Credit Union (SWSCU) is a customer-owned ADI that has been in operation since 29th June 1972. During its 52 years in operation, SWSCU has built up a trusted name in its regions of operation, as well as a strong business Balance Sheet with strong supporting Capital Adequacy and Liquidity.

SWSCU's road map for success is based on engaging with its members while training and empowering its people to be able to have quality conversations and deliver an exceptional member experience [Member Value Proposition (MVP)]. This continues to be an on-going strength for SWSCU and its continued strong penetration in the markets (branches) where it operates.

2. Interest Rate Risk in the Banking Book (IRRBB):

SWSCU believe that reducing the types of wholesale investment options available for MLH calculation [by taking out bank bills, certificates of deposits (CDs) and debt securities issued by ADIs as part of MLH assets] will have a strong (and potentially adverse) impact on management of interest rate risk in the banking book (IRRBB).

As APRA are aware, most Mutual ADI's (including SWSCU) have a large amount of member deposits held in call/short-term accounts (50-70% of deposits in the last decade).

Floating Rate Notes (FRNs) issued by ADIs are currently reported in the ***ARF 117.0A Capital Adequacy: Interest Rate Risk*** in the Banking Book at the dates when the rate is reset. FRNs are the perfect foil to managing the gap in MLH ADI shorter term member deposits. Forced reduction of wholesale investment in FRNs, and increased investment in longer dated government, semi-government bonds and the like would create an imbalance of current management of IRRBB. This would increase the gap between assets and liabilities and end up making management of the gap harder.

APRA have indicated in the past that smaller ADIs should not use the derivative markets to hedge their IRRBB, which also makes on-going management of IRRBB more difficult. The proposed amendments will also have adverse effects on maturity repricing gap and value at risk (GAAP and VAR) as ADI's would not be able to manage this as succinctly when evaluating their IRRBB.

<u>Summary:</u> The proposed changes to liquidity and capital requirements will have the unintended effect of making the management of the IRRBB much more difficult and less efficient for MLH ADI's.

3. Liquidity of Fixed Investment Assets

Following from the point about managing the IRRBB, SWSCU put forwards that the main issue relating to Silicon Valley Bank (SVB)'s collapse was not so much the classic run-on money from the bank, but rather that SVB had ploughed billions into US government bonds when interest rates were low, and the subsequent marking-to-market and liquidity of the bonds, crystallising real losses.

When the USA's Federal Reserve hiked interest rates to tame inflation, bond prices fell, and consequently so did SVB's wholesale investment assets. Thus, when SVB sold these government bonds to offset member deposits, it lost $1.8b. We argue that it was SVB's large holdings in US government bonds, and lack of internal controls that led to its demise.

Given SVB's large holdings in low-interest government bonds was one of the main causes of its departure from the banking sector, surely the new liquidity proposal for MLH ADIs to increase their concentrations of this and reduction of other instruments will have the opposite effect to leaving the current MLH calculation as is?

Summary: The proposed changes to liquidity and capital requirements are counter-intuitive to its purpose in that increased holdings in government bonds would exacerbate the issues it is intending to placate. Large holdings of government bonds and being forced to crystallise these losses are what caused SVB to collapse.

4. Reduction of Investment Income

The new proposals for MLH calculations will affect the wholesale investment options available to MLH ADIs, as investment in government and semi-government instruments generally offer lower returns than other ADI related options. This will in turn reduce MLH ADI wholesale investment income.

Reduced wholesale investment income will also have the effect of diminishing net interest income (NIM), and eventually capital and long-term liquidity of MLH ADI's. Surely this is counter-intuitive to the intent to strengthen the resilience of MLH ADI liquidity and capital?

In addition, for MLH ADIs utilising wholesale markets as a form of funding, the proposed reduced holdings will mean a lower demand for MLH ADI instruments, as these same ADIs and their counterpart's source more government and semi-government instruments. This will have the effect of narrowing the sources and funding base for MLH ADIs.

To raise funds and offer competitive products in the marketplace, higher returns will need to be offered to counter the decreased demand. This, in turn, will increase the cost of funds for these MLH ADIs and increase pressure on MLH ADI profitability, NIM and ultimately cost of capital and liquidity. This will have the effect of MLH ADIs being less competitive and potentially increase further customer concentration towards the major banks. Surely, the banking sector does not want to face the lack of competition available to Australians, as is presently experienced in the duopoly telco, grocery and heaven forbid, aviation sector.

Summary: The proposed changes to liquidity and capital requirements will have a dual-pronged effect of reducing wholesale investment income on the one hand, as well as increasing funding sources and narrowing the funding base for MLH ADIs.

This will lead to less competitiveness from MLH ADIs and consequently higher market share available to the majors, giving Australians less options in the banking sector.

5. Treatment of Assets – FRNs vs Bonds

The proposed changes to liquidity and capital requirements for MLH ADIs will mean that wholesale assets which have the same functionality would need to be treated differently for regulatory purposes.

Bank bills, certificates of deposits (CDs) and debt securities issued by ADIs have the same functional characteristics as those of Commonwealth Government, Australian Government (AGS) and semi-government securities and debt securities.

Both classes of assets are liquid assets (when repo-eligible) through the Reserve Bank of Australia (RBA). Consequently, these can be repo-ed at any time through the RBA.

In the unusual event that any MLH ADI might be faced with raising large amounts of liquidity unexpectedly, a better strategy would be to “Repo” or “Rent out” their holdings in either of the above categories of assets through the RBA, instead of selling them and crystalling losses (like in the case of SVB).

Given the above, SWSCU suggest that for MLH ADIs to substantially change their wholesale investment holdings from one class of assets to the other would not ultimately change their functionality and be a mere regulatory requirement.

Summary: The proposed changes to liquidity and capital will require a forced change of holdings for MLH ADIs from one class of wholesale investments, which add a regulatory layer to ADIs that are at odds with the actual functionality of those asset classes.

6. Wrap up

SWSCU are proud of being a member-owned bank in one of the few countries in the world with a AAA rating from all three major credit rating agencies. Whilst this is a result of excellent banking regulatory oversight in a free market economy, SWSCU would suggest that unnecessary regulation would add excessive regulatory burden and costs to MLH ADIs.

It could have the long-term unintended consequences of reducing competition to the Australian banking landscape. Presently Mutual ADIs, and MLH ADIs in general, provide a successful and long-term source of competition and options for banking to the everyday Australian. Most MLH ADIs continue to operate successfully either individually or through merges, as a result of natural market forces. Adding another layer of regulation, which would add all the issues outlined above, could have unintended negative consequences that might affect not just MLH ADIs, but the banking sector in general and ultimately the Australian consumer as well.

SWSCU appreciate APRA's consideration of our submission to the new proposed changes to liquidity and capital requirements and look forwards to a positive response.