

5 July 2019

Ms Heidi Richards
General Manager - Policy Development
Policy and Advice Division
Australian Prudential Regulation Authority

Via email: ADIpolicy@apra.gov.au

Dear Ms Richards

Draft APS 220 Credit Risk Management and APS 220 Discussion Paper

COBA welcomes the opportunity to comment on APRA's Draft ADI Prudential Standard Credit Risk Management (APS 220).

COBA is the industry association for Australia's customer owned banking institutions (mutual banks, credit unions and building societies). Collectively, our sector has \$119 billion in assets, 10 per cent of the household deposits market and 4 million customers.

COBA has concerns about the proposed implementation date of 1 July 2020. APRA's intention to finalise this standard by the end of 2019 does not provide an adequate implementation period for ADIs.

We do not see a compelling case for such an abbreviated implementation period, particularly given the banking sector is currently undergoing significant regulatory change. We strongly believe that our sector's credit risk is currently being well managed through existing practices that already reflect the objectives of these requirements. This incremental change does not justify a short implementation period. A short period will bear unnecessary costs onto ADIs and divert scarce regulatory resources from other priorities.

APRA should extend the implementation period to provide at least 12 months from the date it finalises this standard. This aligns with the previously considered 'best practice' period of 12 months. COBA recognises that the current proposed July 2020 date may reflect APRA's original timetable for a mid-2018 consultation on the revised APS 220. COBA believes this extension is reasonable given that there are many other competing priorities over the next year that are likely to provide greater benefit to both ADIs and APRA.

COBA has also provided further comments on the draft APS 220 standard in **Appendix A**.

Pushing back the timeline to provide a reasonable implementation period

APRA must extend the implementation date to provide at least a 12-month implementation period from the release of the final standard in line with what has previously been considered "best practice".

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Given that APRA expects to finalise this standard by the end of 2019 then an implementation date of at least 1 January 2021 is appropriate. If APRA is unable to do this for all ADIs, we suggest it should be done for smaller ADIs (i.e. all non-majors) to recognise the increasing regulatory burden on smaller ADIs.

APRA's current proposal only provides a short six-month period from APRA's expected finalisation for ADIs to make the necessary changes to meet APS 220 such as changes to reporting, IT systems, governance and internal policies. In practice this period is likely to be even shorter with the December 2019/January 2020 holiday period further reducing ADIs' ability to implement these measures due to staffing leave and IT system moratorium periods.

COBA notes that APRA's consultation on a revised APS 220 has been delayed. APRA's 2018 Policy Agenda states that "APRA expects to commence consultation on revisions to APS 220 during 2018 [second half of 2018]".¹ This delay is unsurprising given the impact of the Financial Services Royal Commission on both regulators and ADIs. COBA recognises that this 1 July 2020 date may have been set with this initial timetable in mind. This delay has reduced what would have been a 12-month transition period.² Extending the deadline to account for this delay would be pragmatic.

COBA also believes that APRA's statements in the Discussion Paper that "any system changes would be immaterial" and that "embedding these as requirements in the prudential standard may not have material effects [on practices]" could be true in isolation but they do not consider the collective level of regulatory change over the last few years. This regulatory change will continue over the proposed implementation period. APRA must recognise the existence of these competing priorities and the potential impact on ADIs' risk and compliance resources.

To illustrate this point, next year will see the introduction or preparation for the following changes:

- Open Banking
- a revised RG 209 Responsible Lending Conduct
- new design and distribution obligations - 6 April 2021
- APRA's revised BEAR product responsibility
- a revised e-Payments code
- a revised internal dispute resolution reporting (RG165)
- a revised Customer Owned Banking Code of Practice (COBCOP)
- Comprehensive Credit Reporting, and
- Modern Slavery Act compliance.

These changes do not include the implementation of further Royal Commission recommendations.

While APS 220 implementation may be relatively straight-forward in isolation, it should be considered alongside these other projects. Many of these regulatory projects are new requirements as opposed to the formalisation of existing practices like APS 220. The potential benefits to both APRA and ADIs from these other regulatory projects are likely to outweigh those from rushing the implementation of APS220 given that most of the APS 220 requirements exist as current practices. While we acknowledge the potential benefits of formalising these practices, COBA does not believe it outweighs the potential benefits from these other competing projects.

¹APRA Information Paper: APRA's Policy Priorities, 2018, https://www.apra.gov.au/sites/default/files/policy_agenda_2018.pdf

² COBA believes that a draft APS 220 consulted on in mid-2018 was likely to have been finalised by 1 July 2019.

Extending the implementation period is unlikely to have material negative impacts on financial stability or financial safety. APRA has recently undertaken a significant amount of work on credit risk management practices. Previous deficiencies regarding ADIs' assessments have been addressed through APRA's supervisory reviews. ADIs are also meeting several of these requirements as practices under *APG 223 Residential Mortgage Lending*³ or as broader prudential requirements under *CPS 220 Risk Management*. Similarly, given credit risk is the "single largest risk facing ADIs" according to APRA, it is in an ADI's individual interests to be managing their credit risk. A longer implementation is unlikely to expose the ADI to additional levels of credit risk. Even if this were the case, this would only happen for a temporary period. If APRA did have concerns about a particular ADI's practices over this temporary period, it should deal with that individual ADI.

In the absence of an extension, a shortened timeframe places a costly and unreasonable burden on ADIs which falls most heavily on smaller ADIs. Smaller ADIs are less able to absorb any unnecessary costs compared to their much larger major bank counterparts. Recent APRA QADIP data shows that operating expenses for customer-owned ADIs increasing by around 6 per cent compared to around 2.8 per cent for the ADI system.⁴ This reflects the increasing pace of regulatory change over the last year. When customer-owned ADIs are working hard to realise efficiencies, short transition timeframes are unlikely to be helpful unless there is a compelling argument for these timeframes.

A longer period is unlikely to be limit APRA's 'ability to act' given that the proposed APS 220 'supervisory discretions' are already features of the existing supervisory framework. COBA also notes that there is no international deadline to implement these revisions unlike the Basel-driven reforms. While this extension reduces the 'international comparability' of ADI reporting, this is not relevant for smaller ADIs. In addition, any extended frame merely delays this comparability for a temporary period.

While ADIs could 'jump the gun' and start implementation now, that is not prudent given the draft APS 220 currently holds no formal status and is subject to change. Similarly, COBA members have noted that the detailed implementation will be heavily influenced by the expected Prudential Practice Guide. Similarly, it is not certain that third-party providers will commit resources to provide a compliance solution ahead of the final standard. Many customer-owned banking institutions rely upon third-party providers for these system changes. This shows that a reasonable implementation period is needed from the release of the final standard.

APRA's Discussion Paper notes that it is proposing to develop a Prudential Practice Guide (PPG). COBA assumes that this PPG is likely to be some combination of APG 223 (broadened for all exposures) and CPG 220 (narrowed for credit risk). Given that there may now be three PPGs in this overlapping space, APRA must ensure that they remain consistent as multiple sources of conflicting advice could lead to unnecessary confusion.

An extended implementation period allows APRA to align finalising APS 220 with the PPG development process. The final APS 220 should feed into the development of, and industry consultation on, a draft PPG. This would allow the release of a draft PPG to happen after release of final standard. Industry is then able to provide better feedback on the PPG and if there are any particular areas requiring clarification arising from the final APS 220. As previously noted, the finalised PPG contents will play a significant role in APS 220 implementation.

³ COBA notes that residential mortgage lending is the most material credit risk faced by most Australian ADIs.

⁴ Based on APRA's March 2019 Quarterly ADI Performance statistics – growth in 'operating expenses' for year end March 2019 from year end March 2018

Accommodating a proportionate approach for smaller ADIs

COBA emphasises the importance of APRA taking the size, business mix and complexity of the ADI into consideration given that this is reflected in the prudential standard objectives. The APS 220 requirements should reflect this to allow a proportionate approach for smaller and simpler ADIs. This allows supervisors the flexibility to take a proportionate approach to reduce the regulatory burden on smaller ADIs.

COBA recognises that there are a number of areas that already reflect a more proportionate approach. Examples include: the requirements of the credit risk management framework to consider size, nature and complexity (e.g. in the 'objective and key requirements') and allowing the credit risk management strategy to be part of the existing CPS 220 risk management framework documents (draft APS 220 para 16).

COBA notes that the draft APS 220 includes several references to reviews. COBA believes it should be clear for all these reviews whether ADIs are able to insource or outsource these reviews. Allowing for internal reviews can reduce the costs on all ADIs, but also on smaller ADIs. Some smaller ADIs may also outsource these reviews, so there should be clear guidelines in the PPG on APRA's review expectations.

COBA welcomes that APRA has taken a proportionate approach by retaining the 'prescribed provisioning approach'. COBA agrees that removing this approach may create a regulatory burden with little meaningful change in the provisioning outcome for relevant ADIs.

Other comments

Classification of non-performing loans

COBA also notes that the revised 'impaired loans' definition is likely to have a significant impact on different ADIs in terms of their reported level of non-performing loans (NPLs). ADIs with many "well-secured" non-performing loans will see a spike in their reported figures. Some COBA members have provided initial estimates which show their reported NPLs increasing by up to 2 to 4 times while others have reported minimal change. This is despite no increase in the underlying risk. APRA should consider this when these revised figures are reported.

Thank you for the opportunity to comment on APRA's draft APS 220. Please contact [REDACTED] or [REDACTED] if you would like to discuss any aspect of this submission.

Yours sincerely



MICHAEL LAWRENCE
Chief Executive Officer

Appendix A: COBA comments on draft APS 220

Para	Description	Comment
12a	Definition of non-performing exposures	<p>The draft APS 220 references an attachment to APS 113 as the definition’s source.</p> <p>Given that APS 113 is up for review later this year, for clarity and drafting purposes the non-performing exposures definition should be defined in APS 220 rather than by reference to APS 113.</p> <p>This will reduce the need for non-IRB ADIs to make any reference to APS 113, which in most other cases is completely irrelevant.</p>
12b	Definition of past-due	<p>COBA notes there is a potential change regarding the timing of ‘past-due’ status.</p> <p>The draft APS 220 defines past-due as “from the first calendar day of missed payment”.</p> <p>The current APS 220 states: “A facility is past due or irregular when a contracted payment (principal or interest) has not been met when due” (APS 220 para 10)</p> <p>The current ARS 220 states: “if a contractual payment was made on 30 March, the facility is past due when the payment on 30 April is not made”</p> <p>This creates a potential inconsistency about the date on which a facility/exposure becomes past-due. The draft APS 220 implies that it is the next calendar day after the missed payment while the current APS220/ARS220 states that this is on the day the payment is missed.</p> <p>COBA seek clarification if this is an intended change.</p>
15b	Credit Risk Management Framework	<p>Some COBA members have expressed concerns about being able to put this particular framework in place within the 6-month proposed period. COBA notes that this may be more a case of documentation given that these risks are dealt with at a higher level through CPS 220 Risk Management.</p>

Para	Description	Comment
15d	Requirement for a designated credit risk management function	<p>COBA believes that further clarification is required about the 'designated' credit risk management (CRM) function. Credit risk management is an end-to-end function so could sit over multiple areas.</p> <p>Given that credit risk is the primary risk faced by ADIs, credit risk management forms a key component of the existing risk management function's responsibilities (as required under CPS 220 para 37). COBA notes that while CPG 220 outlines what is expected from the CPS 220 'risk management function', clarification is needed about how/if the APS 220 function differs from this existing function.</p> <p>COBA also seeks clarification that this is not a 'dedicated' function. COBA raises these concerns given that it is unrealistic to expect smaller ADIs to have a function (or even staff) purely dedicated to credit risk management. CPG 220 para 10 creates the possibility of the 'general' risk management function having dual roles in smaller ADIs.</p>
15f	Independent Review Process	<p>As noted in the introduction letter, COBA seeks confirmation that this 'independent review' process relates to functional independence and does not entail an external review. Any requirements for an external independent review can be costly. This would be disproportionately burdensome for smaller ADIs. COBA believes that all review requirements should make it clear that there is no need for an external party (unless this is a critical part of the review – e.g. for a special purpose engagement under APS 220 para 110).</p>
22	Credit Risk Management Strategy References to currency and maturity	<p>APS 220 para 22 references "currency" and "maturity". COBA seeks clarification as to what APRA is referring with these terms.</p> <p>This includes whether:</p> <ul style="list-style-type: none"> - "currency" refers to "dollar currency" that the loan or loan payments are denominated in (i.e. US dollars) or "currency of payments" (i.e. whether the loan is in arrears or not) - "maturity" relates to the original term of the loan (i.e. period to maturity) or seasoning of the loan (i.e. period of time the loan has been written for).
24	Board Review	<p>COBA questions whether this Board review is necessary if there are no material changes to an ADI's credit risk appetite and/or credit risk management strategy.</p>

Para	Description	Comment
25	Board Responsibilities	COBA seeks clarification about what 'regular challenge' and 'seeking assurance' is considered from a Board perspective with respect to its role in the credit risk management framework.
27	Board-approved policies	COBA seeks clarification that this reference to 'appropriate policies' does not imply that they are Board-approved and that only the credit risk management strategy is required to be approved by the Board.
30	Price terms	COBA seeks further guidance and clarification about 'price terms'. COBA notes that this could be interpreted regarding discounts/fee waivers or alternatively an ADI's price-setting policy.
30	Reference to "nature and complexity" of the ADI's activities.	COBA believes that this should refer to size , nature and complexity of an ADI's activities. This aligns with references and sentiments expressed throughout the rest of the standard in the APS 220 Objectives, para 15, para 49c, para 51 and para 67.
36	Higher level of diligence where credit decisions are made distance from borrower location or underlying collateral	<p>COBA members have a variety of different operating models. As such, these credit decisions are made varying distances from the location of the borrower or underlying collateral.</p> <p>COBA seeks further clarification of the rationale behind the inclusion of the second part of para 36 and it considers to be a 'higher level of diligence'. COBA also seeks consideration of how this particular requirement plays out in the future where decisions are more automated.</p> <p>COBA does note that this requirement reflects APG 223 for the case of residential mortgages.</p>
43	An ADI must give due consideration to the integrity and reputation of the borrower as well as its legal capacity to assume liability.	<p>COBA seeks clarification about the underlying intent of the first part of this requirement regarding a borrower's "integrity and reputation". COBA particularly requests clarification about how this applies to natural persons.</p> <p>Does this requirement intend to avoid fraudulent applications? Or rather is it an interpretation of a 'character' aspect of the 5Cs of credit? Would this requirement be more appropriately considered as a subpoint to para 45 (Exposures other than to individuals)?</p>

Para	Description	Comment
44	The borrower’s repayment history and capacity, assessed under various scenarios such as:	<p>COBA notes that for clarity purposes it may be better to separate borrower’s repayment history into a separate dot point to make it clear that this wouldn’t be assessed under the various stress scenarios.</p> <p>In terms of the ‘such as’ sub paras (ii) through (iv) - COBA believes it is more appropriate to include these factors in the PPG rather than the prudential standard. There are not relevant to all situations. COBA notes that (i) is likely to be a consideration in all situations.</p>
50 and 51	Personnel accountability Ensuring ongoing “appropriate experience and knowledge”	<p>COBA seeks further clarification as to whether APRA expects ADIs to monitor the status of loans approved by individuals or whether this relates to individuals staying with their delegated lending authority. If this requires ongoing monitoring than it may require additional system changes.</p> <p>COBA also seeks clarification as to whether this requirement applies to personnel within a third party who approves an individual credit decision. This also applies to para 51. COBA assumes that this is not the case as other parts of the standard addresses third parties. If this is the case, then should this read “ADI personnel”?</p> <p>COBA seeks clarification about how APRA expects ADIs to ensure para 51 on an ongoing basis.</p>
71	Stress testing models must be appropriately validated and checked independently or by an appropriately qualified external party.	<p>COBA notes that for consistency this should state “by an independent internal group” or similar in order to resolve ambiguity about this review. This would be consistent with the APG 223 para 104. The ability for internal independent assessment may reduce ADI costs.</p>
107	Where APRA considers that an ADI is taking excessive credit risk relative to its financial or operational capacity to manage or absorb that risk, APRA may set limits on particular exposures or categories of exposures that may be held by that ADI, including but not limited to limits on growth or limits on the share of the ADI’s portfolio, or may require the ADI to cease a particular type of lending or credit activity	<p>COBA notes that use of these power can have a significant impact on an individual ADI’s business.</p> <p>Where APRA looks to exercise this ‘supervisory discretion on an individual ADI’, then it must ensure that it is able to clearly justify its actions and provide a right of reply and appeal to that ADI.</p> <p>COBA has noted that unjustified use of these powers can limit ADIs to what APRA considers to be their “traditional business model”. This impairs the ADI’s ability to grow and innovate in a fast-changing environment.</p>

Para	Description	Comment
108	<p>If APRA considers that there is an excessive level or growth in higher risk lending or credit activity more broadly, APRA may set limits on particular types of lending, including but not limited to, the share of lending or growth rate of lending, to be complied with by all ADIs or a specified class of ADIs.</p>	<p>COBA notes that APRA should consult with industry ahead of these measures given that they can have a significant impact on an ADI's, or group of ADIs' business.</p> <p>The main example of this was the application of the investor lending cap which had disproportionate burden on the operations of smaller ADIs. Potential consultation on the mechanics of this measure (as opposed to the policy case) may have mitigated the impact on smaller ADIs.</p> <p>COBA also seeks clarification about whether a "specified class of ADIs" can include by size.</p>