20 August 2001

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35 Cole Street
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The Secretary
House of Representatives
Standing Committee on Economics,
Finance and Public Administration
Parliament House
CANBERRA ACT 2600

Dear Secretary

Re: Inquiry into Banking Supervision

This letter represents my second submission to the Inquiry, and follows up on a submission that focussed on the Australian National Audit Office (ANAO) Report.

This submission focuses on an issue not raised by ANAO, but I believe should be considered by the Inquiry. This issue relates the 'lowering of the bar' in supervision. In particular, it relates to a submission made by Australian Prudential Regulation Authority (APRA) to the Basle Committee on Banking Supervision (BCBS) on *The New Basle Capital Accord*.

Lack of a Balanced Input

In 2001 APRA made a submission to the Basle Committee on Banking Supervision (BCBS) on *The New Basle Capital Accord* ('Accord'). The Accord, which is being finalised, is expected to be a foundation stone of bank supervision in Australia and globally.

In preparing its submission, APRA held discussions with a number of institutions and received written submissions from a large number of institutions (although, notably National Australia Bank did not make a written submission).

What is of concern to the writer is APRA's overarching emphasis on 'watering down' the proposed *New Basle Capital Accord* (Accord). The writer does recognise that in some areas the Accord (as it currently stands) may be restrictive to Australian banks, but the emphasis should be on depositors. There may also be substantive areas that may require tightening and which may not overly restrict Australian banks.

The written submissions received by APRA on the Accord were all from financial institutions and, without other substantive external input, it is possible that these institutions had excessive influence over APRA in preparing its own submission on the Accord.

Specific Concerns Raised by APRA

A corner stone in bank supervision is the requirement on banks to maintain minimum levels of capital. The *New Basle Capital Accord* provides new ways to calculate the minimum level of capital, and introduces two methods (a standard approach and, for advanced institutions, an internal ratings based approach).

In its submission to BCBS, APRA expressed a range of concerns on specific areas of the Accord. Indeed APRA stated that 'while APRA's preference is to operate as much as possible within an internationally agreed framework we would find it difficult to implement both the standardised and IRB approach as they currently stand'.

APRA's submission to BCBS requested a number of modifications to, or made views on, the Accord. The writer believes that some of APRA's proposed modifications or views were not adequately supported in its submission (e.g. by way of analysis). Also, the proposed modifications focus mainly on a watering down of the Accord (e.g. reducing proposed risk weightings and capital requirements). It should, however, be stated that APRA did propose some tightening in a few less significant areas.

The following points are made in relation to APRA's submission to BCBS:

- APRA states that overall minimum capital requirements for Australian institutions will rise substantially under the standardised approach for credit risk and are likely to fall substantially under a more sophisticated advanced internal ratings based (IRB) approach. Yet, while APRA argues to reduce risk weights for housing and possibly other retail exposures under the standardised approach, it does not argue to increase risk weights under the IRB approach.

- APRA argues that institutions who are unable to move to the more sophisticated IRB approach face a substantial increase in their minimum capital requirements in the order of 20 per cent to over 30 per cent (which would produce a competitive disadvantage in funding costs). However, institutions that adopt the IRB approach will presumably have a lower risk profile and hence lower capital requirements may be justified. The question is what should the difference in capital requirements be?

- BCBS is aiming to produce, on average, neither a net increase nor net decrease in minimum regulatory capital, after accounting for operational risk. APRA states that as the proposals currently stand, however, overall minimum capital requirements will increase substantially for virtually all institutions on the proposed standardised approach in Australia. However, it is not clear whether this will be the case in other jurisdictions.

- APRA argues that the existing risk weighting for housing loans under the standardised approach is high when compared to actual loan credit history in many countries, including Australia. It must be said that historical comparisons can be dangerous as periods of significant losses can occur on relatively few occasions over a long period. For example, in the 1980s there were a large number of failures of home lenders in the USA; and claims on US mortgage insurers for loans extended in the early 1980s significantly exceeded premiums. Home loan losses are currently relatively low. In the late 1980s/early 1990s, UK-based lenders suffered significant losses on home loans.

  One thing is certain though, and that is a continual reduction in risk weights for housing loans will see a greater emphasis placed on this market by institutions (at the expense of, for example, small business loans). Easier and cheaper access to home loans will see more marginal credits written, and possibly cause an unsustainable rise in real estate values. We have already seen a significant rise in loan to valuation ratios and, it appears, a reduction in requirements on borrowers (e.g. low debt service requirements, acceptance of government grants as full deposit, new 25-year loans for persons in their 50s year olds).

  In the 6 years to June 2001, housing finance extended by Australian finance intermediaries exploded (note this excludes growth in securitised loans that grew at a much faster rate). During this 6 year period, housing finance grew by 70% in real terms to reach about $300 billion, while the economy grew by around 28% overall.

  The issue is what will happen if interest rates increase significantly, or the economy turns down? In February 2001, the Reserve Bank expressed concerns about some households being over-extended, and this was at a time of low interest rates and low unemployment. In the event of a decline in housing prices, will APRA require banks to revalue their security, potentially resulting in an increase in capital requirements?

  It can be argued that housing loan risks have increased since housing loan risk weights were reduced from 100% to 50%. In addition to factors mentioned above, the home loan insurance market has changed. There are fewer home loan insurers. They are insuring loans with high loan to valuation ratios, and their risk levels have grown significantly. In 1997 the Government owned insurer, Housing Loan Insurance Company, was sold.

- APRA has a view that the risk weight for housing loans should be reduced from 50% to 20% under the standardised approach. APRA goes on to say that BCBS may prefer to permit discretion at the lower than 50% housing risk weight where justified by historical loss rates and market characteristics. As outlined above, historical loss rates do not necessarily translate to future loss rates. Also, a market-based approach appears at odds with APRA's concerns about complexity and subjectivity and with APRA's statement that 'we also strongly endorse the Committee's intention to set up a framework to facilitate consistent application of the new Accord globally'.

- APRA states that formal professional revaluation of security every 3 years 'seems excessive if strictly applied to all exposures'. This may be the case in some situations, but APRA does not provide adequate details of where this is excessive (for example, amortising loans with an initial high loan to valuation ratio, say 80%), and this appears a simplistic argument. It appears more thought also needs to go into situations (e.g. economic or market shocks) where the supervisor would require revaluations.

- APRA's submission stated a view, contrary to the Accord, that borrower credit analysis may not be necessary in some limited circumstances, such as where a bank is engaged in margin lending and has in place a sound operational risk control framework commensurate with the bank's margin lending activities. Currently, it is possible to borrow from margin lenders without providing any credit details (e.g. personal income or assets). The writer believes that this is dangerous, and could cause significant bank losses in the event of a major stock market downturn.

- APRA argues in a number of areas that compliance with the Accord will result in banks incurring a 'heavy burden' or 'excessive costs'. How it reached this conclusion, without for example arriving at dollar values, is difficult to ascertain.

- APRA argues that an explicit charge for interest rate risk should be applied to all institutions, and not just to those institutions with excessive levels of risk (as proposed by the Accord). The writer believes, however, that where excessive risks are identified the prudential supervisor should, in the interim, require additional capital. (i.e. prior to the implementation of a broadly applied standard). This is an area where excessive risks, which are measurable, can be addressed.

Yours faithfully

Nigel Fitzpatrick