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Ms Heidi Richards
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By email: ADIpolicy@apra.gov.au

Dear Ms Richards

Interest Rate Risk in the Banking Book for ADIs

The Australian Financial Markets Association (AFMA) welcomes the opportunity to make comment on APRA's proposals in relation to the draft changes for *Prudential Standard APS 117 Capital Adequacy: Interest Rate Risk in the Banking Book*.

Interest rate risk management goes to the heart of good banking practice. It is appropriate that from time to time APRA reviews its standards to ensure they are current and reflect appropriate prudential practice.

We will leave internal ratings-based (IRB) approach to credit risk related matters for others to comment on and will instead focus our submission on the proposed extension of the standard to non-IRB ADIs.

We note that APRA has concerns that some mid-tier ADIs have implemented strategies that introduce uncapitalized interest rate risk into their operations. In response, APRA proposes to extend the application of risk management requirements within APS 117 to all ADIs, so that each ADI must have a framework for managing Interest Rate Risk in the Banking Book (IRRBB) (including spread risk).

While APRA notes that it expects these frameworks to be commensurate with the level and complexity of each ADI's IRRBB exposures we remain concerned that for many ADIs, particularly Foreign Branch ADIs, the proposal is not a proportionate response, and is fundamentally misaligned with long-standing global structures.

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CPS 220

AFMA supports the appropriate management of interest rate risk by all ADIs, including branches of foreign banks.

Where interest rate risk in the banking book is a material risk for non-IRB ADIs this should be identified and managed under CPS 220 Risk Management. This is more likely to result in a proportionate response to the risk particularly in the case of branches of foreign banks. The industry would support "interest rate risk in the banking book" being added as a separately specified category in paragraph 26 of CPS 220.

The proposed requirements in the standard 117, in contrast, are excessive for the risk profile of many ADIs. While they are appropriate for larger banks with significant interest rate risk, the same does not hold true for smaller banks, particularly those that are branches of foreign banks. These banks typically have shorter-dated asset profiles, rely on head office funding to a significant degree, and are not required to keep capital in the location. The distinction between larger institutions and smaller ADIs and foreign branches is something which APRA has recognized previously in its liquidity framework setting and a similarly nuanced approach for APS 117 would be welcomed by the industry.

Non-material levels of interest rate risk for an ADI with lower total exposures, or exposures that are insignificant in their global firm context, simply do not require the burdensome structures proposed by the revised draft of APS 117. While APRA might suggest "commensurate" application will deliver proportional outcomes, in practice using a framework currently reserved for banks with over $100 billion in exposures for all prudentially regulated ADIs will result in a significant and unnecessary increase in cost and complexity as firms will be reluctant to risk scaling back the requirements significantly given the prudential nature of the related supervision.

Leveraging the existing CPS 220 framework allows non-IRB ADIs to manage their risk in a proportionate way and will require active thought from management and the board of each institution as to what the 'right-sized' response is for their organisation. It also allows scope for each institution to manage their risk in the way that best mitigates the challenges posed by their own business model and funding structure and should generate a better prudential outcome than a 'one size fits all' approach.

It is in the industry's broader interest that all ADIs have appropriate capital buffers proportionate to their risk. But we are not aware of the particular mischief APRA wishes to address in this regard, especially as it relates to branches of foreign ADIs which are not required to keep capital in the location.

If APRA has identified particular firms that are not addressing these risks appropriately, and thereby risking even temporary dislocation to markets in stressed scenarios, then AFMA would support these matters being fully addressed by APRA under the existing (or modestly amended) CPS 220 framework.

Branches of Foreign Banks

For branches of foreign banks interest rate risk, and solvency risks more generally, is ultimately managed by head office. This is appropriate and reflects the structures that have been established and supported internationally by the Financial Stability Board and promoted by IOSCO.

Home jurisdiction regulators, including APRA, are the most appropriate to ensure that banks based in their jurisdictions are appropriately capitalized including with regard to their foreign branches, which conceptually form part of the head office risk profile. Again we note that where branches have IRRBB risks that could impact local markets AFMA supports these risks being managed under the CPS 220 framework.

Preserve benefits to the jurisdiction of branch structure

The foreign branch structure is an efficient and effective way of facilitating greater connections into global banking markets and the associated foreign investment and competition benefits this brings.

Foreign Banks operate through foreign bank branches, as opposed to subsidiary structures, specifically because branch licensed activities and the accompanying regulatory obligations are right-sized for their strategic business model in the jurisdiction. While host regulators must assess and determine the appropriate application of their regulations to branches and the extent to which this should be consistent with the regulation of subsidiaries from the host jurisdiction's regulatory viewpoint, this should not result in an inefficient approach that risks losing the advantages and attractiveness of the branch structures for foreign entities, particularly where this creates a dis-competitive impact for no, or little, benefit in the host risk environment. This also has the potential risk that it encourages other countries to adopt a similar approach to foreign branches of Australian headquartered ADIs.

The economic advantages granted to the jurisdiction by having the benefits of branch structures must weigh into the considerations about whether making the requirements for branches effectively the same for IRRBB. Australia gains significant advantages economically from having international branches in the Australian market.

Our members report that:

- For smaller foreign branches establishing the systems and processes suggested by the draft standard will be a significant and burdensome undertaking. For their relative exposures, already managed from head office, the required costs will be disproportionate to both the IRRBB risks and any benefit that would accrue.
- For larger branches of foreign banks, the requirements are largely duplicative of the requirements of their home jurisdiction regulators and unnecessary.

Rather than applying the draft provisions of APS 117 to these organizations, we recommend the addition of "interest rate risk in the banking book" as a separately specified category in paragraph 26 of CPS 220 to ensure that each institution addresses the topic as best mitigates their own risk.

International Framework

The solvency of global banks is unlikely to be materially impacted by operations of branches in the Australian market.

As standard international practice it is head office and the jurisdiction of head office from a regulatory perspective that have the main responsibility for solvency of the branch. Branches are inherently lower in capital requirements than subsidiaries as they pose minimal risks to local investors.

In line with recent calls from IOSCO[1] and the FSB[2] to reduce market fragmentation through appropriate regulatory deference, APRA should as a general principle defer on solvency matters including IRRBB to the home jurisdiction for branches of foreign banks.

It is still appropriate as we have noted above to ensure that all ADIs manage their risks to ensure that they do not cause disruption to markets while awaiting transfers from head office, however, the appropriate approach to ensure this outcome is an amendment to CPS 220 rather than the application of APS 117 to foreign ADIs as proposed.

Conclusion

We emphasise in conclusion our concern that the extension of the standard appropriate for IRB ADIs to all ADIs (excluding some provisions requiring an IRB) results in an inefficient and disproportionate response to APRA's concerns. Further it does not show sufficient support for the branch structure and the benefits it brings the jurisdiction or the international norms around responsibilities for branches.

While AFMA supports appropriate management of IRRBB risks for all ADIs where these are not material and for branches of foreign banks these should be handled under an adapted CPS 220 standard.

We trust this submission is of assistance. Please do not hesitate to contact us for more information or explication.

Yours sincerely

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Director of Policy and Professionalism

[1] https://www.iosco.org/library/pubdocs/pdf/IOSCOPD629.pdf
[2] https://www.fsb.org/2019/06/fsb-report-on-market-fragmentation-2/