

Council of Financial Regulators  
The Treasury  
Langton Crescent  
PARKES ACT 2600

Friday, 7 February 2025

By email: [CFRReview@treasury.gov.au](mailto:CFRReview@treasury.gov.au)

Dear Council of Financial Regulators,

### **Review into Small and Medium-sized Banks**

Bank of Queensland Limited (BOQ) welcomes the opportunity to respond to the Council of Financial Regulators' (CFR) issue paper, developed in consultation with the Australian Competition and Consumer Commission (ACCC).

The Issues Paper comes at an important time for small and medium-sized banks, which are experiencing ongoing challenges in delivering a sustainable return on equity and may face increased consolidation efforts to improve returns and ensure continued access to capital. Industry returns have approximately halved since the Global Financial Crises due to increased capital requirements, regulatory impost and competition. This has escalated more recently with the combination of a material increase in regulation and consumer obligations since the Banking Royal Commission and structural margin compression in an increasingly commoditised retail banking market. Returns for many banks are now below their cost of capital and unsustainable in the medium to long term.

For small and medium sized banks like BOQ these challenges are further compounded by:

1. An unfair capital playing field. BOQ estimates it holds 17-25% more capital than the major banks who currently hold Risk Weighted Assets (RWA) equivalent to 74% of the comparable RWAs required under the standardised regime. APRA's own analysis presented to an Australian Banking Association (ABA) industry session indicated an average of 18% difference in capital requirements for housing loans.
2. The disproportionate impact of the material escalation in regulatory impost. BOQ has invested \$173m to address new regulations since the Banking Royal Commission with regulatory related operating expenses increasing at a compounded annual growth rate of 30%.
3. Higher relative funding costs. BOQ's funding costs are 25-50bps points higher than the major banks.

To address current unsustainable returns, BOQ has announced fundamental changes to its operating model. This includes transforming to a low cost to serve digital retail bank, corporatising our Owner Manager Branch network and consolidating this footprint to align with our strategy, outsourcing and automating processes, reducing FTE and focusing on specialist business banking sectors.



While we recognise these are difficult decisions for many stakeholders, attracting heightened media, they are essential to deliver an enhanced customer experience and sustainable returns in the current operating environment.

BOQ appreciates the focus on the challenges confronting small and medium-sized banks and the unique opportunity the CFR review presents for policymakers to progress initiatives to support their sustainability, reinforcing the significant role and contribution they make to the Australian economy.

While strongly supportive of the sustainability of smaller banks, this submission is focussed on initiatives to supports medium-sized banks with similar attributes to BOQ. Our key recommendations include:

1. An achievable and affordable accelerated pathway to advanced accreditation, levelling the capital playing field.
2. Proportional regulation across a three-tiered framework reducing both the regulatory impost and timing of complying with new regulation for tier two medium sized banks and tier three small banks.
3. Initiatives to lower the cost of funding including increasing the covered bond limit from 8-12%.

BOQ also supports and has made key contributions to the submission by the Australian Banking Association (ABA).

We would welcome the opportunity to discuss any of the matters raised in this response, if required. For additional information, please contact Simon Huggins, Head of Media & Government Relations.

Yours sincerely,

[Redacted signature area]



## BOQ Submission

### Overview of BOQ

BOQ comprises the Bank of Queensland (including BOQ Specialist), ME and Virgin Money Australia (VMA) brands. BOQ services over 1.4m customers across retail and business banking, with \$67b in deposits and \$80b in lending.

With its origins in Queensland dating back to 1874, BOQ has evolved over 150 years to offer a full suite of everyday transaction, investment and lending products and services to retail and business customers across Australia. Throughout our history we have played an important role in helping households achieve their home ownership and savings goals, funding the growth aspirations of small and medium businesses, and supporting Australian communities.

In a steadily more commoditised and concentrated banking sector and during a time of economic and geopolitical uncertainty, BOQ offers the Australian market a compelling alternative banking proposition. Our heritage, and relationship with Queensland customers (as the last standing major Queensland bank), our wider footprint across Australia in key growth segments (particularly in health, agriculture and owner-occupied property) and our strong capability in asset finance and novated leasing, presents an increasingly unique and valuable option for Australian consumers.

BOQ's return on tangible equity has reduced from 15% in 2005 to 7.1% today due to accelerating industry structural shifts, including: increased capital requirements since the Global Financial Crisis, regulatory impost since the Banking Royal Commission and market competition reducing margins. Retail banking is now highly commoditised with more recent margin compression being accelerated by increasing broker market share (74%) and disruption from a new large competitor. These key shifts are exacerbated for small to medium-sized banks due to higher capital weightings under the standardised model, the disproportionate impact of regulation, higher funding costs and higher unit costs due to their smaller scale.

This unsustainable return is a key inflection point in BOQ's history, requiring bold decisions and fundamental changes to the way we operate. We are transforming BOQ to a simpler specialist bank that delivers an enhanced customer experience.

This includes shifting our retail banking model to a digital low cost to serve retail bank. The build of our new digital banking platform is largely complete, with ME Bank customer migration commenced as a first phase onto the new digital banking platform and decommissioning of legacy systems. The digital banking platform is providing a material uplift in customer experience compared to our legacy systems.



We have also announced that we are discontinuing our owner manager franchise network that has served BOQ for the past 22 years. This model is no longer sustainable in the current environment or reflective of the customer trend toward digital banking. We are currently in the process of corporatising and consolidating this network. We have recently announced the closure of 20 branches and anticipate further consolidation as consumers migrate to our digital bank and we focus our branch network on regional growth corridors to service small to medium sized companies.

We are transforming our business bank and finance company to focus on specialist sectors where we have strong capability to compete and win.

We are addressing our high unit cost through outsourcing and automating processes and reducing FTE.

While we recognise these are difficult decisions for many stakeholders, they are essential to deliver an enhanced customer experience and sustainable returns in the current operating environment.

### **Role of Small and Medium-Sized Banks**

Smaller and medium-sized banks play a critical role in supporting the Australian economy through providing capital to support economic growth, offering higher returns to Australian deposit holders, employing tens of thousands of Australians and supporting local communities. Further, they have long offered Australians a vital and compelling alternative to the major banks, providing specialised and targeted services across different market segments, including regional communities. To continue to do so into the future requires change.

Medium-sized banks, which include institutions commonly referred to as 'mid-tier' or 'regional' banks, are different to smaller banks due to their significant market share, systemic importance, and higher regulatory impost. With an aggregate market share of around 12% and serving millions of customers, mid-tier banks like BOQ play a crucial role in maintaining competition within the Australian banking sector. The size of their lending and deposits further underscores their importance, and the need to ensure they can compete on a level playing field with Australia's major banks.

This competition to the major banks fosters innovation and enhances consumer choice, experience, and pricing. Therefore, it is crucial to eliminate barriers and restrictions that hinder the ability of banks like BOQ to compete effectively.

### **Declining Returns Driving Industry Consolidation:**

This review comes at an important moment for small and medium-sized banks, which are experiencing continued pressure on return on equity from an increasingly commoditised retail market and heightened regulatory and consumer obligations. Structural margin compression has accelerated in the past 18 months, with returns for many banks now below their cost of capital. These accelerating industry shifts pose an existential threat to competition.



Achieving organic scale and lower unit costs continues to be a significant challenge in the Australian banking sector with consequent industry consolidation. Five of the top 11 banks have been acquired or merged since the GFC and a significant number of smaller banks have either failed, been acquired or merged<sup>1</sup>.

We anticipate this trend will accelerate unless addressed through initiatives to level the capital playing field, reduce the proportional impact of regulatory impost, and lower funding costs for small to medium-sized banks.

### Key Recommendations

- **Capital requirements:** To level the capital playing field, BOQ recommends that the CFR proposes further simplifications to the IRB accreditation process. These proposals should allow new entrants to build capability, sophistication and maturity through time, similar to how the current IRB banks have been able to. They should also aim to ensure a new entrant is able to achieve accreditation within a reasonable timeframe, at a cost that is not prohibitive and with some certainty of achieving accreditation. If there are elements of the IRB model lifecycle that may be deemed as deficient by the bank or APRA, explicit margins of conservatism or overlays could be applied to ensure sufficient capital is held during the maturation period. Similar to the ABA recommendations, BOQ proposes that simplifications to expectations related to data management, model use and qualifying management systems would allow a bank to achieve accreditation in a more time and cost-effective manner and develop capabilities gradually.
- **Proportionate Regulatory Approach:** BOQ supports the ABA-led initiative for a three-tiered framework for banking regulation to address the disproportionate costs mid-tier banks face under the current 'one size fits all' approach. This framework should include reduced requirements for small to medium-sized banks and tiered timing of obligations to meet new regulation. BOQ recognises that our regulators, where possible, are supporting proportionality, but a tiered approach would formalise this and could be helpful for regulators. The current delineation by APRA only acknowledges Significant Financial Institutions (SFIs) with over \$20bn in assets and non-SFIs with under \$20bn in assets. A size-based three-tiered system would make regulation more fit-for-purpose while maintaining regulatory standards. The proportionality framework in New Zealand categorises banks by total assets, which could be a model for Australia:
  - Group 1: AU\$200bn or more
  - Group 2: Between AU\$20bn and AU\$200bn
  - Group 3: Less than AU\$20bn

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<sup>1</sup> Council of Financial Regulators (2024), 'Review into Small and Medium-sized banks', pp 2-3



- **Funding:** BOQ suggests an increase in the Covered Bond Limit to provide more competitive funding alternatives for mid-tier Authorised Deposit-taking Institutions (ADIs). Recently, BOQ raised EUR600 million via a soft bullet Covered Bond program at a landed cost in AUD of BB+87.6bp for five years, equivalent to major banks' Senior Unsecured Funding costs. Increasing the cap on Covered Bonds from 8% to 12% of Australian dollar assets for mid-tier ADIs would provide access to deep funding markets in Europe at an efficient cost.
- Work with credit rating agencies to adjust perceptions of there being different levels of government support for mid-tier systemically important banks compared to the major banks in times of stress. This would support improved ratings for mid-tier banks, lowering their cost of funding.

## Capital

### Key points

It is BOQ's opinion that there is a material difference in capital requirements between the standardised approach, which BOQ adopts, and the Internal Rating Based (IRB) approach. This is a significant driver of financial performance and an impediment to standardised banks competing with IRB banks. This is particularly pertinent at this time with returns now below the cost of capital.

BOQ supports the recommendations of the ABA to:

- simplify the IRB accreditation process.
- for APRA to consider the difference in capital requirements between the approaches and
- whether there is sufficient justification for the difference in credit risk weights for simple loans.

BOQ acknowledges that IRB accreditation process changes have been implemented by APRA following the 2014 Financial System Inquiry; however, only one bank has achieved accreditation since those changes. Further accreditation simplification is required to ensure certainty in achieving accreditation for larger, more complex non-IRB banks, such as BOQ. More banks using the IRB approach would ensure competition remains in low-risk lending, which ultimately benefits deposit holders and consumers. This would also create an aligned prudential framework, with larger, more complex banks under the same set of requirements for all risk classes.

BOQ does not agree with the CFR issues paper that lower capital requirements under the IRB approach to capital adequacy are largely offset by additional costs, complexity and requirements imposed on IRB banks. As one of the largest non-IRB banks BOQ's internal and external stakeholders, including APRA, expect risk to be managed in similar ways to IRB banks, meaning BOQ incurs similar costs, complexity and requirements as IRB banks do. Whilst complex models are not used for capital purposes, BOQ maintains complex models for credit risk management, interest rate risk management, stress testing and a range of business processes.



The revised capital framework implemented on 1 January 2023 introduced additional safeguards into IRB capital requirements to ensure excessive divergence between the IRB and standardised approach does not occur. However, the analysis BOQ has performed indicates that a material difference in capital requirements between the approaches remains. BOQ has performed a range of benchmarking (Appendix 1) based upon publicly available disclosures that indicates BOQ holds between 17% to 25% more capital than major banks. Major banks are currently holding Risk Weighted Assets (RWA) equivalent to 74% of the comparable RWAs required under the standardised regime.<sup>2</sup> It is BOQ's opinion that the differences in RWA and capital requirements are significant and would not be offset by additional IRB requirements for a bank of BOQ's size and complexity.

In an industry presentation to an ABA working group, APRA presented further details behind the analysis that indicated there was a 5bp impact to pricing as a result of capital requirements for housing loans<sup>3</sup>. This was a useful presentation for industry to understand APRA's assumptions and a number of key insights could be taken from the analysis presented:

- APRA's worked example was calibrated off an "average" housing loan, which confirmed standardised capital requirements that are 18% higher than IRB requirements (e.g. standardised capital of \$2.68 vs IRB of \$2.27).
- The differences in capital requirements has increased since APRA first presented this analysis in March 2024, particularly for the low LVR segment which has seen a material divergence in RWA.
- APRA's analysis assumes additional capital requirements has no impact to return on equity for a bank which implicitly assumes that additional capital costs can be passed onto consumers. This is not the case in a highly competitive market.

Whilst APRA has used a reasonable theoretical construct to estimate a fair market prices incorporating costs of equity and debt, the analysis assumes that cost of debt and equity are fixed and that the asset price can be increased to cover additional capital (equity) requirements of the standardised approach. BOQ agrees with the ABA views that a more appropriate approach to estimate the impact of additional capital requirements would be to estimate the impact on return on equity by assuming a fixed asset price. Given IRB banks hold the vast majority of market share in Australia, market prices are set by IRB banks, and to compete standardised banks must align to these market prices. Using the same theoretical construct as APRA but assuming that return on equity reduces to compensate for the higher capital requirements indicates that standardised banks return on equity is at least 1% lower than IRB banks, or 10% reduction (refer to appendix 1). BOQ views this as a significant impact to profitability. Additionally, this impact may be understated for the following reasons:

- APRA have assumed all banks are operating in line with minimum capital requirements per prudential standards, whereas banks operate well in excess of minimums.

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<sup>2</sup> This ratio can be calculated from disclosures introduced as part of the new capital framework related to the 72.5% standardised risk weight floor.

<sup>3</sup> <https://www.cfr.gov.au/publications/consultations/2024/review-into-small-and-medium-sized-banks/review-into-small-and-medium-sized-banks.html>



- There is an Expected Loss adjustment incorporated into capital requirements which is a capital deduction under IRB standards. APRA's adjustment did not offset the expected loss against eligible provisions held in accordance with accounting standards, which is a requirement of IRB standards.

If alternative assumptions were taken for operating capital levels and the expected loss adjustment, the difference in capital requirements between approaches would increase and the difference in return on equity would increase to 1.6 percentage points or 16% lower than IRB banks. Smaller banks also have higher funding costs and higher proportional costs of implementing regulation, both of which has not been included in this impact analysis. If those additional costs were also included, the cumulative impact to return on equity from capital, funding and regulation differences would be very material.

There are three potential approaches that the CFR could propose to reduce the impact of capital differences between the standardised and IRB approach:

1. Reduce capital buffer requirements for small and mid-sized banks. For example, removing the Counter Cyclical Buffer for non-IRB banks, which is equal to 1% CET1 currently.
2. Reduce standardised RWA's. Standardised RWA's are materially aligned to the Basel framework, meaning this approach would represent a divergence from international banking standards and could implicitly reduce IRB banks capital requirements as there is a standardised floor requirement in the IRB approach.
3. Increase the number of IRB banks in Australia through further simplification of IRB accreditation process, with requirements and expectations that are appropriately calibrated to the capabilities of a new entrant.

It is BOQ's opinion that approach 3 is the most viable option, in line with the ABA recommendations. For mid-tier banks option 1 is not a viable option as a lower CET1 ratio could cause a credit rating downgrade, or heightened funding costs from debt investors, which would have a negative impact on banks who are reliant on wholesale funding sources. Option 2 would be preferable for standardised banks, however BOQ acknowledges that there are limitations to this approach. A hybrid option of approach 1 for small banks and approach 3 for larger non-IRB banks may be appropriate for the whole industry.

Despite some simplifications to the accreditation process through phased implementation allowances, APRA's expectations related to the IRB approach appear to have increased materially since 2008 when most banks achieved accreditation. An example of this is the extensive set of expectations of sound practice articulated in the Prudential Practice Guide *APG 113 Capital Adequacy: Internal Ratings-based Approach to Credit Risk*. The updated guide, released in July 2022, incorporated enhanced expectations related to data quality and maintenance, governance, rating systems design/operations and risk quantification methodologies. The 2022 version of APG 113 is 62 pages long, whereas the prior version was 13 pages. Whilst an increase in expectations over this intervening period is appropriate, IRB banks have had many years to develop these capabilities gradually. Having to meet these expectations at initial accreditation adds significant project costs and timelines. Additionally, the corresponding prudential standard, APS113, stipulates that APRA would only release a significant portion of capital benefit from initial phases of accreditation once final accreditation is achieved. Combined with accreditation uncertainty, these points represent material barriers to entry for a new IRB entrant.



## Recommendation:

To reduce the barriers to entry, BOQ recommends that the CFR proposes further simplifications and an accelerated, more affordable IRB accreditation process. These proposals should allow new entrants to build capability, sophistication and maturity through time, similar to how the current IRB banks have been able to and should aim to ensure a new entrant is able to achieve accreditation within a reasonable timeframe, at a cost that is not prohibitive and with some certainty of achieving accreditation. If there are elements of the IRB model lifecycle that may be deemed as deficient by the bank or APRA, explicit margins of conservatism or overlays could be applied to ensure sufficient capital is held during the maturation period. Similar to the ABA recommendations, BOQ proposes that simplifications to expectations related to data management, model use and qualifying management systems would allow a bank to achieve accreditation in a more time and cost-effective manner and develop capabilities gradually.

## **Proportionate Regulation**

### Key points

BOQ acknowledges its primary regulators work productively to try and understand and where appropriate accommodate the different nature and scale of our business, without lessening the minimum prudential safety and consumer conduct outcomes expected. However, the current approach to bank prudential oversight and regulation in Australia is best described as 'one size fits all', baselined to the systemic risks of the largest banks. Without regulatory nuance, the risks posed by mid-tier banks are currently overstated and, consequently, so too are the burdens placed on these entities by the regulators. Our operating expense, excluding amortisation, for regulatory impost over the past four financial years has been increasing at a compounded growth rate of 30% year-on-year. As a subset of the wider banking sector mid-tier banks have spent over \$900m to deal with the flow of regulatory change they must comply with. Major banks operate with greater resources including teams solely dedicated to project streams for major changes like CPS230 and AML/CTF legislation, and often implementation timelines do not fairly consider the resourcing disadvantage banks like BOQ have, this is particularly acute during industry wide implementation periods. For example:

- On the back of evolving AML/CTF requirements, BOQ must revise multiple systems to collect and record a customer's place of birth (PoB), integrating data into verification platforms. Real-time screening for Politically Exposed Persons (PEPs) and sanctions compliance is necessary, along with real-time risk rating of customers. BOQ must enhance transaction monitoring systems to meet new AML reform specifics and ensure only verified information is used in international funds transfer messages, amongst additional significant system change requirements by 2026.
- Meanwhile CPS 230 requirements necessitate significant operational risk management processes and frameworks. Readiness for the change is a significant challenge across the industry and has a major (and disproportionate) impact on smaller banks, which can lack the resources and dedicated teams to ensure implementation and compliance by 1 July 2025.



- Separately, and of increasing importance, are environmental, social and governance (ESG) requirements to the extent of the rollout of related initiatives, particularly reporting and disclosure requirements.
- We also highlight that investment in the Consumer Data Right has had a disproportionate impact on mid-tier banks. BOQ has invested over \$100m since 2020 on establishing and maintaining its CDR program. This is an extremely significant investment for a bank of our size particularly given there are only 0.4% of BOQ customers currently utilising the CDR capabilities.

BOQ notes recent media reports in relation to a new bank regional branch levy, which, as reported, could be inequitable & disproportionate and have the potential to hinder competition, productivity and innovation by materially impacting BOQ's strategy to deliver a more sustainable operating model that reflects customer banking trends and needs.

Mid-tier banks also continue to face significant reporting obligations given their relative size to major banks. APRA's reporting thresholds determine which EFS reporting forms are applicable for banks, with certain forms being either inapplicable or provided in a reduced format if they fall below the reporting threshold.

One suggestion for easing the burden on small and medium-sized banks may be for APRA to review these reporting thresholds.

Some examples of where reporting could be simplified include:

- Reporting Requirements: Stocks and flows, cost of funds, and value of funds require operationally intensive monthly submissions across various ARFs (742, 743, 744, 746, 747, 748), involving multiple dimensions such as business size, SESCO, loan purpose, deposit type, residual term, and exposure category.
- Overlapping Data Collections: There are several overlaps across data collections, such as days past due, provisions, and non-performing loans reported across various forms, and income and expense information reported in both ARF 330 and ARF 730. Additionally, data in ARF 923.5 duplicates report data in ARF 744 at a more granular level.
- These points highlight the complexity and time-consuming nature of the current reporting requirements. Simplifying these areas could ease the burden on small and medium-sized banks.

Without a concerted effort to incorporate practical and proportionate measures in regulation, supervision and reporting frameworks the oversight of mid-tier and smaller banks will continue to be detrimental to market-based and dynamic competition. Banks acknowledge the importance of system strength and stability. However, balance is critical for fostering a dynamic and innovative banking system.



## Recommendations

### Proportionate Regulatory Approach:

- BOQ supports the ABA led initiative for a three-tiered framework for banking regulation to address the disproportionate costs mid-tier banks face under the current 'one size fits all' approach.
- BOQ believes that proportionate regulation should include extended timeframes for achieving compliance. This approach will allow mid-tier banks to access necessary resources, which are often in high demand and command a premium during industry-wide implementation periods.
- BOQ recognises that our regulators where possible are supporting proportionality, but a tiered approach would formalise this and could be helpful for regulators.
- The current delineation by APRA only acknowledges Significant Financial Institutions (SFIs) with over \$20bn in assets and non-SFIs with under \$20bn in assets.
- A size-based three-tiered system would make regulation more fit-for-purpose while maintaining regulatory standards.
- The proportionality framework in New Zealand categorizes banks by total assets, which could be a model for Australia:
  - Group 1: AU\$200bn or more
  - Group 2: Between AU\$20bn and AU\$200bn
  - Group 3: Less than AU\$20bn

## **Funding**

### Key points

#### **Retail Funding (Pricing)**

In the retail deposit market, mid-tier banks like BOQ Group often act as price takers, relying on higher rates to attract customers. Major banks, with their higher credit ratings and national presence, can grow lower-cost deposit balances without offering higher rates. For BOQ to grow its retail deposits, it often needs to offer savings rates above the majors. This pricing discrepancy is worsened by the disparity in low-cost funding, such as transaction accounts and commercial at-call deposits, which help offset the cost of more expensive retail savings products.

Despite a large branch network and high-performing digital applications, BOQ remains underweight in transactional and commercial deposit balances. Currently, BOQ's transaction account balances are 10.5% of total deposits, compared to between 17% and 31% for some major banks. Similarly, BOQ's business and community deposits make up 19% of total resident balances, compared to 25% for some major banks. This imbalance forces BOQ to support liquidity through higher-cost retail deposits and wholesale funding, further shrinking net interest margins.

#### **Wholesale debt funding**

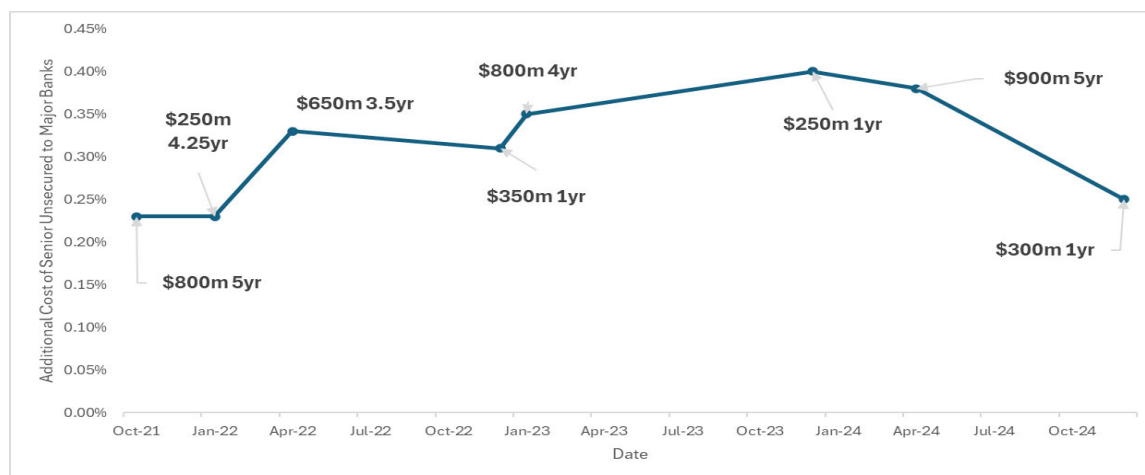
Major banks have access to lower costs of funding in wholesale and debt markets by virtue of their higher credit ratings. By comparison, smaller players either access wholesale funding at a higher rate or are supplied wholesale funding by one of their retail finance competitors at a profit-maximising rate.



This competitive advantage was enhanced by the Australian Government response to the Global Financial Crisis, which reinforced the perception that the government will bail out banks that are ‘too big to fail’ in times of stress. The implicit government backing of the major banks provides these banks with higher weighting for the government support factor within credit rating agencies’ bank rating methodologies, resulting in an uplift in their credit rating and, as a result, access to lower costs of funds.

Figure 3 demonstrates the cost differential for publicly issued Senior Unsecured transactions in the past three years. This highlights the estimated additional cost BOQ has paid above where major banks would raise the equivalent type of funding. BOQ acknowledges that the differential below does not entirely correlate to the higher government support weighting for the major banks due to the implicit government guarantee. Using S&P bank rating methodology, the major banks receive a 1-notch uplift in rating from single A+ to AA- due to the higher government support factor, a material component of the funding differential will be correlated to this component.

**Figure 3: Estimated Additional Cost for BOQ to Raise Senior Unsecured Funding Compared to Major Banks**



This funding cost advantage provides the major banks with a competitive edge when competing against the mid-tier banks, resulting in lower profitability in certain deposit segments.



## Recommendations

### Covered Bond Limit:

- BOQ suggests increasing the Covered Bond Limit to provide more competitive funding alternatives for mid-tier ADIs.
- BOQ recently raised EUR600m via a soft bullet Covered Bond program at a landed cost in AUD of approximately BBSW+88bps for five years, equivalent to major banks' Senior Unsecured Funding costs.
- Increasing the cap on Covered Bonds from 8% to 12% of Australian dollar assets for mid-tier ADIs would provide access to deep funding markets in Europe at an efficient cost.

### Implicit support for major banks:

- Work with credit rating agencies to adjust perceptions of there being different levels of government support for mid-tier systemically important banks compared to the major banks in times of stress. This would support improved ratings for mid-tier banks, lowering their cost of funding.

### Alternate RBA and Federal Government Support:

- Reducing funding costs could be achieved through utilising previously used and existing facilities.
- This could be in the form of reintroducing a small allocation of the Committed Liquidity Facility (CLF) or Term Funding Facility (TFF).
- BOQ would recommend a targeted approach to allocation dependent on size rather than a one-size-fits-all, considering the impact on competition within capital markets and between regulated entities.
- The benefit of this approach would be in transparently maintaining the CLF as part of the market infrastructure. It should assist with the transition of small ADI's liquidity portfolios to HQLA1 assets and provide enhanced liquidity for smaller ADI's debt instruments and assist with access to funding.

## Conclusion

BOQ strongly believes that this review presents a pivotal opportunity to address the unique challenges faced by mid-tier banks. By implementing the recommended initiatives, to equalise capital, adopting a proportionate regulatory approach, and by providing more competitive funding alternatives, policymakers can ensure the sustainability and competitiveness of mid-tier banks. This will foster a more diverse and resilient banking sector, ultimately benefiting the Australian economy and consumers.

Mid-tier banks like BOQ play a crucial role in maintaining competition within the Australian banking sector. Ensuring that these banks can compete on a level playing field with Australia's major banks is essential for fostering innovation and enhancing consumer choice, experience, and pricing.

BOQ remains committed to contributing to this important review and looks forward to collaborating with the Council of Financial Regulators to achieve these critical objectives.



## Appendix:

### Appendix 1: BOQ's capital analysis

#### Capital Benchmarking

BOQ has performed capital benchmarking using major banks publicly disclosed capital outcomes to understand whether BOQ is holding more capital than major banks under the standardised approach. The analysis has considered current capital levels based upon banks most recent year end dates as well as publicly disclosed low points of target capital ranges. All major banks have disclosed a low point of 11% in their target range and BOQ has disclosed a low point target of 10.25%. The low point of the target range incorporates a range of qualitative criteria, including risk appetite and external expectations.

Two approaches were taken to analyse capital levels:

- Simulated major banks CET1 ratios if they were under the standardised regime. This analysis uses major banks disclosures related to the IRB requirement to hold at least 72.5% of standardised RWA's.
- Simulated what BOQ's CET1 ratio would be if the IRB approach was used by assuming industry average RWA's under the IRB approach.

This analysis implicitly considers all conservative elements of the IRB approach, including additional buffers, conservative adjustments in IRB models and IRRBB requirements. This approach does not consider operational costs for maintaining IRB models however as discussed earlier BOQ incurs many of those costs being one of the largest non-IRB banks.

Figure 4 below shows each of the major banks current CET1 ratios under the IRB approach, what their CET1 ratios would be under the standardised approach and their standardised CET1 ratio if they were at their low point of target range. On average CET1 ratios would be approximately 3 percentage points lower if major banks were using standardised RWA.

**Figure 4: Major Bank CET1 and Standardised RWA**

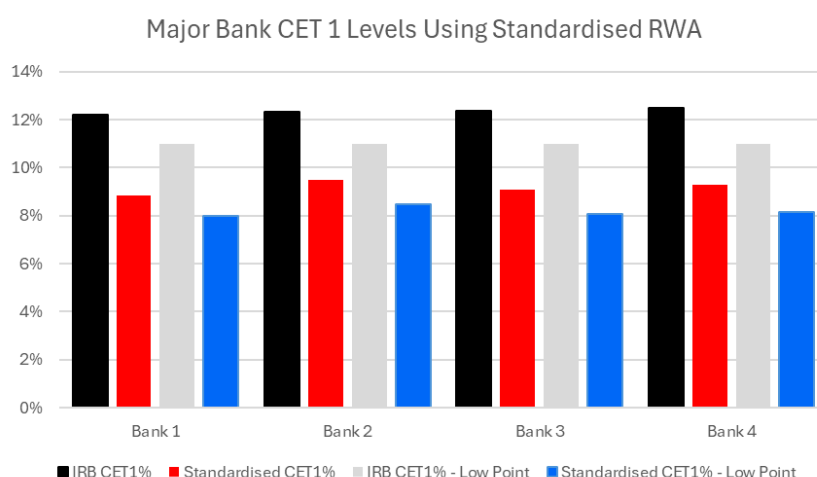
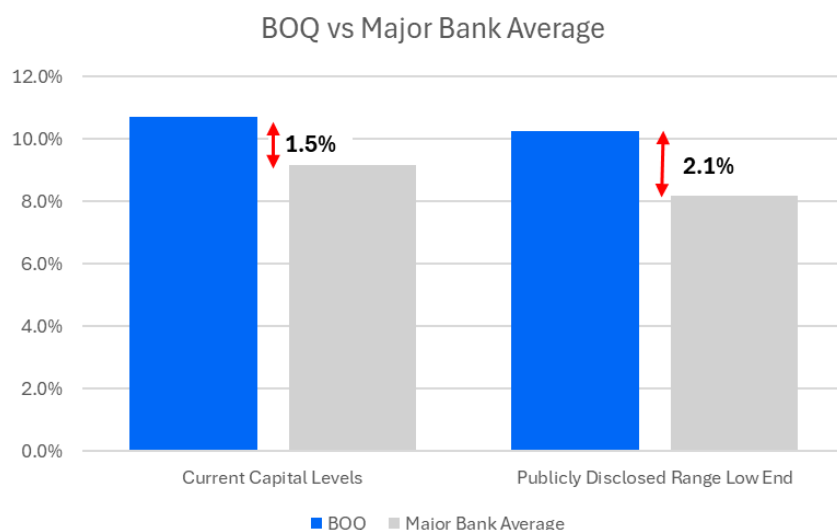


Figure 5 below shows BOQ's capital levels compared to the average of what major banks CET1 ratios would be under the standardised approach, both at current levels and based upon disclosed low points of the target range. At current levels BOQ holds 1.5 percentage points more than major banks would if they were using standardised RWA, which is 17% more capital. At low points of target range BOQ would hold an additional 2.1 percentage points than major banks, which is 25% more capital.

**Figure 5: BOQ Capital Levels Compared to Major Bank Standardised CET1**



The second approach to compare capital levels simulated what BOQ's capital levels may be under the IRB approach, by assuming:

- An average RWA under the IRB approach equal to 74% of standardised RWA, assuming the major bank average ratio of IRB to standardised RWA.
- No expected loss shortfall, on the basis that the shortfall is not a material consideration for major banks, with three major banks having no shortfall and the other having a negligible shortfall.
- A capital level of either 1.25% higher than BOQ's current levels which incorporates the additional requirement under the IRB approach or the major banks low point target of 11%.

The formula below calculated the percentage difference in capital under this approach:

$$\text{Capital \% difference} = 1 - \frac{\text{IRB CET1} * 74\%}{\text{Standardised CET1}}$$

Based upon this analysis and current capital levels BOQ would hold a CET1 ratio of 11.9% and 17% less capital under the IRB approach. If BOQ was on the IRB approach and adopted the same operating range as major banks, BOQ would hold 20% less capital to maintain an 11% CET1 ratio under the IRB approach compared to BOQ's current standardised operating range low point of 10.25%.



This analysis is not designed to indicate what BOQ's target ranges may be under an IRB approach, nor to indicate what major banks requirements may be if they were under the standardised approach. Capital levels held are a result of a range of internal and external stakeholder expectations, Pillar 2 requirements and analytical processes, including stress testing. This analysis also makes assumptions relating to average RWA's under the IRB approach and expected loss shortfalls, both of which are a function of portfolio quality, modelling approaches and data quality.

Overall, whilst this analysis is simplistic, in BOQ's opinion the results indicate a material difference in capital outcomes between the IRB and standardised approach.

### Return on Equity Impact of Standardised Requirements

To estimate the potential impact to pricing from capital requirements APRA have used a weighted average cost of capital methodology, according to the formula below.

$$\text{Asset Price} = \frac{\text{CET1} * \text{Cost of Equity (pre tax)} + \text{Debt} * \text{Cost of debt}}{\text{Asset amount (drawn)}} + \text{Other Costs}$$

The calculations use the following assumptions and inputs (other costs have been excluded as they do not impact pricing differentials between standardised and IRB):

Assumption/Input	Standardised	IRB
Asset amount (drawn)	\$90	\$90
Asset amount (undrawn)	\$10	\$10
Cost of equity (RoE)	10% (post tax, 14.29% pre-tax)	10% (post tax, 14.29% pre-tax)
Cost of debt	4.65%	4.65%
Capital level	8%	9.25%
Exposure	\$94	\$100
EL adjustment	Nil	1.7% (adjusted to be an RWA equivalent. 0.16% base EL)
Risk weight (post IRB adjustments)	\$33.46	\$24.59
CET1 required	\$2.68	\$2.27
Debt required	\$87.32	\$87.73
Price (excl. Other costs)	4.94%	4.89%

This same framework can be used to estimate the impact to RoE that occurs as a result of additional capital requirements under the standardised approach by using the IRB price estimated and calculating the RoE a standardised bank would earn from that price. In a competitive market standardised banks must accept market prices and cannot pass on additional capital costs to consumers.

$$\text{RoE} = \frac{\text{Asset Price} * \text{Asset amount (drawn)} - \text{Debt} * \text{Cost of debt}}{\text{CET1}} * (1 - \text{tax rate})$$



If all assumptions are held consistent with APRA's assumptions, the RoE of a standardised bank reduces to 9% as a result of the additional capital held, compared to IRB bank RoE of 10%. To understand sensitivity of key assumptions in these calculations, BOQ has adjusted some parameters. If capital levels are increased to levels more akin to banks actual operating levels (e.g. 10.5% for standardised, and 11.75% for IRB) and EL adjustment is reduced to 0% (recognising eligible provisions), RoE reduces to 8.4%. The EL adjustment may be higher than 0%, however BOQ's view is that it would be lower than the 0.16% that is used in the APRA calculations.

These examples are hypothetical based upon numerous assumptions, however again confirm that the impact of the capital differential between standardised and IRB requirements is significant.

