Discussion Paper

Implementing Basel III liquidity reforms in Australia

May 2013
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Preamble

In November 2011, the Australian Prudential Regulation Authority (APRA) released a discussion paper, Implementing Basel III liquidity reforms in Australia, outlining its proposals to strengthen the liquidity risk management framework for authorised deposit-taking institutions in Australia. The consultation package included a draft Prudential Standard APS 210 Liquidity (APS 210).

The proposals gave effect to the measures announced by the Basel Committee on Banking Supervision in December 2010 to strengthen liquidity buffers so as to promote a more resilient global banking system. These measures were set out in Basel III: International Framework for Liquidity Risk Measurement, Standards and Monitoring. In January 2013, the Basel Committee released a revised version of these measures, set out in Basel III: The Liquidity Coverage Ratio and Liquidity Risk Monitoring Tools. This discussion paper outlines APRA's proposed amendments to its 2011 proposals in response to the recent revisions to the Basel III liquidity framework announced by the Basel Committee. The paper also addresses the main issues raised in submissions, and in other dialogue with industry and other interested parties, on APRA's 2011 proposals that are not changed by the Basel Committee's recent revisions. Accompanying this paper is an updated draft of APS 210 and a draft Prudential Practice Guide APG 210 Liquidity (APG 210).

This paper mainly addresses the qualitative and quantitative requirements in the Basel III liquidity framework. Liquidity reporting to APRA was the subject of a separate consultation, which closed in February 2013. APRA will also be consulting separately on matters relating to access to the Committed Liquidity Facility that will be provided by the Reserve Bank of Australia.

APRA invites written submissions on its proposed response to the Basel Committee’s recent revisions, and on the updated draft APS 210 and draft APG 210. Following consideration of submissions received, APRA will issue a final APS 210 and APG 210 in mid-2013.

This paper, the revised draft APS 210 and draft APG 210 are available on APRA’s website at www.apra.gov.au. Written submissions on the paper should be forwarded by 17 June 2013 by email to Basel3liquidity@apra.gov.au and addressed to:
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SYDNEY NSW 2001

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All information in submissions will be made available to the public on the APRA website unless a respondent expressly requests that all or part of the submission is to remain in confidence. Automatically generated confidentiality statements in emails do not suffice for this purpose. Respondents who would like part of their submission to remain in confidence should provide this information marked as confidential in a separate attachment.

Submissions may be the subject of a request for access made under the Freedom of Information Act 1982 (FOIA). APRA will determine such requests, if any, in accordance with the provisions of the FOIA. Information in the submission about any APRA regulated entity that is not in the public domain and that is identified as confidential will be protected by section 56 of the Australian Prudential Regulation Authority Act 1998 and will therefore be exempt from production under the FOIA.
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### Glossary

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<thead>
<tr>
<th>Term</th>
<th>Description</th>
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<tbody>
<tr>
<td>ABS</td>
<td>Asset-backed security</td>
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<td>ADI</td>
<td>Authorised deposit-taking institution</td>
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<td>APG 210</td>
<td><em>Prudential Practice Guide APG 210 Liquidity</em></td>
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<td>APRA</td>
<td>Australian Prudential Regulation Authority</td>
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<td>APS 113</td>
<td><em>Prudential Standard APS 113 Capital Adequacy: Internal Ratings–based Approach to Credit Risk</em></td>
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<td>APS 210</td>
<td><em>Prudential Standard APS 210 Liquidity</em></td>
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<td>ASF</td>
<td>Available stable funding</td>
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<td>AUD</td>
<td>Australian dollar</td>
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<td>Basel Committee</td>
<td>Basel Committee on Banking Supervision</td>
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<tr>
<td>CLF</td>
<td>Secured committed liquidity facility provided by the RBA</td>
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<tr>
<td>D2A</td>
<td>Direct to APRA. An electronic data submission system that enables regulated and registered financial entities to lodge their statutory returns with APRA.</td>
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<tr>
<td>FCS</td>
<td>Financial Claims Scheme for authorised deposit-taking institutions</td>
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<td>HQLA</td>
<td>High quality liquid assets</td>
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<tr>
<td>HQLA1</td>
<td>Equivalent to Level 1 HQLA in Basel III liquidity framework</td>
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<tr>
<td>HQLA2</td>
<td>Equivalent to Level 2A HQLA in Basel III liquidity framework</td>
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<tr>
<td>LCR</td>
<td>Liquidity Coverage Ratio</td>
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<tr>
<td>Level 1</td>
<td>Assets determined to be eligible as level 1 liquid assets in Basel III liquidity framework</td>
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<td>Assets determined to be eligible as level 2A liquid assets in Basel III liquidity framework</td>
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<td>Level 2B</td>
<td>Assets that may be considered for inclusion as level 2B liquid assets in Basel III liquidity framework</td>
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<td>MLH</td>
<td>Minimum Liquidity Holdings</td>
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<td>MLH ADI</td>
<td>An ADI exempt from scenario analysis and subject to the MLH requirements</td>
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<td>NSFR</td>
<td>Net Stable Funding Ratio</td>
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<tr>
<td>Term</td>
<td>Description</td>
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<tr>
<td>RBA</td>
<td>Reserve Bank of Australia</td>
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<tr>
<td>RMBS</td>
<td>Residential mortgage-backed security</td>
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<tr>
<td>RSF</td>
<td>Required stable funding</td>
</tr>
<tr>
<td>Scenario analysis ADI</td>
<td>An ADI subject to the Basel III quantitative liquidity requirements</td>
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<td>SME</td>
<td>Small and medium-sized enterprise</td>
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<td>Sound Principles</td>
<td><em>Principles for Sound Liquidity Risk Management and Supervision,</em></td>
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<td>Basel Committee on Banking Supervision, September 2008.</td>
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In November 2011, APRA released a discussion paper and draft prudential standard outlining its proposals to strengthen the liquidity risk management framework for authorised deposit-taking institutions (ADIs) in Australia. The discussion paper gave effect to reforms, announced by the Basel Committee on Banking Supervision (Basel Committee) in December 2010, to strengthen liquidity buffers so as to promote a more resilient global banking system. In January 2013, the Basel Committee released amendments to one of the key elements of these reforms — the Liquidity Coverage Ratio (LCR) — in its document Basel III: The Liquidity Coverage Ratio and Liquidity Risk Monitoring Tools.

APRA is now in a position to complete its consultations on the main elements of the Basel III liquidity framework. This consultation package outlines APRA’s proposed amendments to its 2011 proposals on the implementation of the LCR in Australia. It also addresses the main issues raised in submissions, and in other dialogue with industry and other interested parties, on those of APRA’s earlier proposals that have not been affected by the Basel Committee’s recent revisions. The consultation package includes an updated draft of Prudential Standard APS 210 Liquidity (APS 210) and draft Prudential Practice Guide APG 210 Liquidity (APG 210).

Quantitative requirements: scenario analysis ADIs

The Basel III liquidity framework involves two new minimum global standards:

- a 30-day LCR to address an acute stress scenario; and
- a Net Stable Funding Ratio (NSFR) to encourage longer-term funding resilience.

APRA proposed to apply these quantitative liquidity requirements to those ADIs that are currently required to conduct scenario analysis of their liquidity needs under different operating circumstances (‘scenario analysis’ ADIs). This approach is unchanged in the updated draft APS 210.

The Basel Committee is continuing to review the NSFR, which does not come into effect until 1 January 2018. APRA has not made any amendments to its proposed implementation of the NSFR, but will ensure that concerns raised in submissions are fed into the Basel Committee’s deliberations.

The revisions to the LCR recently announced by the Basel Committee involve:

- discretion for national authorities to include a wider range of liquid assets in the definition of high-quality liquid assets (HQLA); and
- some refinements to the assumed cash inflow and outflow rates; and
- a revised timetable for phase-in of the LCR.

Definition of HQLA

National authorities have discretion to include certain additional assets in a new ‘Level 2B’ category of HQLA, subject to haircuts and provided the assets fully comply with the qualifying criteria. These assets are residential mortgage-backed securities (RMBS) with a long-term credit rating of AA or higher, corporate debt securities with a long-term credit rating between A+ and BBB–, and certain listed non-financial equities.

APRA is not proposing to exercise this discretion. Accordingly, the definition of HQLA in the updated draft APS 210 is unchanged.

1 Principles for Sound Liquidity Risk Management and Supervision, September 2008 http://www.bis.org/publ/bcbs144.htm
APRA has considered the market characteristics of Australian dollar debt securities potentially eligible as Level 2B assets against the qualifying criteria that such assets must trade in large, deep and active markets, be liquid during a time of stress and, in most cases be eligible for use in central bank operations. In APRA’s view, the relevant securities do not meet all of these criteria. Further, APRA does not consider that the inclusion of equities as Level 2B assets would contribute to the resilience of the Australian banking system. Equities are not repo-eligible with the Reserve Bank of Australia (RBA); hence, a large-scale forced sale of equity portfolios by one or more Australian banks could significantly exacerbate a stress event.

However, some of the debt securities included in the definition of Level 2A and Level 2B assets are repo-eligible with the RBA for normal market operations and are eligible collateral for the Committed Liquidity Facility (CLF). ADIs with access to the CLF are likely to hold those assets as part of a well-diversified liquid assets portfolio.

**Cash inflow and outflow rates**

APRA is proposing to adopt the revised Basel III assumed cash inflow and outflow rates, with only one minor modification related to maturing central bank funding transactions.

In its 2011 discussion paper, APRA proposed some other modifications to the Basel III assumed cash inflow and outflow rates. These related to the treatment of self-managed superannuation funds, high run-off less stable retail and qualifying small and medium enterprise (SME) deposits, contingent funding obligations, and recognition of head office liquidity support to Australian branches of foreign banks. These modifications have not been materially changed in the updated draft APS 210.

**Quantitative requirements: minimum liquidity holdings ADIs**

In its 2011 discussion paper, APRA proposed that ADIs currently subject to a simple quantitative liquidity ratio requirement, the minimum liquidity holdings (MLH) regime, would not be subject to either of the Basel III global standards. APRA proposed to leave the MLH regime broadly unchanged but to revise the definition of assets that are eligible for inclusion in an ADI’s minimum liquidity holdings.

Submissions raised concerns about the treatment of industry support schemes and the revised definition of assets eligible for inclusion in MLH portfolios. APRA has made some amendments in updated draft APS 210 in response to these submissions.

**Reporting and prudential disclosure requirements**

Reporting requirements for scenario analysis ADIs have been the subject of a separate consultation process, based on APRA’s November 2012 discussion paper, *Liquidity reporting requirements for authorised deposit-taking institutions*. Since the Basel Committee is continuing to review the NSFR, APRA has decided to remove the NSFR from the standardised reporting framework at this stage.

The Basel Committee is also continuing to develop disclosure requirements for bank liquidity and funding profiles. APRA intends to consult separately on its disclosure requirements once global disclosure standards are finalised.

**Implementation timetable**

In its 2011 discussion paper, APRA proposed to introduce the LCR requirement from 1 January 2015, in line with the then internationally agreed timetable. As noted above, the revised timetable recently announced by the Basel Committee allows for a phase-in of the LCR, with a minimum requirement of 60 per cent from the original start-date rising in equal

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annual steps of 10 percentage points to reach 100 per cent on 1 January 2019. The graduated approach is designed to ensure that the LCR can be introduced ‘...without disruption to the orderly strengthening of banking systems.’

APRA is not proposing to adopt the phase-in arrangements. These arrangements were introduced in light of the considerable stress facing banking systems in some regions. Australia, however, is not one of those regions. Moreover, most large internationally active banks are already compliant with the LCR. Finally, APRA is cognisant of concerns, raised by the International Monetary Fund in its 2012 Financial System Stability Assessment of Australia, that the continued reliance of Australian banks on offshore funding leaves them exposed to disruptions to funding markets.

Accordingly, APRA proposes to retain its original implementation timetable for the LCR. This is a conservative approach, but one that is fully consistent with the capabilities and needs of the Australian banking system. ADIs are, in any event, well placed to meet the requirement and, in doing so, will send a strong message about the soundness of the Australian banking system.

APRA invites written submissions on its proposed response to the Basel Committee’s recent revisions to the Basel III liquidity framework, as set out in the updated draft APS 210. It also invites written submissions on the draft APG 210. Following consideration of submissions received, APRA intends to issue the final APS 210 and APG 210 in mid-2013. The new prudential standard is intended to come into force on 1 January 2014; the LCR and NSFR requirements are intended to commence on 1 January 2015 and 1 January 2018, respectively.

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Chapter 1 – Introduction

1.1 Overview

In November 2011, APRA released a discussion paper, Implementing Basel III liquidity reforms in Australia, outlining its proposals to strengthen the liquidity risk management framework for ADIs in Australia. An accompanying draft APS 210 was also released for comment. The proposals gave effect to the reforms announced by the Basel Committee in December 2010, in its document Basel III: International Framework for Liquidity Risk Measurement, standards and monitoring, with the goal of promoting a more resilient global banking system.

The centrepiece of the Basel Committee’s reforms is two new minimum global liquidity standards:

- an LCR requirement that aims to ensure that banking institutions have sufficient high-quality liquid assets to survive an acute stress scenario lasting for one month; and
- a NSFR requirement that aims to promote longer-term resilience by requiring banking institutions to fund their activities with more stable sources of funding on an ongoing basis.

These two quantitative global minimum standards are intended to apply to internationally active banks. APRA has proposed that, in Australia, ADIs that are currently required to conduct scenario analysis of their liquidity needs under different operating circumstances will be subject to these quantitative requirements.

In January 2013, the Basel Committee announced a package of amendments to the formulation of the LCR in its document Basel III: The Liquidity Coverage Ratio and Liquidity Risk Monitoring Tools. The amendments involve:

- discretion for national authorities to include a wider range of liquid assets in the definition of HQLA;
- some refinements to the assumed cash inflow and outflow rates; and
- a revised timetable for phase-in of the LCR.

This discussion paper outlines APRA’s proposed changes to the implementation of the LCR in Australia in response to the Basel Committee’s recent revisions, and to other issues raised in submissions on APRA’s 2011 proposals that remain relevant. Accompanying the paper is an updated draft APS 210 and a draft APG 210.

APRA anticipates that, following consideration of submissions received on this consultation package, it will issue final versions of APS 210 and APG 210 in mid-2013. The intention is that APS 210 would come into effect from 1 January 2014. At that point, the qualitative requirements for all ADIs and the quantitative requirements for MLH ADIs would apply. For scenario analysis ADIs, the LCR would apply from 1 January 2015 and the NSFR from 1 January 2018.

1.2 Structure of this paper

Chapter 2 summaries the qualitative requirements for liquidity risk management that APRA will adopt in line with the Basel Committee’s Sound Principles.

The following two chapters set out APRA’s proposed implementation of the LCR. Chapter 3 deals with the definition and identification of HQLA in Australia. Chapter 4 deals with cash inflows and outflows.

Chapter 5 deals with submissions on the NSFR. This global standard is still under review by the Basel Committee.

Chapter 6 addresses industry submissions on the MLH regime, which APRA proposes to retain for ADIs with simple, retail-based business models.

Chapters 7 deals with prudential disclosure issues that flow from the Basel Committee’s recent revisions and Chapter 8 covers the implementation timetable.

APRA encourages ADIs to submit cost-benefit analysis as set out in Chapter 9.
Chapter 2 – Qualitative requirements

In its 2011 discussion paper, APRA proposed that the qualitative requirements of the existing APS 210 in respect of an ADI’s liquidity risk management and oversight be expanded to incorporate the Basel Committee’s *Sound Principles* and some APRA-specific requirements.

The expanded prudential requirements included:

- that liquidity risk management is ultimately a Board responsibility. APRA proposed that APS 210 be strengthened to require the operational independence of a liquidity risk management oversight function and a formal role for internal audit or an equivalent independent function in relation to liquidity risk management;
- that the Board articulate its tolerance for liquidity risk. APRA proposed that the risk tolerance statement be explicit, comprehensive, meaningful (in terms of outcomes), designed with the particular vulnerabilities of the ADI in mind and subject to sensitivity analysis;
- that ADIs must have a process that explicitly quantifies liquidity costs and benefits and allocates those costs and benefits to the appropriate business and product;
- that ADIs have a formal, documented funding strategy (approved by the Board); and
- that an ADI with retail deposits must have in place a retail run plan that would focus on ensuring that those customers who seek to withdraw funds are able to do so, in accordance with their contractual rights, as soon as feasible.

Overall, reaction to APRA’s qualitative proposals has been supportive, reflecting the ‘good practice’ nature of the requirements. Two significant matters raised are addressed below.

### The cost and benefits allocation process for funding and liquidity

**Comments received**

Submissions requested that APRA acknowledge within APS 210 that it is suitable for foreign subsidiary banks or branches of foreign banks to implement their head office internal liquidity transfer pricing framework since, in many circumstances, the local operation would have no discretion on its implementation. These submissions raised concerns that APRA’s requirements might oblige branch operations to establish transfer pricing frameworks that were inconsistent with global operations.

**APRA’s response**

APRA understands that, depending on the size and complexity of the operations of foreign subsidiary banks or branches of foreign banks, the internal liquidity transfer pricing policy adopted may be a global policy that is applied locally. However, in this circumstance, members of the local asset and liability committee must satisfy themselves that the policy is appropriate for use in Australia and that it is consistent with the cost and benefits allocation process requirements outlined in APS 210 paragraph 36.

### Additional stress testing

In draft APS 210, APRA proposed that scenario analysis ADIs must conduct stress tests on a regular basis for a variety of short-term and protracted institution-specific and market-wide stress scenarios (individually and in combination).

**Comments received**

Submissions raised questions about the cashflow assumptions to be used in the additional stress tests.

**APRA’s response**

APRA will not be imposing any constraints on the assumptions for cash inflows, outflows, etc given that the purpose of these additional stress tests is to ensure that the ADI’s liquidity management strategy, policies and positions are appropriate in view of the particular vulnerabilities of the ADI.
Chapter 3 – LCR – high-quality liquid assets

The determination of the LCR has two components:

- the value of the stock of HQLA in stressed conditions; and
- total net cash outflows, calculated according to specified scenario analysis.

This chapter deals with the first of these components.

3.1 Original Basel Committee measures

Under the Basel III liquidity framework, assets qualifying as HQLA for LCR purposes must be unencumbered, easily and immediately converted into cash with little or no loss of value under stressed market conditions and, ideally, be eligible for repurchase agreements with the central bank. In the Basel Committee’s original measures, HQLA were categorised into two buckets based on the liquidity characteristics of the assets.

The highest quality liquid assets, which APRA will refer to as HQLA1, can comprise an unlimited portion of the total stock of HQLA. These assets are limited to:

- cash;
- central bank reserves (to the extent that these reserves can be drawn down in times of stress); and
- marketable securities representing claims on or claims guaranteed by sovereigns, quasi-sovereigns, central banks and multilateral development banks, that have undoubted liquidity, even during stressed market conditions, and that are assigned a zero risk-weight under the Basel II standardised approach to credit risk.

HQLA2 are assets with a proven record as a reliable source of liquidity even during stressed market conditions, and comprise:

- marketable securities representing claims on or by sovereigns, quasi-sovereigns, central banks and multilateral development banks, which are assigned a 20 per cent risk-weight under the Basel II standardised approach;
- corporate bonds (not issued by a financial institution or any of its affiliated entities) with a credit rating from a recognised external credit assessment institution of at least AA-; and
- covered bonds (not issued by the ADI itself or any of its affiliated entities) with a credit rating of at least AA-.

HQLA2 are limited to 40 per cent of the total stock of HQLA and attract a minimum 15 per cent haircut.

Following a review of a range of marketable instruments denominated in Australian dollars (AUD) against the Basel III criteria for HQLA, APRA advised that:

- the only assets that qualify for HQLA1 are cash, balances held with the RBA, and Commonwealth Government and semi-government securities; and
- there are no assets that qualify as HQLA2.

APRA also advised that it will keep this position under review, taking into account relevant market developments.

3.2 Recent Basel Committee revisions

Recent revisions to the LCR announced by the Basel Committee introduced a third bucket (Level 2B assets) for categorising HQLA, which national authorities have discretion to include in LCR calculations if the assets fully comply with the qualifying criteria. Level 2B assets are limited to:

- RMBS rated AA or higher not issued by the bank itself or any of its affiliated entities;
- corporate debt securities rated between A+ and BBB- not issued by a financial institution or any of its affiliated entities; and
- ordinary shares not issued by a financial institution or any of its affiliated entities.

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8 Basel III refers to Level 1 and Level 2 HQLA. However, APRA will use the terms “HQLA1” and “HQLA2” to avoid any confusion with the terms “Level 1” and “Level 2”, which have a defined meaning in APRA’s capital adequacy requirements.


Level 2B assets are subject to higher haircuts than HQLA2, and to a limit of 15 per cent of total HQLA. The qualifying criteria include that the assets must trade in large, deep and active repo or cash markets characterised by a low level of concentration, and must have a proven record as a reliable source of liquidity even during stressed market conditions.

Consistent with its review of the eligibility of marketable instruments for HQLA2, APRA has considered the range of possible Australian dollar Level 2B debt securities against the qualifying criteria. This has taken into account the amount of these instruments on issue, the degree to which the instruments are broadly or narrowly held, and the degree to which the instruments are traded in large, deep and active markets. APRA has given particular attention to the liquidity of these instruments during the market disruptions of 2007–2009 in the more acute phases of the global financial crisis.

Based on this review, APRA has concluded that there are no eligible Level 2B debt securities in Australia.

APRA notes, however, that some types of debt securities included in the definition of Level 2A and Level 2B assets are repo-eligible with the RBA for normal market operations and are eligible collateral for the CLF from the RBA. These include certain sovereign, supranational and foreign agency Australian dollar-denominated bonds, RMBS rated AAA or higher, and some corporate debt securities. ADIs with access to the CLF are likely to hold these assets as part of a well-diversified liquid assets portfolio.

APRA has also reviewed the eligibility of unencumbered non-financial equities for inclusion in Level 2B assets. Although the market for many listed equities in Australia is liquid, APRA does not consider that the inclusion of equities as Level 2B assets would contribute to the resilience of the Australian banking system. Equities are not repo-eligible with the RBA and any large-scale forced sale of equity portfolios by one or more Australian banks could significantly exacerbate a stress event.

Accordingly, APRA is not proposing to exercise the discretion available to it to introduce the third bucket of HQLA and it has not included Level 2B assets in the definition of HQLA in the updated draft APS 210. However, as with HQLA2 assets, APRA will keep this position under review, taking into account relevant market developments.

**HQLA for a consolidated banking group**

APRA acknowledges that other national authorities may exercise their discretion to include Level 2B assets for LCR purposes in their jurisdictions. In such cases, APRA may allow an ADI with material banking subsidiaries in such jurisdictions to hold some amount of Level 2B assets to meet the LCR requirements imposed by the host supervisor. No change to draft APS 210 is required.

However, until it is able to gain confidence in the liquidity of foreign currency Level 2B assets in stressed circumstances, APRA does not believe that such assets should be recognised in LCR calculations for the consolidated (Level 2) banking group. At the group level, ADIs will be required to hold sufficient liquid assets that satisfy the HQLA1, HQLA2 and, where relevant, Alternative Liquid Assets criteria to ensure that the minimum LCR level of 100 per cent is met. This approach is set out in Attachment A of updated draft APS 210.

**Use of HQLA in a time of stress**

In its recent revisions to the LCR, the Basel Committee re-affirmed that the stock of HQLA is available for use during a period of financial stress.

APRA endorses this approach, which is reflected in updated draft APS 210. APRA acknowledges that, in a time of stress, an ADI may need to liquidate part of its stock of HQLA and/or draw on its CLF with the RBA, using the cash generated to cover cash outflows and, thereby, falling below the 100 per cent LCR requirement. The updated draft APS 210 requires that an ADI must inform APRA immediately in the event that it becomes aware of the circumstances that will result in a breach of its LCR requirement.

APRA’s supervisory response to a breach of an ADI’s LCR requirement will be appropriate to the circumstances.
Operational requirements for the management of HQLA

The Basel Committee’s original LCR measures, which APRA proposed to adopt, imposed operational requirements for the management of HQLA. These included that the stock must be under control of the specific function or functions charged with managing the liquidity risk of the bank.

In its recent revisions, the Basel Committee has refined and clarified its operational requirements. The amended wording is that the stock of HQLA must be under the control of the function charged with managing the liquidity of the bank, meaning the function has the continuous authority, and legal and operational capability, to monetise any asset in the stock.

APRA proposes to adopt the amended wording. This is expected to result in some assets that were previously excluded now becoming eligible for inclusion in the stock of HQLA.

3.3 Other matters raised in submissions

Alternative liquid asset treatment — The CLF review process

In recognition of jurisdictions with an insufficient supply of HQLA, the Basel III liquidity framework incorporates scope for alternative treatments for the holding of HQLA. One alternative treatment is to allow banking institutions to establish contractual committed liquidity facilities provided by their central bank, subject to an appropriate fee, with such facilities counting towards the LCR requirement.

As the current supply of HQLA in Australia is not adequate to satisfy ADIs’ LCR requirements, APRA and the RBA announced in December 2010 that an ADI will be able to establish a secured CLF with the RBA for the purposes of meeting its LCR requirement in Australian dollars. The CLF will be sufficient in size to cover any shortfall between the ADI’s holdings of HQLA and its LCR needs (both in Australian dollars).

APRA has previously stated that ADIs will be required to demonstrate that they have taken all reasonable steps towards meeting their LCR requirements through their own balance sheet management, before relying on the CLF. APRA will be reviewing each ADI’s liquidity risk management framework and funding practices as the basis for approving the size of the CLF for LCR purposes.

Comments received

Submissions sought further information on APRA’s method of approving access to the CLF. Submissions also raised concern that overly conservative funding obligations would limit the industry’s ability to provide maturity transformation, shifting liquidity risk into unregulated parts of the financial services sector.

Submissions also requested further guidance on the practical definition of a ‘minor LCR shortfall’ for CLF and self-securitisation purposes. APRA had previously proposed that where an ADI expected to have only a minor LCR shortfall without a CLF, the ADI would need to manage its liquidity requirements on its own resources, rather than relying on a CLF. Some submissions raised the concern that this approach may create competitive disadvantages for some scenario analysis ADIs in regard to CLF access. Other submissions argued that the use of self-securitised assets as collateral for the CLF may create competitive disadvantages for MLH ADIs, since such assets are not counted as part of their minimum liquidity holdings.

APRA’s response

APRA does not propose to elaborate on the process for providing access to, or the appropriate composition of eligible assets for, the CLF in APS 210. These issues will be dealt with under APRA’s supervision framework. APRA has commenced its engagement with ADIs on the process for setting CLF size and composition within the LCR and will expand this engagement over coming months. APRA will also consider the need to publish further guidance on access to the CLF in due course.

The second component in the determination of the LCR requires ADIs to calculate their total net cash outflows over the next 30 calendar days under a stress scenario. The original Basel III liquidity framework provided many of the cashflow assumptions to be used for this purpose and APRA proposed to adopt these assumptions, except for minor modifications or clarifications.

The Basel III cashflow assumptions are based on the behaviour, during a stressed period, of the counterparties providing funding to the ADI and of those to which the ADI provides facilities (either credit, liquidity or contingency).

In its recent revisions, the Basel Committee has made a number of amendments to the calculation of net cash outflows. These include additional cash outflow categories, revisions to the cash outflow rates and some revised definitions.

This chapter discusses APRA’s proposed response to these amendments. It also provides APRA’s response to submissions on its 2011 proposals on net cash outflows that are unchanged by the Basel Committee’s recent revisions.

4.1 Recent Basel Committee revisions

This section addresses the main Basel Committee revisions to the cash outflow assumptions. A number of minor revisions, which are not discussed here, have been incorporated into the updated draft APS 210.

Fully guaranteed retail deposits

The revised Basel III liquidity framework includes an additional retail deposit category for deposits that are fully insured under a pre-funded deposit insurance scheme. The deposit insurance scheme in Australia, the Financial Claims Scheme (FCS), is not pre-funded and, as such, this category is not relevant for domestic deposits.

Non-financial corporate, sovereigns, central banks and public sector entity (PSE) deposits

The revised framework has reduced the assumed cash outflow rate for non-operational non-financial corporate, sovereign, central bank and PSE deposits from 75 per cent to 40 per cent. APRA proposes to adopt this amendment.

Liquidity facilities for non-financial corporates

The revised framework has reduced the cash outflow rate for liquidity facilities provided to non-financial corporate customers from 100 per cent to 30 per cent. APRA proposes to adopt this amendment.

Collateral outflows attributable to market moves

The original Basel III liquidity framework gave national authorities discretion in setting the methodology for the calculation of collateral outflows related to market movements of derivative positions. The revised framework has removed this discretion and provides a standardised method for this calculation.

APRA proposes to incorporate the standardised method into APS 210. This method requires ADIs to take the largest absolute net 30-day collateral flow realised in the past 24 months and model this balance as an outflow.

The revised Basel III rules text also states that ‘supervisors may adjust the treatment flexibly according to circumstances’. APRA acknowledges industry arguments, discussed later in this chapter, that a liquidity stress event is much more likely to be associated with a falling Australian dollar than a rising one. Accordingly, APRA invites feedback from industry as to an alternative outflow treatment that would acknowledge this probable direction but would be consistent with the Basel Committee’s intent.
Committed but unfunded inter-financial liquidity and credit facilities

The revised framework has reduced the cash outflow rate for committed but unfunded liquidity and credit facilities provided to banking institutions that are prudentially supervised from 100 per cent to 40 per cent. APRA proposes to adopt this amendment.

Additional derivatives risks

The revised framework includes a number of additional collateral outflow categories designed to ensure that risks associated with derivative positions are correctly captured in the LCR. The cash outflow rate for these categories is 100 per cent of the measured value. APRA proposes to adopt these amendments.

Derivatives secured by HQLA

The revised framework has clarified that where a derivative cash flow is secured with HQLA1, a cash outflow rate of zero per cent is to be applied. APRA proposes to adopt this amendment.

Maturing secured funding transactions

The revised framework has reduced the outflow rate on maturing secured funding transactions with a central bank from 25 per cent to zero per cent.

In the event that a secured funding transaction backed by CLF eligible collateral matures during a stress event, an ADI with a CLF will be able to re-execute the secured funding transaction because of the RBA’s commitment under the CLF. This will result in an outflow against this transaction of zero per cent. However, if the same transaction matured for an ADI that did not have a CLF, that ADI would have no guaranteed ability to roll the transaction, resulting in a possible outflow rate of 100 per cent.

APRA proposes to include an additional category for maturing secured funding transactions backed by CLF eligible debt securities (where the ADI has capacity available under its CLF limit) with an outflow rate of zero per cent. Following consultations with the RBA, APRA proposes that all other maturing secured funding transactions with the RBA that are not backed by HQLA will receive an outflow rate of 100 per cent.

Fully insured unsecured wholesale funding

The revised framework includes an additional outflow category for fully insured non-operational, non-financial, unsecured wholesale deposits. APRA proposes to adopt the outflow rate of 20 per cent.

4.2 Other matters raised in submissions

4.2.1 Cash outflows

Retail and qualifying small and medium enterprises (SME) deposit run-off

Within the LCR, retail deposit balances are classified as either ‘stable’ or ‘less stable’. Stable deposit balances are those that are considered to have the lowest propensity to be withdrawn during times of stress and, hence, receive a low three or five per cent cash outflow rate. Less stable deposits are considered to have a higher propensity to be withdrawn and as a result, depending on deposit characteristics, receive a 10 per cent or higher cash outflow rate. APRA proposed to adopt the Basel III treatment of stable deposits and, consistent with the Basel III approach, to introduce two higher run-off categories for less stable deposits, with run-off rates of 10 per cent and 30 per cent, respectively. APRA proposed a simple scorecard approach to determine which of these two run-off rates applied.

SME deposits that satisfy certain criteria regarding balance and behaviour, as outlined in draft APS 210, are considered retail for LCR purposes.

Comments received

Clarification was requested on the treatment of deposits with a total balance above the guarantee limit of the FCS, which is AUD 250,000 for account-holder per ADI. Submissions sought to understand whether the amount below the limit would receive a stable outflow rate and the amount above the limit receive a less stable outflow rate.

Submissions suggested including client relationship characteristics, such as the term of a relationship, the number of products and the use of a relationship manager, to assist categorisation of the deposit. They also proposed that dormant accounts be classified as
stable due to their expected inactivity in a stress event and that self-managed super fund (SMSF) deposits be eligible to be classified as stable deposits as the trustee overseeing the SMSF deposit account is not necessarily a financially sophisticated individual.

Some submissions argued that the categories for stable and less stable deposits were too broad and proposed that APRA provide more precise definitions of the various criteria that define these categories. It was suggested that the outflow rate of 30 per cent for higher run-off less stable deposits was too high as it did not reflect industry experience or assessments of expected run-off under stress. Alternatives proposed were that the outflow rate be lowered or that an additional lower cash outflow category between 10 per cent and 30 per cent be introduced.

A number of submissions objected to the inclusion of internet access as a criterion in the less stable deposit scorecard. These submissions argued that means of access was not a strong indicator of withdrawal propensity and it should be removed from the scorecard; instead, greater emphasis should be placed on deposit size as this was more consistent with ADI experience.

Some submissions considered that the FCS limit should be the sole determinant of a higher outflow rate as deposits below the limit would be expected to be withdrawn at a much lower rate given that they are guaranteed. Other submissions opposed the implication in the scorecard that a deposit could get a 30 per cent outflow rate even when covered by the FCS if it met the other scorecard criteria.

Concern was also expressed that all New Zealand transactional accounts where established customer relationships cannot be evidenced would need to be classified as higher run-off less stable deposits under APRA’s proposed approach as the New Zealand government guarantee is no longer available.

A number of submissions argued for amendments to the treatment of funds received via an intermediary as that treatment would result in differential outflow rates being applied by ADIs to an equivalent customer depending on the source of the deposit. This issue was raised, in particular, in relation to deposits received from SMSF customers rather than via APRA-regulated superannuation funds.

Another issue raised was that SME customers with no deposits could not be classified under APRA’s proposed approach as the definition of SME in draft APS 210 is linked to deposit size. This is an issue for SME customers who do not have deposit products with an ADI but have other dealings with the ADI that would be captured by the LCR.

Another issue raised concerned the possible offering of the maturing 31-day notice period term deposit which has recently been the subject of an Australian Securities and Investments Commission consultation, and whether the ability of a depositor to withdraw a deposit in the proposed term deposit grace period would result in the entire portfolio being considered in breach of the requirements for retail fixed-term deposits in Attachment A to draft APS 210, and needing to be modelled as at-call deposits.

**APRA’s response**

APRA agrees that the FCS limit may be a determinant of customer behaviour. Consistent with this, for any deposit meeting the criteria of paragraph 36 in Attachment A of updated draft APS 210, that portion of the deposit covered by the FCS can be treated as stable and any balance above the limit is to be treated as less stable.

For stable deposits, APRA considers that paragraph 36 of Attachment A adequately describes the characteristics of stable deposits and does not need amending. For defining the difference between less stable and higher run-off less stable deposits, APRA agrees that client relationship characteristics may play a part but it does not propose to include these in the scorecard as they are already used in the definition of stable deposits and their inclusion in the scorecard would introduce ambiguities between less stable and stable deposits. For dormant accounts, APRA considers that a depositor’s response to a liquidity stress situation is uncertain at best and that dormant accounts are not necessarily a good indicator of a stable deposit. Hence, dormant deposits are to be treated equivalently to other deposits.

As explained in its November 2011 discussion paper, APRA considers SMSF depositors to be self-selected, financially sophisticated individuals, which is an indicator of a greater propensity to withdraw funds in a stress situation. As such, SMSF deposits are appropriately categorised as less stable.
APRA has considered its proposed scorecard criteria for less stable deposits against the arguments made in submissions but has not identified compelling reasons to change these criteria. However, APRA will amend the wording of the scorecard category ‘Deposit is primarily internet accessed’ to ‘Deposit is an online account’ in order to better reflect its objective. Deposits that would be expected to fall into this category are those where the internet is integral to the design, marketing and usage of the product. It is not intended to capture deposits where the internet is simply one of several means of accessing and transacting on the account. Further guidance on these deposit classifications can be found in the draft APG 210.

In the case of deposits in jurisdictions (such as New Zealand) that do not have government deposit guarantees, the absence of a deposit guarantee effectively removes a size criterion from the scorecard and lowers the hurdle for higher run-off deposits. APRA considers that having a size criterion in the scorecard is appropriate. Hence, the first category of the scorecard will be altered to read ‘Deposit balance is greater than any government deposit guarantee limit where it exists and, in its absence, where the deposit balance is greater than the equivalent of AUD 250,000’. This will also address the concerns regarding New Zealand deposits mentioned above.

In addition, APRA has reduced the outflow rate for higher run-off less stable deposits from 30 per cent to 25 per cent. This provides a more appropriate calibration with other category outflow rates, such as operational deposits.

For deposits sourced via an intermediary, where the intermediary retains investment responsibility or has a fiduciary duty to the underlying customer, APRA considers it is appropriate to assume the intermediary will observe the responsibility and duty in a time of liquidity stress. This fiduciary duty is not removed when customers have an investment discretion when initiating an intermediated deposit. Accordingly, these deposits are most appropriately classified as being sourced from a financial institution, regardless of the nature of the customer placing funds with the intermediary. This interpretation will not affect SMSF deposits; SMSF deposits are considered to be those of a natural person and not sourced via an intermediary.

Where an SME client has no deposits with an ADI, APRA proposes for contingent obligation purposes to use the definition of an SME in Prudential Standard APS 113 Capital Adequacy: Internal Ratings–based Approach to Credit Risk (APS 113). Paragraph 47 of APS 113 states that ‘To be regarded as a retail exposure, the total business-related exposure of the Level 2 group to a small-business obligor or group of connected small-business obligors must be less than $1 million.’

For 31-day notice period term deposits that are in a grace period, an ADI will be expected to model the term deposit on an equivalent basis to a demand deposit, consistent with the requirements of paragraphs 40 and 41 in Attachment A of updated draft APS 210. In addition, a 100 per cent outflow rate is to apply to any 31-day notice period deposit that has been called.

**Unsecured wholesale funding run-off**

In the LCR, unsecured wholesale funding is funding provided by non-financial corporate, sovereigns, central banks and PSEs on an unsecured basis. The cash outflow rates against these categories of deposits are set out in the Basel III liquidity framework and APRA proposes to implement them without amendment.

**Comments received**

Some submissions raised the concern that industry experience of unsecured wholesale run-off rates in a stress scenario in Australia is lacking and available international data suggest a lower run-off experience than the LCR assumptions. These submissions argued that cash outflow rates should be identified through empirical calibration. The issue was also raised that small changes in the size of an account or interpretation of account type will have a material impact on the outflow assumption to be applied in the LCR, particularly given the difference in the cash outflow assumptions for operational deposits and other types of deposit from corporations. It was suggested that where accounts are managed through the active participation of a relationship manager, this should significantly reduce the propensity for deposit withdrawal in a stress event.
Clarity was also requested on the definition of operational deposits, particularly on the possible inclusion of defining criteria such as transaction volume, interest rate level and customer relationship. Submissions also argued that correspondent banking (Vostro) accounts are operational deposits and should be included in this category.

**APRA’s response**

The Basel III cash outflow rates are intended to provide a globally consistent representation of an idiosyncratic and/or systemic liquidity stress event. The cash outflow rates represent a plausible estimate of behaviours across a range of categories that are intentionally specified at a conservative level. The Basel III liquidity framework provides simplicity and ensures a globally consistent application.

APRA acknowledges the significant difference in outflow rates for an individual deposit depending on its classification. However, in APRA’s view, the outflow categories and outflow rates will achieve an appropriate outcome from a total portfolio perspective. Recent Basel Committee revisions to the cash outflow rates of unsecured wholesale funding, which APRA proposes to adopt, were discussed earlier in this chapter.

The Basel Committee has determined that Vostro accounts do not have operational deposit status and APRA agrees. The criterion for an operational deposit is that the depositor has a substantive dependency on the continued operation of the account that acts as a practical impediment to closing or moving the account. That is, the account is so integral to the business operations of the depositor that it is unlikely the depositor would be able to transfer this activity to another ADI within 30 days. This is not consistently the case with correspondent banking accounts and, for this reason, they are not included.

**Unsecured financial institution funding run-off**

Unsecured financial institution funding in the Basel III liquidity framework is divided into three categories: operational deposits that receive either a five or 25 per cent cash outflow rate and other deposits that receive a 100 per cent cash outflow rate.

**Comments received**

A number of submissions sought clarity on the definition of a financial institution, expressing concern that the definition in draft APS 210 was too broad. Submissions also argued that lower cash outflow rates could be included for certain types of financial institutions such as health insurers or government sector financial institutions, as these entities are perceived to be less sophisticated than others such as banks. Submissions noted the omission of a Basel III run-off rate for financial institution operational deposits in the cash outflow table in Attachment A of draft APS 210.

Submissions also argued that financial institution intercompany demand deposits would not be withdrawn in a crisis and should receive a cash outflow rate of less than 100 per cent.

**APRA’s response**

APRA has recently released *Prudential Standard APS 001 Definitions*, which includes a definition of financial institutions. Most entities noted as being financial institutions in the previous draft APS 210 are covered in that definition. APRA will use that definition in APS 210 but, for the sake of clarity, will make specific reference to money market corporations, finance companies, superannuation /pension funds, public unit trusts / mutual funds, cash management trusts and friendly societies.

Amendments have been made to ‘Table 3 – Cash outflow categories’ in Attachment A of the updated draft APS 210 to clearly identify operational and non-operational deposits of financial institutions and their cash outflow rates. APRA does not propose to include additional financial institution run-off categories; all financial institution non-operational deposits receive a 100 per cent cash outflow rate if their residual maturity or notice period is within 30 days.

**Other liabilities**

The Basel III framework identifies specific cash outflow assumptions for other liabilities, committed credit and liquidity facilities provided to the ADI’s customers, and items where increased liquidity needs are likely to be required under the LCR scenario. APRA proposed to adopt these assumptions.
Comments received

Some submissions suggested that the definition of a liquidity facility was too broad and could be interpreted to include revolving credit facilities, which was inconsistent with the Basel III liquidity framework. Concerns were raised that the cash outflow rate for a financial institution committed and uncommitted liquidity facility was too high in itself and high in comparison to the equivalent cash outflow rates for other counterparty types. These submissions argued that the cash outflow rates did not reflect the expected behaviour of these types of facilities during a period of stress.

APRA’s response

The recent Basel Committee revisions include a minor clarification to the definition of a committed liquidity facility to ensure that facilities provided to hedge funds, money market funds and special purpose funding vehicles are captured in their entirety as liquidity facilities. APRA proposes to incorporate the full definition of a liquidity facility into APS 210. This inclusion will also provide clarity on items that should be modelled as liquidity facilities and those that should be modelled as credit facilities.

Financial institutions generally have more exposure to liquidity risk than non-financial corporations. A facility provided to a financial institution would represent a ‘wrong-way’ risk during a systemic crisis and would be subject to a greater propensity for drawdown. This justifies a higher cash outflow rate for such a facility.

4.2.1.1 Other contingent funding obligations

The Basel III framework leaves to national discretion the run-off assumptions to be applied to contingent funding obligations that are not committed credit and liquidity facilities. In its 2011 discussion paper, APRA proposed to require ADIs to include the following contingent obligations as a cash outflow:

- Revocable credit and liquidity facilities;
- Guarantees, letters of credit and other trade finance instruments;
- Debt buybacks – domestic Australian debt securities;
- Structured products, managed funds and other non-contractual obligations; and
- Issuers with an affiliated dealer or market maker.

APRA received a number of submissions on contingent funding obligations which are addressed in this section.

Buyback of debt securities

Comments received

Submissions on the buyback of securities argued for relief from the application of a cash outflow rate where there is a policy enforced by the ADI to either not honour debt buyback requests in times of stress, place limits on the quantum of debt buybacks, or require that Group Treasury sign-off on buybacks over a certain threshold. These submissions argued that these criteria should be sufficient to evidence a behaviour of not honouring buybacks in all circumstances.

APRA’s response

APRA expects that in a time of stress, even with a policy to limit debt buybacks in place, some buyback requests may still be honoured due to reputational considerations or because it may take a period of time for the full extent of the liquidity stress to be realised and restrictions on debt buybacks activated. APRA will maintain its buyback assumptions of 10 per cent of short-term debt securities and 5 per cent of long-term debt securities issued in the domestic Australian market. An ADI can apply to APRA for an agreed lower debt buyback rate where the ADI can demonstrate that:

(a) it has adopted tangible measures in policy and practice (e.g. through the implementation of hard limits on buybacks) to reduce the incidence of buybacks; and

(b) these measures are operating effectively on an ongoing basis.
Unconditionally revocable uncommitted facilities

Comments received

Concerns were raised that the cash outflow assumptions for unconditionally revocable uncommitted facilities were too high for all categories of borrowers and that the difference between retail/non-financial wholesale customers and financial institutions was larger than expected behaviour in a stress event would suggest. Some submissions argued that where there are contractual terms that constrain drawdown, a lower outflow rate should be applied; where the terms exclude drawdown in 30 days, these facilities should receive a zero per cent cash outflow rate. Submissions also argued that applying the same outflow rate for uncommitted and committed facilities is unreasonable as ADIs have the ability not to honour the drawdown request on unconditionally revocable uncommitted facilities. In a liquidity stress situation, it was argued, such facilities would be cancelled by the provider; hence no cash outflow assumption should be applied.

APRA’s response

APRA remains of the view that reputational considerations, business budget targets and the possibility of a delayed response to an emerging liquidity stress may mean that ADI lending staff and treasurers will not necessarily respond to a liquidity stress event by cancelling or withdrawing these facilities. Nevertheless, from a liquidity cost-benefit perspective, APRA accepts that some uncommitted facilities could require a smaller liquidity reserve than committed facilities. APRA will therefore amend the cash outflow rate for unconditionally revocable uncommitted facilities to five per cent for all categories.

Trade finance

APRA proposed that ADIs include a cash outflow in the LCR for trade finance facilities based on actual monthly experience over 12 months of data, to be updated on at least an annual basis.

Comments received

Submissions expressed concern that holding liquid assets against uncommitted trade facilities for typical Asian businesses, based on outflows modelled on the past 12 months of going concern behaviour, would be excessive and unnecessary. It was argued that in a liquidity stress event, these facilities would be withdrawn or suspended; hence, a zero per cent outflow should be applied.

APRA’s response

The recent Basel Committee revisions include guidance that the cash outflow rates modelled against trade finance facilities should be between zero and five per cent. APRA expects that its proposed methodology for the modelling of cash outflows against these facilities will result in a cash outflow rate consistent with the Basel Committee’s guidance. As such, no amendment to the methodology is proposed.

Guarantees not related to trade finance

APRA proposed that cash outflows for guarantees not related to trade finance be modelled in the LCR using the average of actual monthly outflows over a recent 12-month period.

Comments received

Submissions expressed concern that APRA’s proposed methodology did not recognise that the cash outflow can be contingent upon a non-ADI related credit default event, rather than a liquidity stress event for the ADI.

APRA’s response

APRA considers that this argument is reasonable. It will amend APS 210 to reflect that where outflows under such guarantees are wholly contingent on events independent of the ADI (i.e. a default by a third party), the outflow rate is to be modelled as 50 per cent of the average of actual monthly outflows in a recent 12-month period.
Structured products, managed funds (that are marketed with the objective of maintaining a stable value) and other non-contractual obligations

APRA proposed that these non-contractual obligations be modelled in the LCR with a minimum five per cent cash outflow rate.

Comments received
Submissions requested clarification on the particular obligations this category is seeking to capture.

APRA’s response
This category is intended to capture ADI-sponsored investment vehicles or structured products that may require liquidity support. The global financial crisis has provided many examples of specialised investment vehicles, previously considered to be remote from the sponsoring bank, that required support. Managed funds needing to maintain a stable value can also fall into this category. In addition, some structured investment products may require additional liquidity in times of stress as customers seek to liquidate their investments due to the impact of market volatility on the value of these investments. APRA acknowledges that these investment vehicles and structured products are not widespread in Australia and this category may not be relevant for many ADIs.

Market valuation changes on derivative transactions

This outflow category seeks to capture the potential for substantial collateral outflows relating to changes in the market value of derivative positions during a liquidity stress. APRA had proposed that ADIs must model a cash outflow against these positions. As noted earlier in this chapter, the recent Basel Committee revisions have removed national discretion for this category and have set out a standardised approach for liquidity risk for market value changes in derivatives positions. ADIs are also required to consider the additional collateral that would need to be posted in the event of a 3-notch credit rating downgrade.

Comments received
Submissions argued that in a systemic liquidity stress event in Australia, the Australian dollar would be more likely to depreciate than to appreciate. This would result in cash inflows for ADIs that source offshore funding denominated in major currencies and that have currency swaps with ‘Credit Support Annex’ agreements against them. Therefore, a conservative liquidity approach would model no cash outflows for such an event. Submissions also suggested that the stress events modelled in the LCR should be consistent with a liquidity stress, not the market risk stress scenarios outlined in Reporting Standard ARS 116.0 Market Risk, which APRA had proposed.

APRA’s response
APRA agrees that an Australian dollar depreciation is a plausible assumption for a systemic liquidity stress event specific to the Australian banking system. As noted above, APRA proposes to adopt the Basel Committee’s standardised approach to the calculation of outflows against market valuation changes. However, APRA invites feedback from industry as to an alternative outflow treatment that would acknowledge the probable direction of the Australian dollar during a stress event but would be consistent with the Basel Committee’s intent. APRA also advises that, as the LCR stress scenario covers both systemic and idiosyncratic events, the 3-notch downgrade is to be considered as an idiosyncratic event and modelled as such.

4.2.2 The LCR and currency mismatches

In its 2011 discussion paper, APRA proposed that ADIs be able to meet their liquidity needs in each material currency and maintain HQLA consistent with the distribution of their liquidity needs by currency. APRA also proposed that ADIs must specifically address currency mismatches in their Board-approved statement of liquidity risk tolerance.

Comments received
Submissions requested that APRA clarify its requirements with respect to currency mismatches. In addition, submissions suggested that the CLF should be allowed to cover some portion of foreign currency cash outflows and liquidity needs in the consolidated
(Level 2) banking group as locally incorporated ADIs operating in foreign jurisdictions may have limited ability to sell liquid assets in those jurisdictions in a time of stress. This could be the case as a result of limited ability to participate in the market operations of the relevant central bank.

APRA's response

APRA confirms that the LCR is to be met by an ADI on both a Level 1 and consolidated (Level 2) banking group basis. For branches of foreign banks, the LCR must be met on a domestic books basis. This minimum requirement is to incorporate exposures in all currencies. APRA also confirms that ADIs must be able to meet their liquidity needs in each material currency and maintain HQLA consistent with the distribution of their liquidity needs by currency. APRA does not see it as appropriate for the CLF to cover non-Australian dollar outflows; other supervisors will define HQLA specific to their jurisdiction and domestic currency that ADIs will be able to hold to meet net cash outflows in that currency.

4.2.3 Home/host liquidity requirements for the LCR

APRA's 2011 discussion paper proposed that, in arriving at their consolidated (Level 2) banking group LCR, ADIs apply the host jurisdiction cashflow treatments for retail and SME deposits in those jurisdictions as this reflects the behaviour of local depositors. This was specified in the Basel III liquidity framework. In addition, where the host regulator elects to use one of the alternative liquid assets treatments allowed by Basel III, APRA stated that it is likely to recognise this for the purposes of calculating the local currency LCR. Where an ADI has a material banking subsidiary in a jurisdiction that does not implement the Basel III framework, APRA proposed to apply the cashflow assumptions outlined in draft APS 210.

Comments received

Concern was expressed that the use of APRA's cashflow assumptions in non-Basel III jurisdictions meant that different assumptions would need to be applied to the same deposit to meet the requirements of different regulators. Submissions stated a preference to apply the assumptions of the non-Basel III jurisdiction host regulator to calculate the consolidated banking group LCR, so as to avoid complexity and inefficiencies in liquidity risk modelling in that jurisdiction. It was also claimed that this problem could extend to Basel III jurisdictions that have not clarified their proposed rules for implementation of the LCR.

APRA's response

The Basel Committee expects that all Basel III jurisdictions will have their LCR requirements in place by 1 January 2015. Hence, there should be no concerns regarding unclarified rules amongst Basel III jurisdictions. APRA also considers that it would be inconsistent to allow stressed cash outflow rates to apply for deposits in non-Basel III jurisdictions that are different to the LCR stress scenario. Hence, APRA does not see any reason to depart from its proposed approach.

4.2.4 LCR requirement for foreign bank branches

In its 2011 discussion paper, APRA proposed that foreign-owned ADIs in Australia that are subject to the scenario analysis approach will need to meet the LCR requirements on a stand-alone basis. However, in arriving at a balanced approach for foreign bank branches, APRA proposed to recognise a committed funding line from head office for inclusion as a cash inflow from day 16 of the LCR scenario under certain circumstances.

Comments received

Some submissions argued that it would be unduly restrictive not to recognise head office support until day 16, noting that APRA allows recognition of head office support in a shorter timeframe within the ‘name crisis’ scenario in the current APS 210. These submissions argued that it would be reasonable to expect head office to provide liquidity support on a much shorter notice period. It was also claimed that it was unfair not to extend the recognition of head office support to foreign-owned ADIs that operate in Australia as both a subsidiary and a branch.
Other submissions suggested that the LCR for foreign branches should be lower than 100 per cent and that APRA should recognise that branches depend on globally managed liquidity. Some submissions also argued that foreign bank branches should be exempt from ‘going concern’ reporting as this is a less meaningful task due to the nature of some operations and imposed a significant reporting burden.

Some submissions sought clarity on functions, tasks and roles that may be completed at the global level rather than at the foreign branch level as they pertain to the qualitative requirements of APS 210.

**APRA’s response**

Under APRA’s LCR requirement, all ADIs, including branches of foreign banks, must have sufficient Australian dollar liquidity to meet potential Australian dollar cash outflows. The recognition of head office support for branches from day 16 is intended to ensure a minimum level of liquidity self-reliance by these branches. APRA does not believe it is prudent to place reliance on a centrally managed liquidity pool alone as this may result in insufficient liquidity being available for the local operation.

APRA is aware of practices that have the potential to transfer liquidity needs between a local subsidiary and a related branch, which could possibly result in increased levels of reliance on parental support than would otherwise be the case. Submissions received did not address this issue. Consequently, APRA confirms that it will not extend the recognition of head office support to foreign-owned ADIs that operate in Australia under both a subsidiary and a branch banking authority.

Local staff responsible for liquidity management and oversight in foreign bank branches may fulfil liquidity risk management governance roles by having the appropriately approved job mandates and delegated authorities.

As per paragraph 47 of updated draft APS 210, APRA intends to continue to require the production of going concern reports by all ADIs, including foreign bank branches. The production of going concern reports by all ADIs will enable APRA to more fully understand the maturity mismatch and funding task of the ADI industry in Australia.
Chapter 5 – Net Stable Funding Ratio

The NSFR is the second quantitative global standard introduced by the Basel Committee with the intention of promoting more stable funding of the assets and activities of banking institutions. The standard establishes a minimum acceptable amount of stable funding based on the liquidity characteristics of an institution’s assets and activities over a one-year horizon. In particular, the requirement is structured to ensure that long-term assets are funded with at least a minimum amount of stable liabilities.

The recent Basel Committee revisions to the Basel III liquidity framework do not include amendments to the NSFR. The Basel Committee has indicated that it is now turning its attention to refining the NSFR and is seeking to complete the refinements by the end of 2014. The NSFR remains subject to an observation period ahead of its implementation on 1 January 2018.

APRA is committed to the implementation of the NSFR and will maintain the start date in the updated draft APS 210. However, it will not be updating its detailed requirements for the NSFR until the Basel Committee has completed its refinements.

As a consequence, APRA will exclude the NSFR from the final Reporting Standard ARF 210 Liquidity and associated reporting forms at this stage. It will continue to collect NSFR information from scenario analysis ADIs using the Quantitative Impact Study template.

NSFR in times of stress

Comments received

Submissions noted that the Basel Committee has confirmed that banking institutions would be expected to use their pool of HQLA in times of stress, which may result in an LCR of less than 100 per cent. A stress period would also have implications for the NSFR calculation as an ADI may not be able to roll funding to longer tenors in the face of counterparties seeking to reduce exposures at that same time. A period of time would then be necessary to build up liquidity and rebuild liability duration. APRA was requested to clarify the NSFR requirement under these circumstances.

APRA’s response

APRA expects that further guidance on this point will be provided by the Basel Committee when the NSFR is finalised.

The RSF and CLF eligible self-securitised assets

In its 2011 discussion paper, APRA proposed that CLF eligible debt securities be given a Required Stable Funding (RSF) factor of 10 per cent, reflecting an approximation of the RSF that would be applied to the HQLA portfolio in a jurisdiction where HQLA is in ample supply. APRA also proposed that self-securitised assets that are eligible for the CLF receive the RSF attributable to the underlying assets in the self-securitisation.

Comments received

Submissions objected to self-securitised mortgage assets that are eligible for the CLF still requiring the same amount of required stable funding as the underlying assets (between 65 and 100 per cent for mortgages). The concern was that not recognising this asset as ‘liquid’ in the NSFR (an RSF of 10 per cent), would likely result in an NSFR shortfall for many ADIs that would become a binding constraint, requiring the issue of excessive amounts of term debt to satisfy the stable funding requirement. It was claimed that this would require ADIs to hold each other’s term debt to overcome the problem, as term debt produces a beneficial 100 per cent Available Stable Funding (ASF) factor for the issuing ADI (when the term to maturity is greater than one year) and a 10 per cent RSF for the holding ADI (when the debt security is eligible as CLF collateral), an outcome that would appear contrary to APRA’s focus on systemic risk. Submissions also asked whether an issue of covered bonds or self-securitisation generates an encumbrance over the assets that would result in a 100 per cent RSF for those assets.

APRA’s response

APRA notes that the purpose of the Basel III liquidity framework is to promote the resilience of ADI liquidity risk profiles over both the short- and longer-term horizon. The LCR and NSFR are separate but
complementary standards introduced to achieve this outcome. By purchasing HQLA or third-party assets that are CLF eligible collateral, and funding these purchases with stable funding, an ADI is taking action to improve both its short- and longer-term liquidity risk profiles. As such, it is appropriate that these actions result in an improvement in both the LCR and NSFR. APRA accepts that the inclusion of self-securitised assets in the CLF for LCR purposes is necessary and appropriate, for the reasons articulated in its 2011 discussion paper. However, under this arrangement an ADI needs to take no additional steps to improve its liquidity self-reliance. For this reason, APRA does not consider it appropriate to extend the recognition of self-securitised assets as equivalent to HQLA in determining the NSFR; the underlying assets must be funded through stable funding sources, consistent with the objectives of the NSFR.

APRA confirms that the issue of covered bonds or RMBS will result in the encumbrance of associated on-balance sheet assets, which will require a 100 per cent RSF under the NSFR. The treatment of self-securitised assets as CLF eligible does not involve an immediate encumbrance of the underlying assets, so applying the RSF of the underlying assets is appropriate.

**Look-through on deposits in the NSFR**

To achieve consistency wherever relevant, definitions have been kept the same across the LCR and NSFR.

**Comments received**

Submissions sought clarification on the treatment, for NSFR purposes, of deposits sourced via financial intermediaries that are recognised in the LCR as being from a natural person.

**APRA’s response**

The treatment of deposits as defined in the LCR will apply in the same manner in the NSFR. A footnote has been added to Table 1 in Attachment B of the updated draft APS 210 to make this clear.

**Negotiable Certificates of Deposit (NCDs) in the NSFR**

In the NSFR, a differential treatment may be applied to funds raised from a given counterparty depending on the means through which the funds have been raised. This is particularly the case for funds raised through deposits rather than through the issue of debt securities.

**Comments received**

Submissions objected to the proposal that funding provided via NCDs held by non-financial corporates receive a lower ASF factor than deposits of equivalent maturity from such corporates. These submissions argued that as the counterparty to the funding transactions was equivalent, the stable funding treatment should be also.

**APRA’s response**

When a non-financial corporate client purchases an NCD from an ADI, APS 210 will require that the ADI apply a zero per cent ASF to the liability in the NSFR and model a buyback assumption in the LCR. If the same client places a deposit with the ADI, the ADI will be allowed to model the deposit with a 50 per cent ASF in the NSFR and exclude the deposit from the LCR if the earliest possible redemption of the deposit is greater than 30 days. This treatment is intentional, as an NCD is an instrument that is tradeable in the money markets and a typical NCD investor will tend to be more sophisticated than other clients. As a result, a lower ASF for NCD issuance in the NSFR and a higher cash outflow rate in the LCR is appropriate compared to deposits from the same customers.
Chapter 6 – Quantitative requirements for MLH ADIs

In its 2011 discussion paper, APRA proposed to exempt MLH ADIs from both of the Basel III quantitative requirements and to make only minor changes to the MLH regime. However, the current APS 210 requirement for a ‘going concern’ cash-flow projection would be extended to MLH ADIs.

20 per cent cap on exposures to credit grade 3 or below ADIs

APRA proposed to limit holding of assets with a credit rating grade 3 or lower to no more than 20 per cent of an ADI’s minimum liquidity holdings and to exclude holdings of RMBS and asset-backed securities (ABS).

Comments received

A number of submissions raised concerns that the twenty per cent limit would be a significant change in the MLH framework, sending the wrong market signal and changing the competitive environment. It was claimed that the limit would impact on funding and put strains on counterparty limits.

APRA’s response

A prudent MLH portfolio would be expected to contain assets sufficient in amount and liquidity to enable an ADI to withstand a severe liquidity stress. A high level of claims on a lower-rated financial institution in an MLH portfolio would generate ‘wrong-way’ risk and would not achieve this aim. During the early phases of the global financial crisis, there was some evidence of increasing cross-holdings of claims between lower-rated MLH ADIs, which was not conducive to system liquidity or self-reliance. Limiting reliance on the debt securities of lower-credit rated ADIs would ensure that the bulk of MLH portfolios have low credit risk, lower wrong-way risk and are tradeable in an active and sizeable market.

Nevertheless, APRA accepts that a hard limit in this area may be unnecessarily prescriptive and it has therefore removed the 20 per cent limit in updated draft APS 210. Guidance on appropriate diversification of MLH portfolios is provided in draft APG 210.

Exclusion of RMBS/ABS and self-securitised assets in the MLH portfolio

Comments received

Submissions argued that it would not be fair to include RMBS, ABS and self-securitised assets as eligible collateral for the CLF available to a scenario analysis ADI and not to do so for MLH ADIs, even though they could use such assets to access liquidity via repo transactions with the RBA.

APRA’s response

APRA does not intend to include RMBS and ABS securities in MLH portfolios on the basis, reinforced by experience during the global financial crisis, that these assets are considerably less liquid and more complex than other assets eligible for inclusion as MLH liquids. The introduction of the CLF for scenario analysis ADIs has a different objective: viz, to balance the need to meet a global liquidity standard with the fact that there is an insufficient supply of HQLA in Australia.

However, APRA acknowledges that an MLH ADI that has a self-securitisation arrangement in place will have strengthened its liquidity risk management framework and contingent liquidity buffer for crisis management purposes. Indeed, APRA has previously outlined its expectation that larger MLH ADIs will establish such arrangements. The existence of these arrangements will continue to be a significant input to APRA’s supervisory assessment of the adequacy of an ADI’s liquidity management framework.

Migration from MLH to scenario analysis

Comments received

Submissions requested guidance on the key factors that would be taken into account by APRA on when an MLH ADI would be expected to move to the scenario analysis framework. The submissions highlighted the need to plan for what they saw as an increased compliance burden involved in scenario modelling.

APRA’s response

12 Speech by Dr John Laker, Mutuals After Turbulent Times, 9 November 2009
MLH ADIs have differing business strategies, funding structures, access to liquidity, balance sheet size and complexity. It is not possible to provide a comprehensive list of attributes that would appropriately cover all MLH ADIs or distinguish scenario analysis candidates. An ADI’s liquidity risk management framework for measuring, monitoring and managing liquidity risk should be commensurate with the nature, scale and complexity of the institution; at the smaller, less complex end of this scale are MLH ADIs. The nature and timeframe of a transition path for an individual ADI is appropriately worked out with an ADI’s responsible supervisor and will follow a tailored prudential supervisory plan.

CUFSS minimum deposit requirement

The CUFSS scheme is an industry support arrangement that is designed to assist ADI members of the scheme going through a liquidity stress. Members of the scheme, which are predominantly credit unions, are obliged to make actual and contingent commitments to the support arrangement.

Comments received

Submissions noted that APRA will continue to exempt a CUFFS member from having to deduct its CUFSS minimum deposit requirement from the calculation of its MLH portfolio. Participants in the CUFSS scheme would like to see this exemption written into APS 210 for purposes of clarity and to enhance the standing of the CUFSS scheme for members and potential members.

In addition, submissions requested that APRA remove the current requirement in APS 210 that a CUFSS member must include its contingent commitment or obligation to this scheme in the calculation of its liability base for the MLH ratio. The argument put was that the current treatment unfairly penalises or disadvantages a CUFSS member as compared to an equivalent non-member.

APRA’s response

APRA supports industry liquidity support schemes since they contribute to increased self-reliance and, as a result, decreased reliance on the central bank for liquidity support. The wording of draft APS 210 provides APRA with the authority to apply an exemption for the calculation of MLH portfolios without the need for further amendments. As per paragraph 3 in Attachment D of draft APS 210 ‘For the purpose of APRA’s MLH requirement, liquid assets must be free from encumbrances (except where approved for a prudential purpose by APRA).’ In order to allow for the exclusion of the contingent commitment required of a CUFFS member, APRA has amended paragraph 2 in Attachment D of updated draft APS 210 to read: ‘For the purpose of this Prudential Standard, liabilities are defined as total on balance sheet liabilities (including equity) and irrevocable commitments (except where approved for a prudential purpose by APRA), less the capital base defined in accordance with Prudential Standard APS 111 Capital Adequacy: Measurement of Capital.’

APRA’s recently released liquidity reporting package contains instructions to exclude any APRA-approved industry support arrangements in the calculation of the liabilities base for the MLH ratio. Therefore, the MLH ratio for a CUFSS member will not be reduced in comparison to an equivalent non-member.
Chapter 7 – Prudential disclosure

Principle 13 of the Basel Committee’s *Sound Principles* states that a banking institution should publicly disclose qualitative and quantitative information on a regular basis to enable market participants to make informed judgements about the soundness of its liquidity risk management framework and liquidity position.

In its 2011 discussion paper, APRA proposed to introduce prudential disclosure requirements in respect of an ADI’s liquidity risk management framework and liquidity position.

For scenario analysis ADIs, the key qualitative information to be disclosed would include the organisational structure and framework for the management of liquidity risk. The relevant quantitative information to be disclosed would include the LCR and NSFR for scenario analysis ADIs and the MLH ratio for MLH ADIs.

The Basel Committee is continuing to develop disclosure requirements for bank liquidity and funding profiles. APRA anticipates that it will incorporate these requirements into its prudential disclosure framework.

Comments received

Submissions were concerned that undesirable market outcomes may result from disclosure of an ADI’s liquidity ratio. Submissions were also concerned that because of the different types of banking operations conducted by ADIs, the ratios would not be easy to compare. It was argued that delayed publication of ratios would be more suitable and that only average ratios should be disclosed, as the publication of a highest and lowest ratio in the previous quarter may create undue negative perceptions. Submissions requested further information on whether the size of the CLF and any draw on the CLF would need to be disclosed.

Other submissions proposed that foreign bank branches should only disclose to regulators and not publicly. The concern was the volume of reporting obligations facing some smaller foreign bank branches; it was also noted that supervisors in other jurisdictions allow exemptions from local liquidity requirements and requiring disclosure by foreign bank branches in Australia would be internationally inconsistent. If disclosure by foreign bank branches was deemed necessary, submissions proposed that branches should include information about calculation methodologies to ensure international inconsistencies are acknowledged.

APRA’s response

APRA is not intending to introduce its disclosure requirements at this stage. The Basel Committee has published further guidance on this issue. It will consult separately on these requirements after the global disclosure standards are finalised.

http://www.bis.org/press/p130106.htm
Chapter 8 – Implementation

In line with the original Basel Committee timetable, APRA proposed to introduce the LCR requirement from 1 January 2015 and the NSFR requirement from 1 January 2018. APRA did not propose to include any transitional arrangements for these quantitative requirements.

In its recent revisions to the Basel III liquidity framework, the Basel Committee allowed for a phase-in of the LCR. The phase-in involves a minimum LCR requirement of 60 per cent on 1 January 2015, increasing by 10 percentage points each year to reach 100 per cent on 1 January 2019.

APRA is not proposing to adopt the phase-in arrangement for the LCR. The Basel Committee has noted that the graduated approach was introduced ‘...in light of the considerable stress facing banking systems in some regions.’ The Australian banking system is not facing these circumstances. Moreover, the Basel Committee has estimated that, on end-June 2012 data, the weighted average LCR for a sample of around 200 of the largest internationally active banks, on the revised calibration, is around 125 per cent. Three-quarters of the banks in that sample are already LCR compliant.

Finally, APRA is cognisant of concerns, raised most recently by the International Monetary Fund in its 2012 Financial System Stability Assessment of Australia, that the continued reliance of Australian banks on offshore funding leaves them exposed to disruptions to funding markets.

In APRA’s view, ADIs are well placed to meet the LCR requirement in full on the original timetable. Meeting that timetable will confirm the improvement in liquidity risk management by ADIs and send a strong message about the soundness of the Australian banking system. Accordingly, APRA proposes to introduce the LCR in full from 1 January 2015, and the NSFR requirement from 1 January 2018, as originally planned.

14 S. Ingves, From Ideas to Implementation, Speech to BCBS/FSI High Level Meeting, Cape Town, 24 January 2013
http://www.bis.org/review/r130124a.htm
15 Ibid
16 Refer to footnote 4.
To improve the quality of regulation, the Australian Government requires all proposals to undergo a preliminary assessment to establish whether it is likely that there will be business compliance costs. In order to perform a comprehensive cost-benefit analysis, APRA welcomes information from interested parties on the financial impact of its proposed approach to the implementation of the Basel III liquidity framework and any other substantive costs associated with the proposed measures. These costs could include the impact on funding costs, balance sheets, and profit and loss.

As part of the consultation process, APRA also requests respondents to provide an assessment of the compliance impact of the proposed approach. Given that APRA’s proposed requirements may impose some compliance and implementation costs, respondents may also indicate whether there are any other requirements relating to ADI liquidity risk management that should be improved or removed to reduce compliance costs. In doing so, please explain what they are and why they need to be improved or removed.

Respondents are requested to use the Business Cost Calculator (BCC) to estimate costs to ensure that the data supplied to APRA can be aggregated and used in an industry-wide assessment. APRA would appreciate being provided with the input to the BCC as well as the final result. The BCC can be accessed at www.finance.gov.au/obpr/bcc/index.html