ABA submission on the Basel Committee's International framework for liquidity risk measurement, standards and monitoring

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Executive Summary

Experiences from the recent global financial crisis (GFC) underscore the need for regulatory change. However, the ABA is concerned that the regulatory changes proposed in the Committee's Consultative Documents are, in general, misdirected and overly severe, transferring too much of the burden of liquidity risk "insurance" to the banking system. As a result, the changes, if implemented fully, will give rise to a significant slowdown in the availability of credit and an increase in the cost of credit, and will present an impediment to economic recovery and longer-term growth. The main channels through which these impacts will be transmitted are funding constraints, which will impede banks' ability to lend, and the cost of lending, which will increase in response to the need to recover the higher costs associated with increased liquidity and capital requirements.

Estimating the final costs of the changes is complicated by assumptions about how banks will implement the changes and how borrowers will respond to the changes, as well as by the response of non-bank investors and competitors. On the latter, while the impact on the global economy will be reduced if non-bank lenders are able to fill the gap left by potential bank lending reductions, and if non-bank investors provide the term funding required by banks to operate under the new framework, it will also have the unintended consequence of transferring credit and/or liquidity risks to the non-bank sector. Hence, the regulatory changes proposed do not alter the aggregate level of liquidity risk in the broader economy but instead transfer liquidity risk to less regulated sectors that are less well placed to manage it.

Policy development timeframes and implementation and transition considerations

In view of the complexity and potential severity of the proposed changes, further analysis, discussion and debate with industry are required to ensure that the Committee's target level of resilience strikes the right balance between the benefits and costs of a more resilient system. There is also a clear need for further impact assessments once the components of the framework have been revised. This may necessitate variation to the proposed timetable.

The significant adjustments required by the changes will take time to implement if severely adverse macroeconomic impacts are to be avoided. There is therefore a need for the framework to be phased in gradually, consistent with global economic recovery. This phased approach would need to be undertaken on an internationally consistent basis and would require phased upward adjustment of parameters and definitions until an acceptable level of resilience is reached. This approach provides the benefit of allowing reforms to be implemented on schedule, while allowing flexibility for the regulatory framework to be "fine-tuned" over time thereby minimising the risks to global economic recovery.

Balancing international consistency and the circumstances of local jurisdictions

The ABA acknowledges, and generally agrees with, the Committee's objective of developing an internationally harmonised regulatory framework. However, we believe that this is best achieved by developing a regulatory framework that is based on clearly articulated objectives and principles that allow national supervisors to implement the framework in a manner that meets the objectives, while responding to constraints or impediments posed by the local environment.

For the definition of capital, it should be possible to develop a regulatory framework that is consistent across jurisdictions given that capital is a largely "global construct", notwithstanding that it is affected by local taxation, legal and accounting requirements. For liquidity, meeting the Committee's objective of a harmonised framework is more difficult, in that liquidity is largely a "local construct" where the structure and constraints of local financial markets have a significant bearing on local balance sheet structures. For example, the shortage of Australian sovereign bonds, the predominance of long-term assets in the form of high-quality full recourse residential mortgages and the disincentives built into bank deposit savings due to Australia's taxation and superannuation schemes, illustrate some of the difficulties faced in applying a global framework to a largely local construct. The proposed framework includes elements of prescription that are based on assumptions about markets, products and economies that do not apply to all jurisdictions.

It is therefore important to develop an international regulatory framework that is based on key principles to which all jurisdictions can adhere, while allowing national supervisors to apply those principles and standards in a way that accommodates local *circumstances*. A framework that takes into account the circumstances of local jurisdictions is more likely to be "competitively neutral", and will allow all supervisors to "opt in". Under such a framework, the ABA believes harmonisation can still be delivered through the regulatory peer review process.

The proposed level of resilience: recalibrating NSFR and LCR

The level of resilience in the Liquidity Document is determined by the two proposed regulatory standards: the Liquidity Coverage Ratio (LCR) and the Net Stable Funding Ratio (NSFR). The ABA is concerned that the proposed changes will set a level of resilience that imposes too high a cost on the community, in the form of contractions in longer term growth. The ABA's modelling of both ratios suggests that Australian banks will need to hold significantly more liquid assets (more than double current liquid asset holdings) and significantly increase term funding. While it is possible that banks may be able to reduce the volume of additional liquid assets required by adjusting the structure of their balance sheets, the modelling undertaken suggests there are constraints on how much adjustment banks can undertake by way of changes to funding profiles and asset composition, without creating downstream unintended consequences.

The severity of the changes is compounded by the impact of the NSFR. The current calibration of this ratio limits the process of maturity transformation. The NSFR also favours investment in securities over high credit quality assets and encourages an "originate to distribute" banking model (which will be exacerbated by the introduction of a simple leverage ratio).

The ABA believes a significant factor in the successful performance of the Australian banks relative to banks in other jurisdictions is their "originate to own" model. The bluntness of the weights used in the NSFR measure (such as the 100 per cent weight for "all other assets greater than one year") introduces obscure outcomes for liquidity risk management. This is a particular problem for Australian banks given that, as noted above, Australian banks maintain a large proportion of high-quality full recourse residential mortgages on balance sheet that are subject to the 100 per cent weight. To meet the required ratio of 'one', Australian banks would need to raise significant amounts of term funding.

The severity of the proposed changes is amplified by both the proposed *narrow* and *broad* definitions of liquid assets. The Australian sovereign bond market is very small owing to a history of strong fiscal management by Australia's governments. For Australian banks, access to sovereign bonds in domestic currency is therefore demonstrably limited, falling short of required liquid assets by several multiples[1], with this outcome unlikely to change substantially over the next five years. The Australian non-financial corporate bond market is also relatively small, and Australian banks are prevented by legislation from issuing covered bonds.

In order to address the structural challenges posed by the circumstances of particular jurisdictions, the definition of liquid assets included in the regulatory framework should be based on acceptable criteria for recognising an asset as a liquid asset for the purpose of the two regulatory standards. For most jurisdictions, these criteria should recognise that central bank repurchase eligibility of a liquid asset promotes the liquidity of such assets in private markets. Moreover, the definition should provide scope for national supervisors to gradually broaden the definition of liquid assets as the short-term crisis evolves, in recognition of the different degrees of liquidity of assets. This 'tiering' of liquid assets is in line with the *Committee of European Banking Supervisors* (CEBS) guidelines on liquidity buffers which suggest that *"for the longer end of the buffer [survival period], a broader set of liquid assets might be appropriate, subject to the bank demonstrating the ability to generate liquidity under stress from them within the specified period of time".*[2]

Main recommendations

Against the backdrop of the above considerations, the ABA makes the following main recommendations[3] each of which is considered in further detail in the submission:

<u>Main Recommendation 1</u>: The Committee's timetable should allow for further industry consultation and disclosure to the community of the costs and benefits of the proposed changes. Implementation of the final changes should be phased and globally consistent.

The ABA is concerned that the completeness and integrity of the policy setting process are being compromised by the aggressive timetable that has been set by

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[1] This outcome takes into account APRA's determination that bond issues made by semi-Government authorities will be included in the narrow definition of liquid assets.

[2] CEBS *CP28: Consultation Paper on Liquidity Buffers & Survival Periods*, July 2009.

[3] These recommendations are combined with other recommendations in the body of the submission.

the G20. To ensure that the final changes will support the industry over the longer term, the ABA recommends that there be further industry consultation, debate and challenge globally once the Committee's impact analysis is complete.

To achieve this while at the same time meeting the goal of releasing fully calibrated standards by the end of 2010, the ABA recommends that the Committee release a final set of principles, setting out key supervisory tools and objectives, by the end of 2010, with detailed application of those principles to follow in mid 2011. Public disclosure by the Committee and national supervisors of the costs and benefits of the framework is also essential to ensure widespread understanding of the direct and indirect consequences of regulatory change as well as alignment with other macroeconomic initiatives.

Depending on the shape and form of the final framework, and in light of the economic impacts noted above, the ABA recommends a globally consistent and phased approach to implementation of the regulatory framework of five years from the time that the final regulatory framework takes effect. This phased approach would require upward adjustment of parameters until the Committee's resilience targets are reached. Given the global nature of capital and the competitive implications of liquidity, it is essential that all jurisdictions implement the changes at the same time to minimise market confusion and misinterpretation, facilitate comparability and market discipline and ensure a level playing field across banks.

<u>Main Recommendation 2:</u> The regulatory framework for liquidity should be based on clearly articulated objectives and principles so as to achieve a consistent level of resilience while allowing for the structural differences in banking and financial markets that exist in local jurisdictions. National supervisors' implementations of the framework should be transparent and readily justified.

The ABA recommends that the regulatory framework be based on clearly articulated objectives and principles that allow national supervisors to implement the framework in a manner that meets the objectives of the framework while responding to the constraints or impediments posed by the local environment, including local market and economic conditions, as well as local taxation, accounting and legislative requirements. More detailed recommendations provided in the main body of this submission further develop this principle. To maintain consistent standards across supervisors, we recommend that the framework require national supervisors to explain, by way of local prudential policies, the linkages between the principles laid out by the Committee and national supervisors' local implementations of those principles in the context of jurisdiction-specific factors.

<u>Main Recommendation 3:</u> The NSFR should be significantly recalibrated to reduce the limitations on the maturity transformation process and address the potentially obscure outcomes of the ratio in adequately assessing liquidity risk. National supervisors should have the flexibility to adjust application of the NSFR requirements, consistent with the circumstances of the local market.

The ABA supports introduction of a measure to encourage long-term funding and notes that the larger Australian banks have been using similar metrics for a number of years. However, the ABA recommends that the NSFR assumptions

undergo significant recalibration such that maturity transformation, which is the core function of banking, is not severely penalised and that the ratio more adequately reflects the drivers of asset liquidity, including credit quality (for example, the ratio should reflect that prime mortgages will contribute much less to liquidity risk than sub-prime mortgages).

Asset categorisations should allow for flexible application by national supervisors where appropriate. To facilitate this, the Committee's rationale and objectives for asset categorisations and factor weightings should be clearly articulated in the framework. Consistent with Recommendation 2, national supervisors should be required to disclose their rationale for local implementation in the context of the circumstances of supervisors' local environments.

<u>Main Recommendation 4:</u> The LCR should be recalibrated to achieve a level of resilience that implies a less severe combined idiosyncratic and market-wide liquidity stress. The definition of liquid assets should be "tiered" over the course of the stress period to allow national supervisors to identify those assets that are most liquid in local jurisdictions.

The ABA recommends that the LCR be recalibrated to a more moderate combined idiosyncratic and market-wide liquidity stress that strikes a more appropriate balance between the benefits and costs of a more resilient system. This could be achieved by reducing the term over which the liquidity stress plays out or adjusting the cash flow assumptions to calculate the ratio.

It could also be achieved by broadening the definition of liquid assets. The proposed definition of liquid assets does not reflect the fact that market liquidity differs across jurisdictions. The ABA recommends that the definition of liquid assets be sufficiently flexible to accommodate jurisdiction-specific factors by basing the definition on acceptable criteria for recognising an asset as a liquid asset for the purpose of the two regulatory standards.

The definition should provide scope for national supervisors to gradually broaden the definition of liquid assets as the short-term crisis evolves in recognition of the different degrees of liquidity of assets. A suitable haircut or portfolio limit to reflect differing liquidity could be applied to each type of liquid asset that is included in the liquid asset definition. Consistent with Recommendation 2, the regulatory framework should require that national supervisors set out those jurisdiction-specific factors that support supervisors' choice of liquid assets in the local market.

1. Introduction

This submission sets out the Australian Bankers' Association's (ABA's) response to the Basel Committee on Banking Supervision's ("the Committee's") Consultative Document *International framework for liquidity risk measurement, standards and monitoring* ("Liquidity Document"), issued for comment on 17 December 2009.[4]

The recent global financial crisis (GFC) highlighted weaknesses in the way in which banks around the world measure and manage risk, as well as in the international framework for regulating banks and other financial institutions. It is therefore both prudent and responsible that the global banking system responds to the GFC by strengthening risk management practices, improving the quality of liquid assets and capital held, and reducing the reliance of the system on implicit public-sector support. This response should be the shared responsibility of regulators and industry, although the ABA accepts that there is an imperative for regulators to play a lead role.

While there is unquestionably a need for regulatory change, there is a question as to the form of that change and the extent of change required. The ABA makes three comments in this regard.

First, we observe that the regulatory changes are focused heavily on additional prescriptive regulation under the realm of Pillar 1. While we agree that additional regulation is warranted given the intensity of the GFC, we emphasise the importance of improved supervisory analysis and challenge. The Basel II Framework laid out by the Committee introduced a range of supervisory tools in Pillar 2 that are available to be used by national supervisors and which allow national supervisors to tailor review processes to suit each bank's risk profile.

While Pillar 1 implementation is useful for setting an overall minimum level of resilience for the global banking system, undue focus on Pillar 1 may have the unintended consequence of less rigorous analysis and challenge by supervisors and the application of a "one size fits all" approach that is not tailored to the riskiest or most vulnerable components of a bank's activities and penalises lower risk banks. We believe that more effective supervision, through application of Pillar 2 tools, is an essential element of the regulatory response to the GFC.

Second, the ABA has significant concerns that the proposed changes are overly severe. We believe the level of resilience proposed by the regulatory framework to be too high, transferring too much of the burden of "insurance against shock" to the banking system. The appropriate level of resilience to a liquidity risk should be considered in the context of resultant benefits and costs, including economy-wide costs. The proposed level of resilience proposed will have a significant adverse impact on global and local economies by way of the lower level of credit provided, the higher cost at which that credit is provided, and the

[4] The ABA's response to the Consultative Document *Strengthening the resilience of the banking sector* ("Resilience Document") has been provided to the Committee in a separate submission. The Liquidity Document and Resilience Document are referred to collectively in this submission as the "Consultative Documents".

disruption of global financial markets. As a result, the changes if implemented fully will present an impediment to economic recovery and longer-term growth.

While the Committee has recognised the trade-off between resilience and economic growth in the Consultative Documents, the potential severity of its implications has not yet been fully explored. In this regard, we note that the Committee is currently working through a process to assess the impact of the Consultative Documents and we encourage rigorous debate, analysis and industry consultation to ensure the ongoing suitability of the regulatory framework for meeting the Committee's stated objectives of resilience, innovation, efficiency and sustainable growth.

Third, we observe that the regulatory changes proposed do not alter the aggregate level of liquidity risk in the broader economy. Instead, the changes transfer liquidity risk to those sectors that are less well placed to manage it and which are not appropriately regulated or supervised. The potential for the re-allocation of risk in the economy from regulated to unregulated sectors should be considered by the Committee in finalising the regulatory framework.

This submission sets out the reasoning underlying the assertions made above. **Section 2** discusses implementation time frames and related considerations. **Section 3** considers the importance of implementing a harmonised regulatory framework that accommodates the unique circumstances of local jurisdictions. **Sections 4** and **5** discuss the proposal to implement two "regulatory standards" to measure bank liquidity over different periods of stress: **Section 4** discusses the proposal to introduce a Net Stable Funding Ratio (NSFR) that focuses on banks' resilience to long-term stress; and **Section 5** considers the Liquidity Coverage Ratio (LCR), the Committee's proposed measure in relation to short-term stress. **Section 6** considers briefly the macroeconomic implications of the proposed changes.

2. The importance of industry consultation and a measured timetable

There is unprecedented activity currently under way in relation to the Consultative Documents, both by regulators and industry. This activity includes not only ongoing policy development and interpretation, but also "top-down" consideration of regulatory targets and, importantly, the implications of the regulatory changes proposed. The Committee has indicated that it expects to release "calibrated" requirements for liquidity and other standards by the end of 2010. The requirements will be *"phased in as financial conditions improve and the economic recovery is assured, with an aim of implementation by end-2012".*

The ABA is concerned that the political nature of the policy-setting response and the aggressive timetable set by the G20 may be impairing the policy development process and the possibility of achieving an effective and sustainable regulatory framework. Without question, implementation of the regulatory framework will have tremendous implications for the global economy, as well as for the operations of individual banks. It is prudent to assess the impact of all of the policies under development as an inter-related suite of policies, as the Committee is doing through the Quantitative Impact Study (QIS). However, it is also important to ensure that the benefits of each proposal outweigh its costs. The interpretation and practical application of the framework should also be "tested and challenged" through industry consultation and debate. This is essential if the

framework is to meet the Committee's objective of achieving an appropriate balance between increased resilience, innovation, efficiency and sustainable growth, and to ensure that all countries "opt-in" to the regulatory framework adopted.

The current timetable proposed may not allow enough time for thorough analysis and industry consultation. The ABA therefore recommends that the Committee release final principles by the end of 2010 with detailed polices to follow in mid 2011.

2.1 Implementing the final framework

Once finalised, the regulatory framework will require time to be absorbed by the economy and by regulated banks, both to facilitate appropriate implementation and to allow for changes in activity. Against the backdrop of the economic implications of these regulatory changes, and depending on where the final framework settles in terms of the required level and composition of liquid assets in the LCR calculation and the calibration of the NSFR, there is a need for the framework to be phased in gradually, consistent with global economic recovery.

This phased approach would need to be undertaken on an internationally consistent basis and would require phased upward adjustment of parameters and definitions until the Committee's resilience targets are reached. We recommend that this phased approach be undertaken over a five-year period. Other requirements in the proposals, such as the implementation of monitoring tools, as well as additional standards proposed by national supervisors, could be subject to a shorter transition period.

A phased approach to implementation will also provide time for financial markets to absorb the regulatory changes. This is particularly important given the financial market responses observed to date. Financial markets will behave more rationally if given time to adjust. Sudden shifts in the demand for certain liquid assets and types of funding, as well as in the supply of particular funding instruments, can create unwarranted distortions in prices in response to anticipated or actual changes in demand or supply.

<u>Main Recommendation 1:</u> The Committee's timetable should allow for further industry consultation and disclosure to the community of the costs and benefits of the proposed changes. Implementation of the final changes should be phased and globally consistent.

The ABA is concerned that the completeness and integrity of the policy setting process are being compromised by the aggressive timetable that has been set by the G20. To ensure that the final changes will support the industry over the longer term, the ABA recommends that there be further industry consultation, debate and challenge globally once the Committee's impact analysis is complete.

To achieve this while at the same time meeting the goal of releasing fully calibrated standards by the end of 2010, the ABA recommends that the Committee release a final set of principles, setting out key supervisory tools and objectives, by the end of 2010, with detailed application of those principles to follow in mid 2011. Public disclosure by the Committee and national supervisors of the costs and benefits of the framework is also essential to ensure widespread

understanding of the direct and indirect consequences of regulatory change as well as alignment with other macroeconomic initiatives.

Depending on the shape and form of the final framework, and in light of the economic impacts noted above, the ABA recommends a globally consistent and phased approach to implementation of the regulatory framework of five years from the time that the final regulatory framework takes effect. This phased approach would require upward adjustment of parameters until the Committee's resilience targets are reached. Given the global nature of capital and the competitive implications of liquidity, it is essential that all jurisdictions implement the changes at the same time to minimise market confusion and misinterpretation, facilitate comparability and market discipline and ensure a level playing field across banks.

2.2 Releasing the final framework: "announcement risk"

When the final regulatory framework is released, the market's assessment of how individual banks fare under the new rules will be immediate. Depending of course on the final rules, this assessment may have significant adverse implications for banks' financial positions by way of share price adjustments.

The release will also stimulate an immediate response in financial markets. Australia's experience on releasing a draft consultative paper on liquidity risk management in September 2009 provides some, albeit small, insight into the potential for a significant and immediate financial market response in anticipation of longer term change.[5] Jointly, the responses of the equity and debt markets to banks' financial positions and the responses of financial markets to longer term supply and demand for financial instruments may have broader implications for the effective functioning of local and global economies. Compounding these outcomes is a significant risk that the regulatory framework or its implementation may be misinterpreted by markets.

These implications are collectively referred to as "announcement risk". While the responses of analysts and markets cannot be controlled, it is important that they are anticipated, such that the risk of adverse outcomes is at least known in advance. Similarly, it is important that misinterpretations by the market are avoided by putting in place an appropriate internationally co-ordinated market communication framework, to be followed by national supervisors in explaining to analysts and investors the detail of the changes and their impacts on banks, and ensuring that the process has been worked through to determine the final regulatory framework.

[5] The ABA observed a number of market responses following release of APRA's liquidity proposals in September 2009 (refer APRA Discussion Paper *APRA's prudential approach to ADI liquidity risk* 11 September 2009). These included a material change in the price differential between physical bonds and the bond futures contract, reflecting greater demand for physical securities. The market changes experienced reflected expectations of lower demand for bank bills, higher demand for physical bonds and more offshore term issuance by banks.

<u>Supplementary Recommendation</u>: An internationally consistent communication strategy is required to minimise over-reaction and misinterpretation by markets

The ABA recommends that the Committee give consideration to the announcement risk that will arise on release of the final standards, including recognition and assessment of the likely market responses to the final standards. The ABA recommends that the Committee develop an internationally co-ordinated communication framework for consumption predominantly by analysts and investors, which mitigates the risk of over-reaction and misinterpretation by the market.

3. Implications of a globally harmonised regulatory framework

In principle, the ABA supports the Committee's focus on the introduction of an internationally harmonised regulatory framework. Successful implementation of such a framework for banks across all jurisdictions will ensure a consistent level of resilience and reduce opportunities for arbitrage. It will also facilitate comparability across banks in different jurisdictions and in doing so lend support to the mechanism of market discipline.

While global consistency is a logical and necessary objective, there are a number of practical constraints that complicate implementation of a harmonised regulatory framework. For the *definition of capital*, these constraints are few: it should be possible to develop a regulatory capital framework that is consistent, in principle, across jurisdictions, given that capital is a largely homogenous construct and is not dependent on local financial markets and economic conditions. There should therefore be minimal national discretion, except to the extent that national discretion is necessary because of the local environment to achieve the objective of the regulatory framework. This is especially the case if the framework is broad, simple and, importantly, transparent.

The same is not true for liquidity. Liquidity is largely a 'local concept': it is a characteristic conferred by a combination of the currency in which an asset is denominated and the nature of the market in which it is traded. An asset that is highly liquid in one country may be illiquid in another. This can be true for government securities as well as private securities. The changes proposed in the regulatory framework do not recognise that liquidity differs across jurisdictions. For example, the proposed liquid asset definition includes sovereign bonds, corporate bonds and covered bonds. In addition to being a seemingly arbitrary collection of assets, the definition does not recognise that, in Australia, there is a shortage of Australian sovereign bonds and that securities issued by banks are amongst Australia's most liquid assets.

Liquidity risk is similarly dependent on conditions and constructs specific to local economies and markets. It depends on many factors that are outside of a bank's control and which may be unique to the economy in which the bank operates. For Australian banks, there is a limit as to how much banks can raise in retail deposits owing to a number of structural features, including a taxation system that favours superannuation over bank deposit saving and a compulsory superannuation scheme that requires employees to divert savings to pension fund savings. These features, when coupled with Australian banks' large on balance

sheet holdings of high quality full recourse residential mortgages, adversely impact how Australian banks fare under the framework.

It is therefore important to balance the objective of an internationally consistent regulatory framework with one that appropriately reflects local liquidity risk profiles, the economic environment and local financial markets. The framework should be based on clearly articulated objectives and principles so as to achieve a consistent level of resilience while allowing for the structural differences in banking and financial markets that exist in local jurisdictions. A framework that takes into account the circumstances of local jurisdictions is more likely to be "competitively neutral".

<u>Main Recommendation 2</u>: The regulatory framework for liquidity should be based on clearly articulated objectives and principles so as to achieve a consistent level of resilience while allowing for the structural differences in banking and financial markets that exist in local jurisdictions. National supervisors' implementations of the framework should be transparent and readily justified.

The ABA recommends that the regulatory framework be based on clearly articulated objectives and principles that allow national supervisors to implement the framework in a manner that meets the objectives of the framework while responding to the constraints or impediments posed by the local environment, including local market and economic conditions, as well as local taxation, accounting and legislative requirements. More detailed recommendations provided in this submission further develop this principle. To maintain consistent standards across supervisors, we recommend that the framework require national supervisors to explain, by way of local prudential policies, the linkages between the principles laid out by the Committee and national supervisors' local implementation of those principles in the context of jurisdiction-specific factors.

4. Implications of the Net Stable Funding Ratio

The Liquidity Document proposes use by regulators of the NSFR *"to promote more medium and long-term funding of the assets and activities of banking organisations".* The ABA acknowledges the Committee's objective of encouraging more stable, longer-term funding as a supplement to the short-term focus of the LCR and agrees, in principle, with that objective. In its simplest form the NSFR requires the available amount of stable funding to exceed the required amount of stable funding. The concept of a stable funding ratio is not new – most large banks have been working to their own internal liquidity 'long-term funding' benchmarks for some time – and conceptually a requirement for available funding to exceed required funding is reasonable.

4.1 NSFR recalibration

The ABA is concerned that the calibration of the NSFR penalises liquidity transformation, the core function of banking. It challenges the arbitrary requirement that the ratio be greater than one (as a point of reference, Australian banks appear to have NSFR ratios in the order of 0.7). Fundamentally, banks are in the business of liquidity transformation. From the time that banks first emerged, a central part of their business has been turning liquid deposits into illiquid loans. Thus banks start from a position where this ratio should naturally be less than one as a result of the business they are in. If banks are forced out

of the liquidity transformation business by arbitrary regulations, there is a question as to whether other less-heavily regulated institutions will start providing similar services, thereby transferring liquidity risk to other sectors and weakening the system overall.

The ABA is similarly concerned about the arbitrariness of the weights assigned to various categories of assets and liabilities under the NSFR calculation. The NSFR must be recalibrated to produce an outcome that does not penalise simple traditional bank balance sheets. This could be achieved by setting a minimum level for the ratio of less than one or, alternatively or in addition to, by adjusting the factors that apply to banks' asset and liability positions.

If we take the simple example of a bank ("Bank A") with a simple asset book of $100 comprising of long-term prime mortgages ($90) and highly liquid sovereign debt securities ($10) which is completely funded by $10 of capital and $90 of retail deposits (half of which is stable and half unstable – a plausible assumption given the proposed criteria that stable retail deposits must be insured), the arbitrariness of the NSFR is such that the bank will be unable to meet the requirement: available funding of $79.75 will be less than required funding of $90.

The only way that this simple and relatively low risk bank can meet the requirement is to significantly reduce its lending and replace this with liquid asset holdings, or fund its assets with all capital or a mix of capital and long-term deposits, an unattractive business model by all accounts. By contrast, another bank ("Bank B") that uses the same funds to invest in a single suitably-rated corporate bond issue will comfortably meet the NSFR, yet would be exposed to at least the same amount of liquidity risk if regulatory assessment of the liquidity of that corporate bond (which determines the Required Stable Funding - RSF - factor) turns out to be misplaced.

For ease of illustration this example is set out in Table 1. Although simple, this example demonstrates the potentially contrary outcomes that the arbitrary nature of the ratio can give rise to.

Table 1: NSFR in practice: a simple example

	Bank A		Bank B	
Assets	Home mortgages (RSF Factor 100%)	$90	Corporate bond (RSF Factor 20%)	$90
	Liquid assets (RSF Factor 0%)	$10	Liquid assets (RSF Factor 0%)	$10
Liabilities	Stable deposits (ASF Factor 85%)	$45	Stable deposits (ASF Factor 85%)	$45
	Less stable deposits (ASF Factor 70%)	$45	Less stable deposits (ASF Factor 70%)	$45
Capital	Capital (ASF Factor 100%)	$10	Capital (ASF Factor 100%)	$10
NSFR	**0.89**		**4.4**	

The example can be further extrapolated by considering a bank which chooses to adopt an originate-to-distribute lending model. Under this model, a bank will reduce its stable funding requirement and be more readily able to meet the NSFR requirement relative to a bank that chooses to retain its lending exposures. Given the issues arising from the originate-to-distribute lending model that were so prevalent in the lead up to the GFC, this example further demonstrates the unintended consequences that may result with the current setup of the NSFR calibration.

The factors and also the categories of the NSFR, therefore require significant adjustment to be meaningful and to ensure that they can be met by banks. While we note that considerably more work is required to determine appropriate weights for the NSFR calculation, we set out below some preliminary thoughts.

Required funding weights require significant recalibration. As illustrated above, the categorisations and relativities of weightings are not intuitive and may give rise to obscure outcomes. It is also not clear, for example, why short-term loans to financial customers require no funding. Short-term loans to non-financial corporates require 50 per cent stable funding, and short-term loans to retail customers must be funded 85 per cent with long-term funds. It is also unclear why particular assets (such as gold) have been separately categorised and why the relative liquidity (by way of haircuts) of assets deemed to be liquid under the LCR do not align with the relative weightings (by way of RSF factors) applied to assets under the NSFR.

The ABA has particular concerns with the blunt 100 per cent weighting applied to "all other assets". This category represents a large proportion of Australian bank balance sheets, particularly given banks' large holdings of long-term high quality residential mortgages. These assets do not give rise to the same levels of liquidity risk as other assets such as corporate securities. The NSFR weights should more adequately reflect the drivers of asset liquidity, including credit

quality. Moreover, asset categorisations should allow for flexible application by national supervisors where appropriate, and the Committee's rationale and objectives for asset categorisations and factor weightings should be clearly articulated in the framework.

We also note that there are some assets that banks hold that do not require funding, such as client segregated funds. Similarly banks have on balance sheet many types of "matched" sources and uses of funds, such as trading assets and liabilities, which should be excluded from the framework at the discretion of the national supervisor. There are other "operational assets", the balance of which are very short-term and fluctuate frequently. The NSFR calculation should provide scope for national supervisors to allow exclusion of such items from the calculation and discretion to relocate assets from the "other asset" category to other categories, if justified by the lower liquidity risk profiles of those assets. As discussed throughout this submission, there will be jurisdiction-specific factors that will determine the liquidity of particular assets. There should therefore be scope for national supervisors to adjust the construct of the NSFR in response to these factors.

In regard to available funding, the ABA recommends that the Committee increases the weightings applied to retail deposit funding to better reflect the stability of those funds over a mild and longer-term scenario. We also recommend that further consideration be given to the definition of term deposits to provide national supervisors with the ability to recognise the stability of a broader set of term deposits than those that impose material penalties on depositors for early withdrawal. Interest penalties are discouraged by the Australian Code of Banking Practice and proposed changes to consumer laws, yet it can be demonstrated that term deposits for particular customer types are stable sources of funding.

4.2 Accommodating NSFR requirements for local market circumstances

Consistent with the remarks made above in relation to the "local nature" of liquidity, the NSFR outcome is dependent on the structure of banks' balance sheets. To a large extent, balance sheet structures are determined by the circumstances in which banks operate. The NSFR as currently calibrated presents particular challenges for Australian banks for a number of reasons:

- Residential mortgages comprise a large proportion of Australian bank balance sheets (approximately 55 per cent of Australian banks' total lending assets). In general, Australian residential mortgages represent high quality full-recourse bank lending, yet must be supported by the largest amount of term-funding in the NSFR calculation.

- Australian mortgages have historically demonstrated very low default rates relative to most other markets. This performance, coupled with the absence of government-sponsored securitisation schemes (such as those in the US) and government-funded mortgage insurance (such as in Canada), means that mortgages tend to remain on the balance sheets of Australian banks.

- Australian banks' ability to attract retail deposit funding, which is the most favoured form of funding for maturities less than one

year, is compromised.[6] This follows from a taxation system that provides attractive concessions to savings in approved retirement or pension funds ("superannuation funds") and penalises bank-deposit saving (by taxing the interest-earned), and a legislative requirement that employers lodge at least 9 per cent of employee salaries with superannuation funds. The treatment of these superannuation savings in the NSFR calculation, that are sourced from a largely retail base but channelled through corporate entities amplifies the challenge for Australian banks.

- Australian banks' ability to "*materially penalise*" depositors on early withdrawal of term deposits beyond the loss of interest incurred is limited by market and regulatory pressures and discouraged by the Code of Banking Practice and proposed changes to consumer laws. As a consequence, it is unlikely that banks will be able to weight many of their term deposits at the more favourable weight of 100 per cent even though those deposits will behave in the same manner as other forms of term deposit under stress (this assumes that the approach for categorisation of term deposits under the NSFR is the same as the approach under the LCR – although we note that this is not clear in the Liquidity Document).

In the case of Australia, the only way that Australian banks will be able to meet the requirement *with certainty* is by reducing the volume of long-term loans. Banks can attempt to raise longer-term funds and more stable deposits but, for the reasons stated above, it is not certain that this will be achievable. While this discussion has focused on Australian banks, the ABA understands that banks in almost every jurisdiction are unable to meet the ratio as currently proposed.

Given the structural differences in local financial markets and its impact on the outcomes of the NSFR, national supervisors should have the flexibility to adjust their application of the NSFR requirement consistent with the circumstances of the local market. National supervisors should be required to disclose their rationale for local implementation in the context of the circumstances of their local environments.

Main Recommendation 3: The Net Stable Funding Ratio should be significantly recalibrated to reduce the limitations on the maturity transformation process and address the potentially obscure outcomes of the ratio in adequately assessing liquidity risk. National supervisors should have the flexibility to adjust their application of the NSFR requirements, consistent with the circumstances of the local market.

The ABA supports introduction of a measure to encourage long-term funding and notes that the larger Australian banks have been using similar metrics for a number of years. However, the ABA recommends that the NSFR assumptions undergo significant recalibration such that maturity transformation, which is the core function of banking, is not severely penalised and that the ratio more

[6] As has been the case in other jurisdictions such as the UK, Australian banks have been competing for deposits by offering higher interest rates, particularly on term deposits, by offering 'special interest rates' and reducing 'penalty fees'. While deposits continue to rise, growth is slowing markedly (refer Reserve Bank of Australia, Financial Stability Review, March 2010).

adequately reflect the drivers of asset liquidity, including credit quality (for example, the ratio should reflect that prime mortgages will contribute much less to liquidity risk than sub-prime mortgages).

Asset categorisations should allow for flexible application by national supervisors where appropriate. To facilitate this, the Committee's rationale and objectives for asset categorisations and factor weightings should be clearly articulated in the framework. Consistent with Recommendation 2, national supervisors should be required to disclose their rationale for local implementatios in the context of the circumstances of supervisors' local environments.

Supplementary Recommendation: Recalibration of the NSFR factors

The NSFR should be reconfigured to make more intuitive sense. In particular, the ABA recommends that the regulatory framework:

- *increase the weightings applied to retail deposit funding;*
- *introduce flexibility to allow 'matched' sources and uses of funds, such as trading assets and liabilities, to be excluded from the framework at the discretion of the national supervisor;*
- *recognise that there are some asset types that do not require funding, and provide scope for national supervisors to allow exclusion of such items from the calculation;*
- *provide national supervisors with discretion to relocate assets from the 'other asset' category to other categories if justified;*
- *align the categories and relative liquidity of assets for the LCR with those of the NSFR.*

5. Short-term resilience to liquidity risk

The level of resilience to short-term liquidity shocks in the Liquidity Document is determined by the requirement that the stock of high quality liquid assets ("HQLA") exceed the 30-day cumulative net cash outflow ("net cash outflow"). The difficulties in meeting too high a level of resilience can be remedied, in part, by adjusting the composition of the HQLA. The HQLA requirement, itself, can be reduced by decreasing the severity of the stress and the net cash flow outcome. The submission considers each of these items in turn.

5.1 Broadening the definition of the stock of high quality liquid assets

For the purpose of calculating the LCR, the Liquidity Document defines liquid assets as *"easily and immediately converted into cash at little or no loss of value".* The liquidity of an asset is said to depend on *"the underlying stress scenario, the volume to be monetised and the time-frame considered".* The Liquidity Document therefore proposes two definitions of high quality liquid assets, a "*narrow"* definition comprising largely sovereign bonds and a "*broader"* definition that includes corporate and covered bonds with specified haircuts.

The ABA makes a number of observations on the proposed definitions of high quality liquid assets:

- Based on the assumptions provided in the Liquidity Document for the calculation of net cash outflows, we estimate that the availability of Australian sovereign bonds in domestic currency will fall short of the HQLA requirement by several multiples.[7] We anticipate that this position will improve slightly over the next four years, before again declining, and will not improve at all if balance sheet growth is taken into account. Even if Australian banks were able to acquire the entire stock of Australian sovereign bonds (which would leave no stock for investment funds, central banks, and the many other domestic and foreign investors that currently account for around 80 per cent of Australian sovereign bond holdings), the total supply would be less than half of the required demand, with the gap set to expand over time. We understand that other jurisdictions, such as the Nordic countries, face similar challenges with the narrow definition of liquid assets.

- The broad definition of liquid assets will not assist Australian banks. Australia's corporate bond market is relatively small and a covered bond market in local currency non-existent owing to legislative restrictions on the issuance of covered bonds. Hence, the suitability of assets for the liquid asset definition will need to be determined in the context of the local Australian market. In this regard, we observe that bank-issued securities are a liquid asset in the Australian context relative to other asset types and should not be discounted entirely although we acknowledge the Committee's concerns in relation to systemic risk. We anticipate that other regulatory frameworks in the Asian region will face similar constraints owing to a lack of depth in non-bank securities markets.

- We observe that the broad definition of liquid assets proposed appears arbitrary. It is not clear why covered bonds are singled out as a liquid asset relative to the universe of other available assets.

- We recognise that some jurisdictions do not face the same constraints on the availability of sovereign bonds. We emphasise, however, that fiscal positions for any economy can change quickly and over a short period. Moreover, a globally harmonised liquidity framework should reflect the situations of *all member countries*.

- We highlight that restricting the definition of high quality liquid assets to a very narrow one can give rise to other risks such as the market and credit risks that come from holding an undiversified portfolio. The recent volatility in the values of sovereign bonds issued by some European countries is a good example of those risks. A narrow definition of liquid assets also has broader market implications. The proposals have the unintended consequence of potentially locking up stock with captive holders, thereby hindering the effectiveness of markets to facilitate liquid transactions and accurately price for risk.

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[7] This finding takes into account APRA's determination that bond issues made by semi-Government authorities will be included in the narrow definition of HQLA.

> Assets that are not defined as liquid, but have been defined as liquid to date by national supervisors, would be adversely impacted by structural shifts in demand. Notwithstanding the Committee's concerns in relation to the systemic risk associated with securities issued by financial institutions, if banks can no longer hold other bank paper for liquid asset purposes, a large part of the demand for that paper would disappear. This could lead to a downsizing of these markets and a potential reduction in lending by some banks.

In view of the above considerations, the ABA supports a *broader* definition of high quality liquid assets that provides scope to respond to the circumstances of individual jurisdictions at any point in time. The ABA is of the view that the composition of liquid assets should comprise a well-diversified portfolio. While we do not dispute that the market for sovereign bonds will, under most stress events, be more liquid than the markets for most other assets, there are conceivably events where sovereign bonds will not retain their capacity to generate liquidity. Moreover, a well-diversified portfolio should assist in minimising the market implications highlighted above.

Similarly, the haircuts attached to particular types of liquid assets should be specific to the local jurisdiction in which those assets are traded. For the reasons noted above, the liquidity of assets depends on the market in which they are traded. Hence, prescribing general haircuts across broad asset pools runs the risk of under- or over-stating the market value of those assets should they need to be realised. Providing national supervisors with the flexibility to adopt haircuts that are appropriate to how the assets trade in the local market will allow supervisors to determine the weight that those assets have in the liquid asset pool. As a general comment, we note that the haircuts attached to corporate bonds and covered bonds (either 20 per cent or 40 per cent depending on credit rating) in the Liquidity Document are very large and appear at odds with the principle that assets included in the stock of liquid assets be *"high quality"* assets.

The ABA therefore recommends that the Committee introduce a broad definition of liquid assets that provides national supervisors with discretion to substitute those assets that are more liquid than others in local markets, subject to meeting the criteria for a liquid asset established by the Committee. This could be achieved by specifying a set of criteria against which a liquid asset must be assessed – similar to the 'characteristics' of a liquid asset included in the Liquidity Document. It could also be met by providing a prescriptive definition of liquid assets, such as the narrow definition in the Liquidity Document, and setting out jurisdictional-specific circumstances that justify use of a different definition to that prescribed. This would include an inadequate sovereign bond market denominated in the local currency.

The Committee sets out fundamental and market-related characteristics for an asset to be regarded as liquid. Consistent with the above recommendation, the ABA supports this approach which will allow national supervisors to draw on the criteria specified to ensure that local liquid asset definitions meet local conditions while ensuring consistency with the objectives of the globally harmonised liquidity framework. We note that for most jurisdictions, the definition of liquid assets will allow for inclusion of those liquid assets that are eligible (for "repurchase") with the central bank; this is consistent with the Committee's principle that liquid

assets ideally be central bank eligible and further promotes the liquidity of such assets in private markets.

The ABA makes two additional comments on the criteria proposed in the Liquidity Document:

- While we agree with the Committee's statement that liquid assets should have *"low correlation with risky assets",* we disagree with the Committee's view that *"assets issued by financial firms...are more likely to be illiquid in times of liquidity stress in the banking sector."*

  One key concern with this position is that in the Australian economy the role of banks is such that a liquidity stress in the banking sector would typically be associated with a system-wide economic stress. In these circumstances, bank assets would become more liquid than most other assets owing to the "flight to quality" behaviour of markets. During the GFC Australian bank short-term assets demonstrated higher liquidity than many other assets.

  Our second key concern relates to the level of liquidity resilience being set on the basis of individual bank crises and not systemic crises. In this case, while the principle of the criterion for low correlation with risky assets would remain valid, broadening the criterion to highlight assets issued by financial firms would not be.

- We acknowledge the principle underlying the Committee's criterion that assets *"listed on a developed and recognised exchange market"* increases their transparency. We argue, however, that this should neither be a necessary nor sufficient criterion for the definition of a liquid asset. There are many assets, particularly fixed interest assets, which are not traded on an exchange but that can be regarded as liquid. Similarly there are many exchange traded assets that we believe should not be regarded as liquid assets. This would include many types of exchange-traded commodities.

As a further comment, the Liquidity Document also includes operational requirements in relation to the stock of liquid assets. These include the requirement that the liquid assets *"be under the control of the specific function or functions charged with managing the liquidity risk".* The ABA seeks clarification that this requirement does not imply that the stock of liquid assets should form part of a bank's Treasury portfolio. Provided that the definition of a liquid asset is met, that the assets are not encumbered, that those responsible for managing liquidity risk are able to demonstrate that they have immediate access to the assets if required, and that the bank is able to satisfy required monitoring and reporting requirements, then the bank should be able to count liquid assets held towards the HQLA requirement, irrespective of where those assets are held in the bank.

<u>Supplementary Recommendation:</u> Criteria for asset liquidity

The ABA recommends that the definition of liquid assets be based on acceptable criteria for counting an asset as a liquid asset for the purpose of the LCR. These

criteria should exclude the requirement that the asset be traded on a recognised exchange (although this criterion could be provided as a useful guide). The criteria should also qualify that low correlation with risky assets is dependent on both the asset and the nature of the liquidity stress.

Alternatively or in addition to the above, the ABA recommends that the definition of liquid assets set out jurisdictional-specific circumstances that justify a different definition from that prescribed. For most jurisdictions, the definition of liquid assets will allow for inclusion of those liquid assets that are eligible (for "repurchase") with the central bank; this is consistent with the Committee's principle that liquid assets ideally be central bank eligible and further promotes the liquidity of such assets in private markets.

5.2 Reducing the cumulative net cash outflow: issues of time horizon and 'tiering' of liquid assets

The level of resilience under the LCR is also determined, in part, by the 30-day time period over which the cumulative net cash outflow is measured. The decision about the appropriate length of the survival horizon is about striking a balance between the extent to which a (solvent) bank should be expected to provide its own liquidity and the extent to which it can expect to rely on the central bank for liquidity support.

One option for reducing the level of resilience is to reduce the time horizon over which the period of short-term stress plays out. We recognise, however, the Committee's objective of lengthening the stand-alone survival horizon of individual banks. Another option is to reduce the net cash outflow. We consider this option in Section 5.3.

The ABA recommends that the Committee consider a third option: to allow national supervisors to gradually broaden the definition of liquid assets as the short-term crisis evolves. A simple example of how this would work is set out in Table 2. We observe that this approach is similar to the broad definition of liquid assets set out in the Liquidity Document. This is because bank modelling of net cash outflows suggests that the HQLA requirement can be broadly calculated as a straight-line amount over the 30 days, thereby meaning that approximately half the HQLA requirement will comprise sovereign-equivalent assets and no more than half private securities (consistent with the limit specified in the Liquidity Document). The difference is that the types of private securities eligible to be counted as liquid assets will depend on the local market and local currency of the bank.

Table 2: Example definition of liquid assets

	Type of Liquid Asset (Local Currency)	Haircut (Per cent)
Day 1 to Day 10	Sovereign bonds and equivalent assets[8]	0
Day 10 to Day 30	Private security assets as specified by national supervisors	As appropriate

This option is predominantly a response to the shortage of sovereign bonds that is evident in some markets including Australia's and the trade-off acknowledged by the Committee *"between the severity of the stress scenario and the definition of the stock of liquid assets".* It would allow national supervisors to recognise those assets that are liquid in local jurisdictions, while retaining the flexibility for supervisors to require banks to build up stocks of sovereign bonds. It will also assist in alleviating some of the market implications of too narrow a definition of liquid assets discussed earlier, many of which come about owing to structural changes in the demand and supply of those assets. An alternative but broadly equivalent approach would be to attach weights to different types of liquid assets to ensure that a proportion of the highest quality liquid assets are held by banks.

Main Recommendation 4: The Liquidity Coverage Ratio should be recalibrated to achieve a level of resilience that implies a less severe combined idiosyncratic and market-wide liquidity stress. The definition of liquid assets should be "tiered" over the course of the stress period to allow national supervisors to identify those assets that are most liquid in local jurisdictions.

The ABA recommends that the LCR be recalibrated to a more moderate combined idiosyncratic and market-wide liquidity stress that strikes a more appropriate balance between the benefits and costs of a more resilient system. This could be achieved by reducing the term over which the liquidity stress plays out or adjusting the cash flow assumptions to calculate the ratio.

It could also be achieved by broadening the definition of liquid assets. The proposed definition of liquid assets does not reflect the fact that market liquidity differs across jurisdictions. The ABA recommends that the definition of liquid assets be sufficiently flexible to accommodate jurisdiction-specific factors by basing the definition on acceptable criteria for recognising an asset as a liquid asset for the purpose of the two regulatory standards.

The definition should provide scope for national supervisors to gradually broaden the definition of liquid assets as the short-term crisis evolves in recognition of the different degrees of liquidity of assets. A suitable haircut or portfolio limit to reflect differing liquidity could be applied to each type of liquid asset that is

[8] It is recommended that this category is equivalent to paragraph 34 of the Liquidity Document, or in Australia's case, all items of General Collateral specified by the Reserve Bank of Australia.

included in the liquid asset definition. Consistent with Recommendation 2, the regulatory framework should require that national supervisors set out those jurisdiction-specific factors that support supervisors' choice of liquid assets in the local market.

Supplementary Recommendation: Criteria for asset liquidity

The ABA recommends that the definition of liquid assets be based on acceptable criteria for counting an asset as a liquid asset for the purpose of the LCR. These criteria should exclude the requirement that the asset be traded on a recognised exchange (although this criterion could be provided as a useful guide). The criteria should also qualify that low correlation with risky assets is dependent on both the asset and the nature of the liquidity stress.

Alternatively or in addition to the above, the ABA recommends that the definition of liquid assets set out jurisdictional-specific circumstances that justify a different definition from that prescribed. For most jurisdictions, the definition of liquid assets will allow for inclusion of those liquid assets that are eligible (for "repurchase") with the central bank and which are clearly the most liquid of all assets.

5.3 Reducing the cumulative net cash outflow: cash flow assumptions

In addition to the liquid asset composition and the time horizon of the liquidity stress discussed above, the level of liquidity resilience (as measured by the HQLA requirement) is also determined by the modelling assumptions that underlie the net cash outflow.

The Liquidity Document prescribes liquidity characteristics based predominantly on asset and liability types. In principle, given the dearth of data available on cash flow run-off, the ABA supports an approach that prescribes assumptions for all main cash flow types. However, consistent with the comments made earlier in relation to the local nature of liquidity risk, the ABA seeks flexibility for national supervisors to vary those assumptions where warranted by product or customer characteristics, driven by local markets and/or local practices or legislation.

Further to our earlier comments, the ABA is strongly of the view that the assumptions set too high a level of resilience on the banking system. Recalibration is required to ensure that the HQLA requirement strikes an appropriate balance between benefit and cost. We anticipate that the outcomes of the QIS will demonstrate the degree of calibration required.

It is our understanding that the cash flow assumptions have been set on the basis of analysis of volatility of limited data and/or on intuitive judgments as to the likely behaviour of product cash flows. The ABA cautions against extrapolating the experience of only a handful of banks, with particular customer sets, to all types of banks.

The ABA's view is that liquidity is best characterised by a range of factors that include:

- type of customer;
- the nature of the bank's relationship with the customer (including whether the account is used as working capital or can be deemed to

be a 'relationship' account in which case the cash flow run-off would be higher than that for 'working capital customers', but less than for a customer that had no such relationship – this differentiation applies to both non-financial and financial corporate customers);

- the size of the customer deposit; and
- for some customers and deposit balances, ease of access.

Consistent with this approach, we set out below our observations in relation to the cash flow assumptions that determine net cash outflows under the LCR. As a general comment, we note that categorisation of assumptions in the Liquidity Document does not adequately take into account the variation in behaviour arising from different deposit balance levels. Customer deposit balance is an important driver of stability and we recommend that the framework provide national supervisors with the flexibility to take deposit balance into account where justified. We also note, consistent with the ABA's earlier comments in relation to the importance of adopting a flexible and principles-based approach, given the local nature of liquidity, that national supervisors should be able to apply the categorisations of cash flows set out in the framework as appropriate provided that the objectives of the framework are met.

5.3.1 Retail call deposits

The ABA welcomes the Committee's proposal to recognise the strength of the customer relationship as a driver of stability for retail customers. We agree that the presence of deposit insurance will contribute to the stability of a retail deposit cash flow; however, we are of the view that a customer does not require deposit insurance to provide a stable source of funds. Deposit insurance, while an important factor, should not be a necessary factor.

In Australia, the deposit insurance scheme is new and untested[9]. Australian banks have, for many years, been modelling the stability of customer deposits and identifying those customers that provide a stable source of funding and those that do not. While Australian banks have not over this time experienced a 'deposit' run, we believe there are a number of factors that contribute to stability, including the size of deposit balances and the history and breadth of the relationship that a customer has with a bank (such as the number and size of loans, credit cards and other facilities that the customer may have with the bank).

Moreover, the structure, operation, coverage and effectiveness of deposit insurance schemes across jurisdictions are very different. As demonstrated during the GFC, depositor awareness of, and confidence in, deposit insurance schemes may also vary.

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[9] Prior to the GFC, Australia's deposit insurance scheme was proposed to protect deposits up to an amount of A$20,000. The GFC saw the level of the guarantee increase to A$1 million however this limit is due to be reviewed next year.

5.3.2 Retail term deposits

For retail term deposits, Australian banks often do not impose withdrawal penalties that are materially in excess of the loss of interest and in some cases are discouraged from doing so by local banking code of conduct and consumer laws. Regardless, our experience is that retail term deposits demonstrate consistently stable funding. We therefore favour flexibility to allow regulators to develop rules that accommodate practices in local jurisdictions.

5.3.3 Non-financial SME

For small business customers, the ABA concurs with the application of the Basel II threshold to categorise a customer as small business. We note, however, that the difference in required assumptions above and below the threshold is substantial and customers may frequently move from one side of the threshold to the other, particularly when different types of deposit accounts are aggregated. Consistent with the general comment made earlier in relation to the need for a principles-based approach to the categorisation of cash flows, we recommend that the threshold be implemented as a guide rather than a 'hard rule'. Moreover, we do not agree with the approach that affiliated small businesses will behave synonymously such that the deposit balance of those businesses should be aggregated. We therefore recommend that aggregation for the purpose of liquidity management for small business customers be implemented on a case-by-case basis.

5.3.4 Unsecured wholesale funding

The ABA welcomes the Committee's proposal to recognise the strength of the customer relationship as a driver of stability for retail customers and believes that relationship should be recognised as a driver for wholesale funding also. We believe this to be the case for both non-financial and financial customers. Further, for financial customers, the existence of an operational account remains important and will contribute to the stability of customers' funding.

5.3.5 Secured funding

For secured funding, the ABA does not agree with the asymmetric treatment applied to the definition of liquid assets: specifically, that secured funding cannot be assumed to roll over even if the security is in the form of assets deemed to be liquid under the broad definition. The ABA recommends that the security determining rollover should be consistent with the definition of liquid assets in operation within a jurisdiction, narrow or broad.

5.3.6 Contingent facilities (inflows and outflows)

Asymmetry exists for the treatment of credit facilities to financial corporate clients: specifically, the requirement that banks assume that credit facilities to third parties will be drawn, but credit facilities provided to themselves will not be. The ABA is strongly of the view that a bank's decision to provide credit facilities to third parties in a crisis situation will depend on the circumstances prevailing at the time. Banks will not provide these facilities as a matter of course. The ABA therefore recommends that the assumption attached to credit facilities provided be agreed between banks and their national supervisors on a case-by-case basis.

Importantly, when setting this assumption it is important to take into account the nature of the credit line and its associated terms. Both will have an important bearing on the likelihood of drawdown. For example, in the case of credit lines that form part of a syndicated lending facility, any drawdown would be funded proportionally by all syndicate members and would come at a cost to the borrower. The ABA is of the view that, for many undrawn credit lines, there is no reason to assume a higher than 'business as usual' assumption. Moreover, the experience of banks during the GFC was that customers, including financial customers, did not draw on the credit facilities available to them, presumably owing to the reputational consequences of doing so. We also note reliance of smaller banks on undrawn lines from larger banks. We recommend that national supervisors be permitted to give consideration to the implications of the proposals for the pricing and availability of these lines.

5.3.7 Securitisation (inflows and outflows)

Securitisation-related cash flows are considered separately in the Liquidity Document. Specifically, maturing debt must be assumed to roll off; assets that could be returned due to embedded options must be recognised as outflows; and the undrawn portion of liquidity facilities to special purpose vehicles must be assumed to be drawn. In the case of liquidity facilities supporting securitisation vehicles, it is sometimes the case that the facility may be drawn only to redeem existing commercial paper. Similarly, there are other types of facilities that limit the amount of drawdown over a period, such as warehouse facilities that are partitioned into parcels of possible drawdowns. The ABA is of the view that the framework should be sufficiently flexible to accommodate these types of facilities.

5.3.8 Collateral calls for derivatives and related transactions

The Liquidity Document proposes that banks give greater consideration to obligations arising from collateral calls. In particular, counterparty calls for collateral should be assumed to be made for "each contract in which 'downgrade triggers' exist". The bank is required to assume that 100 per cent of collateral "will have to be posted for any downgrade up to and including a 3-notch downgrade". The ABA is uncertain as to how to apply this requirement in practice. We would expect that the notch downgrade be consistent with the confidence level assumed, but seek clarity on this from the Committee and suggest that further work is required to develop this assumption.

5.3.9 Incorporating other inflows for measuring the net cash outflow

The ABA concurs with the Committee's approach of recognising as inflows for the purpose of the LCR only those cash flows that are likely to be received within the 30-day horizon. We note that the Liquidity Document does not refer to assets that are outside of the liquid asset definition but that a bank would be able to realise, with a suitable haircut, within the term of the liquidity stress. This would include those assets that are eligible for repurchase with the central bank but also other assets that are traded in deep and liquid markets or on exchanges, as in the case of equities. The ABA strongly recommends that these items be included in the LCR.

<u>Supplementary Recommendation</u>: Adjustments to cash flow assumptions for the LCR

The ABA recommends that the categorisations for LCR cash flows take into account the variation in behaviour arising from different deposit balance levels. Customer deposit balance is an important driver of stability and we recommend that the framework provide national supervisors with the flexibility to take deposit balance into account where justified. We also note that, consistent with the ABA's earlier comments in relation to the importance of adopting a flexible and principles-based approach given the local nature of liquidity, national supervisors should be able to apply the categorisations of cash flows set out in the framework as appropriate provided that the objectives of the framework are met.

Notwithstanding the above comments in relation to flexibility, the ABA makes the following recommendations in relation to the cash flow assumptions included in the Liquidity Document for calculation of the LCR:

Cash flow type	**ABA recommendation**
Retail call deposits	While the presence of deposit insurance will contribute to the stability of a retail deposit cash flow, it may not be a necessary factor; a customer does not require deposit insurance in order to provide a stable source of funds.
Retail term deposits	Acceptable withdrawal penalties are not a characteristic of Australian term deposit products. There should be flexibility to allow regulators to develop rules that accommodate practices in local jurisdictions.
Non-financial SME	Consistent with the recommended principles-based approach to asset categorisations, the threshold for SME should be implemented as a guide rather than a 'hard coded rule'.
Unsecured wholesale funding	The nature of the relationship between a customer and the bank, including the existence of operational accounts, should be recognised as a driver for wholesale funding provided by both non-financial and financial corporates.
Secured funding	The security determining rollover should be consistent with the definition of liquid assets in operation within a jurisdiction, narrow or broad.
Contingent facilities (inflows and outflows)	The assumption attached to credit facilities to third parties should be agreed between banks and their national supervisors. In agreeing these assumptions, national supervisors should be permitted to give consideration to the implications of the proposals for the pricing and availability of these lines.
Securitisation (inflows and outflows)	The framework should be sufficiently flexible to accommodate different types of securitisation facilities.
Collateral calls for derivative and related transactions	The ABA seeks clarity as to the application of the three-notch downgrade for collateral calls.
Other inflows	The regulatory framework should allow for recognition (with appropriate haircuts) of cash flows arising from the potential sale of assets other than those assets included in the definition of liquid assets.

6. Macroeconomic implications

The combined impact of the regulatory changes proposed in the Consultative Documents will have major implications for the cost and availability of loans and,

consequently, for economic growth and employment. The ABA acknowledges that there is significant regulatory activity under way currently to assess the "top down" and "bottom up" implications of the regulatory changes. In particular, the QIS appropriately commissioned by the Committee will likely reveal a very large gap between the current state of the industry and the world envisaged by the proposed framework. It is also likely that the QIS will highlight the significant impact that the proposals would have on bank lending activity. Consistent with later comments, the ABA recommends that the Committee comprehensively consider and consult on the analyses undertaken.

In the meantime, the ABA sets out below a framework for the potential impact of regulatory change. The main channel through which the impact will be transmitted is interest rates. Banks will respond to the changes by raising spreads between deposit and lending rates owing to the need to recover the higher costs associated with increased liquidity and capital requirements. It is, in part, the repricing of deposit and lending rates that will impact the community. The extent to which the impact of the changes falls on the quantity of lending rather than on the price of lending depends on the demand elasticity for bank lending and the supply elasticity of non-bank lending. Also, any action that increases the cost of funds will, other things being equal, increase the cost of loans.[10]

Estimating the potential impact of regulatory change is complicated greatly by assumptions about how banks will implement the changes – such as by raising lending rates or by tightening underwriting standards to "crowd out" higher-risk borrowers. These decisions on pricing and underwriting standards flow through to the markets for borrowing and lending; to consumption and savings; and finally to production and employment as economies find a new equilibrium. It is also complicated by how borrowers will respond: if the demand for loans is highly elastic, a small increase in lending rates will reduce lending significantly, thereby absorbing the pressure more in the quantity of lending than in the price. Finally, the assessment will also depend on the response of non-bank competitors. On the latter, we note that although the impact on the economy will be greatly reduced if there is a ready market of non-bank lenders able to fill the gap left by potential bank reductions in lending, it will also have the unintended consequence of transferring credit and liquidity risks to the non-bank sector.

Unfortunately, there are no readily available numerical or statistical models to guide assessment of these interactions and to assist in calibrating the outcomes. The ABA has, however, undertaken a preliminary assessment of the implications of the proposed LCR in the Liquidity Document. Under the LCR, the ABA estimates that Australian banks will be required to hold about double the level of high quality liquid assets that is currently required to be held under existing rules.[11,12] This amount does not take into account either the types of liquid

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[10] In part these trends have already emerged as banks have rebuilt their capital bases following the GFC; the cost of funding from wholesale markets has risen following the liquidity crisis; and banks have generally increased their pricing of risk following the period of under-pricing leading up to the GFC. The net impact on borrowing rates has nevertheless, to date, been mitigated somewhat by the global low-interest environment established by central banks in response to recession.

[11] Refer Australian Prudential Regulation Authority (APRA) Prudential Standard APS 210 Liquidity (APS 210).

assets permitted to be held in liquid assets (and specifically the required replacement of existing interbank funding under the current definition of eligible liquid assets in APS 210) or the likely changes to banks' liquid assets holdings in response to the NSFR requirement.

Of principal concern to the ABA is the ability of banks to fund the additional HQLA requirement and the impact that this could have on bank balance sheet growth and on the local economy. The ABA believes that lending will have to be reduced (potentially quite sharply) if the level of resilience is set too high and the proposals are introduced too quickly. The lending contraction would derive from crowding out, as well as from the higher credit pricing that was mentioned earlier. There are four possible ways that banks could respond to a requirement of this size:

- Banks could attempt to maintain existing domestic private sector lending by funding the increase in prescribed assets by bidding for additional liabilities (which could raise the HQLA requirement further depending on the types of funding secured and the regulatory standard in question). These additional liabilities would necessarily come largely from international wholesale funding given the low elasticity of domestic deposits and the size of the local wholesale investor base.[13] Coupled with concerns about concentrated exposure to offshore investors, this would in turn have the unintended consequence of increasing banks' exposures to foreign currency risk and/or counterparty credit risk to the extent that foreign currency exposures are hedged.

  While this is one option for meeting the new requirement, fully funding the requirement through extra liabilities would be uneconomic unless banks were able to pass the incremental cost of this additional funding (i.e. the cost of funds relative to the low yield on liquid assets) through to bank customers.

  Regardless of the economics of seeking additional funding, the ABA is strongly of the view that there is insufficient appetite to absorb the quantity of new debt that would be required to fund the additional liquid assets. There is little historical evidence of high demand elasticity for retail deposits in Australia, and wholesale markets are showing strong rationing tendencies since the GFC. Thus Australian banks are unlikely to find much additional funding by offering higher interest rates in either retail or wholesale markets.

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[12] To assess required HQLA, the ABA compiled the current and expected holdings of 14 of its member banks, including the 4 major banks. In total, these banks represent 90 per cent of the industry by domestic assets. While the sample is less than 100 per cent, the estimates are nonetheless highly representative of the sector and we believe them to provide a sufficiently sound estimate of the impact of the proposals.

[13] Refer Ric Battellino, Deputy Governor of the Reserve Bank of Australia, *Some Comments on Bank Funding*, Remarks to the 22nd Australasian Finance and Banking Conference, December 16, 2009 for further discussion of constraints facing banks' access to deposit funding.

- Some of the reduction in lending could be facilitated by securitising existing loans from bank balance sheets or by accessing other forms of secured funding.[14] While securitisation may appear to be superficially attractive, it is questionable whether the market could absorb the quantity of securitised paper required.

- Banks could meet the requirement by reducing lending. It is difficult to assess where lending would fall most heavily without undertaking detailed risk-return analyses of different market segments; however it is possible to conclude that there is the potential for a significant impact on the economy in the event that some of the adjustment falls on reduced lending.

- Banks could restructure their balance sheets to reduce the liquid asset requirement. We recognise that one of the reasons for the introduction of the NSFR as a regulatory standard was to encourage banks to extend the term of "available stable funding" and, in so doing, avoid banks maintaining high proportions of funding between 30 days and one year. We highlight the significant challenges that banks face in restructuring their balance sheets, including the constraints to accessing alternative forms of funding, and the importance of allowing sufficient time for the banking industry to adjust to the new requirements.

It is likely that the Australian banking industry's response to the proposals will include a combination of the above options. Even then, we estimate that there will be a substantial 'gap' between the HQLA requirement and banks' net funding capacity over the next 12 months. Once translated into reduced lending, there could be a material impact on spending and GDP growth.

At this early stage, we have not undertaken extensive modelling to translate such a large reduction in credit directly into spending and GDP. As a broad guide, however, we refer to research undertaken in an IMF Working Paper that suggests that reductions in credit availability of 20 percentage points will reduce economic activity by 0.75 per cent after one year.[15] Based on the gap referred to above, we anticipate that credit availability will decline by approximately 10 per cent[16] over the first 12 months suggesting a reduction in GDP of around 0.4 per cent over the first year. The actual outcome could be much higher than this once second-order effects (generated by the exclusion of bank debt from the definition of liquid assets) are taken into account. The final outcome is also dependent on

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[14] The ABA notes that covered bonds are not a permissible source of funds in Australia owing to the depositor protection provisions in the *Banking Act 1959 (Section 13A).*

[15] Refer International Monetary Fund (IMF) Working Paper WP/08/161, *A US Financial Conditions Index: Putting Credit Where Credit is Due*, Andrew Swiston.

[16] In making this determination we deliberately use the level of liquid asset holdings implied by current balance sheets. This implies that the requirements will be implemented immediately. In practice, a longer transition period will likely apply. Normally we would use the liquidity level implied by balance sheets projected over the implementation horizon. We have not done that here, partly because we do not know what the transition period will be but mostly because we have no reliable basis on which to project future balance sheets given that, as highlighted below, balance sheet contraction will be an inevitable consequence of the proposals.

the period over which the requirements are implemented. In general, the longer the implementation period, the more dispersed the impact will be.

We encourage the Committee to work with industry to develop a comprehensive cost/benefit analysis that ensures the trade-offs are understood and fully worked through. The outcomes of the analysis should be publicly disclosed to assist in managing community expectations as to the impact of the proposals. As highlighted elsewhere in this submission, the costs to banks will inevitably flow through to the community and the economy. We strongly support steps by the Committee to assess the costs of a more resilient prudential framework. Clearly, there is still much work to be undertaken in order that the regulatory community and banking industry be fully apprised of the costs and implications for banks and the economy of the changes proposed in the Consultative Documents.