AFMA Response to Basel Committee

Consultative Document

International Framework for Liquidity Regulation

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TABLE OF CONTENTS

1. Introduction

The Australian Financial Markets Association (AFMA) represents the interests of participants in Australia's financial and wholesale banking markets. Our members include domestic and foreign owned banks, securities companies and specialised traders operating in Australia. AFMA acknowledges the considerable work undertaken by the Basel Committee in preparing the Consultative Document, *International framework for liquidity risk measurement, standards and monitoring*, and appreciates the opportunity to comment on its proposals.

AFMA understands the desire of global regulators to promote the development of stronger liquidity buffers to ensure greater resilience of banking institutions and supports the objective to strengthen banks' liquidity risk management systems. Our primary focus in responding to the Committee is to provide information that might assist in the design of policy measures to achieve this policy objective in the least cost manner.

We appreciate that the reforms to banking regulation, including the liquidity reforms, will increase the cost of financial intermediation through banks but we believe that credible reform outcomes can be achieved through more measured actions than those proposed in the Consultative Document.

The most obvious and serious policy constraint facing banks in an Australian context is that there is insufficient high quality liquid assets, under either of the definitions considered in the Consultative Document, to meet the banking system's liquid assets requirement under its proposals. We are concerned that the proposals would consequently have a significant adverse impact on the efficient operation of Australia's financial markets, with the perverse effect of reducing the capacity of markets to provide the liquidity that enhances bank resilience. Therefore, we believe it is important for the effects on financial markets to be carefully assessed and properly weighted in the impact analysis that underpins the proposed global liquidity framework.

We are also concerned that the Committee's proposals in their current form would impose a high penalty on Australian banks relative to banks globally, even though the Australian banking system was one of the strongest performers during the global financial crisis and Australian governments have relatively low debt. This suggests that the proposals must be reworked to address liquidity risk in a proportionate manner before they are finalised.

2. Liquidity Reforms and Financial Markets

Australia has a range of sophisticated, deep and mature markets for debt securities and derivatives that enables efficient and cost effective risk management. These markets have the capacity to absorb the impact of significant events and continue to operate, transferring funds and risk within

the system. The financial markets and banking system are tightly integrated and, consequently, disturbing the equilibrium in one area can have flow on effects to the other; the economic effects of which could be material.

Therefore, the design of policy actions to increase the resilience of banks and improve banking system stability must look beyond the immediacy of the banks' balance sheets and take into account the downstream impact of these measures on the financial markets and the economy in which banks operate, if they are to be effective. Thus, the analytical horizon of the Committee may need to be further extended to meet the stability objective it has set.

Banks are the key participants in the rates and currency markets, so their resilience depends in part on the efficiency of those financial markets and vice versa. For example, banks rely on the markets to sell marketable assets to obtain liquidity in the event of funding pressure. The organisation and structure of financial markets can vary from one country to the next and the impact of liquidity regulation on financial markets may vary accordingly. We can see two problems at this level with the approach adopted in the Consultative Document:

> First, the proposals would reduce the efficiency of financial markets in Australia (see below) and, perversely, run the risk of increasing systemic risk to that extent;
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> Second, the proposals may be excessive because they do not appear to adequately reflect measures being undertaken by regulators to make markets (especially OTC markets) safer from a systemic perspective; that is, to reduce risk in financial markets by improving the operating infrastructure.

It will be costly for banks to implement the proposed liquidity arrangements. While economic analysis of this impact is necessarily preliminary because the regulatory rules are still being developed, we are concerned that work that has been done in the Australian context finds that implementation of the proposals would have a significant adverse economic impact. The macroeconomic impact of the proposed changes is likely to be felt through higher interest rates, reduced credit to the private sector and higher risk management costs. This might lead to a lower stock of capital in the economy and less output than would otherwise be the case.

Against this backdrop, there is a strong incentive for governments, regulators and banks to ensure that liquidity regulation strikes a good balance between better management of liquidity risk and supporting a cost-effective and efficient financial system. In practice, this means that national regulators must be able to calibrate the detailed application of the global liquidity framework in a manner that reflects the features of their particular financial system and the economic environment within which it is based.

The immediate challenge for the Basel Committee is to provide a global regulatory framework that enables national regulators to react to and manage the specific needs of their domestic banking system. We think some change is necessary to achieve this, as the measures proposed in the Consultative Document are based on a paradigm that does not reflect Australian conditions (eg the relatively small amount of sovereign bonds on issue and the prohibition of covered bonds). As a result, the proposals will need some refinement to accommodate the situation of the Australian banking system and economy to avoid the risk of perverse regulatory outcomes.

3. Why the Proposed Approach Creates a Problem for Financial Markets

If the definition of liquid assets is too narrow, the eligible assets may actually become less liquid, as they will need to be held in large amounts and solely for liquidity-buffer purposes. The market for eligible assets will be dominated by the banks which will buy and hold them. This will greatly reduce the 'free float' available for trading by investors generally and restrict market liquidity, which is counterproductive to the objectives of policy here. Market makers require both an inventory of stock and the ability to readily trade stock in the market, which become more difficult and expensive in relation to eligible assets, if a narrow definition of liquid assets is adopted.

Moreover, in a systemic crisis, all banks would be trying to liquidate the same class of assets which could make the market one-sided and hence illiquid, so the market would not operate in the smooth manner contemplated in the Consultative Document. Dealing with market instability of this type would likely involve central bank intervention, which is also contrary to the objective of strengthened liquidity regulation.

Conversely, assets that regulation deems not to be liquid will be re-priced in accordance with the consequent reduction in demand and market liquidity may decline; especially if banks had previously been large investors and active traders in that market. This can also have implications for the functioning and efficiency of those markets. For instance, bond arrangers often make a two-way market for issues they facilitate and the cost of maintaining inventory will rise if these bonds are not recognised as liquid assets. Given the narrow margins that prevail in markets, this could affect the market's capacity to service issuers and investors. Thus, assets that are not part of the solution can become part of the problem and this should be factored into an assessment of the impact of liquidity regulation.

In an Australian context, the implications for financial markets of changed liquidity management practices are significant. This may be evident in markets themselves or it may be evident directly through reduced liquidity or indirectly through less efficient interest rate sets or through a reduced capacity to support futures markets. In addition, a thinning of the fabric of

the financial markets would be counterproductive by leaving the financial system less well placed to cope with systemic events.

Table 1 - Principal Securities Markets in Australia

	Market Turnover 2008-09		BIS Reform Impacts
OTC Markets	*AUD bn*	*GDP%*	
Government Debt Securities	792	63	Liquidity reduced, more concentrated market
Non-Government Debt Securities	494	39	Uncertain
Bank Short Term Paper	4,519	359	Liquidity significantly reduced, benchmark pricing impaired
Exchange Traded			
ASX equities	1,119	89	Unaffected

Note: Turnover data are sourced from AFMA's 2009 Financial Markets Report

Table 1 outlines the scale of activity on Australia's principal securities markets and the likely impact of the proposed reforms. The problem lies in the narrow definition of eligible liquid assets and the stringency of assumptions for the conduct of stress tests.

To give some sense of perspective on this problem, even if banks were able to acquire the entire stock of Australian government debt currently on issue, this would fall well short of the liquidity buffer requirement under the proposals. While the Committee is considering the inclusion of highly rated corporate debt and covered bonds through a broader definition of liquid assets, this is of limited assistance in Australia where covered bonds are considered to be inconsistent with depositor preference provisions set out in the Banking Act and the corporate debt market is not deep. In short, there are not enough outside assets in Australia to meet banks' liquidity buffer requirements.[1]

Banks are key participants in the interest rate markets and the nature of the anticipated market impact would increase liquidity risk for them. This illustrates the need to consider the effect on financial markets of the reforms, even though the impact on markets in other jurisdictions may be much less significant in practice.

Government Bond Market

If eligible liquid assets of the banking system are defined too narrowly, such that they rely substantially on government bonds, then the market will be dominated by the banks who act as 'buy and hold' investors to meet their liquid buffer obligation. This will greatly reduce the 'free float' available for trading by investors generally and reduce market liquidity. If the government bond market were to function much less effectively than at present, which is

[1] See Reserve Bank Research Discussion Paper 2008-06, Promoting Liquidity: Why and How?, Jonathan Kearns and Philip Lowe.

likely in these circumstances, this would have broad implications for the financial sector and the economy.

Government bonds perform a number of roles in a modern financial system that cannot be filled by other financial instruments. These include setting the risk-free benchmark curve for pricing other instruments (including derivatives), supporting cost effective risk management, providing a secure investment outlet and facilitating the financial system's liquidity management. The more efficient the government bond market is, the more efficient the futures markets will be, and the futures market is where most interest rate risk management and trading occur.

The benefit of an efficient government bond market has been recognised in public policy since the review of the future of the market for Commonwealth Government Securities in 2002. In particular, the then Government felt that the Australian financial markets may become less diversified and more vulnerable during periods of instability in the event that the government bond market were to become less effective and interest rates would be slightly higher.[2]

Bank Short Term Paper

Australia has a large and efficient market for bank paper in the form of bank bills and negotiable certificates of deposit (NCDs). It is the largest market for securities (by turnover) in Australia and has a diverse range of active issuers and investors. It provides vital liquidity for banks and the rates set by the market (called BBSW rates) serve as benchmark interest rates for a broad range of financial products. Thus, the BBSW rates have a benchmark role in Australia similar to LIBOR internationally.[3]

The effect of any impact of the proposed liquidity rules on the bank bill/NCD market must be assessed in the context of the broad reach of the market and its liquidity management role. In particular, many OTC derivatives and business loan/deposit products are priced off a BBSW rate. For example, this includes swaps, FRAs and options that had aggregate turnover in excess of AUD8.7 trillion in 2008-09. Similarly, interest payable on many infrastructure and project finance facilities is determined as BBSW plus a facility-specific margin. The SFE Bill Futures contract, which had turnover in excess of AUD14 trillion in 2008-09, is based on a liquid bank bill/NCD market.

If bank paper were totally or substantially excluded from liquid asset portfolios, the issuance of short term paper (especially 3 months or less) would be reduced and the stock of bank bills/NCDs would likely decline noticeably. This would affect liquidity and, hence, the reliability and integrity of the BBSW rate set process. As 30 day paper would need full liquidity

[2] Commonwealth Budget Paper No. 1, 2003-04, p 7-3.
[3] While BBSW rates are broadly analogous to LIBOR rates, there are material differences in the methodology behind the respective rate derivations.

cover, issuance of that maturity would dry up, so setting the 30 day BBSW rate would be a problem. If liquidity in short term issuance diminished, investors, even those looking for yield pickup, would exit this sector.

These changes would have significant ramifications for borrowers, investors and holders of derivatives contracts, with some suffering a consequent loss of wealth and others a windfall gain. The challenge from a policy perspective is to capture the liquidity and market efficiency benefits of the bank short term paper market in a manner that supports the banking system but does not rely unduly on this market as a source of liquidity in a crisis situation. The cost of any disruption and loss of efficiency to this market from the final rules should be factored into an assessment of the impact of the new regulation.

International Operations

The Basel Committee's liquidity framework should promote regulation that recognises banks' global operations and, thus, contains the additional liquidity cost for foreign branches to a reasonable level. The alternative would involve a higher liquidity cost for foreign bank branches that would affect their capacity to participate in the financial markets. This issue is important in jurisdictions like Australia, where foreign banks have a sizeable presence in banking and financial markets and, thereby, enhance the depth and diversity of the financial system.

4. Defining Liquid Assets

An appropriate definition of liquid assets is central to the effective management of liquidity risk by banks. Given the interconnectivity between the banking system, financial markets and the real economy and the variability of these components across jurisdictions, it is important that the liquidity framework set by the Basel Committee provides sufficient flexibility for national regulators to regulate liquidity in a manner that will deliver the most effective regulatory outcome in their jurisdiction.

AFMA believes that a portfolio approach to determining acceptable liquid asset buffers would provide an effective regulatory outcome. We propose that the portfolio for the purpose of the Liquidity Coverage Ratio could be a weighted mix of asset classes that exhibit consistent liquidity and low credit risk. The composition of a portfolio should reflect the particular characteristics of the jurisdiction within which the bank operates, including the financial markets.

Banks collectively have quite diverse businesses and some will hold other financial instruments, some of which will have good liquidity attributes. For example, a bank with a strong precious metals business may hold gold bullion for which there is a consistent, liquid market, a transparent price formation process and a safe haven attribute. We believe the Basel liquidity framework should not automatically exclude assets from being eligible for a liquidity

buffer but rather it should retain flexibility for the national regulators of banks to consider the merits of each case.

This approach would enable banks to diversify their liquid assets in a manner that is consistent with the objectives of the policy, whilst avoiding undue concentration in any particular asset or market. A bank that required funds would then have the flexibility to dispose of liquid assets in the most advantageous sequence under the prevailing market conditions. This would also reduce the risk of the policy detracting from the functionality of the markets that trade liquid assets (or derivatives based on them). This approach would meet the policy objectives of ensuring that bank stress situations do not immediately place a call on the public purse or effectively place central banks as the lender of first resort in stress situations

Fundamental Characteristics of High Quality Liquid Assets

While many liquid securities are listed and traded on exchange markets, we believe that the Consultative Document errs in suggesting that a fundamental characteristic of a high quality liquid asset is that it is listed on a developed and recognised exchange.

Many high quality liquid assets, such as government bonds, may not be listed on exchanges but have a transparent price formation process (which may include feedback through futures prices) and are highly liquid. Moreover, there many instances of exchange listed securities and contracts that do not actively trade. Exchanges often provide crossing facilities, so that large orders can be transacted off market and reported to the market with a delay to minimise the price impact of the transaction and promote liquidity. Moreover, we note that the most successful listed securities, equities, are not recognised as liquid assets under the Consultative Document's proposals.

Thus, we believe that being listed on a developed and recognised exchange market is not a unique or intrinsic indicator of liquidity or price transparency and, therefore, this should not be treated as a fundamental characteristic of high quality liquid assets. The strict application of this condition would impose a significant cost on the financial system, which we do not think the Committee intends.

Renewal and Development of the Liquid Assets Base

The threshold conditions for a marketable asset to qualify as a high quality liquid asset are stringent. While a security may quickly lose liquidity as a result of a particular event (eg an adverse tax law change or asset sales enable a government to largely retire its debt), there is concern that the financial system will face more significant challenges than before in generating new high quality liquid assets.

A feature of financial markets is that liquidity tends to attract liquidity and also securities that are eligible liquid assets will attract a certain amount of liquidity by virtue of the fact that banks may invest in and actively trade those products. Without the participation of banks as active traders, it would be more difficult to establish the critical mass of liquidity to enable a security to qualify as a high quality liquid asset. Thus, it could be a ‘chicken and egg’ situation, with sufficient liquidity likely to develop only with bank involvement but bank participation being deterred by the higher cost of holding assets that are not yet accepted as high quality liquid assets.

This problem of creating new high quality liquid assets will be most relevant to jurisdictions where liquid assets that are widely held by banks either decline in volume or are deemed not to be high quality liquid assets going forward. Therefore, we recommend that the Basel Committee should reflect on the threshold conditions it recommends for high quality liquid assets and give some further thought to the mechanisms through which regeneration of the high quality liquid assets base might be facilitated.

5. Concluding Comments

AFMA appreciates the opportunity to respond to the Consultative Document. We have focussed our attention on the interaction between proposed liquidity reforms and the financial markets, which we believe present significant issues in an Australian context and potentially in other jurisdictions, especially over time.

The problems we have identified are solvable within the framework being considered by the Basel Committee but they do require some refinement of the proposals to ensure that the most effective form of liquidity regulation can be adopted in individual national jurisdictions.

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