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Basel Committee on Banking Supervision
Bank for International Settlements
CH-4002 Basel, Switzerland

By e-mail

DISCUSSION PAPER: BCBS PRUDENTIAL APPROACH TO LIQUIDITY RISK

We refer to the above and appreciate the opportunity to provide feedback on this issue of far-reaching importance.

Preamble

Whilst the ASF will focus on matters within its direct purview, it would nonetheless like to initially make some general remarks.

Prudential liquidity requirements need to balance an economy's need for confidence, stability and growth; *de maximus* prudential requirements of any kind might imbue the greatest sense of confidence and stability but at the expense of growth, and even introduce some perverse outcomes that are counter-prudential. For example:

- preventing diversification of liquid assets by obliging banks/ADIs/credit-institutions (herein referred to as *Deposit-taking institutions*) to all dominate their liquid asset holdings into public sector paper significantly reduces Deposit-taking institutions' ability to diversify their liquids book – a central and basic tenet of liquidity management;

- significantly increasing the blended cost of funds for the Australian economy as a result of unprecedented demand for those same assets (early estimates range between 14bp to 100bps), thus reducing bank profitability and replenishment of capital reserves as a consequence; and,

- reducing competition in the Australian deposit and lending markets because of the crowding out of non-Major Deposit-taking institutions in their bid to compete with Major Deposit-taking institutions for scarcer asset and liability opportunities.

Securitisation-specific remarks

Two key securitisation-related instruments insofar as they directly relate to prudential liquidity standards are covered bonds and residential mortgage-backed securities ('RMBS').

Both financial instruments are in our view relevant to the prudential soundness of Deposit-taking institutions' asset as well as liability management.

BCBS rightly places considerable emphasis on Deposit-taking institutions' profitability because this ultimately enables their beneficiaries to maintain confidence – be they retail depositors, wholesale institutional investors or borrowers in the broader economy. This in turn permits Deposit-taking institutions to raise capital to continue to fund and in turn serve these same stakeholders. This mutual, self-reinforcing interest in ensuring Deposit-taking institutions remain profitable is driven to a very large extent by the cost of capital and the cost of funds that Deposit-taking institutions can sustain on balance sheet.

ASF acknowledges that Australia and BCBS respectively sit on the G20 and FSB and, in doing so, are obliged to a greater or lesser degree to adopt the agreements handed down at those fora. However, ASF is concerned that Australia is obliging itself to imitate other prudential regimes, which have differing regulatory environments to start with, and which by their own admission did not perform adequately in averting the GFC. Australia's already sound regulatory base should also be taken into account when considering changes to Australia's regulatory environment. We therefore urge BCBS to ensure appropriate degrees of flexibility are built-in and that cross-border mutual recognition is supervised and enforced.

Asset-side liquidity management

Managing liquidity in one single asset class neglects the most basic principles of portfolio management, diversification, risk management and portfolio construction principals.

Depriving Australian deposit-takers from counting covered bonds and RMBS as liquid assets inevitably not only means they will have to pay more for their liquidity because they will be have to pay more for scarcer assets, which in turn will yield less (for much the same reason), but they will become materially less diversified.

It should also be noted that junior Deposit-taking institutions do not have the sophistication to analyse sovereign risk, which can be quite unique in comparison to classic credit risk investments. In contrast, they understand residential mortgages extremely well.

The ASF urges BCBS to introduce a system that rewards diversification of assets to be deployed to meet liabilities. This could be one or both of haircuts to certain assets and caps or ratios on different types of assets being capable of meeting an overall liquidity requirement.

It should also be emphasised that the ECB has not borne any losses as a consequence of accepting RMBS or covered bonds as repo collateral. Indeed, in the case of covered bonds, it has been one of the few bond markets to have remained open throughout the GFC because of its very high credit quality. The same holds true of the Reserve Bank of Australia ('RBA') vis-à-vis RMBS repo collateral.

One of the main reasons for the secondary market for such assets proving to be highly unreliable during the recent crisis was that everyone around the world was trying to sell out of their RMBS assets at the same time (requiring the central banks to provide the liquidity via their respective repo windows). The point we make is that if everyone across the globe was trying to sell out of US Treasuries at the same time, would this not have the same impact. Therefore, we stress the need to encourage a diverse portfolio of assets.

Indeed, the RBA recently indicated that such collateral will remain acceptable to it in performing its financial stability and monetary policy duties. It also acknowledges that Deposit-taking institutions have only availed themselves of such intervention and support apparatus temporarily.

> "*The Bank intends to maintain the broader range of securities that it accepts in its market operations, that is, internal RMBS will remain eligible collateral. To repeat, we are not going to wind-back the pool of eligible collateral. However, with the improvement in funding conditions, we generally no longer expect or wish to see internal securitisations offered as collateral in our market operations on a regular basis. Given that many of these repos backed by RMBS were initiated over a year ago now, the Bank's holdings of related RMBS have shrunk considerably in recent months as these repos have matured.*[1]"

This statement evidences that for monetary policy purposes (in terms of having enough private sector collateral to pledge for repo so that interest rate policy can be transmitted effectively) and for prudential policy purposes (in terms of *Exchange Settlement Account* holders being permitted to access cash liquidity swiftly, discretely and confidently) that the RBA regards the credit quality of such collateral as acceptable to it in supporting maturity transformation.

Further, the proposition that sovereign bonds are superior to 'AAA'-rated covered bonds and RMBS is dubious[2] given that the ratings stability of some G20 sovereign nations is in question, and may even migrate to 'AA' or 'A' ratings.

Liability-side liquidity management

Covered bonds and RMBS both enable deposit-taking institutions to fund themselves in tenors; currencies; investor bases; and prices that their global competitors are currently exploiting.

It is worth emphasising that price alone is not the sole advantage of such instruments: Deposit-taking institutions are able to increase and diversify the stream of investors available to them as well as improve their liquidity profile/time horizon in comparison to that achieved by, say, commercial paper.

The ASF also wishes to highlight – so that the relative liquidity of various instruments is correctly assessed – that retail deposits as a funding source are not especially 'sticky' when compared to the contractual features of covered bonds and RMBS, which typically have non-callable maturities of between three and ten years.

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[1] *Whither Securitisation?* Guy Debelle, Assistant Governor (Financial Markets), Address to the Australian Securitisation Conference 2009, Sydney – 18 November 2009.

[2] "Although highly unlikely, it is conceivable that a large and wealthy economy could lose its AAA rating if it were to experience a material and irreversible deterioration in its debt conditions over the next five years or so, following the fate of Japan in the 1990s." S&P, August 2009.

It is also worth amplifying the point made in our opening remarks in relation to the cost for the economy, such that the Australian Government's aspiration to see Australia's net savings rate improve will be hampered because the cost of maintaining enough liquid assets to meet non-contractual liabilities. That is, even so-called 'fixed term' retail deposits are available at call albeit with a loss of accrued interest. Indeed, in an idiosyncratic name crisis they inevitably would be called at sight.

BCBS would know that Australia has a structural current account deficit. This feature of our economy makes our need for offshore investor funds all the more important. We cannot afford to close off potential sources of stable funds; we cannot afford to stymie our banking system from supporting the economy during this period of expansionary economic growth. Limiting particular instruments eligibility offends the realities and objectives.

Conclusion

We believe that BCBS should re-visit the eligibility of assets such as RMBS and covered bonds (and any other assets that are central bank repo eligible) from qualifying liquid assets. Excluding these type of assets will:

- Increase cost to consumers and business through increased cost of funds
- Discourage diversification (and encourage concentration risk)
- Encourage smaller Deposit-taking institutions to rely on ratings – a major contributor to the recent crisis

Further, the RBA repo window has not been abused either in the extent or duration of its use nor has it incurred losses, demonstrating also that the haircut applied is adequate to discourage the 'lender of last convenience' concern whilst sufficient to address credit risk.

Please do not hesitate to contact The Australian Securitisation Forum should you wish to discuss any aspect of this submission further.

Yours sincerely

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