

Guy Debelle: The committed liquidity facility

Speech by Mr Guy Debelle, Assistant Governor (Financial Markets) of the Reserve Bank of Australia, APRA (Australian Prudential Regulation Authority) Basel III Implementation Workshop 2011, Sydney, 23 November 2011.

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As you know, last week the Reserve Bank released details of the Committed Liquidity Facility (CLF) that forms part of Australia's implementation of the Basel III liquidity reforms. At the same time, the Reserve Bank also released details of a revised set of margins for the collateral that is eligible in both its regular open market operations and for the CLF. Today, I will talk to those two press releases and provide more detail and some of the thinking behind them.

Why do we need a CLF?

Charles Littrell has already explained the motivation behind the need for the CLF, but it is worth reiterating some of those arguments. The Basel liquidity standard requires that banks have access to enough high-quality liquid assets to withstand a 30-day stress scenario, and specifies the characteristics required to be considered an eligible liquid asset.

The issue in Australia is that there is a marked shortage of high quality liquid assets that are outside the banking sector (that is, not liabilities of the banks). As a result of prudent fiscal policy over a large run of years at both the Commonwealth and state level, the stock of Commonwealth and state government debt is low. At the moment, the gross stock of Commonwealth debt on issue amounts to around 15 per cent of GDP, state government debt (semis) is around 12 per cent of GDP.¹ These amounts fall well short of the liquidity needs of the banking system. To give you some sense of the magnitudes, the banking system in Australia is around 185 per cent of nominal GDP. If we assume that banks' liquidity needs under the liquidity coverage ratio (LCR) may be in the order of 20 per cent of their balance sheet, then they need to hold liquid assets of nearly 40 per cent of GDP.

In addition to government debt, the Basel standard also includes balances at the central bank in its definition of high-quality liquid assets (level 1 assets in the Basel terminology). That is, the banks' exchange settlement (ES) balances at the RBA are also a liquid asset. Hence, one possible solution to the shortage of level 1 assets would be for banks to significantly increase the size of their ES balances to meet their liquidity needs. While this is possible, it would mean that the RBA's balance sheet would increase considerably. The RBA would have to determine what assets it would be willing to hold against the increase in its liabilities, and would be confronted by the same problem of the shortage of assets in Australia outside the banking system. Similarly, the government could increase its debt issuance substantially with the sole purpose of providing a liquid asset for the banking system to hold. Again, it would be confronted with the problem of which assets to buy with the proceeds of its increased debt issuance. Moreover, it would be a perverse outcome for the liquidity standard to be dictating a government's debt strategy.

However, the Basel Committee acknowledges that there are jurisdictions such as Australia where there is a clear shortage of high quality liquid assets. In such circumstances, the liquidity standard allows for a committed liquidity facility to be provided by the central bank against eligible collateral to enable banks to meet the LCR.

¹ The net stock of Commonwealth government debt on issue is considerably lower at 6 per cent of GDP, reflecting the assets held by the Commonwealth government, including through the Future Fund.

Access to the CLF

As Charles has explained, APRA will work with the banks to determine their overall liquidity needs. They will discuss how much of these liquidity needs can be met through holdings of government paper. An important consideration in that discussion is ensuring that the banking system's holdings of government paper are not so large that they compromise the liquidity of the market. Otherwise this would be completely self-defeating, as the whole aim of the liquidity regime is to ensure the banks hold liquid assets. One influence in this determination is the large amount of government debt that is held offshore by investors that are not overly price sensitive (and also do not necessarily lend their securities). This further limits the size of the government debt stock that the banking system can realistically hold.

As a result of that discussion, APRA will allow banks to reach an agreement with the RBA for a CLF for a specified amount, subject to RBA approval, to enable them to meet the balance of their liquidity requirement under the LCR. APRA may ask banks to specify the size of their access to the CLF as much as 12 months in advance. The facility will only be available for banks to meet that part of the liquidity requirement agreed with APRA.

Access fee

The Reserve Bank has set a fee of 15 basis points in return for its commitment to provide liquidity to a bank under the CLF. The fee will be paid on both the drawn and undrawn amount.

The general motivation in determining the price of the Reserve Bank's commitment was to replicate the effect in other jurisdictions where a bank could meet its liquidity needs of holding eligible assets in a liquid market, solely through holding government paper. Hence the yield differentials between government bonds and the assets that will be eligible for the facility is a logical starting point.² However, the spreads on the eligible securities incorporate compensation for a variety of risks, including credit and liquidity. It is only the latter risk that the facility is addressing and hence the banks should be charged only for the liquidity access. Importantly, the Reserve Bank will not be offering any credit protection on these assets and so the banks should be able to retain the compensation for holding these riskier assets. The Reserve Bank is protected as it provides the liquidity to an institution under a repo with appropriate margining (see below).

While at times like the present, liquidity can have considerable value, the Reserve Bank will not be varying the size of the fee through the cycle. Consequently, the facility is to be priced at a level that takes into account the value of liquidity in more normal conditions, as well as in stressed circumstances.

From the history of the Reserve Bank's own market operations, we can look at repo rates on some of the eligible securities to try and gauge how much a one month liquidity premium might be worth. The answer is not very much in normal circumstances, generally less than 10 basis points. Moreover, when you take into account the fact that to access the facility, an institution has to pay a penalty rate and, in most cases, with greater haircuts than previously applied, a "market-based" valuation from historical rates would imply a low fee.

However, part of the point of the new liquidity regulations is to recognise that the market has underpriced liquidity in the past. Consequently, it is appropriate to levy a fee which is greater than implied by a long run of historical data. The net outcome is thus a weighted average of a

² One complication in doing this calculation in Australia is that because government paper has been in short supply for many years, it has tended to trade with a scarcity premium. This widens the observable spread between the yield on government paper and the yield on other assets in a way that is not present in most other jurisdictions.

relatively low liquidity premium in normal times and a much higher liquidity premium in stressed times.

In determining the fee, it must be remembered that ADIs will not only have the option of meeting their LCR requirements through the Reserve Bank's liquidity facility, they will always have the option of meeting their LCR requirements through holding RBA obligations. This is because, as mentioned earlier, ES balances are also recognised as liquid assets.

Within the Reserve Bank's monetary policy framework, the supply of ES balances is effectively market-determined. That is, the Reserve Bank stands ready to supply whatever quantity of ES balances is necessary (against eligible collateral) to keep the cash rate trading at the Board's target. In normal times, and even at times like the present, the demand for ES balances is very low. This is because the remuneration on ES balances is purposefully set at a "below-market" rate – 25 basis points below the cash rate target – in order to encourage banks to recycle their surplus balances.

However, in an environment where banks need to obtain more liquid assets, there is the possibility that a liquid asset (one that is in every way risk-free) priced 25 basis points below the OIS curve may become more attractive. This would particularly be the case were the fee on meeting a bank's LCR requirement through non-liquid assets to be set at a sufficiently high level so as to make ES balances appear reasonable value.

While ES balances pay 25 basis points less than the cash rate, the cash market is not risk-free; it is an unsecured interbank market. Consequently, a fee a little less than the 25 basis points has been deemed necessary to ensure banks did not have the incentive to meet the LCR by holding unduly large amounts of ES balances. Beyond the problem (discussed above) that such an outcome would present to the RBA in terms of what assets it would need to hold, this outcome would also significantly affect the ability to meet the cash rate target set by the Reserve Bank Board. That is, we do not want to impair the operational framework for monetary policy which has served us well for many years.

If the banks were to hold large ES balances with the RBA, this would also be likely to significantly impair the short-term interbank market in Australia, which is an important pricing reference for many other markets.

As a result of these considerations, the RBA concluded that the fee needed to be set high enough to ensure banks had the appropriate incentives under the liquidity standard, but low enough to not generate unwarranted distortions in the domestic market.

Interest rate on the facility

Should a bank need to obtain liquidity under the facility, it will undertake a repo with the Bank using its eligible collateral and pay an interest rate on the repo of 25 basis points above the Reserve Bank Board's target for the cash rate. This is the same as the current arrangements for the RBA's overnight repo facility. This 25 basis points charge will be in addition to the ongoing access fee of 15 basis points.

Eligible securities

The securities that a bank can hold to access the CLF are the same as those which are eligible for the RBA's normal market operations. In addition to government paper, these securities include domestic issues by supranationals and other foreign governments, ADI-issued debt securities and asset-backed securities, including residential mortgage-backed securities (RMBS).

However for the purposes of the CLF, the RBA will also allow banks to present certain related-party assets such as self-securitised RMBS. There are a number of reasons for this

decision, but the primary motivation is to reduce the systemic risk of excessive cross-holdings of bank-issued instruments.

As mentioned earlier, a large share of the securities on issue in Australia are “inside” the banking system. That is, they are securities issued by the banks themselves. The available pool of outside assets in Australia which includes securities issued by supranationals and corporates is small. Hence, the primary type of asset available in the market to the banking system to meet its liquidity needs is a security issued by another bank. In our judgement, and that of APRA’s, it would be undesirable for a bank to meet its liquidity needs by significantly increasing its exposure to the rest of the banking system. If a stressed situation was to arise at one bank, the increased cross-holdings could rapidly translate this to other banks. Moreover, if the stressed bank was to meet its liquidity needs by selling its holdings of securities issued by other banks into the market, this would also serve as a possible source of contagion to the rest of the banking system.

Thus to reduce the likelihood of systemic risk, a bank will be able to hold some share of its liquid assets in the form of self-securitised mortgages. There is a trade-off here between systemic risk and reduced “market” liquidity of the bank’s asset holdings, but the bank will have access to liquidity from the RBA with these assets.

In terms of the range of assets eligible for the CLF, the RBA reserves the right to broaden that range at any time, but will give 12 months’ notice of any decision to narrow the range. The latter condition will give banks adequate time to adjust their liquid holdings in response to any change.

Margins

At the same time as the RBA released the details of its CLF, we also issued a revised schedule of margins for the securities that are eligible in our domestic market operations. This revised schedule of margins will take effect on 1 February next year.

The Reserve Bank applies margins to the collateral held under repo in its domestic market operations in order to protect the Bank against all but the most extreme movements in market prices, should its counterparty in the repo be unable to repay the repo.

The margins are set to ensure that the Reserve Bank’s contingent risk is the same across all eligible securities. This implies that margins need to be higher on those securities with longer duration, greater illiquidity and greater credit risk.

It was appropriate to revisit the Reserve Bank’s schedule of margins in light of the experience of recent years which has provided some indication of how the various asset classes perform in stressed situations. Moreover, the margins are important in determining the amount of liquid assets a bank will need to obtain a given level of access to the CLF.

In conducting the review, we examined the average daily yield movements across the range of eligible securities, as well as the largest daily yield movements. We also compared the margins set by the RBA with those in other jurisdictions. As a result of this review, we have made a number of changes. The principal change is that the margins on unsecured bank paper have been increased, with the margin increasing with time to maturity and the lower the credit rating. The RBA has also adjusted the eligibility criteria for unsecured bank paper. All senior debt securities with less than 12 months to maturity issued by ADIs with a public credit rating will be eligible. There will no longer be a requirement that an ADI hold an ES account with the Bank. For securities with longer than 12 months to maturity, the minimum credit rating required is BBB+.

Margins on asset-backed securities were maintained at 10 per cent. For self-securitised mortgages, and other private securities for which it is difficult to identify a timely market price, the securities will be valued at a price equal to 90 per cent of par, prior to the application of a

margin. Hence, for example, to obtain liquidity of \$100 under the CLF, a bank will need to present a self-securitised RMBS with a value of \$122.

Conclusion

I have provided some background to the decisions taken by the Reserve Bank around the application of the new Basel liquidity regime in Australia. The new Basel standards are designed to ensure that the banking system in Australia is even more resilient and stable than it has been to date. While these reforms are not costless to comply with, the benefits of a stable banking system are considerably larger. Both ourselves and APRA will continue to work together to promote a strong and resilient financial system.