



Discussion Paper

APRA's prudential approach to ADI liquidity risk

11 September 2009

Disclaimer and copyright

While APRA endeavours to ensure the quality of this Publication, APRA does not accept any responsibility for the accuracy, completeness or currency of the material included in this Publication, and will not be liable for any loss or damage arising out of any use of, or reliance on, this Publication.

© Commonwealth of Australia

This work is copyright. You may download, display, print and reproduce this material in unaltered form only (retaining this notice) for your personal, non-commercial use or use within your organisation. All other rights are reserved.

Requests and inquiries concerning reproduction and rights should be addressed to:

Commonwealth Copyright Administration
Copyright Law Branch
Attorney-General's Department
Robert Garran Offices
National Circuit
Barton ACT 2600
Fax: (02) 6250 5989

or submitted via the copyright request form on the website <http://www.ag.gov.au/cca>

Preamble

This discussion paper outlines proposed changes to APRA's current prudential approach to liquidity risk management for authorised deposit-taking institutions (ADIs), as set out in *Prudential Standard APS 210 Liquidity* (APS 210).

The proposed changes include:

- enhanced qualitative requirements consistent with the *Principles for Sound Liquidity Risk Management and Supervision*, issued by the Basel Committee on Banking Supervision in September 2008;
- extending the 'going concern' cash flow projection requirement to all ADIs, regardless of the size and nature of their operations;
- lengthening the time horizon for the current APRA-defined 'name crisis' stress scenario from five business days to one month;
- an additional APRA-defined three-month 'market disruption' stress scenario; and
- introducing a standardised reporting framework via the *Financial Sector (Collection of Data) Act 2001*.

Subject to industry feedback, APRA will release a draft APS 210, an associated prudential practice guide (PPG), draft reporting standards and second-round draft reporting forms (including instructions) for further consultation early in 2010. APRA intends to issue final standards and reporting forms in the first half of 2010. Transition arrangements will apply.

The Basel Committee on Banking Supervision is currently developing a global quantitative framework for liquidity risk supervision to complement its September 2008 *Principles*. APRA's prudential approach and timetable may be amended as this international work evolves.

Written submissions on these proposals should be forwarded not later than 30 November 2009 to:

Mr Neil Grummitt
Senior Manager
Policy Development
Australian Prudential Regulation Authority
GPO Box 9836
SYDNEY NSW 2001
or email: adi.liquidity@apra.gov.au

Important

Submissions will be treated as public unless clearly marked as confidential and the confidential information contained in the submission is identified.

Submissions may be the subject of a request for access made under the *Freedom of Information Act 1982* (FOIA). APRA will determine such requests, if any, in accordance with the provisions of the FOIA.

Contents

| | |
|---|-----------|
| Glossary | 5 |
| Executive summary | 6 |
| Chapter 1 – Introduction | 9 |
| Chapter 2 – Qualitative requirements | 10 |
| Governance | 10 |
| Risk tolerance | 10 |
| Internal transfer pricing | 11 |
| Funding strategy | 11 |
| Public disclosure | 11 |
| Other matters | 11 |
| Chapter 3 – Scenario analysis | 13 |
| Background | 13 |
| Going concern scenario | 13 |
| Supervisor-defined stress tests | 13 |
| Design considerations for APRA-defined stress tests | 14 |
| Specification of APRA-defined stress tests | 15 |
| Summary | 17 |
| Chapter 4 – Reporting to APRA | 18 |
| Background | 18 |
| Issues with current liquidity reporting arrangements | 18 |
| Current interim measure | 18 |
| Proposed reporting framework | 19 |
| Regulatory developments in other jurisdictions | 21 |
| Summary | 21 |
| Chapter 5 – Application | 22 |
| Chapter 6 – Implementation | 24 |
| Chapter 7 – Request for cost-benefit analysis information | 25 |
| Attachment 1 – BCBS Principles for Sound Liquidity Risk Management and Supervision | 26 |
| Attachment 2 – APRA-defined stress test assumptions | 28 |

Glossary

| | |
|---------------------------|--|
| ADI | Authorised deposit-taking institution |
| APRA | Australian Prudential Regulation Authority |
| APS 210 | <i>Prudential Standard APS 210 Liquidity</i> |
| BCBS | Basel Committee on Banking Supervision |
| BCBS Liquidity Principles | <i>Principles for Sound Liquidity Risk Management and Supervision</i> , Basel Committee on Banking Supervision, September 2008 |
| CFP | Contingency funding plan |
| CUFSS | Credit Union Financial Support System |
| D2A | Direct to APRA. An electronic data submission system which enables regulated and registered financial entities to lodge their statutory returns with APRA. |
| FOIA | <i>Freedom of Information Act 1982</i> |
| FSCODA | <i>Financial Sector (Collection of Data) Act 2001</i> |
| HQLA | High quality liquid assets |
| MLH | Minimum liquidity holdings |
| PPG | Prudential practice guide |
| RBA | Reserve Bank of Australia |
| SME | Small and medium-sized enterprise |

Executive summary

This discussion paper sets out APRA's proposals to enhance its current prudential framework for ADI liquidity risk management. In making these proposals, APRA has taken into account financial market developments and changing ADI practices over the past decade, lessons learned from the global financial crisis and recent international supervisory developments. Key proposals are summarised below.

Qualitative requirements

In response to the crisis, the Basel Committee on Banking Supervision (BCBS) has issued a revised set of principles for sound liquidity risk management and supervision. There are some requirements in these principles not explicitly addressed in the current *Prudential Standard APS 210 Liquidity* (APS 210). APRA's observation is that ADIs with better practice liquidity risk management frameworks currently consider these matters, although not necessarily with the rigour and completeness described by the BCBS. Accordingly, APRA proposes to revise APS 210 where necessary to ensure that the BCBS principles are adequately addressed.

Specifically, APRA proposes that APS 210 be strengthened to require:

- a formal role for an ADI's internal auditors in liquidity risk management;
- operational independence of an ADI's liquidity risk management function;
- an ADI's board to articulate its tolerance for liquidity risk;
- an ADI to have an internal transfer pricing process that explicitly quantifies and allocates liquidity costs and benefits to relevant businesses and products. The objective is to ensure alignment of business and individual incentives with the board-approved risk tolerance;
- a board-approved funding strategy;
- an ADI to publicly disclose information on a regular basis that enables market participants to make an informed judgement about the soundness of its liquidity risk management framework and liquidity position; and

- an ADI's contingency funding plan (CFP) to address retail run management strategies.

APRA will take a risk-based approach in assessing ADIs' compliance with these qualitative requirements. APRA proposes to apply the requirements to all Australian-owned ADIs on a solo basis and to the ADI group. As with current practice, the requirements will also apply to foreign bank subsidiaries on a stand-alone basis and to the Australian branches of foreign banks. APRA expects foreign-owned ADIs will be able to utilise much of their group risk management frameworks to comply with APRA's qualitative requirements. However, the proposed requirement for ADIs to have an internal liquidity pricing mechanism will not apply to smaller ADIs that are subject to APRA's minimum liquidity holdings (MLH) regime.

Liquid assets

APS 210 currently provides little guidance as to what constitutes a liquid asset for stress-testing purposes. There is an emerging international consensus amongst prudential supervisors that liquid assets should be high quality assets that can be readily sold or used as collateral in private markets, even when those markets may be under stress; as a backstop, liquid assets should also be eligible central bank collateral for normal market operations. APRA proposes to adopt this definition of liquid assets in APS 210.

In most currencies, sovereign bonds will be the assets that most clearly satisfy these criteria.

Due to the budget surpluses run by the Commonwealth Government over a number of years, it may be the case that the AUD-denominated stock of assets satisfying APRA's proposed liquid asset definition is insufficient for the aggregate need of ADIs. If so, APRA will consider permitting some limited portion of the liquid asset buffer to comprise assets that are Reserve Bank of Australia (RBA) eligible collateral for normal market operations as the sole criterion.

ADIs with operations outside Australia or with positions in currencies other than AUD must carefully consider and document their definition of liquid assets, based on the policy position of the relevant prudential supervisor and/or central bank. If in any doubt, ADIs must revert to APRA's guiding principle.

Scenario analysis

APS 210 currently requires an ADI to conduct scenario analysis on a regular basis to assess and measure its liquidity position under different operating circumstances. However, APS 210 also allows APRA to exempt an ADI from scenario analysis in favour of a simple quantitative metric (the MLH regime) in light of the nature and size of the ADI's operations. In APRA's view, the MLH regime is working effectively in delivering an appropriate degree of resilience for ADIs with simple business models. Accordingly, APRA intends to retain the current approach for these ADIs.

For scenario analysis ADIs, in addition to the requirement that they conduct their own scenario analysis, APS 210 also requires that their scenario analyses must, at a minimum, include APRA-defined 'going concern' and 'name crisis' scenarios. APRA proposes to continue the current approach that ADIs augment their own scenario analysis with APRA-defined scenarios. APRA's objective is that ADIs have a robust internal stress-testing framework targeted at their own particular vulnerabilities but can also demonstrate to APRA that they meet a commonly defined minimum acceptable level of resilience.

However, APRA proposes to strengthen the current APRA-defined scenarios. This will involve extending the requirement for a going concern cash flow projection to all ADIs and lengthening the projection to at least 12 months. In addition, the minimum survival horizon for the current APRA-defined name crisis scenario will be lengthened from five business days to one month, and there will be an additional APRA-defined three-month 'market disruption' stress scenario that primarily targets the resilience of ADIs to a disruption in access to offshore wholesale funding. For the latter two scenarios, APRA will specify the key assumptions but will have flexibility to vary these assumptions where considered appropriate. ADIs will need to demonstrate sufficient liquidity to survive the two APRA-defined stress tests.

The APRA-defined name crisis and market disruption stress tests will apply to Australian-owned ADIs (except MLH ADIs) at the solo and ADI group levels. For the latter, ADIs will be required to demonstrate that the group has sufficient liquid assets to meet the stress tests, having regard to any constraints on the free flow of funds within the group.

For foreign-owned ADIs, APRA's proposed approach is to have a clear, stringent default position but with wide-ranging flexibility available, subject to rigorous supervisory assessment. Thus, the two APRA-defined stress tests will apply to foreign bank subsidiaries on a stand-alone basis and to the Australian branches of foreign banks. In demonstrating their survivability under these stress tests, assurances of parental support, regardless of contractual form, will not be taken into account since there can be no certainty that those assurances will be honoured when they are needed, either because the parent is itself in difficulty, or its management systems fail, or due to disruptions in currency swap markets. While APRA is prepared to take a flexible approach to many aspects of the prudential requirements for foreign-owned ADIs, it is unlikely to approve exemptions from stress testing in favour of the MLH regime, which is directed at smaller retail-based ADIs.

Reporting to APRA

APRA proposes to introduce a standardised reporting framework for collecting regular liquidity data from all ADIs and for accessing, at short notice, updated information on an ADI's liquidity position in times of stress. APRA acknowledges the potential increase in reporting burden but is satisfied that the changes are necessary from prudential and financial stability perspectives. Prudential supervisors in other jurisdictions have reached similar conclusions.

The regular liquidity data, to be provided on a quarterly basis, comprises a contractual maturity schedule, a cash flow analysis on a going concern basis, stress-test results for APRA-defined scenarios or HQLA ratios as appropriate, funding concentration and liquid asset portfolio composition.

The stress/crisis reporting will comprise latest stress-test results for APRA-defined scenarios and recent funding experience. Upon APRA's request, affected ADIs will need to submit the crisis reporting form on the same day (as at close of business the previous day), or next day if the request was made in the afternoon, and continue such reporting as frequently as APRA requires. To ensure that ADIs maintain this reporting capability, APRA will conduct a random test from time to time. Most ADIs can expect a 'fire drill' at least once a year.

APRA proposes to apply the standardised reporting requirements to all Australian-owned ADIs on a solo basis, covering both the domestic and overseas branch operations. For foreign-owned ADIs, the proposed standardised reporting requirements will apply to foreign bank subsidiaries on a stand-alone basis and to the Australian branches of foreign banks. It is unlikely that APRA will approve exemptions from the standard reporting framework.

Implementation

Subject to industry feedback and international supervisory developments, APRA intends to issue final standards and reporting forms in the first half of 2010, after a second short period of consultation in early 2010. Transitional arrangements will apply to ensure there is sufficient time for ADIs to adjust their liquidity risk management frameworks to comply with the new prudential requirements. The central element of the implementation process will be a board-approved self-assessment of ADI compliance with the new requirements, together with gap closure plans. APRA would expect standardised reporting to commence in respect of the December 2010 quarter and material compliance with the complete prudential framework by the first quarter of 2011.

Chapter 1 – Introduction

APRA has undertaken a broad-ranging review of its prudential framework for ADI liquidity risk management, to take into account financial market developments and changing ADI practices since the framework was introduced in 1998. APRA's experience in monitoring ADIs' liquidity positions during the global financial crisis has been clearly relevant to this review. The crisis has highlighted the need for ADIs to have adequate levels of liquidity and robust liquidity risk management systems, and has provided considerable insights into better practice in this area. APRA has also taken into account recent international supervisory developments, notably the BCBS *Principles for Sound Liquidity Risk Management and Supervision* (BCBS Liquidity Principles), which are provided in Attachment 1.

This discussion paper outlines APRA's proposed changes to its current approach, based on this review.

Liquidity risk – the risk that an institution has insufficient liquidity to meet its obligations as they fall due – is critical to the continued operation of an ADI and to the stability of the financial system as a whole. To ensure ADIs manage this risk adequately, the current APS 210 requires each ADI to have a liquidity management strategy that is appropriate for the operations of that ADI – that is, a strategy that ensures the ADI has sufficient liquidity to meet its obligations as they fall due. The strategy should set out how the ADI measures, manages and assesses its liquidity position and how it is able to respond to a liquidity crisis.

In addition, APS 210 also requires an ADI to conduct scenario analysis on a regular basis to assess and measure its liquidity position under different operating circumstances. The two sets of scenarios specified in APS 210, which an ADI is required to consider at a minimum, are a business-as-usual or going concern scenario and a name crisis scenario. The purpose of the first scenario is to assess the ADI's ability to meet its obligations under normal operating conditions. The second scenario is one in which the ADI confronts adverse circumstances specific to it and, as a consequence, has significant difficulty in rolling over or replacing its existing liabilities. For this scenario, the ADI must be able to demonstrate that it is capable of operating for at least five business days in a crisis.

In other words, the ADI's cumulative net cash flow position over the five-day period must be positive, taking into account any expected cash inflows from realising liquid assets and other funding sources that would be available to the ADI in that situation.

In general terms, APRA's conclusion is that the broad framework established by APS 210 remains appropriate, although there are areas where improvements could be made.

APRA is proposing to adopt additional qualitative requirements in the BCBS Liquidity Principles, as set out in Chapter 2, and an expansion in the APRA-defined scenarios, as described in Chapter 3. APRA has also concluded that a standardised reporting requirement is essential. Details are set out in Chapter 4.

Chapter 5 describes how APRA proposes to apply the revised liquidity requirements to Australian- and foreign-owned ADIs, including smaller ADIs where a scenario analysis approach may be unnecessarily complex. Chapter 6 outlines APRA's proposals regarding implementation and transitional arrangements.

Finally, cost-benefit data in relation to the proposed requirements is requested in Chapter 7.

Chapter 2 – Qualitative requirements

The qualitative requirements of APS 210 in respect of an ADI's liquidity risk measurement and management systems remain broadly appropriate. However, recent international supervisory developments, as represented by the BCBS Liquidity Principles, have focussed attention on a few issues not explicitly addressed in APS 210. APRA intends to adopt the BCBS Liquidity Principles in full through amendments to APS 210. In most respects, the intent of the BCBS Liquidity Principles is already covered by APS 210, so the BCBS document should be seen primarily as an expanded discussion of the issues, somewhat similar to APRA's prudential practice guides (PPGs). APRA proposes to revise APS 210 where necessary to ensure that each of the 17 'principle statements' is adequately addressed, and the related PPG will reference the BCBS document.

APRA encourages ADIs that have not already done so to review and, where necessary, improve their liquidity risk management practices to achieve the better practice standard reflected in the BCBS Liquidity Principles.

The few issues where enhancements to APS 210 will be required or where APRA intends to expand on the BCBS Liquidity Principles are discussed in the remainder of this chapter.

Governance

The BCBS Liquidity Principles inevitably reflect some diversity between jurisdictions regarding the obligations of boards and senior management. Consistent with APRA's general approach (and the current APS 210), APRA views liquidity risk management as a board responsibility.

APRA proposes that APS 210 be strengthened to require:

- the operational independence of a liquidity risk management function, with the skills and seniority to challenge treasury and other profit-making businesses; and
- a formal role for internal audit.

These requirements will be similar to those in place for other types of risk (e.g. market risk).

Risk tolerance

APRA is proposing to introduce a requirement that the board articulate its tolerance for liquidity risk. The risk tolerance statement should be explicit, comprehensive, meaningful (in terms of outcomes), designed with the particular vulnerabilities of the ADI in mind and subject to sensitivity analysis. APRA will consider not only the articulation of risk tolerance but also the actual level of liquidity risk. As with other risk types, APRA will intervene where the liquidity risk tolerance is considered excessive.

APRA does not propose to specify how the board's risk tolerance should be described but will instead offer some guidance via a PPG. In summary, APRA's proposed approach is:

- in the absence of any workable mathematical model for describing an ADI's resilience to liquidity risk, stress testing becomes a key tool for understanding, quantifying and limiting liquidity risk. Hence, the board could express its risk tolerance in terms of minimum survival horizons (without extraordinary central bank or sovereign intervention) under a range of severe but plausible stress scenarios, chosen to reflect the particular vulnerabilities of the ADI. Key assumptions should be transparent to the board, including the sensitivity of the modelled survival horizons to changes in those key assumptions. This identification and sensitivity analysis of key assumptions needs careful consideration. In particular, the identification of assumptions that are in some way implicit to the modelling approach is critical;¹

¹ For example, ADIs may make strong implicit assumptions about the depth and robustness of currency swap markets, or may assume their continued access to private repo markets is assured even when their access to unsecured markets is severely impaired; or they may assume that term securitisation markets are robust and primary issuance is not dependent on market confidence in the originating or servicing ADI. In these examples, the experience of the last two years would require reconsideration of the assumptions.

- however, whilst stress testing is an important tool, it is not necessarily comprehensive. In particular, the relatively short-term focus of typical stress-test frameworks does not address structural aspects of liquidity risk. A more complete statement of risk tolerance would include explicit, quantitative controls on:
 - the quality and diversification (e.g. by instrument and counterparty) of liquid asset portfolios;
 - liability diversification (e.g. by domestic/foreign, market, product, counterparty and maturity);
 - the overall level of maturity mismatch (e.g. how much short-term or volatile funding is reasonable in absolute terms and relative to an ADI's assets and contingent liquidity exposures);
 - the management of liquidity risk across borders and legal entities, having regard to any legal, regulatory or practical impediments to the intra-group transfer of funds;
 - currency mismatch; and
 - contingent liquidity exposures, which are inherently difficult to model (e.g. non-contractual funding exposures triggered by idiosyncratic events or apparently diversified exposures that can be highly correlated in response to certain events).

APRA's strong view is that ADIs should have some form of measurable internal control on the overall level of maturity mismatch. There is, in addition, an emerging international consensus amongst prudential supervisors that a minimum regulatory standard in this area should be developed.² APRA supports this international effort.

Internal transfer pricing

APRA is proposing that ADIs must have a process that explicitly quantifies liquidity costs and benefits, and allocates those costs and benefits to the appropriate business and product. The goal is to ensure alignment of business and individual incentives with the board-approved risk tolerance, including the ability to estimate the profit or loss outcome related to the liquidity risk accepted and to attribute that profit or loss to its various strategic and tactical drivers.

Funding strategy

APRA's current supervisory approach includes an expectation that ADIs have a formal, documented funding strategy. APRA is proposing to elevate this expectation to a prudential requirement (including board approval) consistent with BCBS Liquidity Principle 7.

Public disclosure

APRA is proposing to introduce a prudential requirement to give effect to BCBS Liquidity Principle 13 on public disclosure.

Other matters

Unencumbered liquid assets

Liquid assets must be 'unencumbered' and APRA intends to make this requirement explicit in APS 210.

In practice, there are degrees of encumbrance, ranging from a narrow legalistic view to a broader view. For example, some collateral received may be unencumbered in a narrow sense but its future availability may be constrained. Another example is where assets are part of a 'tied position' – that is, the assets are held as a hedge of some other position. As a matter of good practice, ADIs should understand and take into account this dimension of their liquid asset portfolios and the associated consequences of using collateral that is not unencumbered in the broadest sense. APRA expects ADIs to quantify these consequences.

² In its *Declaration on strengthening the financial system* (April 2009), the leaders of the G20 agreed that 'the BCBS and national authorities should develop and agree by 2010 a global framework for promoting stronger liquidity buffers at financial institutions, including cross-border institutions.'

Collateral calls

One observation from the global financial crisis, seen particularly in other jurisdictions, was the extent to which institutions had an incomplete understanding of their exposure to collateral calls in respect of derivative positions and secured funding. This exposure arises from unusually large market moves with a breakdown in normal correlation structures (so that 'hedged' positions can generate exposures) and/or ratings downgrade triggers in collateral agreements. Anecdotal evidence of counterparties demanding additional collateral to continue their dealings with a troubled bank, consistent with multi-notch downgrades even when such downgrades had not occurred, is another factor. It is difficult for a bank trying to demonstrate its soundness to ignore such counterparty demands.

ADIs also need to consider that their net exposure to collateral calls is not necessarily the same as their net market risk, since not all transactions are subject to (identical) collateral agreements.

APRA expects ADIs to have a complete understanding of this exposure.

Second-round effects

APRA believes that so-called 'second-round' effects need to be considered. That is, an ADI needs to consider how its stress event and compensating actions will impact on the broader market and how those impacts will feed back to its own position. This is especially relevant for large ADIs. It is likely to be unrealistic for these ADIs to assume they are experiencing a name crisis but the broader market continues to function normally.

Contingency funding plans (CFPs)

Another lesson from the global financial crisis is that retail run management is an important component of an effective CFP. APRA expects that an ADI's retail run contingency plan will include (at a minimum):

- cash distribution arrangements;

- procedures to ensure non-branch distribution channels (e.g. ATMs, internet and phone banking) continue to function in the face of a sudden surge in transaction volumes;
- co-operative arrangements with other ADIs for cash and customer service; and
- an extensive communication plan for customers, key counterparties, staff, regulators, media and other parties (e.g. Australian Stock Exchange for listed entities, foreign regulators, etc).

Chapter 3 – Scenario analysis

Background

BCBS Liquidity Principle 10 states:

‘A bank should conduct stress tests on a regular basis for a variety of short-term and protracted institution-specific and market-wide stress scenarios (individually and in combination) to identify sources of potential liquidity strain and to ensure that current exposures remain in accordance with a bank’s established liquidity risk tolerance. A bank should use stress test outcomes to adjust its liquidity risk management strategies, policies and positions and to develop effective contingency plans.’

In practice, in addition to scenario analysis designed by the banking institution itself, various supervisory approaches are used to assess an institution’s resilience to liquidity stress. For example, a prudential supervisor may conduct its own stress tests based on the data it collects from banking institutions, both to facilitate peer group comparisons and to understand more systemic vulnerabilities. APRA’s reporting proposals (see Chapter 4) will facilitate the conduct of such stress tests. Also, a prudential supervisor may require banking institutions to consider specified scenarios, beyond those the institution would conduct in consideration of its own risk tolerance. In this way, a supervisor can establish a partial regulatory floor on the liquidity risk an institution is willing to tolerate.

Under APS 210, the requirement that ADIs conduct their own scenario analysis is supplemented by a requirement that an ADI’s scenario analysis must include (at a minimum) a going concern and a name crisis scenario. APRA is proposing to define a third scenario – a market disruption scenario – and will specify the key assumptions for this scenario as well as the name crisis scenario.

Going concern scenario

The objective of the going concern cash flow scenario is to ensure that ADIs forecast future funding needs and develop tactical and strategic plans to meet those needs. The current APS 210 focus on a one-month horizon³ is not consistent with that objective and APRA has not found it to be of particular value. Thus, the one-month requirement will be removed. Instead, APRA is proposing that ADIs consider their own projection timeframe, subject to a minimum period of 12 months. A 12-month focus was found useful for the two funding plan exercises APRA conducted with selected ADIs during the crisis. Standardised reporting under the going concern scenario is envisaged (see Chapter 4).

Supervisor-defined stress tests

The issues in relation to supervisor-defined stress tests are whether such tests are useful and, if so, how prescriptive they should be. Currently, APS 210 has a single APRA-defined stress test – the name crisis – but APRA has specified little detail about the test.

The BCBS Liquidity Principles are silent on the subject of supervisor-defined stress tests, focusing instead on bank-defined stress tests, with supervisory oversight used to ensure that the banking institution meets a minimum acceptable level of resilience. Nevertheless, many prudential supervisors opt to define a specific stress test to facilitate the supervisory oversight process in a transparent manner.

The main argument against supervisor-defined stress tests is that they may either become a compliance exercise without meaning to senior management or, alternatively, they may become the complete focus of senior management at the expense of an ADI conducting its own stress testing, aligned to its own particular vulnerabilities. On the other hand, supervisor-defined stress tests may become the binding constraint during long periods of benign conditions, when memories of the last crisis fade for management (and supervisors). In these circumstances, a hard supervisory minimum arguably does its job by becoming the binding constraint.

³ Refer Guidance Note AGN 210.2 Scenario Analysis, paragraph 1(a).

In APRA's view, the balance of these arguments favours a supervisor-defined stress testing requirement.

Accordingly, APRA is proposing that its prudential approach include a requirement for ADI-defined stress testing, broadly consistent with the BCBS Liquidity Principles, augmented by APRA-defined stress tests. The remainder of this chapter deals with these APRA stress tests, unless otherwise stated.

Design considerations for APRA-defined stress tests

Scenarios

An ADI can face either idiosyncratic stress events, market disruption stress events or some combination of the two. The current APS 210 has an APRA-defined name crisis scenario, but market disruption and combination scenarios are left to an ADI's own stress testing.

APRA's experience is that ADIs had not paid particular attention to market disruption scenarios. As a consequence of the global financial crisis, better practice ADIs will now have addressed this deficiency. Nevertheless, the arguments supporting supervisor-defined stress tests apply equally to idiosyncratic and market disruption events. Accordingly, APRA intends to retain a shorter-term name crisis scenario and add a longer-term market disruption scenario.

APRA proposes to define only a single scenario in each case. APRA's view is that, in large measure, the common vulnerabilities of most ADIs can be captured in these two scenarios. Defining additional scenarios would cross the boundary from supervision to micro-managing the ADI, undermining APRA's objective that ADIs have a robust internal stress-testing framework targeted at their own particular vulnerabilities.

The existing name crisis scenario is a satisfactory starting point. However, clarification and adjustment is required as follows:

- the term 'name crisis' is used deliberately. That is, the scenario represents a severe (yet plausible) loss of confidence in the ADI itself. The global financial crisis has redefined expectations of how severe a name crisis can be; and
- the scenario is a global name crisis, given recent experience that the local name crisis⁴ may be both less likely and less severe than the global version. A supervisor-defined stress test should therefore consider the global case. This proposal is an explicit change from the current APS 210 for foreign-owned ADIs, which requires both local and global crisis scenarios to be considered.

For the market disruption scenario there are a range of options, but the global financial crisis has highlighted several key vulnerabilities that have guided APRA's thinking:

- Australia's banking system has a reliance on offshore investors who in turn, however, have little reliance on Australian issuers. Offshore investors can quickly eliminate their weighting to Australian names, in favour of other issuers;
- investors, particularly offshore investors, do not greatly differentiate between names of similar credit rating within the Australian banking sector; and
- Australia's banking market is concentrated, with significant transactional activity between ADIs.

The natural corollary of the name crisis scenario is a market disruption scenario where the disruption has been triggered by the name crisis of a large Australian ADI. This scenario also allows APRA to stress the vulnerabilities listed above. This is APRA's proposed approach.

4 A local name crisis is one where an ADI is experiencing a name crisis in Australia but not in other jurisdictions.

Survival horizons

With regard to the name crisis scenario, the current five-day survival horizon is a very short period, chosen primarily to reflect the time APRA and other relevant agencies would need to decide upon and implement a response (if any) in respect of a troubled ADI.

There is an emerging international consensus amongst prudential supervisors that minimum survival horizons should be based on different considerations. In particular, the survival horizon should:

- promote an appropriate balance between liquidity 'insurance' provided by the private and public sectors; and
- provide incentives for prudent private sector liquidity risk management.

The current five-day horizon does not meet these goals. Instead, APRA proposes a one-month⁵ survival horizon for the name crisis scenario.

With regard to the market disruption scenario, APRA proposes a three-month survival horizon, primarily driven by considering the time it might take for ADIs to regain the confidence of foreign investors.

Degree of detail specified

The existing APRA name crisis scenario is set out only at a high level, with little further specification or guidance. APRA proposes to specify in the prudential standards the assumptions to be used, based on the following considerations:

- the current approach results in the use of a wider range of cash flow modelling assumptions than can be supported by differences in customer or business model characteristics. It is difficult to achieve consistency at this level of detail through APRA's normal supervisory process;
- there are some modelling aspects where APRA is better placed to develop a suitable assumption than any individual ADI. In particular, APRA may have access to data not generally available (e.g. in relation to retail deposit behaviour under stress); and

- there are some highly significant modelling aspects where an arbitrary judgment is all that can be applied. In these situations, APRA proposes to define the appropriate assumption.

There may be instances where ADIs have an arguable case that a particular assumption is too harsh.

Conversely, there may be instances where APRA itself forms a view that the assumptions are too light. To cater for these possibilities, APRA will have the flexibility to vary the specified assumptions where considered appropriate.

Summary

The APRA-defined stress tests can be described at a high level as follows:

- *Name crisis*: a severe idiosyncratic stress event impacting on all of an ADI's businesses and geographies simultaneously. Key features would include a depositor run, especially for deposits not fully covered by any government guarantee, and a total loss of confidence by wholesale investors.
- *Market disruption*: a severe disruption triggered for all ADIs by the name crisis of a large ADI. Key features would include a total loss of confidence in Australian banking institutions by offshore investors and significant domestic market disruption due to the withdrawal of the troubled ADI from its normal role.

Specification of APRA-defined stress tests

The proposed APRA-defined stress tests are summarised in Attachment 2. Other considerations are set out below.

⁵ Technically, the survival horizon proposed is 20 business days. The 'one-month' description is used for convenience.

Liquid assets

APS 210 currently provides little guidance as to what constitutes a liquid asset for stress-testing purposes. During the long period of benign conditions prior to the global financial crisis, APRA observed an inclination for ADIs to lower the quality of liquid asset buffers in a search for return, with little apparent loss of marketability. More recently, the working definition of a liquid asset seems to have become any asset which is eligible collateral with a central bank, regardless of the extent to which acceptance of such collateral could be considered an extraordinary central bank response to the crisis.

The emerging international consensus amongst prudential supervisors is that liquid assets should be high quality assets that can be readily sold or used as collateral in private markets, even when those markets may be under stress. As a backstop to the robustness of the liquid asset buffer, liquid assets should also be eligible central bank collateral for normal market operations. APRA proposes to adopt this definition of liquid assets in APS 210.

In most currencies, sovereign bonds will be the assets that most clearly satisfy these criteria. APRA seeks industry comment on whether there are other AUD-denominated assets that might be considered liquid, consistent with the above criteria.

Due to the budget surpluses run by the Commonwealth Government over a number of years, it may be the case that the AUD-denominated stock of assets satisfying APRA's proposed liquid asset definition is insufficient for the aggregate need of ADIs. If so, APRA will consider permitting some limited portion of the liquid asset buffer to comprise assets that are Reserve Bank of Australia (RBA) eligible collateral for normal market operations as the sole criterion.

For the purposes of the APRA-defined stress tests, some assumptions are required about the eligibility of collateral for normal RBA market operations. Specifically, APRA is proposing that ADIs assume self-securitisations only qualify under the market disruption scenario and then only from month three.

This assumption is made only for the purpose of APRA's prudential standard; the RBA will respond (or not) to any actual stress event as it judges necessary.

ADIs with operations outside Australia or with positions in currencies other than AUD must carefully consider and document their definition of liquid assets, based on the policy position of the relevant prudential supervisor and/or central bank. If in any doubt, ADIs must revert to APRA's guiding principle.

Finally, liquid assets must be unencumbered, as described in Chapter 2. For the APRA-defined stress tests, however, APRA proposes that the broadest possible interpretation of encumbrance must be employed. Thus, only assets which are unencumbered and specifically held in a segregated pool of liquid assets for the sole purpose of providing a liquidity buffer can be counted.

Credit lines

For a troubled ADI under the name crisis scenario, recent experience suggests that structured finance vehicles sponsored by or with liquidity support from the ADI will be deserted by investors. Similarly, smaller ADIs and other financial institutions are likely to draw down on their credit lines from the troubled ADI, because of their concerns about gaining credit elsewhere. Hence, the assumptions specified in Attachment 2.

Household and SME deposits

Since it has some data on the behaviour of household and SME deposits under stress, APRA is proposing to define the modelling assumption to be used.

APRA is proposing to group households and SMEs on the presumption that the behaviour of both groups of depositors is similar. The data suggest SME deposits may be a little less sticky than retail deposits, but not substantially so. However, APRA will differentiate between deposits on the basis of whether they are fully or not fully covered by any government guarantee; depositor protection arrangements that are well understood and credible do provide depositor confidence.

The data also support the intuition that internet accounts are likely to be significantly less stable sources of funding than are branch-based accounts. There are some clear examples of internet accounts and branch-based accounts, but there is also an increasing middle ground which is not so easily defined. APRA's proposal is that the distinction between these two types of accounts be left to supervisory judgement based on some broad principles, rather than be specified in the prudential standard.

Buyback of debt securities

It is common practice for ADIs to make a market in their own short-term securities and some level of buyback activity is normal as investors adjust their holdings to manage their own cash flows. APRA's concern is that, under stress, buyback requests will increase significantly and it will be impossible for the ADI to refuse, since to do so would confirm the fears of counterparties.

APRA understands that ADIs are under no contractual obligation to accede to these buyback requests, but significant buyback activity has occurred during the global financial crisis. Accordingly, APRA intends to specify a very short-term buyback assumption.

Secured funding

APRA's proposed assumptions for funding capacity are the same regardless of whether the funding is secured or unsecured. An important lesson from the crisis is that investors in secured funding markets took little or no comfort from the availability of collateral; once investors have lost all confidence, the quality of the security is largely irrelevant.

Collateral calls

Consistent with the discussion in Chapter 2, APRA proposes to require this potential exposure to be included in the APRA-defined scenarios.

Currency

Foreign currency swap market disruptions during the crisis have challenged the simplifying assumption that currency does not matter, at least for the most (normally) liquid currencies. APRA expects ADIs to acknowledge this issue in their own risk management

frameworks, perhaps via stress testing, but does not intend to add such disruptions to the APRA-defined stress tests.

APRA's reporting proposals will provide sufficient data on currency mismatch to identify those ADIs most exposed to these risks and to undertake follow-up supervisory action as necessary.

Corporate deposits and credit lines

APRA does not propose to specify assumptions about the behaviour of corporate customers; it has no better data on this aspect than individual ADIs. The behaviour of corporate customers is likely to depend on amounts deposited, upcoming commitments, availability of alternative finance and depth/breadth of the business relationship with the ADI. In other words, ADIs need to know their customer. This is the type of analysis APRA will be looking for in support of an ADI's assumptions.

This is not to say, however, that APRA considers these assumptions insignificant. Historically, the withdrawal of corporate customer deposits has been an important factor in the failure of some banks in other jurisdictions.

Summary

In summary, APRA's proposals are:

- ADIs will be required to conduct their own scenario analysis, consistent with BCBS Liquidity Principle 10;
- ADIs will also be required to include a 12-month going concern scenario and two APRA-defined stress tests: a one-month idiosyncratic (name) crisis and a three-month market disruption scenario;
- the idiosyncratic crisis and market disruption scenarios will be severe but plausible and ADIs will need to demonstrate sufficient liquidity to survive for the period of the scenario; and
- APRA will specify in the prudential standard many of the assumptions to be used in these two scenarios, but will have flexibility to vary these assumptions where warranted. The specifications are summarised in Attachment 2.

Chapter 4 – Reporting to APRA

Background

A review of APRA's liquidity framework, completed shortly before the global financial crisis erupted, identified issues with liquidity reporting arrangements. The crisis has validated those findings and revealed further deficiencies. In response, interim informal measures were put in place for collecting regular standardised information from selected ADIs. APRA's intention is to develop a formal, standardised and comprehensive liquidity reporting framework for all ADIs to replace these interim measures.

APRA acknowledges the potential increase in reporting burden but believes the changes are necessary from prudential and financial stability perspectives. Prudential supervisors in other jurisdictions have reached similar conclusions.

Issues with current liquidity reporting arrangements

APS 210 currently requires each ADI to agree with APRA on a set of internal liquidity reports to be submitted to APRA (at least) quarterly. These reports must include the results of liquidity scenario analysis for APRA-defined going concern and name crisis scenarios or, for ADIs exempted from scenario requirements and subject only to APRA's minimum liquidity holdings (MLH) regime, details of high quality liquid assets (HQLA). MLH ADIs currently report their HQLA and HQLA ratios to APRA on a quarterly basis using a standard return.⁶

Issues with APRA's current policy on liquidity reporting are summarised below:

Inconsistent reporting across ADIs

Since APRA receives internal liquidity reports, its data collection varies significantly from one ADI to another. The lack of consistency in format and content makes it difficult, if not impossible, to conduct peer group comparisons and other benchmarking exercises. Similarly, aggregation to provide industry and system insights is impossible.

Limited scope and granularity of reporting

APRA's experience during the global financial crisis was that existing statistical returns and regular internal liquidity reports provided insufficient coverage and detail for the purpose of assessing and monitoring ADIs' liquidity positions on a continuing basis. For example, no contractual maturity data are collected and there is a lack of granular data on ADIs' funding profiles with regard to sources (e.g. retail vs. wholesale, onshore vs. offshore and intra-group vs. third party), concentration and capacity.

No mechanism for crisis reporting

The existing statistical returns and regular internal liquidity reports provided outdated liquidity information that was not particularly useful when APRA turned to it at the onset of the global financial crisis. This experience has highlighted the importance of APRA having immediate access to updated liquidity information when one or more ADIs are under liquidity stress.

Current interim measure

In view of these limitations, an informal standardised reporting template (in the form of an Excel spreadsheet) has been used since April 2008 for collecting liquidity and funding information from selected ADIs on a monthly basis. APRA has been using these data primarily to conduct peer group analyses against certain benchmarks, as the basis for follow-up supervision activity.

This interim reporting template has been used as the starting point for developing a new set of standardised reporting forms. The new forms extend the scope of the data collected, the granularity of those data and the forward-looking time horizon. Eventually, the interim template will be replaced by the new forms.

⁶ ARF 210.0 Statement of High Quality Liquid Assets Calculation

Proposed reporting framework

The proposed liquidity reporting will form a subset of the existing ADI prudential reporting framework established under the *Financial Sector (Collection of Data) Act 2001* (FSCODA). Consistent with this framework, data will be collected using standardised reporting forms and ADIs will submit these forms via APRA's D2A system. New reporting standards determined under the FSCODA will give legal effect to the liquidity reporting requirements.

The proposed framework consists of two components: regular and crisis reporting. Key elements of each are outlined below.

Regular reporting (Form A)

Scope

APRA is proposing that the scope of regular liquidity reporting encompass the following information:

- contractual maturity profile of assets, liabilities and contingent exposures to sponsored structured vehicles (refer to Part A of Form A). These data provide a baseline collection from which APRA can conduct benchmarking against certain metrics, including funding diversification by type and maturity, and perform *ad hoc* idiosyncratic and market-wide stress testing. These objectives drive the granularity of the balance sheet breakdown and the time buckets. For the purpose of a standardised data collection, contractual data, free of behavioural assumptions, are preferred;
- details on funding concentration by counterparty⁷, liquid asset portfolio composition and contingent funding exposures and sources (refer to Parts A3 and D of Form A). These items are natural areas of supervisory interest;

- going concern balance sheet forecast and associated funding plans for the next 12 months (refer to Part B1 of Form A). In response to the crisis, APRA has conducted two funding plan reviews with selected ADIs, which have been instructive individually, in comparison with peer ADIs, and in aggregate. APRA's proposal would standardise the format and frequency of this collection.

APRA intends to collect this information in two distinct parts:

- cash flow mismatch projections based on the balance sheet as at the reporting date, and forecast loan growth; and
- the plan to meet any cash flow shortfalls identified above, including assumptions such as deposit growth, rollover of maturing term deposits, planned new debt issuances and securitisation activities.

This layout is more rigorous than a simple balance sheet forecast, providing APRA with an enhanced tool for assessing the reasonableness of funding plans individually, in comparison with peer ADIs, and in aggregate;

- liquidity stress-test results under the APRA-defined stress tests, where applicable (refer to Parts B2.1 and B2.2 of Form A)⁸;
- liquidity positions in foreign currencies (refer to Parts A and B of Form A). This is an area of increased focus for APRA. The proposal is that ADIs provide detail on an all-currency basis (expressed as an AUD equivalent) with further breakdown on the aggregate position by major currency (AUD equivalent). The contractual maturity profile collects data on unhedged foreign currency funding as well as maturity mismatches by major currency. The proposed cash flow projections collect data on projected currency mismatches by major currency;

⁷ This will replace current reporting of large liability exposures (greater than five per cent of total liabilities) under Section D of ARF 221.0 Large Exposures.

⁸ Only ADIs that are subject to APRA's scenario analysis requirements will need to complete these parts of the regular reporting form. APRA may request ADIs to submit copies of internal stress test reports in respect of their own scenario analysis.

- HQLA ratios, where applicable (refer to Part C of Form A); and
- breaches of regulatory liquidity requirements. The existing breach reporting framework (i.e. the 'Notification of breaches of ADI prudential requirements under s. 62A of the *Banking Act 1959*' form and associated notes for completing the form) will continue to be the basis for ADI reporting of breaches of regulatory liquidity requirements. This includes, for example, which breaches must be reported to APRA and when. APRA is also proposing that ADIs provide, on a regular basis, copies of internal reporting of breaches of internal liquidity limits or ratios. Such information is essential for supervisors as it may provide early warning signals for potential liquidity issues.

As with current practice, APRA may also require an ADI to provide copies of relevant internal management reports to supplement the information provided in the standardised form.

Frequency

The regular reporting suite will be required quarterly, due 20 business days after the end of the quarter.

Publication of liquidity data

In line with its current approach of publishing relevant statistical data on a regular basis, APRA's intention is to publish a summary of these liquidity data at industry and peer group levels. APRA would be interested to receive industry feedback on the appropriate level of aggregation and detail for publication.

Crisis reporting (Form B)

Based on its experience during the global financial crisis, APRA is proposing to introduce a standardised framework for ADI liquidity reporting at times of stress. The proposed framework aims to ensure that APRA has immediate access to updated and comparable liquidity data, which will provide a view on liquidity for individual ADIs and for various aggregations.

Scope

The crisis liquidity reporting will include the following:

- cash flow mismatch projections for APRA-defined stress scenarios, using the same format as for regular reporting (refer to Parts A1 and A2 of Form B). This will provide updated near-term maturity profiles and confirm that the ADI continues to meet APRA's minimum quantitative requirements; and
- recent funding experience (refer to Part B of Form B).

There is a balance to be struck in designing these requirements. At one extreme, the requirement could be made very comprehensive (and burdensome) so that the likelihood of APRA requiring extra *ad hoc* reporting in an actual crisis is low. APRA has decided against this approach in favour of a standard request which covers only basic data for a crisis scenario. The consequence is that extra *ad hoc* reporting in an actual crisis, tailored for the circumstances, is likely.

Frequency

Upon APRA's request, affected ADIs will need to submit the crisis reporting form on the same day (as at close of business the previous day), or next day if the request was made in the afternoon, and continue such reporting as frequently as required by APRA (e.g. daily, weekly or at some other interval) until it is no longer required. In an actual crisis, APRA will consider the nature of the event and tailor reporting in terms of which part(s) of the form, which ADIs and what frequency would be required.

To ensure that ADIs maintain this reporting capability, APRA will conduct a random test of ADIs from time to time. APRA will expect ADIs to be able to meet this 'fire drill' requirement. Inability to provide adequate same/next day crisis liquidity reporting will be considered a material prudential issue.

APRA proposes to conduct fairly frequent fire drills to ensure initial compliance but over time, as ADIs master the capability, the frequency will reduce. On an ongoing basis, APRA expects the frequency of fire drills to be relatively higher for larger ADIs. Most ADIs can expect a fire drill at least once a year.

Regulatory developments in other jurisdictions

BCBS Liquidity Principle 15 establishes the expectation that prudential supervisors will supplement their supervisory focus on a bank's liquidity risk management process by the collection of standardised prudential reports, although the scope of that reporting is not addressed. APRA's proposed liquidity reporting framework is also consistent with the BCBS Liquidity Principles in respect of expectations about the capability of management information systems (MIS). For example, an ADI's MIS should be capable of providing relevant stakeholders with timely and forward-looking information on its liquidity position, calculating liquidity positions in all of the currencies in which the ADI conducts business, providing liquidity information both on a subsidiary/branch basis in all jurisdictions in which the ADI is active and on an aggregate group basis, delivering more granular and time-sensitive information during stress events, and producing cash flow mismatch or liquidity gap analysis to calculate cumulative net excess or shortfall over the timeframe for the liquidity assessment.

APRA also considers the proposed framework to be consistent with the direction under consideration by other prudential supervisors. Common themes include:

- standardised, granular and frequent reporting that gives supervisors the capability of monitoring across the industry and performing their own *ad hoc* institution-specific and market-wide stress tests; and
- a crisis reporting capability to provide up-to-date information.

Summary

In summary, APRA's proposals are:

- a suite of regular (quarterly) reporting comprising a contractual maturity schedule, a cash flow analysis on a going concern basis, stress-test results for APRA-defined scenarios (one-month name crisis and three-month market disruption scenarios) or HQLA ratios as appropriate, funding concentration and liquid asset portfolio composition. This reporting will eventually replace the current interim template introduced in April 2008;
- a suite of reporting to be done in a stress/crisis situation, as required by APRA, comprising latest stress-test results for APRA-defined scenarios and recent funding experience. In an actual crisis, APRA will consider the nature of the event and tailor reporting in terms of which part(s) of the form, which ADIs and what frequency would be required;
- the one-month name crisis and three-month market disruption templates are the same under both suites. These stress tests effectively define APRA's prudential minimum level of resilience. During a stress event, it is essential that an ADI continue to meet this prudential minimum notwithstanding the deterioration in its liquidity position due to the actual stress event; and
- ADIs must have the capability to produce the crisis reporting suite at short notice (same or next day) based on the most current data practicable. APRA will test this capability on a random basis.

Chapter 5 – Application

Australian-owned ADIs

With the exceptions outlined below, APRA is proposing that the qualitative requirements set out in Chapter 2 apply to all ADIs on a solo basis and to the Level 2 ADI group.

APRA will take a risk-based approach in assessing ADIs' compliance with these requirements. In particular, the option currently in APS 210 for APRA to exempt an ADI from scenario analysis in favour of a simple quantitative metric (the MLH regime) will be retained. The MLH regime delivers an appropriate degree of resilience for ADIs with simple operations and the regime is working effectively. However, APRA is proposing one significant amendment to the MLH regime in that MLH ADIs will no longer be exempted from the going concern scenario⁹. Recent experience has highlighted the need for all ADIs to consider business as usual funding. For MLH ADIs, the going concern requirement is relatively straightforward.

APRA is not proposing to apply the qualitative requirements in respect of stress testing to MLH ADIs. In addition, the requirement for an internal liquidity pricing mechanism will not apply.

The APRA-defined name crisis and market disruption stress scenarios will apply to ADIs at the solo and ADI group levels, except for MLH ADIs. At the solo level, application is expected to be straightforward and this is the level at which standardised reporting will apply. At the group level, APRA will not necessarily require a mechanical expansion of the solo level stress testing. ADIs will be required to demonstrate that the group has sufficient liquid assets to meet the stress tests, having regard to any constraints on the free flow of funds within the group. Mechanical expansion of the solo level stress testing may not be the only or indeed the best way of demonstrating the minimum resilience.

APRA is proposing that the standardised reporting requirements apply to all ADIs on a solo basis, covering both the domestic and overseas branch operations; however, MLH ADIs will not be required to complete the name crisis and market disruption templates under either the regular or the crisis suite. For smaller ADIs, APRA does not expect the new standardised reporting will impose a significant burden. Given the scale and nature of their operations, these ADIs will simply 'zero check' most of the data items.

To better understand Australian-owned ADIs' liquidity positions at the group level (in particular, key intra-group liquidity dependencies), APRA may also require the parent ADI to provide relevant liquidity data of defined subsidiaries for regular and crisis reporting. This will be limited to significant onshore and offshore subsidiary operations. The format of any such reporting will be agreed by APRA and the relevant ADI.

Foreign-owned ADIs

APS 210 currently applies to foreign subsidiaries on a stand-alone basis but provides supervisors with a wide discretion in relation to branches. Consequently, a range of practice has evolved.

During the global financial crisis, APRA observed isolated instances where foreign branches did not maintain their local liquid asset buffer at a reasonable level, given the stress they were experiencing. This led to some specific supervisory intervention, followed by a general tightening of APRA's approach to all branches.

⁹ One further amendment APRA intends to implement is to ensure that the revised MLH regime does not penalise membership of the CUFSS scheme.

The crisis has provided a reminder of several concerns for host supervisors:

- whilst conceptually there is no reason a highly centralised liquidity management model will not work, the crisis has challenged the operation of those models. It would appear that either the simplifying assumptions required in practice to construct a central model were not borne out (e.g. guaranteed, immediate currency convertibility in large size) or the communication and organisational capabilities of the central model were overwhelmed by a crisis where the business came under severe stress in a number of jurisdictions simultaneously. APRA's experience supports the view that local liquidity management capabilities add considerably to the robustness of the total liquidity risk management of a cross-border banking institution;
- there is a practical limit on the extent to which home authorities can supervise the global liquidity risk management of their cross-border banking institutions. For example, home supervisors cannot have a detailed understanding of local market characteristics in all relevant jurisdictions nor can they possibly monitor individual currency mismatches for any more than the top few currencies; and
- whilst banking institutions may seek to manage their business on a global basis, when it comes to problem resolution legal vehicles and jurisdictions matter. Even before that point, market participants look to local authorities for support. For example, some foreign branches in Australia have used the Commonwealth guarantee of wholesale funding.

At the same time, it would not be reasonable for a host supervisor to ignore the reality of the group context for foreign branches.

APRA's proposed approach in this area is to have a much clearer, more stringent default position but with wide-ranging flexibility available. Specifically:

- APRA is proposing that all aspects of its liquidity risk management approach apply to foreign subsidiaries and branches¹⁰ on a stand-alone basis. Since all BCBS member supervisors will be implementing the BCBS Liquidity Principles, APRA expects foreign-owned ADIs will be able to utilise much of their group risk management frameworks to comply with APRA's qualitative requirements. For APRA-defined stress tests, assurances of parental support, regardless of contractual form, will not be taken into account since there can be no certainty that those assurances will be honoured when they are needed, either because the parent is itself in difficulty, or its management systems fail, or due to disruptions in currency swap markets. However, funding actually provided by the parent, especially term funding, will be acceptable; and
- APRA will be willing to consider exempting a foreign-owned ADI from certain aspects of the prudential requirements, having regard to the nature of the Australian operation, the systemic importance of that operation, APRA's detailed understanding of the liquidity risk management framework and position of the global bank and APRA's detailed understanding of home supervisor oversight. However, APRA is unlikely to approve exemptions from the standard reporting framework or from stress testing in favour of the MLH regime, which is directed at smaller retail-based ADIs.

¹⁰ Application is to the Australian branch.

Chapter 6 – Implementation

APRA anticipates that the new APS 210 will come into force in the first half of 2010. Delays to this timetable are possible, depending on the nature of submissions received or in order to align with the timetable of similar work currently underway by the BCBS.

To ensure there is sufficient time for ADIs to adjust their liquidity risk management frameworks, proposed transitional arrangements are as follows:

1. All ADIs will be required to submit a copy of their board-approved self-assessment of compliance with the new APS 210 by end-December 2010. The self-assessment must be supported by an independent review (e.g. performed by the ADI's internal audit or an external expert as appropriate). The report submitted must also include board-approved gap closure plans for areas of non-compliance.
2. After reviewing each ADI's self-assessment, APRA will take one of the following steps in response:
 - (a) where the self-assessment indicates full compliance, APRA will review the ADI's liquidity risk management framework and compliance with APS 210 during on-site liquidity reviews as part of the normal supervisory review process¹¹;
 - (b) where:
 - the self-assessment indicates that the ADI will require a longer transition period to fully comply with the new requirements; or
 - the ADI's gap closure plan involves seeking some flexibility on APRA-specified stress testing assumptions or some exemption from prudential requirements

the appropriateness of the ADI's gap closure plan (both content and timing) will be assessed by APRA on a case-by-case basis.

Where necessary, APRA may conduct on-site liquidity reviews in making these assessments. APRA would expect material compliance by the first quarter of 2011.

3. All ADIs will be required to submit the new quarterly D2A form to APRA for regular liquidity reporting from the December 2010 quarter. All ADIs will also be required to meet APRA's crisis liquidity reporting requirements at the same time.

¹¹ APRA's on-site review process provides the flexibility to prioritise certain risk areas. ADIs indicating full compliance should anticipate that APRA will prioritise liquidity risk in 2011.

Chapter 7 – Request for cost-benefit analysis information

To improve the quality of regulation, the Australian Government requires all proposals to undergo a preliminary assessment to establish whether it is likely that there will be business compliance costs. In order to perform a comprehensive cost-benefit analysis, APRA welcomes information from interested parties. As part of the consultation process, APRA requests respondents to provide an assessment of the impact of the proposed changes and, specifically, the marginal compliance costs ADIs are likely to face.

Given that APRA's proposed requirements may impose some compliance costs, respondents may also indicate whether there are any other regulations relating to ADI liquidity risk management that should be improved or removed to reduce compliance costs. In doing so, please explain what they are and why they need to be improved or removed.

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

Attachment 1 – BCBS Principles for Sound Liquidity Risk Management and Supervision

The table below sets out the 17 BCBS principles for the management and supervision of liquidity risk. Detailed guidance on each of these principles is set out in the BCBS Liquidity Principles which can be found on the BIS website at <http://www.bis.org/publ/bcbs144.htm>.

| Fundamental principle for the management and supervision of liquidity risk | |
|--|---|
| Principle 1 | A bank is responsible for the sound management of liquidity risk. A bank should establish a robust liquidity risk management framework that ensures it maintains sufficient liquidity, including a cushion of unencumbered, high quality liquid assets, to withstand a range of stress events, including those involving the loss or impairment of both unsecured and secured funding sources. Supervisors should assess the adequacy of both a bank's liquidity risk management framework and its liquidity position and should take prompt action if a bank is deficient in either area in order to protect depositors and to limit potential damage to the financial system. |
| Governance of liquidity risk management | |
| Principle 2 | A bank should clearly articulate a liquidity risk tolerance that is appropriate for its business strategy and its role in the financial system. |
| Principle 3 | Senior management should develop a strategy, policies and practices to manage liquidity risk in accordance with the risk tolerance and to ensure that the bank maintains sufficient liquidity. Senior management should continuously review information on the bank's liquidity developments and report to the board of directors on a regular basis. A bank's board of directors should review and approve the strategy, policies and practices related to the management of liquidity at least annually and ensure that senior management manages liquidity risk effectively. |
| Principle 4 | A bank should incorporate liquidity costs, benefits and risks in the internal pricing, performance measurement and new product approval process for all significant business activities (both on- and off-balance sheet), thereby aligning the risk-taking incentives of individual business lines with the liquidity risk exposures their activities create for the bank as a whole. |
| Measurement and management of liquidity risk | |
| Principle 5 | A bank should have a sound process for identifying, measuring, monitoring and controlling liquidity risk. This process should include a robust framework for comprehensively projecting cash flows arising from assets, liabilities and off-balance sheet items over an appropriate set of time horizons. |
| Principle 6 | A bank should actively monitor and control liquidity risk exposures and funding needs within and across legal entities, business lines and currencies, taking into account legal, regulatory and operational limitations to the transferability of liquidity. |
| Principle 7 | A bank should establish a funding strategy that provides effective diversification in the sources and tenor of funding. It should maintain an ongoing presence in its chosen funding markets and strong relationships with funds providers to promote effective diversification of funding sources. A bank should regularly gauge its capacity to raise funds quickly from each source. It should identify the main factors that affect its ability to raise funds and monitor those factors closely to ensure that estimates of fund raising capacity remain valid. |

| | |
|--------------------------------|---|
| Principle 8 | A bank should actively manage its intraday liquidity positions and risks to meet payment and settlement obligations on a timely basis under both normal and stressed conditions and thus contribute to the smooth functioning of payment and settlement systems. |
| Principle 9 | A bank should actively manage its collateral positions, differentiating between encumbered and unencumbered assets. A bank should monitor the legal entity and physical location where collateral is held and how it may be mobilised in a timely manner. |
| Principle 10 | A bank should conduct stress tests on a regular basis for a variety of short-term and protracted institution-specific and market-wide stress scenarios (individually and in combination) to identify sources of potential liquidity strain and to ensure that current exposures remain in accordance with a bank's established liquidity risk tolerance. A bank should use stress test outcomes to adjust its liquidity risk management strategies, policies, and positions and to develop effective contingency plans. |
| Principle 11 | A bank should have a formal contingency funding plan (CFP) that clearly sets out the strategies for addressing liquidity shortfalls in emergency situations. A CFP should outline policies to manage a range of stress environments, establish clear lines of responsibility, include clear invocation and escalation procedures and be regularly tested and updated to ensure that it is operationally robust. |
| Principle 12 | A bank should maintain a cushion of unencumbered, high quality liquid assets to be held as insurance against a range of liquidity stress scenarios, including those that involve the loss or impairment of unsecured and typically available secured funding sources. There should be no legal, regulatory or operational impediment to using these assets to obtain funding. |
| Public disclosure | |
| Principle 13 | A bank should publicly disclose information on a regular basis that enables market participants to make an informed judgement about the soundness of its liquidity risk management framework and liquidity position. |
| The role of supervisors | |
| Principle 14 | Supervisors should regularly perform a comprehensive assessment of a bank's overall liquidity risk management framework and liquidity position to determine whether they deliver an adequate level of resilience to liquidity stress given the bank's role in the financial system. |
| Principle 15 | Supervisors should supplement their regular assessments of a bank's liquidity risk management framework and liquidity position by monitoring a combination of internal reports, prudential reports and market information. |
| Principle 16 | Supervisors should intervene to require effective and timely remedial action by a bank to address deficiencies in its liquidity risk management processes or liquidity position. |
| Principle 17 | Supervisors should communicate with other supervisors and public authorities, such as central banks, both within and across national borders, to facilitate effective cooperation regarding the supervision and oversight of liquidity risk management. Communication should occur regularly during normal times, with the nature and frequency of the information sharing increasing as appropriate during times of stress. |

Attachment 2 – APRA-defined stress test assumptions

| | Idiosyncratic crisis (20 business days) | Market disruption (three months) |
|----------------------------------|---|--|
| Scenario | Severe but plausible global name crisis. | Market disruption caused by a major Australian ADI experiencing a global name crisis. |
| Franchise impact | All commitments to be honoured but otherwise new lending may be assumed to cease. | Business activity to continue as normal. |
| Liquid assets | High quality assets that can be readily sold or used as collateral in private markets, even when those markets may be under stress. As a backstop to the robustness of the liquid asset buffer, liquid assets should also be eligible central bank collateral for normal market operations. Some limited scope to rely on central bank eligibility alone may be necessary on implementation, depending on the currency in question. Must be unencumbered and held in a segregated pool for the sole purpose of acting as a liquidity buffer. Market value less haircut. | As for name crisis. |
| Self-securitisation | Not allowed. | Allowed from month three. |
| Credit lines (source of funds) | Maximum contractual amount, only if committed and irrevocable, but not before day six. | Not allowed. |
| Credit lines (use of funds) | 100 per cent of maximum contractual drawdown for financial institution counterparties. | For largest ADI exposure and offshore financial institution counterparties, 100 per cent contractual drawdown. |
| Household or SME deposits – call | Where fully covered by government guarantee, 10 per cent runoff. Not fully covered, 30 per cent runoff. For internet deposits, an extra 30 per cent runoff. Runoffs to be uniform, except a third of the extra internet runoff should be modelled on day three. | No impact. |
| Household or SME deposits – term | Where fully covered by government guarantee, 25 per cent runoff at maturity. Not fully covered, 75 per cent. | No impact. |

| | Idiosyncratic crisis (20 business days) | Market disruption (three months) |
|---------------------------------------|--|--|
| Financial institution deposits | 100 per cent loss at first contractual opportunity. | For largest ADI exposure and offshore counterparties, 100 per cent loss at first contractual opportunity. |
| Debt securities | 100 per cent runoff at maturity. 10 per cent early buyback of domestic short-term securities on day one, five per cent on day two. | For largest ADI exposure and offshore financial institution counterparties, 100 per cent runoff at maturity. |
| Secured funding | 100 per cent loss at first contractual opportunity. | For largest ADI exposure and offshore financial institution counterparties, 100 per cent runoff at maturity. |
| Collateral calls | Extreme market move plus a three-notch downgrade (subject to a minimum of total collateral currently held). | Extreme market move (subject to a minimum of total collateral currently held). |
| Currency | Currency convertibility can be assumed. | As for name crisis. |
| Applicability (Australian-owned ADIs) | Solo and ADI group, but with some flexibility as to how group resilience is demonstrated. | As for name crisis. |
| Applicability (foreign-owned ADIs) | Australian operation only, on a stand-alone basis (for branches, some flexibility available) | As for name crisis. |

Notes:

1. For any category of balance sheet item or contingent source or use of funds not specified above, ADIs are to use their own assumption, consistent with the scenario described and the specified assumptions for that scenario.
2. Financial institutions include entities supervised by APRA, financial businesses not supervised by APRA and structured financing vehicles.
3. Under the market disruption scenario, ADIs are to assume that the troubled ADI triggering the scenario is the ADI to which they have the largest exposure. This test is applied to each assumption independently. ADIs able to demonstrate a robust understanding of their aggregate liquidity exposures may apply the test on an aggregate basis.



Telephone
1300 13 10 60

Email
contactapra@apra.gov.au

Website
www.apra.gov.au

Mail
GPO Box 9836
in all capital cities
(except Hobart and Darwin)