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APRA

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To all authorised deposit-taking institutions subject to the Liquidity Coverage Ratio

Implementation of the Basel III liquidity framework in Australia

Committed liquidity facility

In December 2010, the Australian Prudential Regulation Authority (APRA) and the Reserve Bank of Australia (RBA) announced that authorised deposit-taking institutions (ADIs) subject to the Liquidity Coverage Ratio (LCR) will be able to establish a secured committed liquidity facility (CLF) with the RBA. The CLF will be sufficient in size to cover any shortfall between the ADI's holdings of high-quality liquid assets (HQLA) and the requirement to hold such assets under the LCR. ADIs will be required to demonstrate that they have taken 'all reasonable steps' towards meeting their LCR requirements through their own balance sheet management, before relying on the CLF.

In its letter to authorised deposit-taking institutions of 8 August 2013[1], APRA indicated that:

'APRA is undertaking a trial exercise with all [LCR] ADIs in 2013. In the exercise, ADIs have been requested to submit an application for a pro forma CLF to cover their expected Australian dollar LCR shortfall for the calendar year 2014. Through this process, APRA is focusing particularly on the project plans that ADIs are putting in place to ensure they are taking all reasonable steps to reduce liquidity risk. APRA is also seeking to satisfy itself that the Board-approved tolerance for liquidity risk, the robustness of the ADI's liquidity transfer pricing and the remuneration incentives of executives responsible for the ADI's funding plan and liquidity management are all appropriately aligned to APRA's objective of prudent liquidity risk management.

APRA will release further details on the CLF process and, in particular, its expectations with regard to the composition of the CLF portfolio of eligible securities, once it has completed the 2013 exercise.'

This note provides some observations arising from that trial exercise. It also outlines the timetable for the 2014 exercise as well as some changes to the process going forward.

Principles applicable to the LCR and CLF

The 8 August 2013 letter outlined APRA's principles in regard to the LCR and CLF. APRA's intention is that the CLF arrangements must not alter the incentives of ADIs in managing their liquidity risk, compared with a situation in which there were sufficient HQLA to allow ADIs to meet their LCR requirements without reliance on the CLF. The LCR is designed to be business model-agnostic; so too is the CLF. These principles guided APRA's assessment of CLF applications.

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[1] *Letter to ADIs: Committed Liquidity Facility* http://www.apra.gov.au/adi/Publications/Pages/other-information-for-adis.aspx

The 2013 trial exercise

A total of 35 ADIs, including both locally incorporated ADIs and foreign bank branches, took part in the trial exercise. ADIs were asked to nominate a specific dollar amount of notional CLF sufficient to allow them to comply with a notional LCR requirement for the calendar year 2014.

The system-wide CLF size at 100 per cent LCR coverage was calculated as follows:

$CLF_{system} = NCO_{system} - HQLA_{est.}$, where:

- NCO_{system} is the sum of ADI Australian dollar net cash outflow targets as agreed between each ADI and APRA; and
- $HQLA_{est.}$ is the amount of Australian dollar HQLA that the RBA estimated could reasonably be held by LCR ADIs.

Following APRA moderation of the applications, the aggregate Australian dollar net cash outflow of the 35 ADIs projected for 2014 was approximately $418 billion. This amount represented NCO_{system}.

The RBA determined that the amount of Australian dollar HQLA that could reasonably be held by LCR ADIs was equivalent to around 30 per cent of the outstanding stock of Commonwealth Government Securities and securities issued by state and territory governments[2]. This amount represented $HQLA_{est}$.

On this basis, CLF_{system} was determined to be $249 billion and the total notional CLF granted (including buffers over 100 per cent) was $282 billion. This was lower than the amount of $344 billion requested by ADIs because:

- ADIs had not been informed of the amount of $HQLA_{est.}$ prior to submitting their projections, since that figure had not yet been determined. As a result, some ADIs projected a lower holding of HQLA than their presumed allocation while others projected a higher holding of HQLA. In aggregate, the dollar amount of under-projection was greater than the dollar amount of over-projection. Those ADIs that projected a lower holding of HQLA than their presumed allocation had their notional CLF reduced accordingly;

- a number of ADIs had their NCO projections reduced from their original applications. This resulted from either the correction of errors, removal of overly conservative assumptions or APRA's engagement with ADIs to improve consistency of approach[3]. Where projected NCOs were reduced, ADIs had their notional CLF reduced accordingly; and

- a number of ADIs requested a CLF amount sufficient for an LCR significantly greater than 100 per cent. Where the requested buffer over 100 per cent was deemed to be excessive, ADIs had their notional CLF reduced accordingly.

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[2] This should not be confused with 30 per cent of NCO_{system}, which will be a different amount.

[3] This was particularly the case with projected cash outflows relating to commitments, contingent cashflows, derivatives, non-contractual obligations and the like. These items are more opaque than those relating to deposits, wholesale funding and secured borrowings.

A summary of some other important observations arising from the trial exercise are listed below.

HQLA holdings

APRA noted during the trial exercise that the CLF is expressed as an absolute amount, calculated from projected NCOs and presumed HQLA holdings. Where actual NCOs prove to be lower than projected NCOs, this could in theory allow ADIs to hold a lower amount of HQLA as a consequence. APRA's intention is that ADIs should not have any incentive to apply for a CLF amount in excess of their true needs. Accordingly, APRA's expectation is that the proportion of HQLA to actual NCOs will remain reasonably stable throughout the calendar year.

A buffer over 100 per cent LCR

A large number of ADIs requested a CLF sufficient in size to ensure an LCR in excess of 100 per cent. Reasons cited for this request included operational risks, unfamiliarity with a new process and uncertainty over external stakeholders' expectations in this regard. During the trial exercise, APRA assumed that a suitable buffer would lie in the range of 10-15 per cent of NCOs and allocations were made on that basis.

Related-party transactions: locally incorporated ADIs

APRA noted that a number of locally incorporated ADIs highlighted funding from related-party entities as having the potential to reduce cash outflows. While a number of the initiatives were acceptable, there were two categories that raised prudential concerns:

- firstly, where an ADI assumed that in a stress situation the related-party entity would not choose to withdraw funds from the ADI even though it had the right to do so[4]; and
- secondly, where the related-party entity entered into a contractual arrangement that significantly impeded its ability to withdraw funds from the ADI without any obvious compensating benefit to that entity.

APRA cannot accept assumptions relating to the potential behaviour of directors or trustees of related-party entities that are not consistent with their duties and fiduciary obligations, in particular where these are imposed through legislation such as the *Corporations Act 2001* or the *Superannuation Industry (Supervision) Act 1993*. Nor can APRA accept directors or trustees of related-party entities signing legal agreements that are not in the best interests of their own entity, its customers or members. APRA expects that ADIs will give careful and detailed consideration to such matters as they assign related-party deposits to particular outflow categories. Where the related-party entity is itself subject to APRA prudential supervision, APRA will be closely examining the liquidity risk profile of that entity.

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[4] For example, cash placed with the ADI on an at-call basis or purchased debt securities falling due in the 30-day period.

Appropriate composition of CLF collateral

APRA will not generally specify a required CLF collateral mix for ADIs. As part of the annual CLF assessment process, APRA will consider the current and projected future collateral mix of each ADI. Material changes in composition will be analysed and ADIs will be required to justify them. Where it believes that proposed changes would result in an unsuitable collateral mix, APRA will require ADIs to submit an amended proposal.

In assessing the suitability of an ADI's CLF collateral mix, APRA will employ the following two principles:

- CLF collateral has an appropriate degree of diversification. APRA expects that concentrations in debt securities of a particular type, issuer, credit quality or tenor will be avoided; and

- the need for liquid markets in debt securities needs to be balanced against the dangers of exacerbating interconnectedness. It is in the interests of all market participants that the market for short-term ADI-issued paper remains deep, liquid and active. APRA will not expect ADIs to hold term debt securities issued by other ADIs, such as senior unsecured debt, covered bonds or asset-backed securities, but ADIs may choose to do so.

Liquidity transfer pricing

APRA noted that a number of ADIs, especially smaller locally incorporated ADIs and some foreign bank branches, do not currently meet its expectations with regard to the coverage and granularity of and conceptual approach to liquidity transfer pricing. Throughout 2014, APRA will engage ADIs on this topic and outline its expectations more clearly.

Remuneration

APRA noted that some key persons within ADIs are remunerated in a manner that could be inconsistent with its requirement that ADIs seek to minimise reliance on the CLF. In particular, APRA expects that persons with responsibilities such as:

- prudent stewardship of the balance sheet;

- effecting a prudent, stable and well-diversified funding profile; and

- maintaining a diversified portfolio of high-quality and readily liquefiable assets as a mitigant to unanticipated cash outflows

would have variable remuneration materially determined by meeting these objectives. APRA does not believe that financial measures such as divisional profit, entity net profit after tax or return on equity are appropriate in gauging the degree of success in meeting these objectives. Indeed, prudent liquidity management often comes at the expense of short-term profit. Where APRA has identified remuneration arrangements of concern, it will take the matter up directly with the relevant ADIs.

Statement of liquidity risk appetite

ADIs were asked to submit their Board-approved Statement of Liquidity Risk Appetite[5]. APRA noted that these varied greatly, both in conceptual approach and level of detail. APRA's general observation is that best practice is to have a Statement of Liquidity Risk Appetite that includes both qualitative statements and quantifiable metrics[6]. Where balance-sheet forecasts and projected NCOs were able to be reviewed alongside clearly articulated and well-defined Statements of Liquidity Risk Appetite, including quantifiable metrics, it was much more straightforward for APRA to assess whether 'all reasonable steps' had indeed been taken.

APRA will make two particular changes to the NCO projection process for 2014.

Related-party transactions: foreign bank branches

APRA encountered considerable difficulty in assessing applications from foreign bank branches that had a high proportion of projected cash inflows or projected cash outflows arising from transactions with related-party entities. Nor was it evident why a foreign bank branch needed a CLF to ensure its ability to repay obligations to its own parent or sister branch. This issue is exacerbated by the fact that projected NCOs from any individual ADI contribute to the system-wide total and hence affect the CLF for all ADIs. Accordingly, from 2014 onwards, foreign bank branches will be required to make the following assumptions when projecting Australian dollar only NCOs for the purposes of applying for a CLF[7]:

- projected cash outflows from transactions with or commitments to related-party entities are zero, regardless of contractual tenor; and
- projected cash inflows from transactions with or commitments from related-party entities are no greater than 50 per cent of projected cash outflows. This maximum limit is in addition to the general stipulation that cash inflows (from all sources) cannot be greater than 75 per cent of cash outflows.

The definition of 'related-party entity' for these purposes includes:

- the branch's own parent;
- other branches of the same legal entity; and
- wholly owned subsidiaries of the legal entity of which the branch is a part.

APRA's intention is that transactions that disappear on consolidation of the parent's balance sheet are excluded from NCO projections for CLF purposes, but not from the liquidity management of the branch, including determining NCOs for LCR compliance. As a

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[5] Or the equivalent for foreign bank branches.

[6] ADIs will also need to ensure that their risk appetite statements meet the requirements of *Prudential Standard CPS 220 Risk Management* once it comes into effect.

[7] For the avoidance of doubt, there is no change in the methodology for calculating NCOs or LCR as outlined in *Prudential Standard APS 210 Liquidity*. These assumptions are solely for the purpose of determining the size of the CLF.

result, the liquidity implications of these related-party transactions need to be managed by the branch through its own resources, rather than through reliance on the CLF. APRA will discuss the appropriate application of these assumptions with branches as required.

Foreign exchange (FX) derivatives

APRA noted that, for some ADIs, FX derivatives contributed a very significant proportion of cash inflows and cash outflows. NCO projections for CLF purposes are Australian dollar (AUD) only and hence capture only one side of FX transactions. For some ADIs, AUD-only NCOs were greater than all-currency NCOs as AUD cash outflows were matched by non-AUD cash inflows. In some circumstances, it would be reasonable to exclude AUD cashflows arising from FX derivatives but in other circumstances it would not be reasonable.

Accordingly, from 2014 onwards ADIs may, as part of their CLF application, request a 'customised assumption' regarding projected FX derivative cashflows. Any such request should include:

- an explanation of the underlying activity leading to the request with specific facts, figures and examples, not just general assertions; and
- a statement from the ADI explaining why it believes that introducing a customised assumption for such items would not lead to a genuine liquidity risk being ignored or understated.

APRA will determine whether it is appropriate to use a customised assumption on a case-by-case basis.

Timetable for 2014

APRA will ask ADIs to submit formal CLF applications by 30 May 2014 in order to determine the size of an ADI's CLF that will apply for the 2015 calendar year. Applications should be based on 31 March 2014 data. APRA will endeavour to agree the size of each ADI's CLF by 30 September 2014.

Please contact Nick Palmer on 9210 3105 (or your Responsible Supervisor) if you have any further queries.

Yours sincerely,

Charles Littrell
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