



4 November 2014

To: All authorised deposit-taking institutions (ADIs)

## LIQUIDITY RISK - RECENT CONSULTATIONS

Over the course of the last six months, APRA has released two separate consultations related to liquidity risk:

- In April 2014, APRA released a letter to ADIs advising of proposed changes to funding and liquidity reporting arrangements. The letter formed the basis of a consultation on a proposal that all ADIs should have the capacity to produce a set-format daily liquidity report on request;<sup>1</sup> and
- In September 2014, APRA released for consultation proposed amendments to *Prudential Standard APS 210 Liquidity* (APS 210) and related reporting instructions. In addition to proposed changes to a derivatives definition, this consultation addressed a proposed revised Liquidity Coverage Ratio (LCR) framework for foreign bank branches (FBBs). This consultation also flagged a proposed comprehensive review of the appropriate prudential liquidity regime for FBBs to be commenced in 2015.<sup>2</sup>

APRA is now releasing the final package of reforms related to these consultations: a revised APS 210; revised reporting standards and instructions; and this letter which sets out APRA's response to submissions to both consultations. The package of reforms and links to the non-confidential submissions can be found on the APRA web-site at: <http://www.apra.gov.au/adi/PrudentialFramework/Pages/adi-consultation-packages.aspx>.

### 1. Daily liquidity report

APRA first signalled its intention to introduce a set-format daily liquidity report as part of its proposed enhanced liquidity requirements for ADIs in 2009, and subsequently, as part of its consultation on Basel III liquidity implementation in Australia.

APRA received five submissions on its April 2014 proposals, of which one was non-confidential. Four submissions were generally supportive, but one did not support the

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<sup>1</sup> <http://www.apra.gov.au/adi/Publications/Pages/other-information-for-adis.aspx>

<sup>2</sup> <http://www.apra.gov.au/adi/Pages/September-2014-Consultation-liquidity-amendments-standard-reporting-instructions.aspx>

proposal to apply the requirement to minimum liquidity holdings (MLH) ADIs. The key issues and APRA's responses are set out below.

**a) Close of business**

APRA proposed that an ADI should be able to submit the set-format daily liquidity report with no more than a one business day time lag.

One submission asserted that this was not possible without manual intervention because it received data from the parent's central repository following close of business (COB) in the home country. As such, it requested producing the report using data on a day+2 basis.

Similarly, another submission highlighted that in its case a particular data item required for the daily liquidity report is currently updated on a weekly basis rather than on a daily basis. On a slightly different, but related point, another submission suggested that the COB, for the purpose of identifying data to be used in the report, should be defined by a single agreed point in the global trading day.

*APRA response*

In order to meet the 'on-demand' nature of this reporting, ADIs will need to make certain assumptions and estimates when submitting the report. Given the 'best endeavours' basis, an ADI would not need to produce this report daily, but would need to have the operational capacity to do so on APRA's request - potentially daily for a number of consecutive business days. Given the 'best endeavours' basis, APRA expects that all ADIs should be able to produce the report with no more than a one business day time lag, i.e. a day+1 convention.

APRA does not expect that individual data items in the report will be automatically subject to review or audit by the external auditor. However, quality control, consistent with the requirements of paragraphs 14 and 15 of the revised *Reporting Standard ARS 210 Liquidity* (ARS 210) and internal controls relating to prudential requirements, consistent with paragraph 39(d) of *Prudential Standard APS 310 Audit and related matters* (APS 310), will still apply given that, in times of liquidity stress, ADIs and APRA will place reliance on the reported net cashflow results.

**b) Scope of application**

APRA proposed that the set-format daily liquidity report should apply to all ADIs. One submission argued against this, claiming that it was unclear why APRA would broaden the requirement to smaller and less complex ADIs. This submission asserted that the current MLH regime is sufficient for liquidity risk management purposes.

*APRA response*

APRA's proposed daily liquidity report forms part of its Basel III liquidity reporting framework. It is being introduced to ensure that APRA has immediate access to updated and comparable liquidity data, which will provide a view on liquidity for individual ADIs and, in aggregated form, across groups of ADIs.

APRA agrees that the current MLH regime is relevant for the liquidity risk management of smaller and less complex ADIs. However, the issue of whether an ADI is an MLH ADI or subject to the LCR requirement is separate from the issue of daily liquidity reporting.

APRA views the MLH requirement as an ex-ante measure of an ADI's liquid asset position that falls short of providing the information needed during a crisis to build a view of an ADI's daily liquidity position. All ADIs need to monitor liquidity on a daily basis and have access to the necessary information to manage liquidity. Therefore, it is APRA's view that the daily liquidity report should apply to all ADIs.

APRA does not anticipate that the proposed daily liquidity report will be a significant burden for MLH ADIs as the data is likely to be readily available. APRA envisages that a prudent ADI would, in any event, generate and monitor this data as part of its existing liquidity risk management process.

**c) Other - additional guidance sought**

One submission sought APRA's guidance on the reporting of at-call deposits with third parties, collateral paid/received over the last five business days, as well as contingent funding drawdowns over the last five business days.

*APRA response*

LCR ADIs must not report at-call funds with third parties in the daily liquidity report. This is only applicable to MLH ADIs.

For clarity, inflows/outflows from collateral received/paid are to be reported on a gross basis. This is reflected in items 5.1 and 5.2 of the instructions to *Reporting Form ARF 210.5 Daily Liquidity Report* (ARF 210.5).

For contingent funding arrangements, APRA expects only the drawdown amount to be reported over the last five business days. This is also reflected in item 4.1 of the instructions to ARF 210.5.

**2. Foreign bank branches and derivatives**

APRA received eighteen submissions on its September proposals, of which fourteen were confidential. While comments received from FBBs were broadly positive regarding the direction of the proposals, a number of practical issues were highlighted and suggestions made. These issues and APRA's responses are set out below.

**a) LCR time horizon and status of non-HQLA liquid assets**

In its consultation, APRA proposed, as an interim measure, the application of a 15 calendar day time horizon to FBBs (rather than the full 30 calendar day time horizon applied to locally-incorporated ADIs). Submissions highlighted that while the proposed 15-day LCR period resulted in a reduction in liquid asset requirements, it also imposed a need to change system report specifications. Concerns were raised over the cost of these changes, the short timeframe available to implement them before 1 January 2015 and the ongoing incompatibility with entity-consolidated reporting by Head Office to satisfy home supervisor requirements – which would remain on a 30-day LCR basis.

Submissions also noted that the removal of the need for a committed liquidity facility (CLF) for FBBs, while removing the requirement to pay the CLF fee, also removed the ability for the underlying securities used as CLF collateral to be recognised as high-quality liquid assets (HQLA) when calculating entity-consolidated LCR. This raised the prospect of Head Office having to hold additional HQLA centrally on the branch's behalf.

In response to these concerns, submissions included three main alternative suggestions:

- postpone or cancel the implementation of the proposed interim solution, persisting with the current Scenario Analysis regime instead;
- give FBBs a choice of reporting on a 15-day or 30-day LCR basis; and
- implement a 50 per cent LCR requirement for FBBs, similar to the implementation regime recently announced by the Monetary Authority of Singapore.

#### *APRA Response*

APRA acknowledges that the implementation timetable is tight and that these proposals are an interim measure. As such, APRA also acknowledges that it is appropriate to take into account compatibility with home supervisor requirements.

In considering the alternative suggestions put forward in submissions, APRA's is seeking to achieve an appropriate balance between prudent liquidity outcomes and concerns of FBBs regarding the additional implementation burden.

The suggestion to postpone or cancel the implementation of an interim solution and persist with the current Scenario Analysis regime in the meantime would not address two of the key concerns raised by industry – those of compatibility with home supervisor requirements and non-HQLA liquid assets. Although a secondary but not insignificant consideration, it would also necessitate significant changes to APS 210 and would not allow the use of *Reporting Form ARF 210.1A Liquidity Coverage Ratio - all currencies* (ARF 210.1A) and *Reporting Form ARF 210.1B Liquidity Coverage Ratio - AUD only* (ARF 210.1B). Instead, it would perpetuate the need for spreadsheet-based reporting – a result which would be sub-optimal for ADIs and APRA alike.

The suggestion to give ADIs a choice of reporting on a 15-day or 30-day LCR basis would also make cross-ADI comparisons difficult and aggregate data inaccurate. This suggestion would also require APRA to make significant changes to APS 210, ARF 210.1A and ARF 210.1B and their associated reporting instructions, and it would not address the concern regarding non-HQLA liquid assets.

APRA considered the suggestion to implement LCR with a compliance threshold of 50 per cent. As a pragmatic solution to an immediate and time-limited problem, APRA accepted the essence of this suggestion. APRA notes that this suggestion addresses FBBs' key concerns in that it requires only very minor changes to system report specifications; is compatible with home jurisdiction 30-day LCR requirements; and Australian liquid asset requirements are met in full by assets recognised as HQLA on an entity-consolidated basis. Furthermore, it satisfies APRA's main objectives, and minimal changes are required to APS 210, as well as ARF 210.1A and ARF 210.1B and their associated reporting instructions.

Accordingly, APRA has determined that from 1 January 2015 FBBs will:

- be subject to a 30 calendar day time horizon LCR;
- have a minimum compliance threshold set at 40 per cent;
- not be eligible to apply for a CLF; and

- be required to meet their liquid assets requirement using HQLA only. MLH securities will not be allowable as liquid assets.

The figure of 40 per cent, instead of the higher threshold 50 per cent suggested in submissions, was arrived at by APRA in consideration of the current APS 210 (dated January 2014). Under that standard, FBBs would have been eligible to apply for a CLF, but not to cover the entire amount of their AUD-only net cash outflows (NCOs). APRA's analysis indicated that the outcome of the CLF assessment process would have seen FBBs being granted a CLF of approximately 60 per cent of projected AUD-only NCOs. By implication, AUD HQLA holdings would have been approximately 40 per cent of AUD-only NCOs.

The arrangement described above, therefore, results in FBBs holding a near-identical amount of AUD HQLA when compared with the current APS 210 (dated January 2014). The need to hold non-HQLA assets as collateral for a CLF – and the consequent need to pay a fee for the CLF – are both removed.

The proposed compliance threshold of 40 per cent applies to the all-currency NCO. APRA does not propose to vary the liquidity requirement by currency as this would require more changes to APS 210, increase implementation costs and make the overall liquidity requirement strongly dependent on the definition of FX derivatives that affect the currency distribution of NCOs. APRA also notes this is an interim measure ahead of a review of the appropriate prudential liquidity regime for FBBs to be commenced in 2015. Introducing such complexity at this stage is therefore not warranted.

#### **b) 'Level playing field' and competition**

A number of submissions noted concerns about the potential for competitive inequalities arising from APRA's proposed amendments. The most frequently cited concern was that the differential between a 15 calendar day LCR time horizon for FBBs and a 30 calendar day LCR time horizon for locally-incorporated ADIs would allow branches to create products (such as a 16-day notice period corporate deposit account) to take advantage of this differential.

#### *APRA Response*

The specific concern – that of the potential for regulatory arbitrage arising from differential time horizons – has been addressed by APRA's maintenance of a 30 calendar day time horizon LCR for FBBs. APRA notes that the current APS 210 (dated January 2014) already allows for the assumption of Head Office support from Day 16 and this had not lead to the creation of any such products.

APRA considers it unlikely that significant competition issues will arise in applying different liquid assets requirements to FBBs compared with locally-incorporated ADIs. All but a handful of FBBs have home supervisors that are Basel Committee members. Hence those branches will be subject to LCR on an entity-consolidated basis from 1 January 2015. Lowering the stand-alone liquid asset requirements of FBBs in Australia will not lower the entity-consolidated liquid asset requirements imposed by their home supervisors. Therefore, it is not likely that a significant competitive distortion will occur.

#### **c) Asset-backed (ABS) and residential mortgage-backed securities (RMBS)**

Numerous submissions in relation to the framework for FBBs argued that the definition of MLH securities should be expanded to include all RBA eligible securities, including ABS and RMBS.

#### *APRA Response*

With regards to the proposal as it relates to FBBs, the removal of MLH securities as a liquid asset deals with this issue.

More generally, Australian and foreign ABS and RMBS suffered a sudden and near-total loss of secondary market liquidity for an extended period commencing in mid-2007. When the secondary market cannot be relied upon, the only remaining means of liquidating such assets is via repo with the RBA. Where the RBA has given a commitment to do so (i.e. it has entered into a CLF) it is reasonable to treat those assets as liquid. Where the RBA has not given a commitment to do so – which is the case for MLH ADIs – it is not prudent to treat those assets as liquid.

#### **d) Non-AUD HQLA**

A number of responses in relation to the framework for FBBs demonstrated that a measure of uncertainty exists regarding ADI ability to hold non-AUD HQLA. In particular, some submissions referred to ADI ability to hold foreign government bonds as a new development.

#### *APRA Response*

APRA's proposed amendments do not entail any change to Australian ADIs' ability or obligation to hold non-AUD HQLA. APS 210 defines HQLA in Paragraphs 6-10 of Attachment A. APRA announced on 28 February 2011 that:

*'APRA has been reviewing a range of marketable instruments denominated in Australian dollars against the Basel Committee's criteria for high quality liquid assets...Based on this review, APRA has determined that, at this point of time:*

- the only assets that qualify as Level 1 assets are cash, balances held with the Reserve Bank of Australia, and Commonwealth Government and semi government securities; and*
- there are no assets that qualify as Level 2 assets.'*

Some ADIs may have misinterpreted this to mean that 'cash, balances held with the Reserve Bank of Australia, and Commonwealth Government and semi government securities' are the only assets that are defined as HQLA. APRA's determination was that they are the only Australian dollar-denominated assets that are defined as HQLA. APRA has not determined assets that qualify as HQLA denominated in currencies other than the Australian dollar; it is appropriate that home supervisors in those jurisdictions should make that determination where appropriate to do so. Furthermore it is appropriate that ADIs hold HQLA denominated in a range of currencies appropriate for its liquidity risk profile.

Paragraph 40 of APS 210 states:

*'An ADI active in multiple currencies must:*

- a) *maintain HQLA consistent with the distribution of its liquidity needs by currency;*
- b) *assess its aggregate foreign currency liquidity needs and determine an acceptable level of currency mismatches; and*
- c) *undertake a separate analysis of its strategy for each currency in which it has material activities, considering potential constraints in times of stress.'*

Paragraph 40(a) means that non-AUD HQLA should be used to meet liquid asset requirements arising from non-AUD NCOs. So not only do ADIs – including FBBs – have the ability to hold non-AUD HQLA, they are expected to do so where those liquidity needs are material.

**e) Derivatives cashflows and netting**

APRA received very few comments regarding the proposed amendments relating to derivative cashflows, netting and associated reporting instructions. However, responses demonstrated some uncertainty regarding the appropriate treatment of certain products.

*APRA Response*

For the purposes of LCR, which is an all-currency metric, the cashflows arising from all FX transactions (that is, a transaction that involves full exchange of principal amounts in two or more different currencies) should be treated as 'derivative cash inflows' or 'derivative cash outflows'. That is true even for products that would not normally be considered to be a 'derivative', such as spot FX transactions.

Where a derivative transaction involves a cashflow or cashflows in a single currency, it should not be treated as an FX transaction even when those cashflows are denominated in a currency other than Australian dollars. In order for these cashflows to be netted, they must be subject to a valid master netting agreement. This is reflected in footnote 4 in Attachment A of the revised APS 210.

**3. Other matters**

As part of its consultation on Basel III liquidity implementation in Australia, APRA had also consulted industry on a change to the instructions to *Reporting Standard ARS 221.0 Large Exposures* (ARS 221.0) that require all ADIs to complete Section D of the form. This relates to the reporting of funding concentrations. Currently, ADIs subject to Scenario Analysis are not required to complete this section of the form. All ADIs will need to complete Section D of ARS 221.0 from 1 January 2015.

Yours sincerely,



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Policy, Statistics and International