Discussion Paper

Basel III liquidity — the net stable funding ratio and the liquid assets requirement for foreign ADIs

31 March 2016

Preamble

This discussion paper outlines the Australian Prudential Regulation Authority's (APRA's) proposed approach to the implementation of the Net Stable Funding Ratio (NSFR) for authorised deposit-taking institutions (ADIs). In addition, it sets out two alternative proposals for the liquid assets requirement for foreign ADIs.

APRA invites written submissions on the proposals in this discussion paper. Following consideration of submissions received, APRA proposes to issue a further consultation package, including a revised draft of *Prudential Standard APS 210 Liquidity*, later in 2016. APRA anticipates finalising its position on these matters in the second half of 2016. Also, later in 2016, APRA will undertake consultation on the liquidity reporting framework reflecting changes necessary for the implementation of the NSFR and any changes to the existing liquid assets requirement for foreign ADIs.

It is proposed that the NSFR as well as any changes to the Liquidity Coverage Ratio (LCR) for foreign ADIs would take effect from 1 January 2018. The commencement date for the NSFR is consistent with the Basel Committee on Banking Supervision's timetable.

This discussion paper is available on APRA's website at: http://www.apra.gov.au.

Written submissions should be sent to Basel3liquidity@apra.gov.au by 31 May 2016 and addressed to:

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Glossary

Term	Definition
ADI	Authorised deposit-taking institution
ALA	Alternative liquid assets
APRA	Australian Prudential Regulation Authority
APS 120	*Prudential Standard APS 120 Securitisation*
APS 210	*Prudential Standard APS 210 Liquidity*
APS 220	*Prudential Standard APS 220 Credit Quality*
ASF	Available stable funding
Banking Act	*Banking Act 1959*
Basel Committee	Basel Committee on Banking Supervision
Basel III LCR standard	*Basel III: The Liquidity Coverage Ratio and liquidity risk monitoring tools*, Basel Committee, January 2013
Basel III liquidity framework	*Basel III: International framework for liquidity risk measurement, standards and monitoring*, Basel Committee, December 2010
Basel III NSFR standard	*Basel III: net stable funding ratio*, Basel Committee, October 2014
CLF	Committed liquidity facility
December 2013 response paper	*Implementing Basel III liquidity reforms in Australia*, APRA, December 2013
ESA	Exchange settlement account
FALAR	Foreign ADI liquid assets requirement
Foreign ADI	Has the meaning given in section 5 of the Banking Act
FSI	Financial System Inquiry
HQLA	High-quality liquid assets
HQLA1	The highest quality liquid assets as defined in paragraph 9 of APS 210

Term	Definition
LCR	Liquidity Coverage Ratio
LOC	Local operational capacity
May 2013 discussion paper	*Implementing Basel III liquidity reforms in Australia*, APRA, May 2013
MLH	Minimum Liquidity Holdings
Non-maturity asset	An asset without a defined maturity
November 2011 discussion paper	*Implementing Basel III liquidity reforms in Australia*, APRA, November 2011
November 2014 letter	*Liquidity risk - recent consultations*, APRA, November 2014
NSFR	Net Stable Funding Ratio
OBS	Off-balance sheet
RBA	Reserve Bank of Australia
RBNZ	Reserve Bank of New Zealand
RBNZ-eligible securities	Securities accepted by the RBNZ as part of its domestic market operations that are not HQLA in their own right
RSF	Required stable funding
September 2014 letter	*APRA releases proposed amendments to liquidity standard and reporting instructions*, APRA, September 2014

Executive summary

In December 2010, the Basel Committee on Banking Supervision (Basel Committee) released *Basel III: International framework for liquidity risk measurement, standards and monitoring* (Basel III liquidity framework), which set out measures designed to strengthen the liquidity buffers of banks, thereby promoting a more resilient global banking system.

The Basel III liquidity framework consists of key quantitative requirements in the form of two global minimum standards:

- *Basel III: The Liquidity Coverage Ratio and liquidity risk monitoring tools* (January 2013) (Basel III LCR standard); and
- *Basel III: the net stable funding ratio* (October 2014) (Basel III NSFR standard).

As noted by the Basel Committee, the objectives of these standards are first to promote short-term resilience of a bank's liquidity profile by ensuring that it has sufficient high-quality liquid assets (HQLA) to survive a significant stress event lasting for 30 days. The Liquidity Coverage Ratio (LCR) was designed to meet this objective. The second objective of the Basel III liquidity framework is to promote longer-term resilience of a bank's liquidity risk profile through banks funding their activities with more stable sources of funding on an ongoing basis. The NSFR seeks to achieve this objective.

NSFR

Following the release of the final Basel III NSFR standard by the Basel Committee in October 2014, APRA is consulting on the implementation of the Net Stable Funding Ratio (NSFR) in Australia. As with the LCR, APRA proposes to apply the NSFR to only a small number of larger, more complex ADIs.

As the final report of the Financial System Inquiry (FSI) noted 'Australia is a capital-importing nation with a significant component of domestic investment funded by foreign savings channelled through the banking system' and 'Australia's use of offshore funding, while beneficial to economic growth, makes the country vulnerable to sudden changes in international investor sentiment. Because of this, it is critical that the Australian financial system is resilient.'

ADIs have increased the amount of funding from more stable funding sources over the past seven years or so, reflecting an important lesson from the financial crisis as to the need for greater liquidity and funding resilience. The LCR and, when implemented, NSFR will serve to reinforce and maintain those improvements in ADI funding profiles. These improvements will also be an important consideration, in addition to capital strength, when determining how to implement the FSI's recommendation regarding 'unquestionably strong' ADIs.

Liquid assets requirement for foreign ADIs

APRA implemented the LCR requirement with effect from 1 January 2015. In late 2014, APRA consulted on a modified form of the LCR for foreign ADIs (i.e. foreign bank branches) which recognised a number of differences in their operations which made the LCR less suited to them. These modifications were an interim measure, and APRA indicated that it would undertake further consultation on the most appropriate short-term quantitative liquidity standard for foreign ADIs.

This discussion paper details two alternative proposals for the application of a liquid assets requirement to foreign ADIs. The first is the existing modified LCR that currently applies to foreign ADIs; the second is a modified version of the Minimum Liquidity Holdings (MLH) regime, which currently applies to small domestic ADIs. This second option is referred to as the foreign ADI liquid assets requirement (FALAR). APRA's preference is to implement the proposed FALAR rather than continue with the current 40 per cent LCR, for the reasons outlined in Chapter 3. APRA is seeking the views of foreign ADIs on the alternatives and will take into consideration issues raised in submissions in making a final decision on the appropriate approach.

Balancing financial safety with other considerations

As part of its consideration of the introduction of the NSFR and proposals for liquid asset requirements for foreign ADIs, APRA has sought to find an appropriate balance between the objectives of financial safety and efficiency, competition, contestability and competitive neutrality. The proposals in this discussion paper will deliver improved prudential outcomes through improving the resilience of impacted ADIs, which themselves comprise the bulk of the banking system. They will also ensure larger, more complex ADIs are subject to the internationally-agreed NSFR requirements, which will be important when raising funds in wholesale markets. In the case of smaller ADIs, the benefits of applying the NSFR appear limited, so APRA has chosen not to apply the requirement to these ADIs in the interests of efficiency and minimising regulatory burden.

Timetable

APRA is proposing to release a revised draft *Prudential Standard APS 210 Liquidity* (draft APS 210) later in 2016 and expects to finalise its position on these matters in the second half of 2016. It is further proposed that the NSFR, and any changes to the liquid assets requirement for foreign ADIs, will commence on 1 January 2018.

Chapter 1 — Introduction

1.1 Background

In December 2010, the Basel Committee released a package of measures designed to strengthen the liquidity buffers of banks, thereby promoting a more resilient global banking system. The Basel Committee subsequently made revisions to its original package of measures. The final measures were set out in two standards:

- *Basel III: The Liquidity Coverage Ratio and liquidity risk monitoring tools* (January 2013) (Basel III LCR standard); and
- *Basel III: the net stable funding ratio* (October 2014) (Basel III NSFR standard).

Collectively, these measures are referred to as the Basel III liquidity framework.

As noted by the Basel Committee, the objectives of these measures are first to promote short-term resilience of a bank's liquidity profile by ensuring that it has sufficient HQLA to survive a significant stress event lasting for one month. The LCR was designed to meet this objective. The second objective is to promote longer-term resilience of a bank's liquidity risk profile through banks funding their activities with more stable sources of funding on an ongoing basis. The NSFR seeks to achieve this objective.

APRA has released a number of discussion and response papers concerning the Basel III liquidity framework:

- *Implementing Basel III liquidity reforms in Australia*, November 2011 (November 2011 discussion paper);
- *Liquidity reporting requirements for ADIs*, November 2012;
- *Implementing Basel III liquidity reforms in Australia*, May 2013 (May 2013 discussion paper);
- *Implementing Basel III liquidity reforms in Australia*, December 2013 (December 2013 response paper);
- *APRA releases proposed amendments to liquidity standard and reporting instructions*, September 2014 (September 2014 letter); and
- *Liquidity risk – recent consultations*, November 2014 (November 2014 letter).

This discussion paper sets out details of APRA's proposed implementation of the NSFR, including appropriate adjustments to reflect Australian conditions. In addition, APRA is consulting on the future application of a modified liquid assets requirement for foreign ADIs.

1.2 Net stable funding ratio

In November 2011, APRA released a consultation package that included the November 2011 discussion paper and draft APS 210 incorporating APRA's proposed prudential requirements concerning implementation of the NSFR. APRA's proposed position was based on the original draft of the NSFR released by the Basel Committee.

In the May 2013 discussion paper, APRA responded to a number of matters concerning the NSFR raised in submissions to the November 2011 discussion paper. APRA noted, at that time, that it would not be updating its detailed requirements for the NSFR until such time as the Basel Committee had completed refinements to the NSFR. The Basel Committee subsequently announced its final position on the NSFR in October 2014.

This discussion paper details APRA's proposed application of the NSFR, including adjustments to appropriately reflect Australian conditions. Given the passage of time since previous discussion papers on the NSFR, this discussion paper makes comment on earlier submissions, where relevant, and APRA's consideration of those matters in reaching the position set out in this paper.

ADIs have increased the amount of funding from more stable funding sources over the past seven years or so, reflecting an important lesson from the financial crisis as to the need for greater liquidity and funding resilience. The NSFR will help to reinforce and maintain those improvements in

ADI funding profiles, alongside the LCR which was introduced in 2015.

1.3 Liquid assets requirement for foreign ADIs

In September 2014, APRA consulted on proposed temporary changes to the way the LCR would be applied to foreign ADIs. These temporary changes acknowledged a number of issues that had been identified in the implementation of the LCR to ADIs established as branches. In November 2014, APRA announced an interim measure, that foreign ADIs would need to maintain an LCR of 40 per cent (compared with a requirement of 100 per cent for domestically-incorporated ADIs) but, in doing so, would not be able to access the Committed Liquidity Facility (CLF) provided by the Reserve Bank of Australia (RBA). As foreshadowed in September 2014, APRA noted that it would reassess the nature of, and rationale underlying, its application of a liquid assets requirement for foreign ADIs, and publish a consultation paper on this matter.

APRA is proposing two alternative options for the future application of a quantitative liquid assets requirement to foreign ADIs. Both options recognise the difficulties for foreign ADIs in applying the LCR in the same manner as domestic ADIs.

1.4 Structure of this paper

Chapter 2 sets out the key details of the NSFR including appropriate adjustments to reflect Australian conditions.

Chapter 3 provides details of two options for a liquid assets requirement for foreign ADIs to enable them to withstand a severe liquidity stress event.

Chapter 4 seeks cost-benefit information from ADIs on the expected impact of these proposals.

1.5 Balancing financial safety with other considerations

As part of its consideration of the introduction and application of the NSFR, and proposals for liquid asset requirements for foreign ADIs, APRA has sought to reach an appropriate balance between the objectives of financial safety and efficiency, competition, contestability and competitive neutrality; whilst promoting financial stability. APRA considers the proposals in this discussion paper will deliver improved prudential outcomes and provide efficiency and competitive benefits to ADIs, including:

- the NSFR is designed to promote financial safety by ensuring that ADIs maintain a stable funding profile relative to their on- and off-balance sheet activities. This reduces the possibility that disruptions to funding could undermine an ADI's liquidity position, and in so doing offers benefits to the Australian community by improving the capacity of ADIs to continue to operate even in stressed conditions;
- for ADIs that access international funding markets, ensuring they meet internationally agreed liquidity standards may be an important consideration when competing for funding with other internationally-active banks;
- in the context of the Australian banking system's reliance on funding sourced from offshore, by assisting with improving the resilience of larger, more complex ADIs, the NSFR will help to promote financial stability;
- the NSFR is proposed to apply to larger, more complex ADIs. In APRA's view, ADIs with simpler retail-based business models are likely to easily meet the NSFR requirements and, as such, additional requirements are not needed for this purpose. APRA is of the view that adopting a proportionate approach to the implementation of the NSFR will result in enhanced efficiencies, and minimise the regulatory burden, in the financial system; and
- a modified liquid assets requirement for foreign ADIs recognises that a foreign ADI is able to place some reliance on the liquidity of the broader banking group of which it forms a part. Such recognition promotes a competitive and efficient Australian financial system, without unduly compromising financial safety.

APRA invites stakeholders to provide views on the impact its proposals may have on these objectives, including views on proposals that might enhance efficiency, competition, contestability and/or the competitive neutrality of the proposals without jeopardising APRA's prudential safety objectives.

1.6 Timetable

The Basel Committee has indicated that the NSFR should apply from 1 January 2018. APRA proposes to release a draft APS 210 incorporating the NSFR, including the matters set out in this paper, later in 2016. This will be followed by the release of the final APS 210, most likely in the second half of 2016. In line with the Basel Committee's effective date, APRA intends to apply the NSFR from 1 January 2018.

APRA also proposes to finalise the liquidity regime for foreign ADIs in 2016. Any changes to the current approach will also apply from 1 January 2018.

In addition to the proposals set out in this discussion paper, APRA will be consulting separately on proposals relating to reporting requirements for the NSFR and the liquid assets requirement for foreign ADIs in 2016.

Chapter 2 — Net stable funding ratio

This chapter sets out APRA's proposed implementation of the NSFR. Although APRA proposes to generally follow the internationally-agreed standard, it does propose, in some areas, tailoring the NSFR to Australian circumstances, and the exercise of national discretion. The chapter also outlines, where relevant, matters pertaining to APRA's previous consultation on the NSFR. While APRA's responses to submissions on the November 2011 discussion paper were originally set out in its May 2013 discussion paper, APRA has reviewed its position in the context of the final Basel III NSFR standard published by the Basel Committee.

Subject to the outcome of this consultation, APRA proposes to release for consultation a revised draft APS 210 later in 2016 which incorporates the NSFR, including the matters set out in this paper.

2.1 Definition of the NSFR

The NSFR is the second quantitative global liquidity standard introduced by the Basel Committee with the intention of promoting more stable funding of assets and off-balance sheet (OBS) activities of banking institutions. The standard establishes a minimum stable funding requirement based on the liquidity characteristics of an ADI's assets and OBS activities over a one-year time horizon. Importantly, the NSFR seeks to ensure that long-term assets are financed with at least a minimum amount of stable funding.

The NSFR is defined as the ratio of the amount of available stable funding (ASF) to the amount of required stable funding (RSF). Consistent with the Basel III NSFR standard, APRA proposes that ADIs should have available stable funding in excess of their required stable funding, i.e. that ADIs maintain an NSFR of at least 100 per cent.

The amount of ASF is the portion of an ADI's capital and liabilities expected to be a reliable source of funds over a one-year time horizon. It is calculated by assigning the carrying value of an ADI's capital and liabilities to the relevant ASF category, multiplying the amount assigned to each category by the relevant ASF factor (ranging from zero to 100 per cent) and adding the weighted amounts. The ASF factors reflect the expected stability of an ADI's funding sources: a higher factor indicates that the funding source is expected to be more stable. The proposed ASF factors and categories are outlined in Appendix 1.

The amount of RSF is a function of the liquidity characteristics and residual maturities of an ADI's assets and OBS exposures. It is calculated by assigning the carrying value of an ADI's assets and OBS exposures to the relevant RSF category, multiplying the amount assigned to each category by the relevant RSF factor (ranging from zero to 100 per cent) and adding the weighted amounts. The RSF factors are intended to approximate the amount of each asset or OBS exposure to be supported by stable funding. Assets considered to have a higher liquidity value receive lower RSF factors; conversely, assets considered to have a lower liquidity value received higher RSF factors. The proposed RSF factors and categories are outlined in Appendix 2.

Generally, APRA proposes to adopt the ASF and RSF factors prescribed in the Basel III NSFR standard.

2.2 Scope of application

The Basel III NSFR standard states that the NSFR should be applied to internationally-active banks on a consolidated basis, but may be used for other banks and any subset of entities of internationally-active banks in order to ensure consistency and a level playing field between domestic and cross-border banks.

The Basel III liquidity framework also notes that the LCR and NSFR are minimum standards for funding and liquidity designed to achieve two separate but complementary objectives. In this context, the LCR and NSFR are intended to be complementary measures designed to strengthen an ADI's resilience to liquidity risk. Given this, APRA proposes to apply the NSFR only to those locally-incorporated ADIs that are subject to the

LCR. At this point in time, only 15 larger, more complex ADIs would be subject to the NSFR requirement. These ADIs, however, account for 89 per cent of the total resident assets of the Australian banking system.

APRA also proposes that the NSFR requirement be met on both a Level 1 (stand-alone) and Level 2 (consolidated banking group) basis, consistent with APRA's application of the LCR.

2.3 LCR definitions and the NSFR

To achieve consistency between the complementary standards, APRA proposes that definitions in the NSFR will mirror those adopted for the LCR as set out in APS 210, unless there is a compelling reason to adopt an alternative definition.

2.4 CLF-eligible assets and other assets

For LCR purposes, locally-incorporated ADIs may establish a CLF with the RBA to cover any shortfall between the ADI's Australian dollar HQLA securities and the ADIs' estimated net cash outflows under the LCR. An ADI with a CLF will need to maintain additional assets as collateral for the facility. These assets can be a combination of selected debt securities and self-securitised assets, and may be included in the numerator of an ADI's LCR calculation after application of RBA margins, up to the amount of the CLF.

In addition, where an ADI has a banking presence in other jurisdictions, it may, in calculating its Level 2 LCR, include in the numerator:

- alternative liquid assets (ALA) allowed by the relevant host supervisor; and
- assets that are formally recognised as eligible liquid assets by a host supervisor and that APRA allows the ADI to include in the numerator (other LCR assets). For example, assets that are accepted by the Reserve Bank of New Zealand (RBNZ) in its domestic market operations that are not otherwise HQLA in their own right (i.e. RBNZ-eligible securities).

For the purposes of the NSFR, and reflecting Australian conditions, APRA proposes specific RSF factors in relation to CLF-eligible assets, other jurisdictions' ALA and other LCR assets as outlined below.

2.4.1 Debt securities

In its November 2011 discussion paper, APRA proposed treating CLF-eligible debt securities as being equivalent to HQLA in determining the NSFR by applying an RSF factor of 10 per cent, reflecting the approximate RSF factor that would apply if an adequate supply of HQLA existed in Australia.

APRA continues to propose treating CLF-eligible debt securities as being equivalent to HQLA in determining the NSFR. While this proposal allows a lower RSF factor to be applied to CLF-eligible debt securities than would otherwise be the case, an ADI that purchases such securities must finance its purchases with stable funding in order to improve its NSFR. As noted in the May 2013 discussion paper, it is appropriate for purchases of such securities that are financed by stable funding to result in an improvement to both the LCR and NSFR.

Consistent with the Basel III NSFR standard, APRA also proposes that the RSF for CLF-eligible debt securities be based on their carrying value on an ADI's balance sheet. This would involve applying an RSF factor to such securities prior to the deduction of applicable RBA margins even though they can only be included in the numerator of an ADI's LCR calculation after RBA margins are applied.

For the avoidance of doubt, the RSF factor of 10 per cent would only apply to the lower of the carrying value of CLF-eligible debt securities prior to the deduction of RBA margins and the amount of the CLF that can be included in the numerator of an ADI's LCR calculation.

Consistent with the proposed treatment of CLF-eligible debt securities, APRA also proposes that the RSF factor for third-party debt securities that are other jurisdictions' ALA or other LCR assets (including RBNZ-eligible securities) would be 10 per cent.

The 10 per cent RSF factor would only apply to unencumbered debt securities that are either eligible as collateral for the CLF or are ALA or other LCR assets and are specifically held for the purpose of meeting the ADI's LCR requirement. Where these debt securities are encumbered, an RSF factor of 10, 50 or 100 per cent would apply for an encumbrance period of less than six months, six months to less than one year and one year or more respectively. These RSF factors reflect those in the Basel III NSFR standard.

2.4.2 Self-securitised assets

The inclusion of self-securitised assets in the CLF was necessary and appropriate as part of the Australian implementation of the LCR, and reflects the balance of two considerations. On the one hand, it is desirable that a significant part of the collateral held for the CLF be made up of liquid assets, even though these instruments do not qualify as HQLA. On the other hand, it would be imprudent from a systemic risk perspective to promote excessive cross-holdings of bank-issued instruments. APRA's view, however, is if self-securitised assets were treated as equivalent to HQLA under the NSFR, an ADI's NSFR would improve numerically without the ADI taking any additional steps to improve its liquidity self-reliance or longer-term resilience. This would be inconsistent with the objectives of the Basel III liquidity framework and prudent liquidity risk management. APRA is of the view that further strengthening of liquidity and funding resilience for larger, more complex ADIs is appropriate from both an individual ADI financial safety perspective and for promoting financial system stability.

Accordingly, it is not appropriate to recognise self-securitised assets as being equivalent to HQLA for NSFR purposes. APRA proposes that self-securitised assets that are eligible as collateral for the CLF should have the same RSF factor as that attributable to the underlying loans in the self-securitisation, ranging from 65 to 100 per cent. When considered in combination, the proposed RSF factors for CLF-eligible debt securities and self-securitised assets strike an appropriate balance between adjusting the Basel III liquidity framework for Australian conditions whilst maintaining consistency with the objectives of the framework.

This treatment is also proposed to apply to self-securitised assets that are ALA or other LCR assets (including RBNZ-eligible securities).

The basis for APRA's proposed treatment is consistent with that articulated in the November 2011 discussion paper and the May 2013 discussion paper. Previous submissions did not present a credible alternative basis on which to make a prudent determination of the RSF factor for self-securitised assets that are eligible as collateral for the CLF. Submissions on this matter are invited, and in particular on any alternative basis.

2.5 Asset encumbrance

The Basel III NSFR standard prescribes specific RSF factors for encumbered assets depending on the remaining period of encumbrance. In general, the RSF factor for an encumbered asset is either the same as, or higher than, the RSF factor for an equivalent unencumbered asset.

More specifically, on-balance sheet assets that are encumbered for one year or more receive an RSF factor of 100 per cent. Assets encumbered for a period of six months to less than one year receive an RSF factor of 50 per cent or higher depending on the RSF factor that would apply if the asset was unencumbered. Encumbered assets with less than six months remaining in the encumbrance period would receive the same RSF factor as an equivalent asset that was unencumbered. In essence, a higher RSF factor for an encumbered asset is intended to reflect the loss of the asset's liquidity value, which results from the asset being unavailable for use as collateral to secure funding or to be sold.

Of particular relevance, in the Australian context, is residential mortgage-backed securities, as such secured funding can result in the RSF factor for residential mortgage loans increasing from 65 per cent to 100 per cent. APRA notes that concerns have been raised in previous rounds of consultation that this treatment of asset encumbrance under the Basel III NSFR standard would unduly penalise an ADI for undertaking secured funding transactions therefore making this type of secured funding relatively less attractive.

APRA supports a robust Australian securitisation market, and sees it as a valuable mechanism for ADIs to increase their funding and liquidity resilience. However, the underlying rationale for the treatment of asset encumbrance under the Basel III NSFR standard remains appropriate. When an asset becomes encumbered its liquidity characteristics have unquestionably changed, and it is appropriate that this is reflected in an adjustment to the relevant RSF factor. Moreover, the 65 per cent RSF for residential mortgage loans was, relative to other sorts of longer-term lending, a concession granted to recognise the potential for these loans to generate additional stable funding via means such as securitisation or covered bonds. Once that funding has been generated, however, there is little grounds for such a concession to continue. Accordingly, APRA proposes to adopt the treatment for encumbered assets consistent with the Basel III NSFR standard. Securitisation will continue to be an attractive form of funding where ADIs are seeking to replace less stable with more stable sources of funding, and/or whether they are able to achieve capital benefits.

2.6 Interdependent assets and liabilities

Under the Basel III NSFR standard, national supervisors have discretion to determine whether certain assets and liabilities, on the basis of underlying contractual arrangements, are interdependent, such that:

- the liability cannot fall due while the asset remains on the balance sheet;
- the principal payment flows from the asset cannot be used other than for repaying the liability; and
- the liability cannot be used to fund other assets.

Where such interdependence exists, the national supervisor may adjust the RSF and ASF factors to zero per cent, subject to the following criteria being met:

a) the individual interdependent assets and liabilities must be clearly identifiable;

b) the maturity and principal amount of both the liability and its interdependent asset must be the same;

c) the ADI must be acting solely as a pass-through unit to channel the funding received (the interdependent liability) into the corresponding interdependent asset; and

d) the counterparties for each interdependent liability and asset pair must not be the same.

APRA proposes, on a case-by-case basis, to allow recognition of interdependent assets and liabilities, and to adjust the RSF and ASF factors for these assets and liabilities to zero per cent where an ADI is able to demonstrate to APRA's satisfaction that the criteria are met in full and there are no perverse incentives or unintended consequences that would result from recognition of the assets and liabilities as being interdependent.

2.7 Off-balance sheet exposures

As noted under the Basel III NSFR standard, while many OBS exposures require little direct or immediate funding, such exposures can generate a significant call on an ADI's liquidity over a longer time horizon. As a result, RSF factors are intended to be assigned to OBS exposures to ensure that an ADI holds stable funding for that portion of an exposure expected to require funding within a one-year time horizon.

Consistent with the LCR, the Basel III NSFR standard identifies OBS exposure categories based broadly on whether the commitment is a credit or liquidity facility or some other contingent funding obligation. The standard assigns an RSF factor of five per cent to the undrawn portion of irrevocable and conditionally revocable credit and liquidity facilities to any customer. APRA proposes to adopt this approach.

The Basel III NSFR standard also outlines various other types of contingent funding obligations and gives national supervisors the discretion to specify RSF factors for these obligations. APRA's proposed RSF factors for unconditionally revocable credit and liquidity facilities and trade finance and other facilities are discussed below.

2.7.1 Unconditionally revocable credit and liquidity facilities

For business and reputational reasons, some facilities, while being legally revocable, are likely to remain available for drawdown in a similar manner to irrevocable facilities. That said, an ADI may have the ability to unconditionally revoke other uncommitted facilities, leading to a lower stable funding requirement for unconditionally revocable facilities than for irrevocable facilities.

APRA therefore proposes that an RSF factor of one per cent would be applied to the undrawn portion of unconditionally revocable credit and liquidity facilities.

2.7.2 Trade finance and other facilities

Drawdowns under trade finance facilities, such as guarantees and letters of credit, are likely to be contingent on conditions in trading markets. Reflecting this, and consistent with the one-year time horizon of the NSFR, APRA proposes that the amount of RSF required for trade finance-related obligations would be the actual net outflow in a recent 12-month period. This figure would need to be updated on a periodic basis (at least annually) for this purpose. In the case of a net inflow the RSF would be zero.

APRA also proposes to apply the same treatment for guarantees and letters of credit that are unrelated to trade finance obligations.

2.8 Maturity of funding

The NSFR is generally calibrated such that longer-term funding is assumed to be more stable than short-term funding. Reflecting this, higher ASF factors are assigned to funding sources with residual maturities of one year or more than to funding sources with residual maturities of less than one year. While the residual maturity of an ADI's funding is based on contractual maturity, the maturity of funding instruments with options and deposits with withdrawal notice periods could be open to interpretation. Accordingly, APRA proposes that the maturity of such instruments and deposits would be taken as being the earliest possible date at which the funds could be redeemed through the exercise of an option or by withdrawal of a deposit.

2.9 Maturity of assets

Under the NSFR, the residual maturity of an asset is a key determinant of the RSF for that asset; a higher RSF factor is typically assigned to an asset with a residual maturity of one year or more. The determination of an asset's residual maturity, however, could be open to interpretation in certain circumstances. Accordingly, APRA's proposed approach is that for NSFR purposes the maturity of an asset will be taken to be the latest possible date at which the asset could mature. For assets with an option to extend maturity it is to be assumed that an option to extend maturity will be exercised. For assets without a defined maturity (non-maturity asset) or subject to periodic review, APRA's view is that all such assets should be classified as having a residual maturity of greater than or equal to one year for NSFR purposes and be assigned an RSF factor on this basis.

2.10 Exchange settlement account balances funded through open repos

An ADI may maintain funds in an exchange settlement account (ESA) with the RBA as a buffer for payment settlement purposes. The size of these buffers is agreed in advance with the RBA and funds held for this purpose are obtained through repos contracted with the RBA without a maturity date ('open' repos). Given these buffers are funded through an ADI's open repo positions, they need not generate an additional stable funding requirement. APRA therefore proposes to allow for a neutral treatment of such balances such that they do not impact on an ADI's NSFR.

2.11 Non-performing loans

Under the Basel III NSFR standard, an RSF factor of 100 per cent applies to non-performing loans, reflecting their lower credit quality and liquidity value.

While the Basel III NSFR standard considers non-performing loans to be loans that are more than 90 days past due, under *Prudential Standard APS 220 Credit Quality* (APS 220) a facility must be classified as impaired regardless of whether it is 90 days or more past due when there is doubt over the timely collection of the full amount of cashflows contracted to be received by an ADI. Accordingly, APRA proposes to use the methodology in APS 220 for determining non-performing loans for NSFR purposes.

2.12 Securitisation

Where an ADI, or a member of its Level 2 group, is an originating ADI of a traditional securitisation under *Prudential Standard APS 120 Securitisation* (APS 120), APRA proposes that the ADI would include the assets and liabilities of the relevant special purpose vehicle (SPV) in calculating the NSFR, except where the ADI meets the operational requirements for regulatory capital relief under draft APS 120[1]. APRA also proposes that for securitisation transactions that include date-based calls (as defined in paragraph 11 of draft *APS 120*), the ADI would assume that the first call would be exercised consistent with APRA's proposed treatment of funding instruments with options for the NSFR.

1 Draft APS 120 refers to the draft version of that standard released for consultation in November 2015.

Chapter 3 — Liquid assets requirement for foreign ADIs

In December 2013, APRA published a revised APS 210 which set a 100 per cent 30-day LCR requirement for all scenario analysis ADIs, a category which included most foreign ADIs.

In September 2014, APRA noted that the process of assessing CLF applications raised a number of challenges in applying the LCR to foreign ADIs. At that time, APRA consulted on proposed amendments to the LCR for foreign ADIs. Under those proposals foreign ADIs would have been subject to a 100 per cent 15-day LCR and there would have been a significant widening of the definition of 'liquid assets' that could be held to meet requirements. Industry feedback cited a number of concerns with those proposals, notably non-compatibility with home jurisdiction requirements regarding the LCR time horizon and the definition of HQLA. In November 2014, APRA announced that, as an interim measure, from 1 January 2015 foreign ADIs would:

- remain subject to a 30-calendar day time-horizon LCR;
- only need to maintain a minimum LCR of 40 per cent;
- not be eligible to apply for a CLF; and
- be required to meet the liquid assets requirement using HQLA only.

In announcing those changes, APRA indicated that it would undertake a review of its liquidity regime for foreign ADIs. This discussion paper forms the basis of that review.

3.1 Considerations for a liquidity requirement

A number of factors support consideration of a different short-term liquidity requirement for foreign ADIs. Key amongst these is whether to continue to impose an explicit quantitative liquid assets requirement for foreign ADIs.

A number of matters suggest that a quantitative measure may not be the first choice for a liquidity regime for foreign ADIs, including:

- it is more efficient for a bank with diverse international operations to run a 'global liquidity pool' — held centrally and/or in regional hubs — that can be deployed where required;
- foreign ADIs are indistinguishable from the wider legal entity of which they are a part and the existence of cross-default clauses is standard practice. In such cases, it is likely that, whenever possible, the Head Office would always act to support its branches in need; and
- the implementation of a global liquidity standard, in the form of the LCR, suggests that reliance may be placed on the adequacy of Basel jurisdiction banks' liquidity on a consolidated basis.

After consideration of these matters, APRA nevertheless remains of the view that it is appropriate to impose a quantitative liquid assets requirement for foreign ADIs. The alternative, which would potentially require APRA to place entire reliance on assets, staff and processes over which it has no oversight or jurisdiction, would not be prudent and may be difficult to support in the context of competitive neutrality. In particular, it would expose foreign ADIs to risks that are essentially operational in nature, arising from factors such as time-zone and business day differences, market operating hours and currency-convertibility risk.

Liquidity risk is idiosyncratic and it is not sufficient that liquid assets exist somewhere within a legal entity; liquidity needs to be available in a specific currency, form and location at a specific time. For these reasons, it would be inappropriate to grant broad exemptions to ADIs from a quantitative requirement. As APRA has noted previously, foreign ADIs tend not to be homogenous in nature and are diverse in terms of size, complexity and business models. Accordingly, the most appropriate solution would be one that is simple, fit-for-purpose and uniform but scalable.

3.2 Options for a liquid assets requirement for foreign ADIs

APS 210 currently includes two quantitative requirements regarding short-term liquidity sufficiency for ADIs; namely the LCR and MLH. Neither of these measures in their current form is entirely suitable for foreign ADIs.

The LCR was designed with internationally-active banks in mind. While a foreign ADI typically is part of an internationally-active bank which offers a broad range of banking services, the domestic branch operation does not easily lend itself to application of the LCR in isolation from the rest of the entity of which it is a part.

The MLH while uniform, scalable and simple, uses the liability base from which the liquid assets requirement is scaled. In the case of a foreign ADI, it would include borrowings from other parts of the same legal entity, thereby making it difficult to ascertain the actual liquidity needs of a foreign ADI in isolation from the entity of which it is a part.

Given the shortcomings of both the LCR and MLH in relation to foreign ADIs, APRA is consulting on two options:

- a foreign ADI liquid assets requirement (FALAR); or
- making the existing interim arrangement involving a 40 per cent LCR permanent.

The proposed FALAR would be modelled on the existing MLH, but modified to make it suitable for application to foreign ADIs.

It is proposed that under the FALAR a foreign ADI would need to hold, at a minimum, specified liquid assets equal to at least nine per cent of the aggregate value of external liabilities that have:

- a residual contractual maturity of 12 months or less; or
- an open maturity (e.g. at-call deposits); or
- an indeterminate maturity.

For this purpose, it is assumed that:

- the definition of Australian dollar liquid assets is identical to that for the existing MLH requirement, being:
    - notes and coin and settlement funds;
    - Commonwealth Government and semi-government securities;
    - debt securities guaranteed by the Australian Government or foreign sovereign governments;
    - debt securities issued by supra-nationals and foreign governments;
    - bank bills, certificates of deposit (CDs) and debt securities issued by ADIs;
    - deposits (at-call and any other deposits readily convertible into cash within two business days) held with other ADIs net of placements by other ADIs; and
    - any other securities approved by APRA.
- external liabilities are liabilities to a third party (whether related or unrelated to the foreign ADI); and
- the minimum ratio may be increased above nine per cent by APRA, to take account of the specific risk profile of a foreign ADI.

The FALAR is APRA's preferred option. This is because the proposed FALAR best meets the criteria for a quantitative measure that is simple, fit-for-purpose and uniform but scalable. However, the FALAR may pose some concerns for foreign ADIs, including that:

- a definition of liquid assets that differs from the LCR HQLA could create problems when calculating the LCR on a consolidated basis at Head Office level; and
- reporting requirements that diverge from the LCR may result in a duplication of effort, as a foreign ADI would still need to report its LCR on a consolidated basis.

The alternative proposal is that the adjusted 40 per cent LCR, originally introduced as an interim measure, could be adopted as the permanent quantitative liquidity standard for foreign ADIs.

This is likely to be more straightforward for foreign ADIs and avoids the concerns noted above regarding the FALAR, though it may be a less risk-sensitive approach.

APRA seeks views on these proposals. For the avoidance of doubt, APRA is not proposing to operate two regimes: APRA will apply either the FALAR requirement or the existing 40 per cent LCR to all foreign ADIs.

3.3 Local operational capacity

APRA's review of current liquidity requirements has also highlighted that a key risk facing foreign ADIs is their potential inability to access liquid assets when required.

Locally-incorporated ADIs typically have their main Australian dollar liquidity and settlement functions located in Australia. As a result, local staff have knowledge of, and proficiency in, using key systems, processes and market infrastructure (such as Austraclear). The same is not always true for foreign ADIs. Consequently, APRA proposes to address this matter by requiring foreign ADIs to perform a local operational capacity (LOC) assessment, at least annually, and provide the results to APRA.

The LOC assessment would consider a scenario in which a combination of time zones, different public holidays and an offshore operational risk event requires a foreign ADI to operate, including making and receiving payments, for three business days without assistance from staff located outside Australia. For this purpose, a foreign ADI could assume that related-party operations in Australia, such as locally-incorporated subsidiaries, are functioning normally.

APRA may consider imposing additional requirements on a foreign ADI where the LOC assessment highlighted an inability to liquidate assets, make or receive payments or perform other vital functions. These could include, for example, a requirement to rectify an identified inability, cross-train local staff and provide them with access to vital systems, or to hold increased settlement balances in Nostro accounts.

Chapter 4 — Request for cost benefit 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. The preliminary assessments for the proposals outlined in this discussion paper concluded that measurable compliance costs are likely and thus a formal Regulation Impact Statement (RIS) will be required. In order to perform this comprehensive cost-benefit analysis, APRA requests that all interested stakeholders use this consultation opportunity to provide information on the compliance impact of the proposed changes and any other substantive costs associated with the changes. Compliance costs are defined as direct costs to businesses of performing activities associated with complying with government regulation. Specifically, information is sought on any increases or decreases to the compliance costs incurred by businesses as a result of this proposal.

Consistent with the Government's approach, APRA will use the methodology behind the Regulatory Burden Measurement Tool to assess compliance costs. This tool is designed to capture the relevant costs in a structured way, including a separate assessment of upfront costs and ongoing costs. It is available at https://rbm.obpr.gov.au/home.aspx.

Respondents are requested to use this methodology to estimate costs to ensure that the data supplied to APRA can be aggregated and used in an industry-wide assessment. When submitting their cost assessment to APRA, respondents are asked to include any assumptions made and, where relevant, any limitations inherent in their assessment. Feedback should address the additional costs incurred as a result of complying with APRA's requirements or expectations, not activities that institutions would undertake regardless of regulatory requirements in their ordinary course of business.

Appendix 1 — Components of available stable funding and associated ASF factors

ASF factor	Components of ASF category
100 per cent	• The total amount of regulatory capital, before the application of regulatory adjustments, as defined in *Prudential Standard APS 111 Capital Adequacy: Measurement of Capital*, excluding the proportion of Tier 2 instruments with residual maturity of less than one year. • The total amount of any capital instrument not included above that has an effective residual maturity of one year or more, but excluding any instruments with explicit or embedded options that, if exercised, would reduce the expected maturity to less than one year. • The total amount of secured and unsecured borrowings and liabilities, including term deposits, with effective residual maturities of one year or more. Cash flows with a time horizon of less than one year but that arise from liabilities with a final maturity greater than one year are not eligible for the 100 per cent ASF factor.
95 per cent	• Liabilities classified as 'stable'[2] demand deposits and/or term deposits with residual maturities of less than one year provided by retail and SME customers[3].
90 per cent	• Liabilities classified as 'less stable'[4] demand deposits and/or term deposits with residual maturities of less than one year provided by retail and SME customers.
50 per cent	• Funding (secured and unsecured) with a residual maturity of less than one year provided by non-financial corporate customers. • Operational deposits[5]. • Funding with a residual maturity of less than one year from sovereigns, public sector entities (PSEs), and multilateral development banks (MDBs). • Other funding, secured and unsecured, not included in the categories above with a residual maturity of between six months to less than one year, including funding from central banks and financial institutions.
0 per cent	• All other liabilities and equity categories not included in any other ASF categories, including other funding with residual maturity of less than six

2 Refer to paragraph 36 of Attachment A of *Prudential Standard APS 210 Liquidity (APS 210)*.
3 Refer to paragraph 33 of Attachment A of APS 210. Also refer to paragraph 46 and footnote 6 of Attachment A for the definition of SME.
4 Refer to paragraph 37 of Attachment A of APS 210.
5 Refer to paragraphs 47 to 50 of Attachment A of APS 210.

ASF factor	Components of ASF category
	months from central banks and financial institutions[6]. • Other liabilities without a stated maturity. This category may include short positions and open maturity positions. Two exceptions may be recognised for liabilities without a stated maturity: o deferred tax liabilities, which must be treated according to the nearest possible date on which such liabilities could be realised; and o minority interest, which must be treated according to the term of the instrument, usually in perpetuity. Note, these liabilities would be assigned either a 100 per cent ASF if the effective maturity is one year or greater, or 50 per cent, if the effective maturity is between six months and less than one year. • NSFR derivative liabilities net of NSFR derivative assets, if NSFR derivative liabilities are greater than NSFR derivative assets[7]. [note – method of calculation of derivative amounts will be included in draft standard] • 'Trade date' payables arising from purchases of financial instruments, foreign currencies and commodities that (i) are expected to settle within the standard settlement cycle or period that is customary for the relevant exchange or type of transaction, or (ii) have failed to, but are still expected to, settle.

6 At the discretion of national supervisors, deposits between banks within the same cooperative network can be excluded from liabilities receiving a 0% ASF provided they are either (a) required by law in some jurisdictions to be placed at the central organisation and are legally constrained within the cooperative bank network as minimum deposit requirements, or (b) in the context of common task sharing and legal, statutory or contractual arrangements, so long as the bank that has received the monies and the bank that has deposited participate in the same institutional network's mutual protection scheme against illiquidity and insolvency of its members. Such deposits may be assigned an ASF up to the RSF factor assigned by regulation for the same deposits to the depositing bank, not to exceed 85%.

7 ASF = 0 per cent x MAX ((NSFR derivative liabilities – NSFR derivative assets), 0).

Appendix 2 — Components of required stable funding and associated RSF factors

RSF	Components of RSF category
0 per cent	• Notes and coins immediately available to meet obligations. • Central bank reserves, to the extent these reserves can be drawn down in times of stress. • All claims on central banks with residual maturities of less than six months. • 'Trade date' receivables arising from the sale of financial instruments, foreign currencies and commodities that (i) are expected to settle within the standard settlement cycle or period for the relevant exchange or type of transaction, or (ii) have failed to, but are still expected to, settle.
5 per cent	• Unencumbered HQLA1 assets, but excluding assets receiving a zero per cent RSF as specified above: ○ marketable securities representing claims on or claims guaranteed by sovereigns, central banks, PSEs, the Bank of International Settlements (BIS), the International Monetary Fund (IMF), the European Central Bank (ECB) and European Community, or MDBs that are assigned a zero per cent risk weight under Attachment A of APS 112; and ○ certain non-zero per cent risk-weighted sovereign or central bank debt securities as specified in paragraphs 9(d) and (e) of Attachment A of *Prudential Standard APS 210 Liquidity*.
10 per cent	• Unencumbered loans to financial institutions with residual maturities of less than six months, where the loan is secured against HQLA1 assets as defined in paragraph 9 of Attachment A of APS 210, provided the ADI has the ability to freely rehypothecate the received collateral for the life of the loan. • CLF-eligible debt securities, other jurisdictions' ALA and assets recognised as eligible liquid assets by a host supervisor and that APRA allows to be included in the numerator of the LCR (e.g. RBNZ-eligible securities). Note, the 10 per cent RSF factor would only apply to third-party debt securities in these categories and to the lower of the carrying value of the securities and the amount of the CLF that can be included in the numerator of an ADI's LCR under APS 210[8].
15 per cent	• Unencumbered HQLA2 assets as defined in paragraph 10 of Attachment A of APS 210. • All other unencumbered loans to financial institutions with residual maturities of less than six months not included in the 10 per cent RSF

8 Note this excludes self-securitised assets.

RSF	Components of RSF category
	category above.
50 per cent	• Any HQLA as defined in Attachment A of APS 210 that is encumbered for a period of between six months and less than one year. • All loans to financial institutions and central banks with residual maturity of between six months and less than one year. • Operational deposits held at other ADIs that are subject to the 50 per cent ASF factor. • All other non-HQLA not included in the above categories that have a residual maturity of less than one year, including loans to non-financial corporate clients, loans to retail customers (i.e. natural persons) and SME customers, and loans to sovereigns and PSEs.
65 per cent	• Unencumbered residential mortgages with a residual maturity of one year or more that would qualify for a 35 per cent risk weight under APS 112. • Other unencumbered loans not included in the above categories, excluding loans to financial institutions, with a residual maturity of one year or more that would qualify for a 35 per cent or lower risk weight under APS 112.
85 per cent	• Cash, securities or other assets posted as an initial margin for derivative contracts[9] and cash or other assets provided to contribute to the default fund of a CCP. Where securities or other assets posted as an initial margin for derivative contracts would otherwise receive a higher RSF factor, they must retain that higher factor. • Other unencumbered performing loans that do not qualify for the 35 per cent or lower risk weight under APS 112 and have residual maturities of one year or more, excluding loans to financial institutions. • Unencumbered securities with a remaining maturity of one year or more and exchange-traded equities that are not in default and do not qualify as HQLA. • Physical traded commodities, including gold.
100 per cent	• All assets that are encumbered for a period of one year or more. • NSFR derivative assets net of NSFR derivative liabilities, if NSFR derivative assets are greater than NSFR derivative liabilities[10]. [note – method of calculation of derivative amounts will be included in draft standard] • All other assets not included in the above categories, including non-performing loans, loans to financial institutions with a residual maturity of

9 An initial margin posted on behalf of a customer, where an ADI does not guarantee performance of the third party, is exempt from this requirement.

10 RSF = 100 per cent x MAX ((NSFR derivative assets – NSFR derivative liabilities), 0).

RSF	Components of RSF category
	one year or more, non-exchange-traded equities, fixed assets, items deducted from regulatory capital, retained interest, insurance assets, subsidiary interests and defaulted securities. • 20 per cent of derivative liabilities (i.e. negative replacement cost amounts) as calculated according to APS 210 (before deducting any variation margin posted).

Off-balance sheet categories and associated RSF factors

RSF	Components of RSF category
5 per cent	Irrevocable and conditionally revocable credit and liquidity facilities to any client
1 per cent	Unconditionally revocable credit and liquidity facilities

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