Australian Banking Association

14 April 2022

Mr [redacted]
General Manager, Policy
Policy and Advice Division
Australian Prudential Regulation Authority

By email: [redacted]

Dear Mr [redacted]

Post-implementation review of the Basel III liquidity ratios in Australia

The Australian Banking Association (**ABA**) welcomes the opportunity to respond to the Australian Prudential Regulation Authority's (**APRA**) discussion paper, *Post-implementation Review of the Basel III Liquidity Ratios in Australia*, which focuses on the Liquidity Coverage Ratio (**LCR**) and the Net Stable Funding Ratio (**NSFR**).

Our Position

The LCR and NSFR were and remain important elements of the Basel III Liquidity reforms. Overall, these liquidity measures have achieved their objectives of promoting short-term and long-term resilience of banks' liquidity and funding profiles and are supported by the banking industry.

Unarguably, increased resilience stemming from these reforms is a benefit to both the financial system and broader economy. These reforms, however, have also introduced costs to the Australian banking system and, indirectly, to the Australian economy. While the ABA does not contest the overall value of the reforms, it remains less clear if some of the conservative elements adopted by APRA are of net benefit.

Additionally, a number of new risks and opportunities to enhance the Basel III Liquidity reforms are present. These, along with other suggestions and observations, are discussed in Appendix A.

Finally, the ABA is supportive of APRA's intention to review APS 210 in 2023 and is available to provide more detailed feedback at the appropriate time.

If you have any questions or require any additional information, please contact me at [redacted] or [redacted]

Yours sincerely,

Brendon Harper

Policy Director
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Appendix A: APS 210 Post-implementation Review

Question 1: Have the LCR and NSFR achieved their intended specific objectives (as set out in Table 1), and supported the overall objectives of the Basel III reforms?

Table 1. Overview of the LCR and NSFR measures

Measure	Intended objectives	Definition
LCR	The LCR is intended to promote short-term resilience of a bank's liquidity profile by ensuring that it has sufficient high-quality liquid assets to survive a significant stress event lasting for one month.	The LCR requires banks to hold high-quality liquid assets at least equal to an estimate of short-term net cash outflows under a stress scenario, to build resilience to liquidity shocks.[1]
NSFR	The NSFR is intended to promote longer-term resilience in a bank's funding profile through requiring more stable sources of funding on an ongoing basis.	The NSFR requires banks to maintain an amount of available stable funding at least equal to their required stable funding, to promote sustainable funding structures

Industry response

Both the LCR and the NSFR are targeted ratios to increase banks' short-term and longer-term resilience and therefore reduce the likelihood for government intervention. At the time of implementation, the ABA and banking industry supported the adoption of these ratios. We continue to support the use of these ratios.

The LCR in particular has driven a significant increase in High-Quality Liquid Asset (**HQLA**) holdings across the industry and, therefore, has strengthened the ability of banks', collectively and individually, to withstand a significant stress event lasting for 30 days. Arguably, the new Basel III Liquidity requirements have increased the liquidity management governance approach across the banking sector.. Though this increased 'liquidity buffer' has come at a direct cost for banks and indirect costs for the broader economy, and, as highlighted below, market expectations have increased in line with the increased buffer.

Additionally, the implementation of these ratios have generated a range of potential new risks and considerations. These include:

- **Public Disclosure requirements:** Potential continuous market disclosure requirement if spot LCR falls below 100%, , aiming to avoid exacerbating a stress event. A clear directive, including public articulation when bank should utilise their liquidity buffer, would help to prevent unintended market reaction.
- **Market expectations** on the level of assets that banks hold. As general levels of liquidity have increased, market expectations have shifted higher in lockstep. . Therefore, the 'liquidity buffer' between BAU holdings and the level of liquidity perceived by the market to demonstrate 'adequacy' has remained broadly unchanged. This has, to some degree, neutralised perceptions of increased bank resilience.

  This has led to discussions at international fora and in foreign jurisdictions regarding the usability of HQLA in high stress scenarios.[2] For example, "the Bank [of England] and the PRA have been concerned for a number of years that banks may be reluctant to draw on their HQLA in periods of unusual liquidity pressures, possibly to such an extent that it is limiting the benefits

[1] For a foreign bank branch, the LCR value must be at least equal to 40 per cent.
[2] Such as the BCBS and FSB in July 2021, and more recently the Bank of England and Prudential Regulation Authority's 31 March 2022 discussion paper, *DP1/22 – The prudential liquidity framework: Supporting liquid asset usability*.

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of the flexibility built into the framework. Evidence from the last few years has reinforced these concerns"[3]. This is despite the Prudential Regulation Authority explicitly stating in its 'Q&A on the use of capital and liquidity buffers' that "It is to be expected that the stock of these [high quality liquid] assets will decline during a stress, and that… Banks are expected to use their liquidity buffers in [providing liquidity to the economy]… even if it means LCR ratios go significantly below 100%".

The Australian experience has seen banks continue to raise funding to neutralise any deterioration in liquidity metrics during a stress.

The ABA recommends that APRA closely monitor the developments in international thinking and consider if more explicit public articulation of APRA's expectations regarding the use of HQLA and liquidity buffers during times of stress would enhance the usability and effectiveness of these buffers and increase confidence in the system.

- Consideration of **future Australian financial market composition**. The dominance of a small set of banks and (very large) superannuation funds could create future inter-dependencies. The ABA encourages APRA to consider the end investors (that is - depositors and superannuation fund members) and work collaboratively with both industries to allow optimal outcomes for those investors.
- **'Uniform' view on liquidity risk across industry:** A more unified or homogenous view on/approach to liquidity risk across the industry increases potential systemic risk. This is an issue currently being considered globally and the ABA is available to work with APRA to develop domestic solutions at the appropriate time.

Questions 2: Are there areas where the prudential and reporting framework for the LCR and NSFR could be improved to better achieve the intended objectives?

Industry response

There are various opportunities to improve the effectiveness (and efficiency) of APRA's liquidity framework. In addition to those above, the ABA recommends that APRA considers the following opportunities for improvement:

Enhance the understanding of APRA's 'spirit and intent' and the consistency of interpreting APS 210

Aspects of APS 210 are, to varying degrees, open to interpretation. Individual banks can interpret the rules and guidance in different ways, bilateral advice to ADIs can vary and there can be difficulties in working through complex products and agreeing on the correct liquidity treatment. This can be exacerbated by little explanation being provided for judgements/decisions and rules/guidance being spread out across APS / ARS / APG / FAQ / Basel. Examples where more specific guidance or clarification is required to ensure consistent interpretation across the industry:

- Operational deposit methodology including treatment of correspondent banking. More specifically, APRA should provide clear methodology how to perform an excess balance test.
- For largest absolute net 30-day collateral flow realised in the past 24 months:
  - Clear definition of "other transactions" / scope;
  - design has some deficiencies such as: (1) increasing LCR requirement in a crisis through the feedback loop and (2) backward looking so not responsive to changes in portfolio.
- Simplification of the retail deposit framework could be considered, for example more precise definition of 'heavily rate driven' deposits and 'established relationship'. The current framework

[3] Bank of England and Prudential Regulation Authority (2022) *DP1/22 – The prudential liquidity framework: Supporting liquid asset usability*, discussion paper, 31 March

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including, the scorecard, adds complexity and subjectivity to the calculation, whilst having an overall limited impact on Net Cash Outflows.

The ABA and industry are available to provide further examples at the appropriate time.

LCR application is too complicated/subjective in some areas

An overly complicated and subjective approach to LCR applications can result in unnecessary regulatory burden. This includes:

- Level 2 LCR is not a good measure of a banking entities' liquidity buffers, for example, surplus liquids are excluded and NCOs are kept at Level 2.
- Compliance costs for ensuring New Zealand (for example) LCR is reported accurately to APRA rules. However, both regulators effectively ring fence operations. It is unclear why the liquidity position of New Zealand entities is not managed by the RBNZ, with APRA managing Level 1 liquidity.
- Complexity of the modelled LCR components could hamper market competition for some products, due to the cost/burden of the modelling required. Greater regulatory guidance for some components may reduce this burden and, as a flow on effect, potentially increase competition.

Better configure APS / APG / ARS / FAQ

As APRA's and industry's interpretations mature and as products and markets evolve, so too should the rules and guidance material. Changes in ARSs and FAQs should inform updated APSs and APGs. For example, FAQs which develop over time should be considered and included in APGs. This would ease interpretation and reduce the regulatory burden on ADIs.

There is an opportunity to consider the interaction, interlinkages and currency of the APSs, APGs, ARSs and FAQs in APRA's *modernising the prudential architecture* initiative. Though industry is aware that this is a longer-term project.

Additionally, the liquidity governance/framework section at beginning of APS 210 would likely work better in APG 210.

Greater consideration of competition impacts and opportunities for efficiencies

Compliance with the LCR and NSFR requires substantial internal resourcing to conduct complex analysis. This burden is disproportionately felt by smaller banks, including regional and international banks. Sophisticated analysis is also required for elements of the ratios which are known to have minimal impact. Some of this burden could be removed or at least reduced if clearer and simpler guidance was provided.

A further reduction in regulatory burden could be achieved by articulating materiality thresholds. For example, materiality thresholds for misstatements, and potentially resubmissions, across the ARF 210 regulatory reporting suite.

Closer alignment with international regulators

Particular aspects of the liquidity framework could be more closely aligned to international practice to avoid competitive disadvantage, compared to international peers, for example:

- Maturity profiling of funding where an ADI has the right to repay: APRA takes a more conservative view than Basel and requires that funding with a continuous right to repay by the borrower be profiled as at call, irrespective of market expectations. This conservative interpretation requires all banks to remove any continuous right to repay from funding contracts and reduces the ability to repay excess funding in a BAU scenario.
- Clarity on of FAQ 17 application to NSFR: Scope of FAQ 17 should be limited to LCR only: FAQ 17 is clear that where a funding source has certain terms which may allow repayment within 30 days, then these funds should be treated consistently for both LCR and NSFR profiling. However, it is not clear what the NSFR treatment should be if 31 day notice periods are

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added to relevant clauses to address the LCR considerations. In such cases, the ABAwe believes the scope of FAQ 17 should be limited to LCR only – the main target of FAQ 17 is to avoid accelerated repayment of funds if the ADI is under financial stress but is still solvent. The LCR is defined as a stress event, whereas NSFR does not specifically contemplate a stress scenario.

- Aligning HQLA rules with Basel rules, for example AUD MDBs/covered bonds. HQLA rules on "proven record as a reliable source of liquidity" are also arguably too subjective.