28 October 2016

Ms Heidi Richards
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Australian Prudential Regulation Authority

By e-mail: Basel3liquidity@apra.gov.au

Dear Ms Richards

Draft Prudential Standard 210 & Prudential Practice Guide APG 210 - Liquidity

This letter provides comments from the Australian Financial Markets Association (AFMA) arising from the Draft Prudential Standard 210 & Prudential Practice Guide APG 210 – Liquidity consultation.

These comments are focused on one substantive common point relating to the net table funding ratio (NSFR) that came out of feedback from members. We also make observations on the understanding of members with regard to proposals that affect foreign ADI offshore operations.

1. Treatment of open reverse repo transactions in the Net Stable Funding Ratio (NSFR)

AFMA notes that Prudential Practice Guide APG 210 Liquidity Paragraph 146 outlines the encumbrance treatment of repurchase agreement (repo) collateral in the context of NSFR, consistent with the Basel Committee on Banking Supervision (BCBS) "Basel III - The Net Stable Funding Ratio: frequently asked questions" released in July 2016 FAQ No. 4[1] but APG 210 does not appear to have comparable guidance relevant to repo regarding what is the adequate period for a non-maturity reverse repo (also known as open reverse repo)? Would that be categorised under "loans with residual maturities of less than six months"?

Repo transactions play a vital role within the financial system and underpin the liquidity of primary and secondary capital markets as well as the shorter-term money markets. The International Capital

[1] "Basel III - The Net Stable Funding Ratio: frequently asked questions", July 2016, Answer to Question 4

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Market Association noted in their recent paper entitled "Impacts of the Net Stable Funding Ratio on Repo and Collateral Markets"[2] based on their substantive quantitative analysis that -

> *The impact of the NSFR, if simply adopted exactly as outlined by the BCBS, would create significant additional stress and weaken the effectiveness of the market. Given the role of repo and collateral markets at the heart of the financial system, this would have negative implications for the smooth functioning of broader financial markets - which would, in turn, lead to increased costs and risk for the market participants, including those corporates and governments borrowing to finance their economic needs. At the same time there would also be a detrimental impact on the effectiveness of many of the measures put in place to improve the stability of the financial system, dependent as they are on high quality collateral'*.

Repos offer a flexible instrument for the Reserve Bank of Australia (RBA) to manage the total amount of outstanding Exchange Settlement Account (ESA) balances in the banking system so as to keep the cash rate as close as possible to the target set by the Reserve Bank Board. RBA in executing its monetary policy does not negotiate directly with banks but operates through the medium of executing repos with its counterparties in its open market operations, principally as a cash provider and in doing so the RBA manages the aggregate of institutions' ESA balances and is therefore a major source of funding for the domestic repo and cash markets. Although ensuring that the system cash is set appropriately, the RBA expects that the market itself finds its own equilibrium; a process which generates overnight, open and term repo transactions amongst market participants, governed to a large extent by the immediate and short term liquidity considerations of cash lenders under a reverse repo transaction, and which can be terminated on any day in the future by either party, provided notice is given before an agreed daily deadline. Accordingly open reverse repo serves as a cost effective short term liquidity management instrument for cash lenders, reducing operational costs relative to those incurred under an overnight reverse repo, while retaining all of the flexibility attached to the latter. A Required Stable Funding (RSF) factor which discourages the cash lender to engage the markets under open reverse repo will further exacerbate the slowdown in daily cash movement amongst market participants. More broadly, the repo market promotes the efficient use of available tradable stock for collateral management.

It is noted in relation the proposed modelling of the maturity profile of open dated repos in section 2.8 that there is no distinction drawn between open maturity arrangements and 'arrangements with no maturity date'. Not distinguishing open maturity arrangements would mean that they would require 100% stable funding treatment instead of 10% stable funding treatment under the proposed APS 210 due to their lack of a fixed maturity date.

AFMA proposes that a distinction should be drawn between open maturities that are managed on a daily basis from 'perpetual or no maturity' transactions within the NSFR rules, to recognise that open arrangements can be unwound at short notice. Flexibility on this point is permitted. The Basel Committee on Banking Supervision (BCBS) in its *Basel III - The Net Stable Funding Ratio*: *frequently asked questions* released in July 2016 allows national discretion on "open repo" where banks can demonstrate that the non-maturity reverse repo would effectively mature in a different period[3].

In economic terms open maturity repos are in effect overnight trades. The maturity treatment of the funding and asset side of an open repo can be aligned and so it follows that for an open repo matures

[2] See International Capital Market Association, Report on "Impacts of the Net Stable Funding Ratio on Repo and Collateral Markets", 23 March 2016

[3] "Basel III - The Net Stable Funding Ratio: frequently asked questions", July 2016, Answer to Question 7

at the same time as the associated repurchase funding and accordingly should be treated as having a one day maturity. The global trading standard for open repos is on a 24 or 48 hour call basis. From the market perspective the risk is fully understood and accepted as a very short-dated trade, i.e. 1 or 2 days at most. There is no reputational risk involved in terminating the trade (activating the call on the agreed timeframe). As such an RFS equivalent to a shorter dated trade of 10% would be more appropriate than an RFS of 100% which would imply a trade with a fixed term of more than 1 year.

The draft US rules[4] have recognised the validity of this thinking. The US rules distinguish 'open' maturities in their draft standards so that the maturity treatment of the funding and asset side of an open repo can be aligned. Paragraph .101 *Determining maturity,* subparagraph (d) provides that, in relation to the ASF amount and NSF amount, a bank shall assume- *"With respect to an NSFR liability or asset that has an open maturity, the NSFR liability or asset matures on the first calendar day after the calculation date…"*

2. Foreign ADIs with consent to offshore back offices

AFMA notes that the local operational capacity (LOC) assessment set out in paragraph 67 of draft APS 210 that a foreign ADI has to carry a scenario analysis involving a combination of time zones, different public holidays and an offshore operational risk event under which the foreign ADI would operate, including making and receiving payments, for a minimum of three business days *without* assistance from staff located outside Australia, is not applicable with regard to being "*without assistance from staff located outside Australia"* for foreign ADIs that have received APRA's consent to use offshore back office operations. It should be made clear in APG 210 that the words "*without assistance from staff located outside Australia"* do not apply to foreign ADIs with offshored back office consents.

More generally, there is a desire for the wording on the LOC assessment in the draft APS 210 to provide for guidance to foreign ADIs on the level of extent and detail that will be needed in a satisfactory assessment. For example, is it an expectation that simple execution and settlement in the RTGS/AUSTRACLEAR systems would suffice to be performed onshore for three days where there is reliance on offshore based systems, or would more extensive operational steps such as credit and Office of Foreign Assets Control checks also need to be carried out onshore?

3. Liquid asset requirements for foreign ADIs.

AFMA notes its agreement with the comments in APRA's "Response to Submissions" regarding the inappropriateness of generally applying the previously consulted concept of a foreign ADI liquid assets requirement (FALAR) and applying instead as a default the existing 40 per cent LCR.

It also noted that APRA will entertain applications for a foreign ADI to seek designation to use the minimum liquidity holdings (MLH) approach which is suited to the situation of less complex foreign ADIs. This is understood to provide scope for foreign ADIs to approach APRA to seek designation as an MLH ADI, which in practice could provide the same operational outcome for determining the liquid asset requirement on a simple basis in the way that FALAR would have done. This includes a possible threshold which could apply to a foreign ADI contemplating for designation, and the definition of external liabilities, particularly the treatment of liabilities from related parties (being different legal entities), parent entities, and other branches of the same legal entity.

[4] US Government Publishing Office, 12 CFR Part 329 Net Stable Funding Ratio: Liquidity Risk Measurement Standards and Disclosure Requirements; Proposed Rule Federal Register, Vol. 81, No. 105, June 1, 2016, Proposed Rules, Subpart K para.101(d)

3.1 Head office committed funding facility

AFMA notes that APRA proposes to allow a foreign ADI to meet up to 50 per cent of its LCR liquid assets requirement with a head office committed funding facility, with the remainder of the liquid assets requirement to be met with eligible liquid assets as detailed in Attachment A of draft APS 210. Confirmation is sought on the application of this in the context of it being considered as comparable to High Quality Liquid Assets (HQLA), i.e. that a branch can meet the 40 per cent LCR requirement with up to half through a head office committed funding facility and the balance in HQLA.

If you have any queries with regard to these comments please contact either Murray Regan on 9776 7992 or myself on 02 9776 7995 or at dlove@afma.com.au.

Yours sincerely

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