Discussion Paper

Implementing Basel III liquidity reforms in Australia

16 November 2011

www.apra.gov.au

Australian Prudential Regulation Authority

Preamble

This discussion paper outlines the Australian Prudential Regulation Authority's proposals to implement a package of reforms to strengthen the liquidity framework for authorised deposit-taking institutions (ADIs) in Australia. These reforms give effect to the measures announced by the Basel Committee on Banking Supervision in December 2010 to strengthen liquidity buffers so as to promote a more resilient global banking system. These measures are set out in *Basel III: International framework for liquidity risk measurement, standards and monitoring* and are known as 'Basel III'. As a member of the Basel Committee, APRA has been actively involved in developing these global reforms and fully supports their implementation in Australia.

The Basel III framework also addresses other prudential matters such as global capital rules, which are currently the subject of separate consultation. This discussion paper relates only to the Basel III liquidity requirements.

APRA's September 2009 discussion paper *APRA's prudential approach to ADI liquidity risk* outlined a number of proposed changes to its prudential approach to liquidity risk management for ADIs. APRA's 2009 proposals were similar to global liquidity reforms then emerging from the Basel Committee and, accordingly, APRA delayed finalisation of its proposals in order to ensure that the liquidity framework for ADIs in Australia aligned with the emerging global framework. The proposals contained in this discussion paper and the accompanying draft *Prudential Standard APS 210 Liquidity* (APS 210) build on the 2009 discussion paper and give effect to the Basel III reforms.

APRA invites written submissions on its proposals and on the draft prudential standard. Following consideration of submissions received, APRA intends to issue a final APS 210 in mid-2012. The qualitative requirements in APS 210 are expected to take effect immediately following release of the final APS 210. The quantitative requirements for the larger, more complex ADIs ('scenario analysis' ADIs) will take effect in accordance with the internationally agreed timetable; the quantitative requirements for other ADIs are not materially changed and will take effect upon finalisation of APS 210. Consultation on a draft *Prudential Practice Guide 210 Liquidity* (PPG 210) will also be undertaken in 2012.

This discussion paper and the draft APS 210 are available on APRA's website at www.apra.gov.au. Written submissions on the paper should be forwarded by 17 February 2012 by email to Basel3liquidity@apra.gov.au and addressed to:

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Important

All information in submissions will be made available to the public on the APRA website unless you indicate that you would like all or part of your submission to remain in confidence. Automatically generated confidentiality statements in emails do not suffice for this purpose. Respondents who would like part of their submission to remain in confidence should provide this information marked as confidential in a separate attachment.

Submissions may be the subject of a request for access made under the Freedom of Information Act 1982 (FOIA). APRA will determine such requests, if any, in accordance with the provisions of the FOIA. Information in the submission about any APRA regulated entity which is not in the public domain and which is identified as confidential will be protected by section 56 of the Australian Prudential Regulation Authority Act 1998 and therefore will ordinarily be exempt from production under the FOIA.

Contents

Glossary

2009 discussion paper	*APRA's prudential approach to ADI liquidity risk*, September 2009.
ABS	Asset-backed security
ADI	Authorised deposit-taking institution
APCA	Australian Payments Clearing Association
APRA	Australian Prudential Regulation Authority
APS 210	*Prudential Standard APS 210 Liquidity*
ASIC	Australian Securities and Investments Commission
ASF	Available stable funding
AUD	Australian dollar
Basel III liquidity framework	*Basel III: International framework for liquidity risk measurement, standards and monitoring*, Basel Committee on Banking Supervision, December 2010.
Basel Committee	Basel Committee on Banking Supervision
CLF	Secured committed liquidity facility provided by the RBA
D2A	Direct to APRA. An electronic data submission system which enables regulated and registered financial entities to lodge their statutory returns with APRA.
EUR	Euro – the official currency of the eurozone
HQLA	High-quality liquid assets
HQLA1	Equivalent to Level 1 HQLA in Basel III liquidity framework
HQLA2	Equivalent to Level 2 HQLA in Basel III liquidity framework
LCR	Liquidity Coverage Ratio
MLH	Minimum Liquidity Holdings
MLH ADI	An ADI exempt from scenario analysis and subject to the MLH requirements
NSFR	Net Stable Funding Ratio
PPG 210	*Prudential Practice Guide 210 Liquidity*
RBA	Reserve Bank of Australia
RMBS	Residential mortgage-backed security
RSF	Required stable funding
Scenario analysis ADI	An ADI subject to the Basel III quantitative liquidity requirements
Sound Principles	*Principles for Sound Liquidity Risk Management and Supervision*, Basel Committee on Banking Supervision, September 2008.
SME	Small and medium-sized enterprise

Executive summary

In December 2010, the Basel Committee on Banking Supervision (Basel Committee) announced reforms to strengthen global liquidity rules with the goal of promoting a more resilient banking sector. This discussion paper commences APRA's public consultation on these Basel III liquidity reforms. The paper builds upon the proposals set out in APRA's September 2009 discussion paper *APRA's prudential approach to ADI liquidity risk*.

APRA seeks to ensure that its prudential framework for liquidity is consistent with global standards. APRA therefore proposes that all ADIs implement the qualitative requirements for liquidity risk management promoted by the Basel Committee, and outlined in APRA's 2009 discussion paper.

APRA also proposes to apply the quantitative requirements in the Basel III liquidity framework to the larger authorised deposit-taking institutions (ADIs), with only minor modifications. These modifications relate to certain items where Basel III allows national supervisors to exercise discretion or where clarification is required for Australian circumstances.

A summary of the key proposals is provided below.

Qualitative requirements

The qualitative requirements that underpin the Basel III liquidity framework are based on the Basel Committee's 2008 document, *Principles for Sound Liquidity Risk Management and Supervision* (*Sound Principles*). This sets out the principles to which banking institutions should adhere in order to achieve sound management of liquidity risk. APRA proposes to incorporate these qualitative requirements in a revised *Prudential Standard APS 210 Liquidity* (APS 210). The revised APS 210 includes proposed requirements for enhanced Board oversight of an ADI's liquidity risk management framework and its implementation.

Quantitative requirements: scenario analysis ADIs

The Basel III liquidity framework involves two new minimum global standards:

- a 30-day Liquidity Coverage Ratio (LCR) to address an acute stress scenario; and
- a Net Stable Funding Ratio (NSFR) to encourage longer-term resilience.

APRA proposes to apply these quantitative liquidity requirements to those ADIs that are currently required to conduct scenario analysis of their liquidity needs under different operating circumstances ('scenario analysis' ADIs).

The requirements will need to be met by a scenario analysis ADI on a Level 1 (standalone) basis and on a Level 2 consolidated banking group basis. In the case of foreign-owned scenario analysis ADIs, APRA proposes that the requirements be applied to their Australian bank subsidiaries on a standalone basis and to their Australian branches.

Liquidity Coverage Ratio

The LCR requirement aims to ensure that an ADI has sufficient high-quality liquid assets (HQLA) to survive a significant liquidity stress scenario for a minimum period of 30 calendar days. APRA proposes that ADIs be required to maintain an LCR of no lower than 100 per cent.

In implementing the LCR in Australia, APRA proposes to adopt the Basel III requirements for qualifying HQLA and net cash outflow assumptions. The only modifications or clarifications relate to the treatment of self-managed superannuation funds, high run-off less stable retail and qualifying small and medium enterprise (SME) deposits, contingent funding obligations, recognition of head office liquidity support to Australian branches of foreign banks and recognition of New Zealand dollar liquid assets nominated by the Reserve Bank of New Zealand.

As is well recognised, the supply of HQLA in Australia is insufficient to meet the Australian dollar liquidity requirements of ADIs. As such, APRA and the Reserve Bank of Australia (RBA) propose to allow an ADI to use a secured committed liquidity facility with the RBA, for payment of a fee determined by the RBA, to cover any shortfall in Australian dollars between the ADI's liquidity needs and its holdings of HQLA. This alternative treatment is envisaged by the Basel III liquidity framework.

APRA will require ADIs to demonstrate that they have taken all reasonable steps towards meeting their LCR requirements through their own balance sheet management, before relying on the RBA facility.

Net Stable Funding Ratio

The NSFR requirement aims to strengthen the longer-term resilience of an ADI by requiring it to maintain a sustainable maturity structure of assets and liabilities on an ongoing basis. APRA proposes that scenario analysis ADIs be required to maintain an NSFR of no less than 100 per cent.

APRA is proposing to adopt the Basel III available stable funding and required stable funding factors in determining an ADI's NSFR. In addition, APRA is proposing to introduce a specific required stable funding factor for debt securities held by ADIs as collateral for their RBA facility. This approximates the factor that would apply were adequate supplies of HQLA available in Australia.

In line with the internationally agreed timetable, APRA intends to implement the LCR with effect from 1 January 2015 and the NSFR from 1 January 2018. The period from December 2010 to these respective implementation dates is deemed by the Basel Committee as an 'observation period'.

Quantitative requirements: minimum liquidity holdings ADIs

APRA currently exempts ADIs with simple, retail-based business models from scenario analysis and instead imposes a simple quantitative liquidity ratio requirement, the minimum liquidity holdings (MLH) regime. APRA indicated in its 2009 discussion paper that the MLH regime is working effectively in delivering an appropriate degree of resilience for these ADIs. Accordingly, APRA does not propose to apply either of the Basel III quantitative requirements to MLH ADIs and proposes leaving the MLH regime broadly unchanged.

However, APRA is proposing to update the assets that are eligible for inclusion in an ADI's minimum liquidity holdings to reflect market developments since the MLH regime's inception in 1998 and to ensure consistency with the Basel Committee's *Sound Principles*. APRA proposes to limit holdings of assets with lower credit ratings to no more than 20 per cent of an ADI's minimum liquidity holdings and to exclude holdings of residential mortgage-backed securities (RMBS) and asset-backed securities (ABS).

In the 2009 discussion paper, APRA proposed to extend the requirement for a 'going-concern' cash-flow projection to all ADIs and to lengthen the projection period. Accordingly, APRA is proposing to require MLH ADIs to undertake 'going concern' cash-flow projections and to lengthen the projection period to at least 15 months.

Reporting requirements

APRA proposed in the 2009 discussion paper to introduce a standardised reporting framework for liquidity data. APRA remains of the view that such reporting is necessary from prudential and financial stability perspectives.

APRA is proposing to require scenario analysis ADIs to provide monthly LCR data that is sufficiently detailed to allow the calculation of the LCR in all material currencies. APRA is also proposing that NSFR data be provided on a quarterly basis. APRA may request an ADI to provide the reports on a more frequent basis, as necessary. All ADIs will be required to provide data to APRA for the 'going concern' cash flow projection; this will be required on a monthly basis from scenario analysis ADIs and quarterly from MLH ADIs. APRA is also proposing that MLH ADIs continue their current reporting on their holdings of eligible MLH assets.

Formal reporting requirements (a reporting standard, instructions and forms) will be subject to industry consultation in 2012. Formal reporting of the LCR and NSFR will commence on implementation of these quantitative requirements. From January 2012 until the respective implementation dates, APRA is proposing to require scenario analysis ADIs to submit an LCR and NSFR report on a 'best endeavours' basis, as part of observation period monitoring.

Prudential disclosure

APRA is proposing to introduce a prudential requirement to give effect to Principle 13 of the *Sound Principles* on public disclosure. APRA proposes to amend *Prudential Standard APS 330 Capital Adequacy: Public Disclosure of Prudential Information* (APS 330) to require key qualitative and quantitative liquidity information to be disclosed on a semi-annual basis.

Consultation and implementation

APRA invites written submissions on its proposals to implement the Basel III liquidity reforms in Australia. It encourages all interested stakeholders to use this consultation opportunity to advise it of any implementation issues and to submit relevant cost-benefit analysis information.

Following consideration of submissions received and subject to any refinements to the Basel III liquidity framework, APRA intends to issue the final APS 210 in mid-2012. The qualitative and reporting requirements, and changes to MLH requirements, will be implemented in late 2012 or early 2013 after the final APS 210 is released. The LCR and NSFR requirements will be implemented on the internationally agreed timetable (as above).

During the observation period, the Basel Committee will monitor the implications of the LCR and NSFR for financial markets, credit extension and economic growth, addressing unintended consequences as necessary. The Basel Committee has indicated that any revisions to specific components of these new global standards as a result of the observation period assessment will be made, at the latest, by mid-2013 for the LCR and mid-2016 for the NSFR. APRA will review its proposed prudential framework for ADI liquidity risk management should any such revisions be made.

Chapter 1 – Introduction

1.1 Overview

In its December 2010 document *Basel III – A global regulatory framework for more resilient banks and banking systems*, the Basel Committee released a package of reforms to strengthen global capital and liquidity regulations with the goal of promoting a more resilient banking sector.[1] The Basel Committee's liquidity reforms are set out in detail in a separate document *Basel III – International framework for liquidity risk measurement, standards and monitoring*.[2]

In a letter to ADIs on 17 December 2010[3], APRA expressed its full support for the Basel III reforms and indicated its intention to consult on them in 2011 and 2012. This discussion paper relates only to the Basel III liquidity reforms; other reform measures are the subject of separate consultations.

APRA proposes to introduce the Basel III liquidity reforms with only minor modifications. These modifications relate to items where national supervisory discretion is specifically allowed or where clarification is required for Australian circumstances.

This discussion paper outlines APRA's proposed changes to its current liquidity risk management requirements. These proposals build upon the proposals set out in APRA's September 2009 discussion paper *APRA's prudential approach to ADI liquidity risk*[4] (the 2009 discussion paper), which have been revised to align with the Basel III reforms. Released with this discussion paper is a draft of a revised *Prudential Standard APS 210 Liquidity* (APS 210).

The Basel III liquidity reforms involve both qualitative and quantitative requirements. The qualitative requirements are based on the *Basel Committee's September 2008 document Principles for Sound Liquidity Risk Management and Supervision* (*Sound Principles*)[5], which reflected financial market developments and lessons learned from the market turmoil experienced from mid-2007. The document provides detailed guidance on the prudent management of liquidity risk. All ADIs will be subject to the qualitative requirements of the *Sound Principles*.

To complement the *Sound Principles*, the Basel Committee has developed two new minimum global liquidity standards:

- a Liquidity Coverage Ratio (LCR) requirement that aims to ensure that banking institutions have sufficient high-quality liquid assets to survive an acute stress scenario lasting for one month; and
- a Net Stable Funding Ratio (NSFR) requirement that aims to promote longer-term resilience by requiring banking institutions to fund their activities with more stable sources of funding on an ongoing basis.

These two quantitative global minimum standards are intended to apply to internationally active banks. In Australia, ADIs that are currently required to conduct scenario analysis of their liquidity needs under different operating circumstances will be subject to these quantitative requirements. In line with the internationally agreed timetable, APRA intends to implement the LCR with effect from 1 January 2015 and the NSFR from 1 January 2018. The period from December 2010 to these respective implementation dates is deemed by the Basel Committee as an 'observation period'.

1 www.bis.org/bcbs/basel3.htm
2 www.bis.org/publ/bcbs188.htm
3 www.apra.gov.au/adi/Publications/Documents/20101217-Ltr-to-all-ADIs-re-Basel-III-package.pdf
4 www.apra.gov.au/Policy/Pages/enhancing-prudential-framework-for-adi-liquidity-risk-management.aspx
5 www.bis.org/publ/bcbs144.htm

However, APRA does not intend to apply these quantitative requirements to ADIs that are currently subject to a simple metric, the minimum liquidity holdings (MLH) regime. In APRA's view, the MLH regime is working effectively in delivering an appropriate degree of resilience for ADIs with simple, retail-based business models. Accordingly, APRA intends to retain the current approach for these ADIs, with only minor modifications.

APRA anticipates that, following consideration of submissions received on this consultation package, it will publish a final APS 210 in 2012 that will give effect to the Basel III liquidity reforms in Australia.

1.2 Structure of the paper

Chapter 2 summarises the qualitative requirements for liquidity risk management that APRA is proposing to adopt in line with the Basel Committee's *Sound Principles*.

Chapter 3 outlines APRA's quantitative requirements for scenario analysis ADIs and Chapters 4 and 5 provide more detail on the LCR and NSFR requirements, respectively. Chapter 4 also discusses the eligibility for and use of the secured committed liquidity facility with the RBA.

Chapter 6 summarises the MLH regime and the proposed adjustments to the list of assets eligible to be included in an ADI's minimum liquidity holdings. Chapter 7 addresses reporting obligations for all ADIs while Chapter 8 outlines the proposed disclosure obligations. Chapter 9 outlines the proposed implementation timetable.

APRA encourages ADIs to submit cost-benefit analysis as set out in Chapter 10.

Chapter 2 – Qualitative requirements

In its 2009 discussion paper, APRA noted that whilst the qualitative requirements of APS 210 in respect of an ADI's liquidity risk measurement and management systems remained broadly appropriate, the Basel Committee's *Sound Principles* had identified additional matters to be covered. APRA proposed that the qualitative requirements of APS 210 be expanded to reflect these additional matters. APRA remains of the view that this is an appropriate step and the draft APS 210 incorporates the *Sound Principles* along with proposed APRA-specific requirements. The proposed requirements are substantially unchanged from the 2009 discussion paper. This chapter sets out APRA's qualitative requirements for ADIs.

APRA will take a risk-based approach in assessing compliance with these requirements, with due regard to the size and complexity of each ADI. In particular, ADIs with a material reliance on funding sourced from foreign markets will need to articulate their risk tolerance and liquidity management strategy, as it relates to foreign funding, in their liquidity risk management framework.

2.1 Governance

Consistent with APRA's general approach (and the current APS 210), APRA views liquidity risk management as ultimately a Board responsibility. APRA is proposing that APS 210 be strengthened to require:

- the operational independence of a liquidity risk management oversight function, with the skills and seniority to challenge liquidity management practices when appropriate; and
- a formal role for internal audit or an equivalent independent function in relation to liquidity risk management.

These requirements will be similar to those in place for the management of credit, market and operational risk.

2.2 Risk tolerance

As foreshadowed in the 2009 discussion paper, APRA proposes to introduce a requirement that the Board articulate its tolerance for liquidity risk.

APRA would expect the risk tolerance statement to be explicit, comprehensive, meaningful (in terms of outcomes), designed with the particular vulnerabilities of the ADI in mind and subject to sensitivity analysis. In its ongoing supervisory activities, APRA will assess not only how risk tolerance is articulated but also the actual level of liquidity risk. As with other risk types, APRA will take appropriate steps where it believes that liquidity risk is inappropriately managed.

APRA does not propose to specify how the Board's risk tolerance should be described but will instead offer guidance via a prudential practice guide (PPG). That guidance will address:

- the importance of stress-testing for understanding, quantifying and limiting liquidity risk in large, complex ADIs. The Board could express its risk tolerance in terms of minimum survival horizons (without extraordinary central bank intervention) under a range of severe but plausible stress scenarios, chosen to reflect the particular vulnerabilities of the ADI. Key assumptions should be transparent to the Board, including the sensitivity of the modelled survival horizons to changes in those key assumptions; and
- APRA's expectation that the statement of risk tolerance, particularly for a large, complex ADI, would endorse a structure of explicit quantitative controls in the liquidity management framework. Such controls would apply to:
  - the quality and diversification (e.g. by instrument and counterparty) of liquid asset portfolios;
  - liability diversification (e.g. by domestic/foreign, market, product, counterparty and maturity);

- reliance on funding sourced from offshore markets;
- the overall level of maturity mismatch;
- the management of liquidity risk across borders and legal entities;
- currency mismatch, including cashflow mismatches arising from the use of derivatives associated with funding sourced from offshore markets; and
- contingent liquidity exposures.

2.3 Internal transfer pricing

APRA is proposing that ADIs must have a process that explicitly quantifies liquidity costs and benefits and allocates those costs and benefits to the appropriate business and product. The goal is to ensure alignment of business and individual incentives with the Board-approved risk tolerance. ADIs must have the ability to estimate the profit or loss outcome related to the liquidity risk accepted and to attribute that profit or loss to its various strategic and tactical drivers.

APRA expects that the process for internal transfer pricing adopted by an ADI will be commensurate with the size and complexity of the ADI.

2.4 Funding strategy

APRA is proposing to elevate its current supervisory expectation that ADIs have a formal, documented funding strategy (approved by the Board) to a prudential requirement, consistent with the *Sound Principles* (Principle 7).

2.5 Contingency funding plans

One lesson from the global financial crisis is that retail run management is an important component of an effective contingency funding plan. APRA proposes that an ADI with retail deposits must have in place a retail run plan that would focus on paying out customers as soon as feasible. APRA proposes that an ADI's retail run contingency plan will include (at a minimum):

- cash distribution arrangements;
- procedures to ensure non-branch distribution channels (e.g. ATMs, internet and phone banking) continue to function in the face of a sudden surge in transaction volumes;
- co-operative arrangements with other ADIs for cash and customer service; and
- an extensive communication plan for customers, key counterparties, staff, regulators, media and other parties (e.g. Australian Securities Exchange for listed entities, foreign regulators, etc).

APRA does not propose a standard retail run plan; however, plans based upon restricting customer access to funds during a run would not be acceptable.

The Australian Payments Clearing Association (APCA) has provided guidance to its membership on the subject of retail run management. APRA considers this to be a valuable resource for all ADIs. Smaller ADIs that are not members of APCA may access this guidance ('Code of Conduct – Retail Run') through their affiliation with Australian Settlements Limited, Cuscal Limited or Indue Ltd.

Chapter 3 – Quantitative requirements for scenario analysis ADIs

Currently, APS 210 requires the larger and more complex ADIs to conduct their own scenario analysis to ensure that they can operate under a wide range of operating conditions. At a minimum, scenario analysis ADIs must provide information to APRA on a one-month 'going concern' scenario and a five-day 'name crisis' scenario.

In its 2009 discussion paper, APRA proposed to extend the 'going concern' scenario to cover a 12-month period, extend the 'name crisis' scenario to a 20 business day period and introduce a 'market disruption' scenario lasting a period of three months. APRA now proposes to align the minimum requirements for scenario analysis ADIs with the Basel III global minimum liquidity standards.

The new LCR requirement is based on a combined idiosyncratic and market disruption scenario (see Chapter 4). Therefore, APRA proposes that, once the LCR comes into effect in Australia, the 'name crisis' scenario will cease to be a minimum requirement. Additionally, APRA no longer proposes to introduce the three-month 'market disruption' scenario.

The objective of the 'going concern' scenario is to ensure that ADIs forecast future funding needs and develop tactical and strategic plans to meet those needs. The current APS 210 focus on a one-month horizon is not consistent with that objective and, in the 2009 discussion paper, APRA proposed extending the 'going concern' scenario to 12 months and applying it to all ADIs. As a pragmatic matter, APRA is now proposing that the 'going concern' scenario have a 15-month focus.

Chapter 4 – Liquidity Coverage Ratio

The LCR requirement is intended to promote the short-term resilience of a banking institution's liquidity risk profile. The LCR involves a stress scenario that combines an idiosyncratic and a market-wide stress situation. As noted, APRA proposes to apply the LCR requirement to ADIs that are currently subject to the scenario analysis approach under APS 210. Scenario analysis ADIs generally have a more diversified business mix with greater reliance on wholesale funding than ADIs that operate mainly in retail markets.

APRA is proposing to introduce the LCR requirement with effect from 1 January 2015, in line with the internationally agreed timetable. Ahead of that date, APRA will be encouraging ADIs to manage their liquidity with a view to ensuring continuous progress towards compliance with the requirement.

APRA proposes that the LCR requirement be met by a scenario analysis ADI on both a Level 1 and Level 2 consolidated banking group basis, as defined in *Prudential Standard APS 110 Capital Adequacy* (APS 110). At Level 2, an ADI will be required to demonstrate that the consolidated banking group has sufficient liquid assets to meet the stress scenario, having regard to any constraints on the free flow of funds within the group.

4.1 Definition of the LCR

The LCR requirement aims to ensure ADIs maintain an adequate level of unencumbered, high-quality liquid assets (HQLA) that can be readily converted into cash to meet its liquidity needs for a 30-day period under a significantly severe liquidity stress scenario. Under the LCR, ADIs need to maintain a stock of qualifying HQLA to cover total net cash outflows over the next 30 calendar days. The LCR must be no less than 100 per cent and APRA would expect ADIs to maintain an adequate buffer above the minimum requirement. The buffer should be commensurate with the ADI's liquidity risk appetite and strategy.

Under the Basel III reforms, ADIs are expected to meet the LCR requirement continuously. That said, APRA acknowledges that HQLA are held for use in times of acute liquidity stress. APRA expects to be notified by an ADI as soon as practicable should the ADI determine that it will or may breach its LCR requirement. APRA will consider the need to take supervisory action in the event that the ADI's management is not actively and appropriately managing the liquidity stress in a way that would resolve its liquidity position in a timely manner and to APRA's satisfaction.

The LCR has two components:

- the value of the stock of HQLA in stressed conditions; and
- total net cash outflows, calculated according to specified scenario parameters.

APRA will adopt the Basel III definitions for qualifying HQLA. It will also adopt the Basel III net cashflow assumptions, except for certain cashflow items where APRA proposes to exercise its national discretion or where clarification is required for Australian circumstances. The specific items involve:

- the treatment of self-managed superannuation funds (SMSFs) as retail customers;
- an additional retail deposit category for high run-off less stable deposits;
- run-off rates for various contingent funding obligations;
- recognition of head office liquidity support for foreign bank branches in Australia under certain circumstances; and
- recognition of New Zealand dollar liquid assets nominated by the Reserve Bank of New Zealand.

4.2 High-quality liquid assets

Under Basel III, assets qualifying as HQLA for LCR purposes must be unencumbered, easily and immediately converted into cash with little or no loss of value under stressed market conditions and, ideally, be eligible for repurchase agreements with the central bank. HQLA are categorised into two buckets based on the liquidity characteristics of the assets[6].

The highest quality liquid assets, which APRA will refer to as HQLA1, can comprise an unlimited portion of the total stock of HQLA. These assets are limited to:

- cash;
- central bank reserves (to the extent that these reserves can be drawn down in times of stress); and
- marketable securities representing claims on or claims guaranteed by sovereigns, quasi-sovereigns, central banks and multilateral development banks, which have undoubted liquidity, even during stressed market conditions, and which are assigned a zero risk-weight under the Basel II standardised approach to credit risk.[7]

HQLA2 are assets with a proven record as a reliable source of liquidity even during stressed market conditions, and comprise:

- marketable securities representing claims on or by sovereigns, quasi-sovereigns, central banks and multilateral development banks, which are assigned a 20 per cent risk-weight under the Basel II standardised approach;
- corporate bonds (not issued by a financial institution or any of its affiliated entities) with a credit rating from a recognised external credit assessment institution of at least AA-; and
- covered bonds (not issued by the ADI itself or any of its affiliated entities) with a credit rating of at least AA-.

HQLA2 are limited to 40 per cent of the total stock of HQLA and attract a minimum 15 per cent haircut.

Following a review of a range of marketable instruments denominated in Australian dollars (AUD) against the Basel III criteria for HQLA, APRA advised[8] that:

- the only assets that qualify for HQLA1 are cash, balances held with the RBA, and Commonwealth Government and semi-government securities; and
- there are no assets that qualify as HQLA2.

APRA will keep this position under review, taking into account relevant market developments.

APRA proposes that the stock of HQLA must meet the operational requirements of Basel III. This includes the sole purpose test that requires HQLA to be managed as a separate asset pool for the sole intention of using the assets as a source of contingent funds for the ADI's liquidity requirements. The assets will also need to be managed and controlled by the specific function that is delegated to manage the ADI's liquidity risk.

4.3 Alternative liquid asset – RBA facility

In recognition of jurisdictions with insufficient supply of HQLA, the Basel III liquidity framework incorporates scope for alternative treatments for the holding of HQLA. One alternative treatment is to allow banking institutions to establish contractual committed liquidity facilities provided by their central bank, subject to an appropriate fee, with such facilities counting towards the LCR requirement.

6 Basel III refers to Level 1 and Level 2 HQLA. However, APRA will use the terms 'HQLA1' and 'HQLA2' to avoid any confusion with the terms 'Level 1' and 'Level 2', which have a defined meaning in APRA's capital adequacy requirements.

7 *International Convergence of Capital Measurement and Capital Standards: A Revised Framework, Comprehensive Version* (Basel II Framework) found at www.bis.org/publ/bcbs128.htm

8 See Media Release APRA clarifies implementation of global liquidity standards in Australia (28 February 2011) at www.apra.gov.au/MediaReleases/Pages/11_03.aspx

As the current supply of HQLA in Australia is not adequate to satisfy ADIs' LCR requirements, APRA and the RBA announced in December 2010[9] that an ADI will be able to establish a secured committed liquidity facility (CLF) with the RBA for the purposes of meeting its LCR requirement in Australian dollars. The CLF will be sufficient in size to cover any shortfall between the ADI's holdings of HQLA and its LCR needs (both in Australian dollars). Qualifying collateral for the facility will comprise all assets eligible for repurchase transactions with the RBA under normal market operations and other assets the RBA deems appropriate. Collateral under the CLF must also satisfy the operational requirements outlined in section 4.2 above. In return for the committed facility, the RBA will charge a market-based commitment fee.

In its Media Release of 16 November 2011[10], the RBA has confirmed that this fee has been set at 0.15 per cent per annum, and may be varied at any time by the RBA on giving three months notice. The RBA has also announced that self-securitisation will be allowed to form part of the collateral for an ADI's CLF. The inclusion of self-securitisation 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.

ADIs will be required to demonstrate that they have taken all reasonable steps towards meeting their LCR requirements through their own balance sheet management, before relying on the CLF. APRA will be reviewing each ADI's liquidity risk management framework and management practices as the basis for approving the CLF for LCR purposes. APRA will provide more information on this proposed review process in the draft PPG 210, to be released for consultation in 2012. At a minimum, ADIs will need to demonstrate that they have increased the duration of their liabilities and maximised reliance on stable sources of funding to the greatest reasonable extent. In addition, APRA will have regard to the composition of assets held as collateral for the CLF and proposes that these assets should be diversified in terms of type of instrument and type of issuer.

The amount of the CLF that may be included towards the LCR requirement will be the lower of the contractual limit of the facility or the market value of collateral held by the ADI for the CLF, after applicable RBA haircuts.

APRA expects that, where an ADI has only a minor LCR shortfall without a CLF, the ADI will manage its liquidity requirements on its own resources, rather than relying on a CLF.

If an ADI operates in a foreign jurisdiction where supervisors allow a similar facility or another alternative treatment, APRA is likely to recognise this in the ADI's LCR requirement at Level 2.

As part of the consultation process, APRA seeks feedback as to the steps ADIs can reasonably take to reduce reliance on the CLF, what market developments would be required and what ADIs and other market participants can do to encourage those developments. This involves separate consideration of the development of additional HQLA in the Australian debt markets and of how to reduce LCR net cash outflows.

9 See joint Media Release Australian implementation of global liquidity standards (17 December 2010) at www.apra.gov.au/MediaReleases/Pages/10_27.aspx.

10 www.rba.gov.au/media-releases/2011/mr-11-25.html

4.4 Net cash outflows

The second component in the determination of the LCR requires ADIs to calculate their total net cash outflows over the next 30 calendar days. Basel III provides many of the cashflow assumptions to be used for this purpose and APRA proposes to adopt these assumptions, except for the minor modifications or clarifications noted above.

The Basel III cashflow assumptions are based on the behaviour, during a stressed period, of the counterparties providing funding to the ADI and of those to which the ADI provides facilities (either credit, liquidity or contingency).

4.4.1 Cash outflows

Retail and qualifying small and medium enterprises (SME) deposit run-off

Retail deposits are considered to be the most stable sources of funding. Basel III defines retail deposits as demand and term deposits placed by natural persons. APRA will be adopting this definition of a retail counterparty.

For LCR purposes, Basel III allows non-financial SME customers to be treated in the same way as retail counterparties in relation to deposit run-off. Non-financial SMEs are defined by Basel III as those customers that are managed as retail exposures and are generally considered as having similar liquidity risk characteristics to retail counterparties. Furthermore, the aggregate funding from one SME customer should be less than EUR 1 million.

APRA proposes to adopt the Basel III definition for non-financial SMEs. The volume threshold for aggregate deposits is proposed to be set at AUD 2 million, reflecting the longterm average EUR/AUD exchange rate. An SME with aggregate deposits with an ADI above this threshold is to be treated under the wholesale category.

APRA recognises that there are some deposits that are acquired by an ADI through an intermediary but can be retail in nature where the natural person retains control. Subject to meeting certain conditions, as outlined in draft APS 210, ADIs can treat these deposits as retail for determining cash outflows under the LCR scenario.

APRA also recognises that Australia is a nation with very high participation in superannuation. Although managing one's own retirement savings is not a phenomenon unique to Australia, managing these investments through a self-managed trust is unusual internationally. Given the current legislative requirements for self-managed superannuation funds (SMSFs), particularly in respect to the very limited number of members allowed, APRA proposes to allow the inclusion of SMSF deposits as retail deposits. However, as SMSFs are considered to be operated by sophisticated investors, APRA envisages that the appropriate run-off assumption for SMSF deposits will fall within one of the less stable retail deposit run-off categories, outlined below.

APRA proposes that, consistent with Basel III, retail and qualifying SME deposit run-off assumptions will be categorised as 'stable' deposits, 'less stable' deposits or 'higher run-off less stable' deposits. APRA proposes that ADIs be required to analyse their deposit portfolios to ascertain into which run-off category deposits fall.

Stable deposits are those where withdrawal is highly unlikely, the deposit meets the criteria of being fully covered under a government deposit guarantee scheme and the customer has an established relationship with the ADI or the deposit is in a transactional account. In line with Basel III, APRA proposes that a run-off factor of five per cent be applied to stable deposits.

Basel III states that supervisory authorities are expected to develop additional buckets with higher run-off rates to apply to less stable deposits, with a minimum run-off factor of 10 per cent. Less stable deposits are those that are more likely to be withdrawn during times of stress and do not meet the stable deposit criteria. The four main characteristics of such deposits are that they are high-value (i.e. the deposit amount is higher than the government deposit guarantee threshold), are from customers who do not have other established relationships with the ADI that would make deposit withdrawal less likely, can be accessed primarily through the internet, and have promotional interest rates.

APRA proposes two higher run-off categories for less stable deposits with run-off rates of 10 per cent and 30 per cent, respectively. The 30 per cent assumption for the higher run-off less stable deposits is considered appropriate based on data reviewed by APRA covering actual deposit loss events in recent years in a number of jurisdictions.

In determining whether a less stable deposit would attract a 10 per cent or 30 per cent run-off factor, APRA proposes to adopt a simple scorecard approach. Under this approach, each of the four characteristics of less stable deposits noted above, if present, is assigned a value of one or two; if the deposit has a total value of three or more, the 30 per cent run-off is applied. This is outlined in Appendix A of draft APS 210. Draft PPG 210 will provide further details about APRA's expectations for the characteristics of stable and less stable deposits.

In summary, APRA proposes the following run-off factors for retail and qualifying SME deposits:

- five per cent for stable deposits (as per the minimum run-off factor prescribed by Basel III);
- 10 per cent for less stable deposits (as per the minimum run-off factor prescribed by Basel III); and
- 30 per cent for higher run-off less stable deposits.

Basel III allows fixed-term deposits with a residual maturity date beyond 30 days to be excluded from an ADI's cash outflow if the depositor has no legal right to withdraw the deposit within 30 days, or if early withdrawal results in a significant penalty that is materially greater than the loss of interest. If a category of term deposits does not meet these conditions, that entire category is to be treated as demand deposits and included in the categories of stable, less stable or higher run-off less stable deposits.

APRA recognises that there will be situations where early withdrawal is allowed if the depositor is experiencing hardship. In this instance, APRA does not propose that early withdrawal will result in the ADI being required to treat the whole term deposit category as demand deposits.

APRA notes that it is currently common practice for ADIs to allow fixed-term deposits to be withdrawn prior to maturity without a significant penalty. Under the Basel III liquidity framework, such deposits would be treated as demand deposits. The Australian Securities and Investments Commission (ASIC) has recently released a consultation paper *Term deposits that are only breakable on 31 days' notice: Proposals for relief*[11] that may alter ADI practices in this area. APRA's proposed application of the Basel III criteria for fixed-term deposits will be reviewed, if necessary, following the outcome of ASIC's consultation.

11 www.asic.gov.au/asic/asic.nsf/byHeadline/11-240AD%20ASIC%20consults%20on%20term%20deposits%20relief?opendocument

Unsecured wholesale funding run-off

Basel III defines a wholesale counterparty as a non-natural person, i.e. legal entities (including sole proprietorships and partnerships). APRA proposes to adopt this definition for a wholesale counterparty and the respective run-off assumptions prescribed in Basel III. The run-off assumptions for unsecured funding from wholesale counterparties, including deposits, are:

- five per cent for deposits from non-financial corporations, sovereigns, central banks and public sector entities with operational relationships and where the deposit is fully covered by a government deposit guarantee scheme;
- 25 per cent for deposits from wholesale counterparties where the counterparty has an operational relationship with the ADI;
- 75 per cent for unsecured wholesale funding from non-financial corporations, sovereigns, central banks and public sector entities; and
- 100 per cent for unsecured wholesale funding from other legal entities not included in the 75 per cent bucket.

Wholesale deposits that can be categorised as operational relationships are limited to customers that have a proven clearing, custody or cash management relationship with the ADI.

Non-financial corporations are not defined in Basel III. APRA proposes that a non-financial corporation is a corporation or other legal entity that is not a financial institution. The proposed definition of a financial institution is discussed in the following section.

Unsecured financial institution funding run-off

Financial institutions are not defined by Basel III. APRA proposes the following definition in draft APS 210:

> 'An entity that provides financial services involving the independent management of money for clients or members. This includes banks, building societies, credit unions, money market corporations, finance companies, securitisers, life insurance, general insurance, superannuation/pension funds, public unit trusts/mutual funds, cash management trusts, health insurance funds, private investment funds, hedge funds, common funds, friendly societies and prime brokers.'

The underlying principle reflected in this definition is the distinction between professionally managed money and funds managed by their owner. In APRA's view, a financial institution can be considered to be an institution that manages money on behalf of its customers and provides a financial service.

Unsecured funding from financial institutions will attract the 100 per cent run-off factor that applies to unsecured wholesale funding from other legal entities.

Secured wholesale funding run-off

Basel III distinguishes between secured and unsecured funding from wholesale counterparties, given that the likelihood of the loss of funding during times of stress is dependent on whether the funding is secured. Furthermore, the loss of a secured funding source is largely dependent on the underlying security provided by the ADI. Basel III provides cash outflow assumptions, relating to maturing secured funding, that vary depending on the underlying security. APRA is proposing to adopt these cash outflow assumptions.

Secured funding where the security provided is regarded as HQLA is considered to be reliable and the run-off assumptions for transactions where the ADI provides HQLA as collateral therefore involve a lower run-off rate. Higher run-off rates are applied where the collateral provided is not HQLA.

Basel III includes a category for maturing secured funding transactions with central banks, with a 25 per cent cash outflow. Given the introduction of the CLF, APRA's view is that this category is not required for the implementation of Basel III in Australia.

The proposed run-off assumptions for maturing secured funding transactions are:

- zero per cent if the transaction is secured by HQLA1;
- 15 per cent if the transaction is secured by HQLA2; and
- 100 per cent if the transaction is secured by other assets.

Other liabilities

Basel III identifies specific cash outflow assumptions for other liabilities, committed credit and liquidity facilities provided to the ADI's customers, and items where increased liquidity needs are likely to be required under the LCR scenario. APRA is proposing to adopt these assumptions.

Other contingent funding obligations

As the LCR scenario represents both an idiosyncratic and market-wide stress situation, APRA considers that it is appropriate to include contingent funding liabilities where the ADI may need to honour contractual or non-contractual obligations and potentially buy back its debt.

Basel III leaves to national discretion the run-off assumptions to be applied to contingent funding obligations that are not committed credit and liquidity facilities. APRA proposes to require ADIs to include the following contingent obligations as a cash outflow:

- buyback of debt securities;
- unconditionally revocable uncommitted credit and liquidity facilities;
- trade finance facilities;
- structured products;
- managed funds;
- issuers with an affiliated dealer or market maker; and
- market valuation changes on derivative transactions.

Each of these categories, and the proposed run-off assumptions to be applied, is discussed below. APRA invites submissions, supported by appropriate data, on these run-off assumptions.

- Buyback of debt securities. It is common practice for ADIs to make a market in their own debt securities and some level of buyback activity is normal as investors adjust their holdings to manage their own cash flows. APRA's concern is that, if an ADI comes under stress, buyback requests will increase significantly and it may be impossible for the ADI to refuse, since to do so could heighten market concerns. APRA understands that ADIs are under no contractual obligation to accede to these buyback requests but notes that significant buyback activity did occur during the global financial crisis. Accordingly, APRA intends to specify a buyback assumption of 10 per cent of short-term debt securities and five per cent of long-term debt securities issued in the domestic Australian market. APRA may allow an ADI to adopt a lower assumption if it can demonstrate to APRA's satisfaction that it has formal procedures and policies and established practices that effectively limit buyback activity in both normal and stressed conditions.

- **Unconditionally revocable uncommitted credit and liquidity facilities.** APRA recognises that some credit facilities, whilst being legally revocable, are highly likely to remain available to customers in a similar fashion to committed facilities. However, potential drawdown under some other uncommitted credit facilities may be dependent on other factors such as the ADI's chosen support for a given counterparty. As such, APRA proposes that the same cash outflow assumption as for committed facilities be utilised (five per cent for retail customers, 10 per cent for non-financial wholesale counterparties and 100 per cent for financial institutions). APRA invites responses on alternative treatments that may achieve the desired outcome of differentiating facilities that are expected to operate in a similar manner to committed facilities from those where a contingent activity is required to trigger any drawdown.
- **Trade finance.** Traditional trade finance facilities such as letters of credit and guarantees are recognised as being contingent on commercial trade and as such may be less likely to be drawn upon compared to other credit facilities. As such, APRA proposes that ADIs include a cash outflow in the LCR based on actual monthly experience based on analysis of 12 months of data, to be updated on at least an annual basis.
- **Structured products, managed funds (that are marketed with the objective of maintaining a stable value) and other non-contractual obligations.** For any facilities and products that fall into this category, APRA proposes that a minimum cash outflow rate of five per cent of the total exposure be applied.
- **Issuers with an affiliated dealer or market-maker.** APRA proposes that the cash outflow for outstanding debt securities with a maturity of more than 30 calendar days, where the ADI issues to an affiliated dealer or is a market-maker, be set where relevant on a case-by-case basis in consultation with APRA.
- **Market valuation changes on derivative transactions.** As market practice requires full collateralisation of mark-to-market exposures on derivative and other transactions, an ADI can potentially have substantial liquidity risk exposures to these valuation changes. As part of the LCR scenario, APRA proposes that ADIs must model a cash outflow against these positions. In order to identify the quantum of the valuation change, APRA proposes to utilise the market risk stress scenarios outlined in *Reporting Standard ARS 116.0 Market Risk*.

4.4.2 Cash inflows

Basel III caps the amount of cash inflows for the LCR scenario to a maximum of 75 per cent of the total expected cash outflows. The cap is to ensure ADIs maintain a minimum level of HQLA and do not rely solely on expected cash inflows to meet their liquidity needs and the LCR requirement. APRA proposes to follow this principle and the cash inflow assumptions, which are mainly based on contractual inflows, as set out below.

Retail and SME customer inflows

APRA proposes to include cash inflows from all fully performing facilities provided to retail and SME customers at 50 per cent of the contractual inflows due to the ADI. The 50 per cent inflow rate is based on the assumption that ADIs will continue their lending to retail and SME customers.

The contractual inflows include principal repayments and interest payments. Facilities that are non-performing are not proposed for inclusion as a cash inflow item.

Wholesale inflows

APRA proposes to include cash inflows from all fully performing facilities to financial institutions at 100 per cent of the contractual inflow amount. The LCR scenario assumes that in times of stress ADIs are unlikely to extend funding to financial institutions.

Cash inflows from all fully performing facilities to wholesale institutions that are not financial institutions are to be included at 50 per cent of the contractual inflow amount. This rate is based on the assumption that ADIs will continue their lending to wholesale institutions that are not financial institutions.

APRA proposes a zero per cent inflow rate for amounts that are operational deposits of the ADI and held with other financial institutions. Operational deposits of the ADI are considered to remain with the institution where the deposit is held, given the purpose of the deposit is to continue the ADI's operations.

Similar to the retail and SME inflow assumption, facilities that are non-performing are not proposed for inclusion as a cash inflow item.

Reverse repurchase agreements and securities borrowing

Similar to the cash outflows assumption for secured funding, Basel III recognises that the cash inflow from an ADI's secured borrowing agreements and reverse repurchase agreements depends on the security being held by the ADI. The cash inflow rates proposed for maturing reverse repurchase agreements and secured borrowings are:

- zero per cent if the transaction is secured by HQLA1;
- 15 per cent if the transaction is secured by HQLA2; and
- 100 per cent if the transaction is secured by other assets.

However, if the ADI uses the collateral that it obtained under a reverse repurchase agreement or secured borrowing to cover other positions, the cash inflow rate to be applied is zero per cent.

Lines of credit

No inflow is to be recognised from any credit, liquidity or other contingent funding facilities that the ADI holds with other institutions. In times of stress, it has been observed that funding and liquidity support from other institutions may cease. Other institutions tend to reserve their own liquidity or may not able to honour their commitments.

Where an ADI operates in Australia as a foreign bank branch, APRA may consider recognising a committed funding line from its head office. This is discussed further below.

Other contractual inflows

APRA proposes that derivative receivable amounts that are assured to be received by the ADI be included at 100 per cent of the net receivable amount. That is, the amount is to be reported on a net basis in accordance with the netting requirements outlined in Attachment I of *Prudential Standard APS 112 Capital Adequacy: Standardised approach to credit risk* (APS 112). The inflow amount to be included is proposed to be net of HQLA collateral, if the collateral is already included as HQLA. If the net cashflow amount is a payable item, it is proposed that the net derivative payable be included as a cash outflow.

4.5 The LCR and currency mismatches

APRA proposes that ADIs be able to meet their liquidity needs in each material currency and maintain high-quality liquid assets consistent with the distribution of their liquidity needs by currency.

As noted in Chapter 2, APRA is proposing that ADIs must specifically address currency mismatches in their Board-approved statement of liquidity risk tolerance.

APRA's preference is to apply a quantitative requirement to currency mismatches in the LCR but acknowledges some practical difficulties in doing so. The considerable range of activities undertaken by ADIs and variations in the size of LCR requirements create difficulties in arriving at a single quantitative metric. APRA invites submissions on the feasibility and practical application of quantitative thresholds that could be applied to currency mismatches within the LCR.

4.6 Home/host liquidity requirements for the LCR

As noted earlier, the LCR requirement is to be met by ADIs on both a Level 1 and Level 2 consolidated banking group basis. In arriving at an ADI's Level 2 LCR, APRA proposes that the cashflow assumptions outlined in draft APS 210 will apply, subject to the following exceptions. As specified in the Basel III liquidity framework, the host jurisdiction cashflow treatment for retail and SME deposits will apply as this reflects the behaviour of local depositors. In addition, where the host regulator elects to use one of the alternative liquid assets treatments allowed by Basel III, APRA is likely to recognise this for the purposes of calculating the local currency LCR.

Where an ADI has a material banking subsidiary in a jurisdiction that does not implement the Basel III framework, APRA proposes to apply the cashflow assumptions as outlined in draft APS 210, including retail and SME deposit outflows. At this point in time, APRA envisages that this situation may arise only for ADIs' New Zealand banking subsidiaries. For the purposes of calculating the New Zealand dollar LCR, APRA is proposing to recognise the liquid assets contained in the Reserve Bank of New Zealand's *Liquidity Policy – Annex: Liquid Assets – Prudential Supervision Department Document BS13A*[12].

4.7 LCR requirement for foreign bank branches

APRA is proposing that foreign-owned ADIs in Australia that are subject to the scenario analysis approach will need to meet the new LCR and NSFR requirements on a stand-alone basis. However, APRA recognises that foreign bank branches may be subject to head office direction and strategy. APRA would also be substantially reliant on the home supervisor for oversight of the bank's liquidity position.

In arriving at a balanced approach for foreign bank branches, APRA is proposing to recognise a committed funding line from head office for inclusion in the branch's cash inflow from day 16 of the LCR scenario. This would require the branch to ensure that it can survive a minimum period of 15 days out of its own resources, to cater for the possibility of delays in the receipt of head office support. It is proposed that the degree of head office support allowed would be approved by APRA on a case-by-case basis, would need to be formal and quantified, and the head office would need to recognise its commitment to the branch as a cash outflow in its standalone liquidity reporting to its supervisor.

To avoid regulatory arbitrage, APRA does not propose to extend the recognition of head office support to foreign-owned ADIs that operate in Australia as both a subsidiary and a branch. A foreign bank subsidiary will need to meet the LCR and NSFR requirements on a stand-alone basis.

12 www.rbnz.govt.nz/finstab/banking/regulation/0094291.html

Chapter 5 – Net Stable Funding Ratio

The NSFR is intended to promote more medium and long-term funding of the assets and activities of banking institutions. The standard establishes a minimum acceptable amount of stable funding based on the liquidity characteristics of an institution's assets and activities over a one-year horizon. In particular, the requirement is structured to ensure that long-term assets are funded with at least a minimum amount of stable liabilities.

The NSFR is defined as the ratio of the amount of available stable funding (ASF) to the amount of required stable funding (RSF). The NSFR must be no less than 100 per cent. APRA is proposing to adopt the Basel III prescribed factors for ASF and RSF. One clarification is provided for Australian circumstances, viz., the treatment of assets held as collateral for the CLF.

APRA proposes that the NSFR become effective from 1 January 2018, in accordance with the internationally agreed timetable. APRA will be encouraging ADIs to manage their funding profiles with a view to ensuring continuous progress towards compliance with the NSFR by this date.

5.1 Available stable funding

Under the Basel III liquidity framework, stable funding is defined as the portion of those types and amounts of equity and liability financing expected to be reliable sources of funds over a one-year time horizon under conditions of extended stress.

The firm-specific stress scenario is one in which an ADI encounters, and investors and customers become aware of:

- a significant decline in profitability or solvency arising from heightened credit risk, market risk or operational risk and/or other risk exposures;
- a potential downgrade in a debt, counterparty credit or deposit rating by any nationally recognised credit rating organisation; and/or
- a material event that calls into question the reputation or credit quality of the institution.

The available amount of stable funding is calculated by first assigning the carrying value of an institution's equity and liabilities to one of five categories, as presented in Appendix 1. The amount assigned to each category is multiplied by an ASF factor and the total ASF is the sum of the weighted amounts.

5.2 Required stable funding

The amount of required stable funding is a function of the liquidity characteristics of various types of assets held, off-balance sheet contingent exposures incurred and/or the activities pursued by the ADI.

The RSF is calculated as the sum of the value of the assets held and funded by the ADI, multiplied by a specific RSF factor assigned to each particular asset type. The RSF factors represent the amount of each asset or item that should be supported by stable funding sources. Assets that are more liquid and more readily available to act as a source of extended liquidity in the stressed environment outlined above receive lower RSF factors than assets considered less liquid.

The RSF factors are parameters intended to approximate the amount of a particular asset that could not be monetised through sale or use as collateral in a secured borrowing on an extended basis during a liquidity event lasting one year. Under the NSFR requirement, such amounts are expected to be supported by stable funding.

The specified types of assets to be assigned to each category and the associated RSF factor are summarised in Appendix 2. For amortising loans, the portion that becomes due within the one-year horizon can be treated in the 'less than a year' residual maturity category.

APRA also proposes to include an additional RSF category to reflect the assets held by an ADI as collateral for its CLF. Basel III provides prescribed factors for HQLA, which in the Australian context are currently limited to cash, balances held with the Reserve Bank of Australia and Commonwealth Government and semi-government securities. ADIs may hold additional assets that are eligible as collateral under the CLF and contribute to compliance with the LCR requirement; as advised by the RBA, these assets can be a combination of selected debt securities and self-securitisation. APRA proposes that, in the case of debt securities, a 10 per cent RSF be applied reflecting the approximate RSF that would apply if adequate supplies of HQLA1 and HQLA2 existed in Australia. For self-securitisations, APRA proposes that a 65, 85 or 100 per cent RSF will apply, depending on the RSF of the underlying loans.

Chapter 6 – Quantitative requirements for MLH ADIs

In the 2009 discussion paper, APRA proposed extending the going concern scenario requirement to MLH ADIs but otherwise proposed no material changes to the MLH regime. APRA remains of the view that the MLH regime is working effectively in delivering an appropriate degree of resilience for ADIs with simple, retail-based business models. There are currently around 130 ADIs subject to this regime. Accordingly, as already announced, APRA does not propose to apply the LCR requirements to MLH ADIs and will retain the current quantitative metric for MLH ADIs.

ADIs subject to this regime will also generally have an NSFR considerably in excess of 100 per cent without the need for any additional liquidity management action. For that reason, APRA does not propose to apply the NSFR requirement to MLH ADIs.

Given that the term 'high-quality liquid assets' has a particular meaning under the Basel III liquidity framework, APRA proposes to adopt the term 'MLH eligible assets' for assets that MLH ADIs may hold to satisfy their MLH requirement.

APRA proposes to retain the minimum requirement for holdings of MLH eligible assets at nine per cent of liabilities. APRA may set higher requirements, depending on an ADI's risk profile and the robustness of its liquidity management framework. MLH ADIs are expected to hold a conservative buffer of MLH eligible assets above their minimum requirement.

Market developments since the inception of the MLH regime in 1998 have led to a significant expansion in the range of liquid assets covered by the current definition of MLH eligible assets in APS 210. These developments are generally welcome. At the same time, APRA has taken the opportunity to review the assets appropriate for inclusion to meet the MLH requirement.

A fundamental aspect of the MLH regime is that MLH eligible assets must be readily convertible into cash within two business days. In recent years it has become apparent that market liquidity, in both normal and stressed conditions, can be significantly worse than previously assumed. With this in mind, and to more closely align its approach with the Basel Committee's *Sound Principles*, APRA proposes to limit the amount of lower investment grade debt securities that can be included in MLH eligible assets. The current minimum credit rating criteria for debt securities is 'investment grade' and this corresponds to a Credit Rating Grade of 1 through to 3 (as outlined in Table 1 of *Prudential Practice Guide APG 112 Standardised Approach to Credit Risk* (APG 112)). There are currently no minimum credit rating criteria for deposits held with other ADIs.

APRA notes that in excess of 90 per cent of available ADI debt securities are Credit Rating Grade 1 or 2. The current *Guidance Note AGN 210.3 Minimum Liquidity Holdings* states that, when assessing the acceptability of an asset, APRA will have regard to the 'size of the ADI's holding of that asset relative to the ADI's liquid holding portfolio and to the total volume of the asset on issue'. As such, APRA proposes that no more than 20 per cent of an ADI's MLH eligible assets (deposits and debt securities) can be Credit Rating Grade 3 or lower, excluding 'Other ADIs' that provide services (e.g. payments clearing) to building societies and credit unions.[13] This proposal is consistent with the intent of the current MLH regime.

13 www.apra.gov.au/adi/Pages/adilist.aspx

APRA has also reviewed the range of non-ADI debt securities that are covered by the existing definition of MLH eligible assets and is satisfied that this is appropriate, with the exception of residential mortgage-backed securities (RMBS) and asset-backed securities (ABS). One of the fundamental characteristics of a liquid asset in the Basel III liquidity framework is its 'low correlation with risky assets'. Given that MLH ADIs have substantial exposures to the residential mortgage market, their use for liquidity purposes of assets backed by residential mortgages represents a high correlation or 'wrong-way' risk. For that reason, and given the evaporation of liquidity in RMBS and ABS markets during the global financial crisis, APRA proposes that RMBS and ABS be excluded from MLH eligible assets.

ADIs subject to the MLH regime currently need to be able to convert MLH eligible assets into cash within two business days. This requirement is maintained in the draft APS 210. In the case of debt securities, ADIs must have the operational capability to liquidate these securities in financial markets. APRA will expect MLH ADIs to be able to demonstrate that they have this capability.

Chapter 7 – Reporting to APRA

Following the release of the 2009 discussion paper, APRA consulted on liquidity reporting requirements. Building on this prior consultation, this chapter outlines the proposed liquidity reporting framework for ADIs. Full details of the proposed reporting requirements will be subject to industry consultation at a later stage.

7.1 Standardised reporting requirements

7.1.1 'Going concern' report

Currently, scenario analysis ADIs are required to provide APRA with a going concern report. As noted earlier, APRA proposes to extend this requirement to MLH ADIs. The going concern report will provide a balance sheet forecast for the next 15 months that is aligned with the ADI's funding strategy. The report is to be provided to APRA on a monthly basis (quarterly for MLH ADIs), 20 business days after the end of the month.

The going concern report will allow APRA to monitor an ADI's funding requirements and how it plans to meet any cashflow shortfalls. Any material changes in the forecast balance sheet from the ADI's annual funding strategy should be endorsed by a suitable governance committee, such as the ADI's Asset and Liability Committee.

APRA is proposing a forecast period of 15 months to ensure that, at any time, APRA will have at least a 12-month forecast of the ADI's funding profile.

7.1.2 LCR report

APRA is proposing to require scenario analysis ADIs to provide an LCR report. This would detail their holdings of HQLA (and any CLF) and provide stressed cashflows for a 30 calendar day period, based on the LCR cashflow assumptions outlined in the draft APS 210. This report would be used to inform APRA of the ADI's LCR and overall liquidity position.

The LCR report would be provided on a monthly basis, 10 business days after the end of the month. APRA may also request an ADI to provide the report on a weekly or more frequent basis, as necessary. In those circumstances, APRA acknowledges that the report will be a management assessment of the ADI's LCR given that some cashflow items/amounts may not be readily available.

7.1.3 NSFR report

APRA is proposing to require scenario analysis ADIs to provide an NSFR report to enable APRA to monitor each ADI's NSFR. This report would include details on the contractual maturity of the ADI's balance sheet items, with granular maturity buckets.

The maturity profile report would be provided to APRA on a quarterly basis, 20 business days after the end of the quarter. APRA may request an ADI to provide the report on a more frequent basis, as necessary.

7.1.4 MLH report

APRA is proposing to require that MLH ADIs continue to provide a report similar to the existing statement of high-quality liquid assets. APRA proposes to increase the level of detail on holdings of MLH eligible assets, reflecting the greater range of eligible assets available since the original report was designed.

APRA proposes to apply these standardised reporting requirements, as applicable, to all Australian-owned ADIs on both a Level 1 and Level 2 consolidated banking group basis. The requirements will also apply to foreign bank subsidiaries on a stand-alone basis and to the Australian branches of foreign banks. It is unlikely that APRA will approve exemptions from the standardised reporting framework.

7.2 Other reporting requirements

In addition to the above standardised reports, APRA is proposing that scenario analysis ADIs provide, on a regular basis, a detailed listing of their holdings of liquid assets to enable APRA to monitor the need for a CLF and the collateral backing such a facility. APRA may also require an ADI to provide copies of internal management reports to supplement the information provided in the standardised reporting.

7.3 Observation period reporting

For the purposes of reporting during the observation period, APRA will be requesting scenario analysis ADIs to provide the LCR and NSFR reports on a quarterly basis commencing January 2012, on a 'best endeavours' basis. APRA expects that, as the LCR and NSFR implementation dates approach, the data provided in these reports will become suitably robust. APRA is proposing that the two reports be provided via Microsoft Excel in the form provided by the Basel Committee's *Basel III implementation monitoring workbook.*[14] APRA will investigate migration of the submission of these reports onto D2A as part of the industry consultation on reporting.

Until implementation of the LCR requirement, scenario analysis ADIs must continue to provide their name crisis report to APRA on a monthly basis.

7.4 Crisis reporting

In the September 2009 discussion paper, APRA proposed introducing standardised reporting requirements that would be used at times of crisis. APRA proposes to require that crisis liquidity reporting include the following:

- **Stressed cash flow report.** Applicable to scenario analysis ADIs only, this would follow the same format as the LCR report and allow APRA to obtain updated cashflow information.
- **Recent funding experience report.** Consistent with the 2009 discussion paper, APRA proposes that ADIs provide a summary of their most up-to-date funding experience.

Upon APRA's request, ADIs will need to submit the crisis reporting form on:

- the same day (as at close of business the previous day) if the request is made before 12 noon; or
- the following day (as at close of business on the day of the request) if the request is made after 12 noon.

Such reporting would continue as frequently (e.g. daily, weekly or at some other interval) and for as long as required by APRA.

Consistent with the 2009 discussion paper, APRA is proposing to conduct random tests of ADIs' crisis reporting. APRA will expect ADIs to be able to meet this 'fire drill' requirement. Inability to provide adequate same/next day crisis liquidity reporting will be considered a material prudential issue. On an ongoing basis, APRA expects the frequency of fire drills to be relatively higher for larger ADIs. Most ADIs can expect a liquidity 'fire drill' at least once a year.

14 www.bis.org/bcbs/qis/index.htm

Chapter 8 – Prudential disclosure

Principle 13 of the Basel Committee's *Sound Principles* states that a banking institution should publicly disclose qualitative and quantitative information on a regular basis to enable market participants to make informed judgements about the soundness of its liquidity risk management framework and liquidity position. However, Basel III does not specify the liquidity information to be disclosed.

APRA proposes to introduce prudential disclosure requirements in respect of an ADI's liquidity risk management framework and liquidity position.

For scenario analysis ADIs, the key **qualitative** information to be disclosed would include the organisational structure and framework for the management of liquidity risk. Qualitative information would be disclosed on an annual basis from 2015. Disclosure of qualitative information will not be required of MLH ADIs.

The relevant **quantitative** information to be disclosed would include the LCR and NSFR for scenario analysis ADIs and the MLH ratio for MLH ADIs.

For scenario analysis ADIs, APRA is proposing that quantitative information would be disclosed after the metrics become effective under APS 210, i.e., from 1 January 2015 for the LCR and 1 January 2018 for the NSFR. APRA is proposing that the average, the high and the low of these ratios over the relevant six-month period would be disclosed. For MLH ADIs, APRA is proposing that the MLH ratio be disclosed on a semi-annual basis from 2015, expressed as an average ratio for the ADI over the relevant six-month period.

APRA supports the Basel Committee's view that disclosure will provide market participants with relevant information regarding liquidity risk management. In certain circumstances, however, frequent disclosure might not be conducive to confidence in an ADI or to financial system stability more generally. Accordingly, APRA proposes not to permit ADIs to disclose liquidity information more frequently than on a quarterly basis and no less than 30 days from the relevant quarter's end, unless otherwise approved by APRA.

APRA proposes to amend *Prudential Standard APS 330 Capital Adequacy: Public Disclosure of Prudential Information* (APS 330) to include key liquidity information on a semi-annual basis. Consultation on the proposed amendments to APS 330 will be conducted in due course.

Chapter 9 – Implementation

Subject to industry feedback and any refinements to the Basel III liquidity framework, APRA proposes to finalise APS 210 in mid-2012.

The qualitative and reporting requirements, and changes to MLH requirements, will be implemented in late 2012 or early 2013 after the final APS 210 is released. APRA does not expect ADIs to have any material difficulties in complying with the proposed qualitative requirements, some of which are covered in the current APS 210. As a supervisory matter, APRA would expect that ADIs already meet the proposed requirements.

As noted earlier, APRA intends to introduce the LCR requirement from 1 January 2015 and the NSFR requirement from 1 January 2018. APRA is not proposing to include any transitional arrangements for these quantitative requirements.

The Basel Committee refers to the period from December 2010 until implementation of the LCR and NSFR as an observation period, during which the implications of the new global liquidity standards for financial markets, credit extension and economic growth will be assessed. The Basel Committee has indicated that any revisions to specific components of the liquidity standards as a result of the observation period assessment will be made, at the latest, by mid-2013 for the LCR and mid-2016 for the NSFR. APRA will review its proposed prudential framework for ADI liquidity risk management should any such revisions be made.

Chapter 10 – Request for cost-benefit analysis 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. In order to perform a comprehensive cost-benefit analysis, APRA welcomes information from interested parties on the financial impact of the proposed Basel III liquidity reforms and any other substantive costs associated with the proposed reforms. These costs could include the impact on funding costs, balance sheets, and profit and loss.

As part of the consultation process, APRA also requests respondents to provide an assessment of the compliance impact of the proposed changes. Given that APRA's proposed requirements may impose some compliance and implementation costs, respondents may also indicate whether there are any other regulations relating to ADI liquidity risk management that should be improved or removed to reduce compliance costs. In doing so, please explain what they are and why they need to be improved or removed.

Respondents are requested to use the Business Cost Calculator (BCC) to estimate costs to ensure that the data supplied to APRA can be aggregated and used in an industry-wide assessment. APRA would appreciate being provided with the input to the BCC as well as the final result. The BCC can be accessed at www.finance.gov.au/obpr/bcc/index.html.

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

ASF factor	• Components of ASF category
100 per cent	• The total amount of capital, including both Tier 1 and Tier 2 as defined in *Prudential Standard APS 111 Capital Adequacy: Measurement of Capital*. • The total amount of any preferred stock not included in Tier 2 that has an effective remaining maturity of one year or greater, taking into account any explicit or embedded options that 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 remaining maturities of one year or greater, excluding any instruments with explicit or embedded options that would reduce the expected maturity to less than one year. Such options include those exercisable at the investor's discretion within the one-year horizon.*
90 per cent	• 'Stable' non-maturity (demand) deposits and/or term deposits (as defined in the LCR) with residual maturities of less than one year provided by retail and SME customers.
80 per cent	• 'Less stable' non-maturity (demand) deposits and/or term deposits (as defined in the LCR) with residual maturities of less than one year provided by retail and SME customers.
50 per cent	• Unsecured wholesale funding, non-maturity deposits and/or term deposits with a residual maturity of less than one year, provided by non-financial corporates, sovereigns, central banks, multilateral development banks and public sector entities.
0 per cent	• All other liabilities and equity categories not included in the above categories.

* When determining the maturity of an instrument, investors are assumed to redeem a call option at the earliest possible date. For funding with options exercisable at the ADI's discretion, APRA will take into account reputational factors that may limit the ADI's ability not to exercise the call option. In particular, where the market expects certain liabilities to be redeemed before their legal final maturity date, ADIs should assume such behaviour for the purpose of the NSFR.

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

RSF factor	Components of RSF category
0 per cent	• Cash immediately available to meet obligations, not currently encumbered as collateral and not held for planned use (as contingent collateral, salary payments or for other reasons). • Unencumbered short-term unsecured instruments and transactions with outstanding maturities of less than one year. • Unencumbered securities with stated remaining maturities of less than one year with no embedded options that would increase the expected maturity to more than one year. • Unencumbered securities held where the institution has an offsetting reverse repurchase transaction when the security on each transaction has the same unique identifier. • Unencumbered loans to financial entities with effective remaining maturities of less than one year that are not renewable and for which the lender has an irrevocable right to call.
5 per cent	• Unencumbered marketable securities with residual maturities of one year or greater representing claims on or claims guaranteed by sovereigns, central banks, BIS, IMF, EC, non-central government public sector entities or multilateral development banks that are assigned a zero per cent risk-weight under the Basel II standardised approach for credit risk, provided that active repo or sale markets exist for these securities.
10 per cent	• Debt securities that are eligible collateral under the CLF and contribute to compliance with the LCR requirement.*
20 per cent	• Unencumbered corporate bonds or covered bonds rated AA- or higher with residual maturities of one year or greater satisfying all of the conditions for HQLA2 in the LCR. • Unencumbered marketable securities with residual maturities of one year or greater representing claims on or claims guaranteed by sovereigns, central banks, non-central government public sector entities that are assigned a 20 per cent risk-weight under the Basel II standardised approach for credit risk, provided that they meet all of the conditions for $HQLA^2$ in the LCR.

* Excludes self-securitisation, where the RSF applicable to the underlying loans is applied.

50 per cent	• Unencumbered gold. • Unencumbered equity securities, not issued by financial institutions or their affiliates, listed on a recognised exchange and included in a large cap market index. • Unencumbered corporate bonds and covered bonds that satisfy all of the following conditions: – central bank eligibility for intraday liquidity needs and overnight liquidity shortages in relevant jurisdictions; – not issued by financial institutions or their affiliates (except in the case of covered bonds); – not issued by the respective firm itself or its affiliates; – low credit risk: assets have a credit assessment by a recognised external credit assessment institution (ECAI) of A+ to A-, or do not have a credit assessment by a recognised ECAI and are internally rated as having a probability of default (PD) corresponding to a credit assessment of A+ to A-; and – traded in large, deep and active markets characterised by a low level of concentration. • Unencumbered loans to non-financial corporate clients, sovereigns, central banks and public sector entities having a remaining maturity of less than one year.
65 per cent	• Unencumbered residential mortgages of any maturity that would qualify for the 35 per cent or lower risk-weight under the Basel II standardised approach for credit risk. • Other unencumbered loans, excluding loans to financial institutions, with a remaining maturity of one year or greater, that would qualify for the 35 per cent or lower risk-weight under the Basel II standardised approach for credit risk.
85 per cent	• Unencumbered loans to retail customers (i.e. natural persons) and SME customers (as defined in the LCR) having a remaining maturity of less than one year (other than those that qualify for the 65 per cent RSF above).
100 per cent	• All other assets not included in the above categories.

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