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To all authorised deposit-taking institutions

Implementation of the Basel III liquidity framework in Australia

Committed Liquidity Facility

In December 2010, the Australian Prudential Regulation Authority (APRA) and the Reserve Bank of Australia (RBA) announced that authorised deposit-taking institutions (ADIs) will be able to establish a secured committed liquidity facility (CLF) with the RBA. The CLF will be sufficient in size to cover any shortfall between the ADI's holdings of high-quality liquid assets (HQLA) and the requirement to hold such assets under the liquidity coverage ratio (LCR). The need for such a facility arises from the relatively short supply of Australian dollar HQLA. 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.

This note provides further background on the intended approach of APRA and the RBA to the operation of the CLF.

Principles applicable to the LCR and CLF

In December 2010, the Basel Committee on Banking Supervision (the Basel Committee) released a series of measures designed to strengthen liquidity buffers so as to promote a more resilient banking system. These measures were set out in *Basel III: International Framework for Liquidity Risk Measurement, Standards and Monitoring*[1]. In January 2013, the Basel Committee released a revised version of these measures in its document *Basel III: The Liquidity Coverage Ratio and Liquidity Risk Monitoring Tools*[2]. APRA has been consulting on the implementation of the main elements of the Basel III liquidity reforms.

APRA's core objective in implementing the reforms is that ADIs in Australia, singly and in aggregate, appropriately manage their liquidity risk. The LCR's contribution to this objective is the requirement that ADIs subject to the LCR[3] must at all times be able to demonstrate their ability to withstand a minimum of 30 days severe liquidity stress.

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[1] *Basel III: International Framework for Liquidity Risk Measurement, Standards and Monitoring*, December 2010, http://www.bis.org/publ/bcbs188.htm

[2] *Basel III: The Liquidity Coverage Ratio and Liquidity Risk Monitoring Tools*, January 2013, http://www.bis.org/publ/bcbs238.htm

[3] The LCR will apply to 'scenario analysis ADIs' as defined in *Prudential Standard APS 210 Liquidity*. Broadly speaking, scenario analysis ADIs comprise those ADIs, with larger or more complex operations, that are currently required to conduct scenario analysis of their liquidity needs under different operating circumstances.

The principles that underpin APRA's pursuit of this objective are that:

- Australian arrangements must meet internationally accepted practice;
- the arrangements must avoid undue interference with the efficient operation of Australian financial markets;
- the arrangements must provide ADIs with every incentive to meet their liquidity requirements through their own balance sheet management, before relying on the CLF; and
- the costs of these liquidity reforms must be carefully balanced against their benefits.

The CLF will enable participating ADIs to access, if needed, a pre-specified amount of liquidity. APRA and the RBA have a strong interest in limiting the size of the CLF to no more than is reasonable, thereby ensuring that ADIs manage their funding and liquidity at least as conservatively as their international peers.

Determining the size of the CLF

The CLF will be offered by the RBA, on contractual terms and conditions that will be consistent with the Basel III liquidity framework. APRA's role is to determine the appropriate size of the CLF for each scenario analysis ADI. APRA will then annually review and may adjust the size of the CLF for each ADI.

In its November 2011 discussion paper[4], APRA indicated that:

'*APRA will be reviewing each ADI's liquidity risk management framework and management practices as the basis for approving the CLF for LCR purposes… 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.*'

APRA is now in a position to release further details on its process for determining the appropriate size of a CLF for each ADI.

Access to the CLF

Any scenario analysis ADI may request access to the CLF. APRA will review each request in the context of the 'all reasonable steps' requirement. APRA's expectation is that scenario analysis ADIs with material net cash outflows under the LCR calculations will receive approval to establish a CLF, providing they meet key requirements regarding ongoing compliance with the relevant qualitative and quantitative liquidity requirements. These requirements include having in place:

- a statement of the Board's tolerance for liquidity risk;
- an appropriately robust liquidity transfer pricing mechanism; and

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[4] *Implementing Basel III Liquidity Reforms in Australia*, November 2011, http://apra.gov.au/adi/Documents/ADI_DP_IBLR_November_2011.pdf

- appropriate remuneration arrangements for those executives responsible for the ADI's funding plan and liquidity management.

The CLF is intended to address Australian dollar liquidity needs only. APRA does not intend to allow amounts requested for the CLF to include any liquidity requirements in other currencies.

Maximum CLF size

The size of the CLF for each scenario analysis ADI will be limited to a specified percentage of that ADI's Australian dollar net cash outflow target as agreed by APRA, plus an allowance for an appropriately sized buffer. The limit will be set at a level that reflects the aggregate amount of Australian dollar HQLA[5] that could reasonably be held by scenario analysis ADIs, as estimated by the RBA, and the aggregate amount of Australian dollar net cash outflows[6] for all scenario analysis ADIs taken together.

The annual process for determining the size of the CLF will be as follows:

Step 1: Estimation of available Australian dollar HQLA

The RBA will estimate the amount of Australian dollar HQLA that could reasonably be held by scenario analysis ADIs over the CLF approval period[7]. This estimate will take into account factors such as the total amount of Australian dollar HQLA securities on issue, the market participants that are holding that stock and the need for the continued smooth functioning of markets.

As a starting point, the RBA's assessment is that the level of Australian dollar HQLA currently held in aggregate by scenario analysis ADIs is appropriate.

Step 2: Submission of a three-year funding plan and APRA's assessment of target net cash outflows

Each scenario analysis ADI that is requesting a CLF will be required to submit a three-year funding plan to APRA that includes, amongst other things, a forecast for Australian dollar net cash outflows over the CLF approval period.

APRA will assess each funding plan and, in particular, the forecast of Australian dollar net cash outflows, giving consideration to the planned program of actions that each ADI has in place to minimise reliance on the CLF. As a result of this assessment, APRA will agree with each ADI a target Australian dollar net cash outflow that will then be used to determine the CLF size.

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[5] Currently Commonwealth government securities, semi-government securities, cash balances with the RBA, notes and coin.

[6] As defined in the LCR.

[7] The CLF approval period is defined as the 12-month period following the approval by APRA of the CLF size for inclusion in the LCR.

Step 3: Maximum CLF for an LCR of 100 per cent

The size of the CLF for each ADI will be set in equal proportion to each ADI's target Australian dollar net cash outflows. The system-wide CLF size at 100 per cent LCR coverage will be calculated as follows:

$CLF_{system} = NCO_{system} - HQLA_{est.}$, where:

- NCO_{system} is the sum of ADI Australian dollar net cash outflow targets as agreed between each ADI and APRA; and
- $HQLA_{est.}$ is the amount of Australian dollar HQLA that the RBA estimates could reasonably be held by scenario analysis ADIs.

The maximum CLF size for each ADI will then be calculated as follows:

$CLF_{ADI} = (NCO_{ADI} / NCO_{system}) \times CLF_{system}$, where:

- NCO_{ADI} is the Australian dollar net cash outflow target for each ADI as agreed by APRA.

Step 4: Allowance for an appropriate buffer above an LCR of 100 per cent

The CLF limit will be set in the context of an LCR requirement of 100 per cent. APRA expects that ADIs will put in place a liquidity buffer such that their LCR is at all times greater than 100 per cent. Where APRA has approved the use of a CLF for LCR purposes, the size of the CLF will be increased to allow for an appropriate liquidity buffer as agreed by APRA.

Other matters

No element of the CLF or HQLA calculation is intended to determine which instruments (from the list of eligible instruments) are held by each ADI. Nor are these calculations intended to set a precise minimum or maximum holding amount for HQLA. APRA's expectation, however, is that the combination of economic incentives and regulatory oversight via the all reasonable steps assessment will mean that most ADIs with a CLF will maintain actual HQLA levels reasonably close to their presumed allocations.

Where APRA determines that an ADI is not taking sufficient steps to reduce its liquidity risk, an appropriate supervisory response may include progressively lowering the amount of CLF that an ADI can include in the LCR until a more appropriate liquidity risk profile is reached.

International benchmarks for ADI liquidity risk

The introduction of the LCR for internationally active banks is intended to result in a reduction of liquidity risk in the global banking industry. It is APRA's intention that ADIs in Australia achieve comparable reductions.

APRA will closely monitor ADI liquidity risk in the context of the LCR. ADIs will be compared internationally, using metrics such as net cash outflows to total assets, to ensure that the Australian banking system maintains a liquidity profile that is consistent with other relevant jurisdictions. Amongst other considerations, APRA will use these international comparisons to help set system-wide targets for the reduction of liquidity risk over time. These targets will be used to inform the annual process for setting the size of the CLF for each ADI.

Process

Annual application for a CLF and submission of a three-year funding plan

ADIs will be required to apply for the inclusion of a CLF in their LCR on an annual basis. APRA will assess each ADI's application against the requirement that the ADI is taking all reasonable steps to reduce liquidity risk through its own balance sheet management. The CLF assessment process will include a review of the ADI's three-year funding plan, which must, among other things, detail the steps being taken by the ADI to meet the all reasonable steps requirement.

Out-of-cycle CLF limit change requests

ADIs will be required to update their liquidity projections and resultant CLF limit requests annually, but no more than annually. In the absence of a material change in an ADI's business arrangements, such as a substantial acquisition or divestiture, APRA would not expect that an ADI would need to make any interim request for a CLF limit increase. Such a request could indicate that the ADI wishes to grow its net cash outflows faster than planned, without an offsetting increase in retail deposits and medium to long-term wholesale funding. Similarly, APRA does not intend to consider requests for out-of-cycle CLF limit decreases, absent a material and unplanned change in an ADI's business arrangements that would justify such a request.

In sum, APRA will only consider out-of-cycle CLF limit change requests in circumstances where an ADI can evidence that the request is justified and does not reflect a deteriorating liquidity position.

2013 trial exercise

APRA is undertaking a trial exercise with all scenario analysis ADIs in 2013. In the exercise, ADIs have been requested to submit an application for a *pro forma* CLF to cover their expected Australian dollar LCR shortfall for the calendar year 2014. Through this process, APRA is focusing particularly on the project plans that ADIs are putting in place to ensure they are taking all reasonable steps to reduce liquidity risk. APRA is also seeking to satisfy itself that the Board-approved tolerance for liquidity risk, the robustness of the ADI's liquidity transfer pricing and the remuneration incentives of executives responsible for the ADI's funding plan and liquidity management are all appropriately aligned to APRA's objective of prudent liquidity risk management.

APRA will release further details on the CLF process and, in particular, its expectations with regard to the composition of the CLF portfolio of eligible securities, once it has completed the 2013 exercise.

Conclusion

APRA, the RBA and ADIs are jointly progressing towards the 1 January 2015 commencement of the LCR regime in Australia, including CLF arrangements. This note is intended to update industry and other interested stakeholders about APRA's and the RBA's intentions in this area. It will be followed by another note, probably in the first quarter of 2014, outlining expectations on the use of third-party securities and self-securitisation as security for the CLF. Other notes will be released if and when necessary to ensure all market participants are well-informed about the new liquidity risk management framework.

As APRA has consistently stated, ADIs requiring a CLF will be expected to continue to improve their liquidity risk profiles ahead of commencement of the LCR regime, and beyond. These improvements can come from, amongst other things, increasing the proportion of assets funded by retail deposits, increasing the average tenor of wholesale liabilities, and refining terms and conditions for some products. Since 2008, ADIs have made steady and material improvements to their liquidity risk profiles, but more remains to be done, in both the quantitative and qualitative dimensions of liquidity risk management.

Please contact me or Paul Veerhuis on 9210 3112 if you have any further queries.

Yours sincerely

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