Australian Banking Association

Targeted changes to ADI liquidity and capital standards

16 February 2024

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Australian Banking Association

Key Recommendations

- The ABA notes that the proposed targeted liquidity changes, specifically that bank bills, certificates of deposits and debt securities issued by other ADIs would no longer be counted as eligible liquid assets for ADIs on the MLH regime, will significantly impact the profitability of some institutions affected by them.

- Such a reduction in profitability may need to be passed on, which would lead to worse customer outcomes and a deterioration in the competitiveness of some MLH ADIs.

- Affected members are broadly comfortable with the proposal for MLH banks to use the market value to measure the value of liquid assets. However, there are some areas where additional clarification is requested.

- The ABA note that the proposed changes to deduct any unrealised losses on liquid assets from capital will create an asymmetry in regulatory capital measurement for some ADIs regarding value generated by liquid assets that have held or increased in value (increases not recognised) and those that have lost some value, be it through changes in interest rates or credit quality.

- While members were comfortable with the proposals regarding access to exceptional liquidity assistance, the ABA seek assurance that some of the information requirements will not require significant increases in resourcing capability to meet.

- In terms of the proposed changes to the composition of MLH liquid assets, the ABA suggests that adopting one or more of these proposals would be beneficial:
    - Allow bank securities to be held as MLH liquid assets, but only up to a set percentage limit of the MLH portfolio;

    - Allow bank securities but provide a haircut against their MLH Ratio value;

    - Include covered bonds as eligible MLH liquid assets; and

    - If bank securities are to be ineligible as MLH liquid assets then the MLH requirement should be recalibrated to reflect the higher quality liquid assets (reduced minimum liquidity requirement, access to a CLF type of facility, calibrated with the minimum requirement for self-securitised assets).

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About the ABA

The Australian Banking Association advocates for a strong, competitive and innovative banking industry that delivers excellent and equitable outcomes for customers. We promote and encourage policies that improve banking services for all Australians, through advocacy, research, policy expertise and thought leadership.

ABA submission to APRA

The ABA would like to thank APRA for the opportunity to engage with their consultation process and provide feedback on the proposed targeted changes. Discussions with our members, particularly those on the Minimum Liquidity Holdings (MLH) regime, have demonstrated the potential significance of these changes and we welcome the opportunity to outline the issues they have raised.

To begin with, the ABA notes that the proposed targeted liquidity changes, specifically that bank bills, certificates of deposits and debt securities issued by other ADIs would no longer be counted as eligible liquid assets for ADIs on the MLH regime, will significantly impact the profitability of some institutions affected by them (further details in Section 3).

For some institutions, the reduced profitability that would follow from those changes would threaten the ongoing viability of the institution. Alternatively, the costs would need to be passed on, which would lead to worse customer outcomes and a deterioration in the competitiveness of some MLH ADIs.

The ABA note that the securities that are proposed to no longer be deemed eligible are from entities that are regulated by APRA. Encouraging ADIs to seek liquidity outside of this strongly regulated sector may have unintended consequences.

Another key concern relates to practicality of MLH institutions being able to respond the proposed changes. There are not large amounts of floating-rate Government bonds/notes available. Indeed, it is not clear that there are sufficient Gov/Semi-Gov floating-rate notes being issued presently that would satisfy the high-quality liquid assets (HQLA) demand for MLH purposes.

The ABA also highlight that while these changes are in response to last year's events, particularly in the United States, the existing regulatory environment in Australia is substantially different. As noted above, Australian ADIs are well regulated and required to be 'unquestionably strong', with higher capital requirements than their US equivalents.

This submission will respond to the issues as outlined in Attachment A of the letter to ADIs 'Targeted changes to ADI liquidity and capital standards' sent 15 November 2023.[1]

1. Accounting for unrealised losses

a. Require the use of market value to measure liquid assets for the MLH ratio

While members are broadly comfortable with the proposal for MLH banks to use the market value to measure the value of liquid assets, there are some areas where additional clarification is requested.

Firstly, in the letter of 15 November APRA state that "ADIs on the MLH regime would be required to adjust the value of their liquid assets regularly for movements in market prices". Could APRA provide specific clarification, in the Standard or Guidance, as to what their expectation of 'regularly' is for MLH banks?

Secondly, for ADI's that account for their liquid assets at amortised cost (i.e. as Held to Maturity), should market value be interpreted as the net realisable value? (i.e. market value or fair value +/- any

[1] https://www.apra.gov.au/targeted-changes-to-adi-liquidity-and-capital-standards

unamortised premium or discount). Given the extension to MLH institutions, does APRA intend to define market value in APS 210?

Additionally, members suggested that APRA could consider including the market value of derivative hedging instruments in the MLH calculation. Where a derivative such as an interest rate swap has been used to hedge the interest rate risk on a liquid asset, will the derivative assets (in-the-money) or derivative liabilities (out-of-the-money) be included in the MLH Ratio calculation?

Not including any net impact of a derivative hedging instrument would either overstate (where a hedging derivative is out-of-the-money) or understate (where a hedging derivative is in-the-money) an ADI's net liquidity position.

Finally, there could be instances in which liquid assets are required to be held to meet local liquidity requirements but for which there is no secondary market to depict the market value. What are APRA's expectations regarding deriving the market value in these instances?

b. Deduct any unrealised losses on liquid assets from capital (for all ADIs)

In general, the ABA note that the proposed changes will create an asymmetry in regulatory capital measurement regarding value generated by liquid assets that have held or increased in value (increases not recognised) and those that have lost some value, be it through changes in interest rates or credit quality. This also introduces an asymmetry between the treatment in APS 210, where both asset and liability positions are recognised, and APS 111.

The ABA also note that currently banks subject to Interest rate risk in the banking book (IRRBB) under APS 117 are holding capital for fair value losses on liquid assets if accounted for as held-to-maturity and note the potential for double counting (i.e. capital held under APS 117 and then as a deduction in capital under these changes).

The ABA also seeks some additional clarification on the proposed changes to APS 111.

Where a derivative has been used to hedge the interest rate risk on a liquid asset that is not fair valued, will that derivative asset (in-the-money) be allowed to offset any market value loss otherwise deductible from capital?

Additionally, APS 111 currently requires all ADIs to measure their Hold to Collect and Sell (HTC&S) liquid assets at fair value. The draft APS 111 would mean that all ADIs measure liquid assets which are designated as Hold to Collect (HTC) at fair value as well where the fair value is less than the purchase price.

Would APRA instead consider regulatory guidance on the classification of liquid assets as HTC to ensure there is near certainty in an ADIs "ability" to hold liquid assets to maturity (as required under IFRS 9)? Such an approach would retain the current framework, reduce the risk of excessive build-up fair value losses of HTC liquid assets and ensure there is no subsequent increase in systemic risk caused by an increase in ADI capital volatility.

Similar to what has been highlighted above for the MLH ratio, the ABA also seek clarification on APRA's expectation where there is no secondary market for liquid assets that are required to be held to meet local liquidity requirements.

Finally, does APRA's proposal require deductions for each asset that has a cumulative unrealised fair value (CUFV) loss be deducted or is the deduction required at the portfolio level where some CUFV gains could be used to offset CUFV losses within the portfolio?

2. Formalise requirements for access to exceptional liquidity assistance with the RBA

Members were comfortable with the proposals regarding access to exceptional liquidity assistance (ELA), as outlined in APS 210 (paragraph 70) and APG 210 (paragraphs 75-76), and appreciate the visibility of the proposed template. There was, however, one area where further clarification would be helpful.

The ABA wishes to confirm that, given that if ELA is requested the draft template suggests a capital ratio has to be provided 'As at business day prior to day of ELA request', ADIs would expect to provide capital-related information on a best-endeavours basis.

This may include for example, consideration of the last month-end actual reported ratio and making an appropriate estimate of changes over this time. Can APRA please clarify if this would meet its expectations and provide some guidance to the effect in the updates to the Prudential Standard or Prudential Policy Guide?

We note that were it to be a requirement to implement the capability to create balance sheet and capital ratio reporting for the timeline specified in the template, this would come at a significant cost that would require financial institutions to commit resources to this that would be better served in other areas, given the limited benefit of this level of detail.

3. Reducing contagion risk by strengthening the composition of MLH liquid assets

ABA note that the changes proposed by APRA will present a number of significant challenges to MLH ADIs. The challenges will vary from the difficulty of the practical implementation of some of the measures through to the potentially very significant profitability impact that would result from the changes as planned. In particular, the shift that would be required from ADI floating-rate notes (FRNs) to lower-yielding government bonds would be significant for some institutions. We would be happy to facilitate further details of the impacts if required.

But in general, the higher return available on ADI securities offsets some of the cost of funding supporting the MLH ratio and liquidity management. At a conservative approximate yield give-up of 50 basis points across 60 per cent of an MLH portfolio, at an MLH ratio of 13 per cent, the approximate impact on an ADIs net interest margin is 4 basis points. The ABA note that while other bank securities represent around 60 per cent of MLH ADIs' existing liquid assets, for some ADIs this will be considerably higher and the corresponding impact even larger.

MLH banks in general do not have access to the cash market/exchange settlement funds. Cash management is undertaken with other MLH Banks via the issue of Negotiable Certificates of Deposit (NCD's) (typically 3 months). Removing bank securities from eligible liquid assets would most likely result in a significant change in MLH banks cash management practices. Alternative practices could be:

increased reliance on large ADI Treasuries for overnight cash; overnight lending between MLH banks; and increased participation in RBA open market operations.

In general, MLH banks hold lower credit ratings than their larger Liquidity Coverage Ratio (LCR) ADI peers. In market stress events, due to their lower credit rating, wholesale funding markets are typically closed first to MLH banks. When wholesale funding markets recover, they typically re-open last to MLH banks. Removing MLH banks as funding source will likely create additional volatility in such scenarios which may force MLH banks to draw down on their liquidity reserves earlier than they otherwise would. This may increase the risk to MLH banks of a liquidity stress event and create contagion via reputational risk even if contagion risk via counterpart risk is contained.

The proposal for MLH banks to move out of bank securities will compel them to move to Commonwealth and Semi-Government securities. Typically, the availability of floating-rate CGS and Semi-Gov securities is limited, compelling ADIs to purchase fixed-rate securities. Indeed, it is not clear that there are sufficient Gov/Semi-Gov floating-rate notes being issued presently that would satisfy the HQLA demand for MLH purposes.

Additionally, many MLH banks don't have capacity to hedge interest rate risk on long-dated fixed rate government bonds due to inadequate derivative lines. As such, the market for MLH banks is much 'smaller' than the overall market.

This has implications for the IRRBB frameworks for banks. As MLH banks potentially shift to the fixed-rate assets, given the lack of alternatives, it will bring the market value impacts on capital and MLH ratios under consideration. As such, the proposals will require ADIs to consider updates to risk appetite and policy for IRRBB risk in addition to funding and liquidity risk. Management of the IRRBB risk will also incur hedging costs, to the extent they are available, and general administration of managing the portfolio and governance arrangements of the IRRBB risks and associated regulatory reporting.

Another potential impact of these changes is on the cost of funds for the sector. A number of ADIs issue FRNs and the vast majority of the investors of those FRNs would be other ADIs (especially for the smaller ADIs). Small to medium-sized ADIs will issue fewer FRN's going forward as previous issuance have relied on MLH banks to support the issuance (over the past couple years, peer ADI allocations have typically ranged between 45-65 per cent of <$100 million senior issues and 20-50 per cent for larger ~$200 million+ prints). Their absence will require more institutional investors, which expect larger deal sizes for liquidity and wider spread. This will make an important funding source less attractive and less accessible for MLH banks.

Reduced ADI FRN issuance will force MLH banks into the term deposit market increasing funding concentration and costs for the entire sector. Preliminary feedback indicates this could be in the order of ~20 basis points across all tenors (i.e. +70 basis points for 3-month NCD vs the current +50 basis points). This equates to additional interest expense of $1 million on an NCD funding book of $500 million.

If NCD funding was replaced with higher cost sources (e.g. corporate deposits) this would add at least an extra $0.5 million of interest expense per $100 million of NCD's replaced by corporate deposits (i.e. +50 basis points additional cost). This implicitly assumes that corporate deposit market pricing will not widen (in practice increased demand for this funding source from MLH ADI's may see pricing widen and the interest expense of replacement funding be higher than shown).

Given the need for all ADIs to generate a sustainable profit, if the Treasury incomes are significantly reduced through lower returns and the cost of funding goes up through shifting the composition of their liabilities, it is difficult to see how this will not ultimately result in increased loan rates for customers making it more difficult for MLH banks to compete. Alternatively, the change could push MLH banks to run lower levels of liquidity buffers compared to current levels in an effort to achieve sustainable profitability, which would increase risk and going against APRA's aims for the change.

Proposed alternative approaches

In terms of potential proposals for either an alternative approach or mitigation, the ABA suggests that adopting one or more of these proposals would help:

- Allow bank securities to be held as MLH liquid assets, but only up to a set percentage limit of the MLH portfolio;
- Allow bank securities but provide a haircut against their MLH Ratio value;
- Include covered bonds as eligible MLH liquid assets; and
- If bank securities are to be ineligible as MLH liquid assets then the MLH requirement should be recalibrated to reflect the higher quality liquid assets (reduced minimum liquidity requirement, access to a Committed Liquidity Facility (CLF) type of facility, calibrated with the minimum requirement for self-securitised assets).

The ABA is happy to facilitate discussions on how some of these ratios could be appropriately calibrated.

Implementation timeline

Finally, in terms of the proposed implementation timeline of 1 January 2025, we note that some members have a large proportion of their treasury assets maturing this year and clarity would be needed on their investment decisions. The extended implementation timeline outlined in the letter would be required at a minimum.

However, even with that, ABA note that while the average holdings of other ADIs' securities represent 60 per cent of liquid assets at MLH banks, by definition there are going to be some institutions that are above the average. In such cases, reaching proposed reduction to 40 per cent in one year could be problematic. APRA should give consideration to ensuring that those institutions have a timeline that is realistically geared to transition without unintended consequences on profitability, risk, strategy and ultimately customer impacts.