

31 May 2016

Mr Pat Brennan  
General Manager Policy Development  
Australian Prudential Regulation Authority  
Level 26  
400 George Street  
Sydney NSW 2000  
By email [Basel3liquidity@apra.gov.au](mailto:Basel3liquidity@apra.gov.au)

Dear Pat

## Discussion Paper: Basel III liquidity - the net stable funding ratio and the liquid assets requirement for foreign ADIs

The Australian Bankers' Association (**ABA**) appreciates the opportunity to provide feedback on APRA's Discussion Paper: *Basel III liquidity – the net stable funding ratio and the liquid assets requirement for foreign ADIs* (**Discussion Paper**).

With the active participation of its members, the ABA provides analysis, advice and advocacy for the banking industry and contributes to the development of public policy on banking and other financial services. The ABA works with government, regulators and other stakeholders to improve public awareness and understanding of the industry's contribution to the economy and to ensure Australia's banking customers continue to benefit from a stable, competitive and accessible banking industry.

The ABA welcomes APRA's efforts to tailor the Basel Committee on Banking Supervision (**BCBS**) liquidity framework rules for the Australian financial system. The ABA supports the objective that, to the extent reasonably possible, banks should continue to improve their structural funding position over time. Indeed, Australian banks have already significantly improved their structural funding positions since the onset of the global financial crisis (**GFC**). As a simple example, the proportion of gross loans and advances funded by deposits from households and non-financial corporates has grown from 48% in 2007 to 54% in 2016, at a system level.

The ABA has a number of concerns regarding APRA's proposals for the net stable funding ratio (**NSFR**). The proposals for the NSFR do not appropriately take into account key features of the Australian financial system which act as barriers and place constraints on Australian authorised deposit-taking institutions (**ADIs**) and will make it very difficult, if not impossible, for further significant improvement in the system NSFR.

The proposals, as they stand, could have unintended consequences for the Australian economy, as the proposed calibration fails to recognise the limits on expanding long-term wholesale funding faced by ADIs, which when combined with limited deposit growth, will constrain credit growth and subsequently weigh on economic growth.

The NSFR biases household credit/deposits vis-à-vis business lending/deposits. This will discourage investment in more economically productive areas, which is ultimately negative for the Australian economy. ABA research shows, in Australia, small businesses employ 4.7 million people - equating to 44.0% of all jobs in Australia, and bank loans to small businesses (where the loan amount is under \$2 million) totalled \$261 billion in December 2015<sup>1</sup>. There may also be financial stability implications in the bias towards household credit.

<sup>1</sup> ABA Economic Report, (May 2016), *The small business sector in Australia*



In this regard, the ABA is concerned that the proposed NSFR factors applied to business lending (e.g. 85% required stable funding (**RSF**) for business lending versus 65% RSF for mortgages), business deposits (e.g. a maximum available stable funding (**ASF**) of 50% for business deposits versus an ASF of c. 90% for retail deposits) and superannuation deposits will lead to a significant reduction in the availability of credit for business segments as banks seek to comply on an ongoing basis with NSFR.

While the ABA supports APRA's intention to encourage prudent funding via differential treatment in the NSFR, the combined impact of the RSF and ASF factors applied to business lending and the conservative treatment of superannuation deposits will likely lead to a reassessment of the proportion of capital and liquidity resources allocated to the business sector.

The ABA welcomes the opportunity to provide APRA with recommendations to address the above concerns without lessening any of the incentives to prudently manage liquidity and increase the tenor of liabilities. The ABA considers these recommendations will also ensure a fair and level funding playing field for Australian banks in line with that of their international peers.

The key ABA recommendations are:

- 1) Align the treatment of self-securitised assets with funded assets backing the Committed Liquidity Facility (**CLF**).
- 2) Align the definition of high quality liquid assets (**HQLA**) for the NSFR to the Basel standard.
- 3) Assign a stable funding factor to superannuation fund deposits under the NSFR to acknowledge the value of this source of funding.
- 4) Allow ADIs to use Basel's standardised risk-weights for the NSFR.

This submission will address each of those recommendations in turn. However, first, the ABA will take the opportunity to share why compliance with the NSFR metric is not just an issue for 2018; the challenge for ADIs will grow each subsequent year due to the structure of the Australian banking system and APRA's proposed calibration of the NSFR.

## The funding gap is increasing for Australian ADIs

There are structural reasons why the Australian deposit base cannot be expanded, such as persistent current account deficits which must be funded from offshore, tax and superannuation systems.

Properly understood, system deposit growth is a function of credit growth. The Bank of England has written extensively on this topic<sup>2</sup>, and notes that "the reality of how money is created today differs from the description found in some economics textbooks"<sup>3</sup>. An accurate understanding of this process is important for the right policy decisions to be made.

JP Morgan stated the implications of this process for banks: "deposit growth is mainly a result of credit growth plus or minus a balance of payments factor. Higher rates and better marketing will not expand the pool and a deposit war will not expand the pool and a deposit war is a negative sum game for the system as a whole."<sup>4</sup>

Structural reasons largely dictate the form that liabilities take when they are created through credit growth. Due to these structural reasons, broadly speaking, the proportion of system deposits to total liabilities is relatively constant.

<sup>2</sup> McLeay, M., Radla, A. and Thomas, R. (2014), *Money creation in the modern economy*, Bank of England Quarterly Bulletin, Vol. 51, No. 1, pages 14-29; McLeay, M., Radla, A. and Thomas, R. (2014), *Money in the modern economy: an introduction*, Bank of England Quarterly Bulletin, Vol. 51, No. 1, pages 4-13; Jakab, Z. and Kumhof, M. (2015), *Banks are not intermediaries of loanable funds – and why this matters*, Bank of England Working Paper, No. 529

<sup>3</sup> McLeay, M. et al (2014), p. 14. This statement is supported by an extensive literature review in Jakab and Kumhof (2015)

<sup>4</sup> Brunker, P., Ng, C., Manning, S., Nicholas, J., Anand, B. (2012), *Deposit war: What is it good for?*, Australian Equity Research, JPMorgan Chase & Co



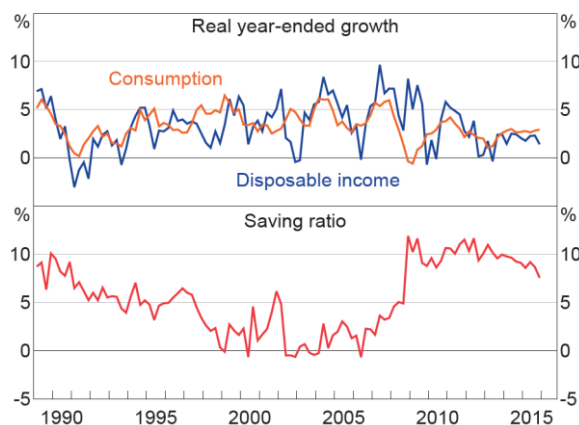
While the industry has made considerable progress (e.g. increasing term wholesale, deposit funding, support for corporate bond markets, etc.), and will continue to reduce liquidity risk, we are running up against structural constraints that are not soluble for individual banks. These structural constraints include:

- **Superannuation.** Given its size in the Australian financial system, asset allocation decisions made with respect to superannuation influence the form total liabilities take in the banking system. Where superannuation funds invest in bank deposits, these attract a lower ASF. Similarly, other forms of debt purchased by superannuation funds will tend to have lower ASF factors. This is discussed further under recommendation 3.
- **Balance of payments.** This is linked to deposit and credit growth as previously referenced. Banks are involved in financing this deficit as a ‘capital-importing country’<sup>5</sup>. The Financial System Inquiry’s Final Report notes that a “significant component of domestic investment funded by foreign savings [is] channelled through the banking system”.<sup>6</sup> These savings generally come in the form of wholesale liabilities rather than deposits, which allow credit to grow faster than would otherwise be possible.
- **Australian jurisdiction specific considerations.** Australia does not have government sponsored entities holding vast quantities of mortgages. We also do not have the deposit balances of many Asian jurisdictions, in lieu of our superannuation system.
- **An existing funding gap.** To neutralise the system funding gap in future years, deposit growth would need to grow around 5% per annum faster than credit, given the lower starting point. This has not been sustainably achieved over any period historically, so appears unlikely in future years.

The outlook for household deposit growth is tied to a variety of factors, none of which are currently suggesting any significant improvement:

- **Household savings ratio.** Whilst there was a structural improvement in the saving ratio post the GFC (to in excess of 10%), this was in part driven by expansionary fiscal policy. With the government looking to tighten fiscal settings, there is a real risk that the savings ratio will continue to decline.

Figure 1: Household income and consumption



\* Household sector includes unincorporated enterprises; disposable income is after tax and interest payments; income level smoothed with a two-quarter moving average between March quarter 2000 and March quarter 2002; saving ratio is net of depreciation

Sources: ABS, RBA

<sup>5</sup> Commonwealth of Australia, The Treasury, (2014), *Financial System Inquiry Final Report*, p. 51

<sup>6</sup> *Ibid* p. 64



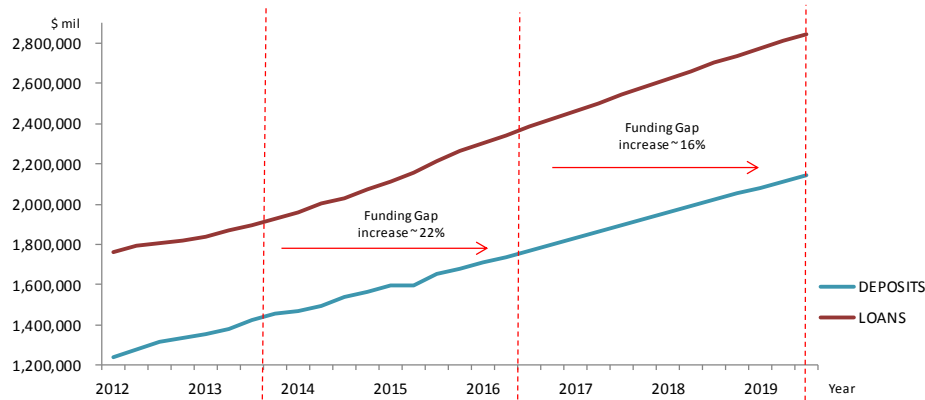
- **Income growth.** There is a clear relationship behind growth in deposits and income growth. Household disposable income growth has been very modest for some years with no signs of an imminent improvement.
- **Compulsory superannuation.** Continued growth in superannuation as a savings tool constrains growth in household deposits.
- **Interest rates.** Low interest rates are a disincentive for savings via deposits.
- **Taxation asymmetries.** The tax treatment of deposits is less favourable than alternative savings options (such as property investment and superannuation). This makes deposits an unattractive asset class for investors, and makes it prohibitively expensive for banks to compensate investors.

The research team at NAB Economics has empirically tested these theories, and found evidence for persistent structural constraints, consistent with the ABA views above. Econometric estimation finds that \$1 of credit growth 'creates' \$0.53<sup>7</sup> of deposit growth, with a correlation of 0.67.

This relationship is evident in APRA's own banking statistics. The March 2016 figures demonstrate that the Australian system continues to deliver lending growth well in excess of deposits. Since September 2015 deposit growth has been \$45bn versus \$92bn of loans.<sup>8</sup>

This relationship is shown in the chart below, which includes a forecast based on expected system asset and deposit growth.

Figure 2: Australian system funding gap<sup>9</sup>



Source: NAB Economics

<sup>7</sup> This number varies between ~\$0.52 - \$0.58 depending on the time period used

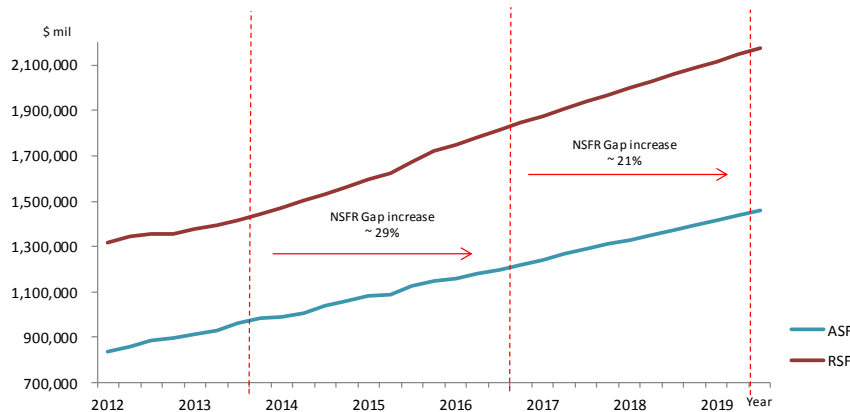
<sup>8</sup> APRA banking statistics, (March 2016)

<sup>9</sup> Based on APRA banking statistics and NAB economics forecasts for system growth

## The funding gap is exacerbated by the proposed NSFR calibration

While the system funding gap continues to grow at a compound annual growth rate (CAGR)<sup>10</sup> of 5.8%, this increases to 7.0% CAGR when NSFR factors are applied. This is largely due to the NSFR weightings on business lending and deposits - shown in Figure 3.

Figure 3: Australian system NSFR gap



Source: NAB

ADIs have a limited ability to compensate for the long-run increase in the system funding gap due to risk appetite and market constraints:

- **Increasing deposits.** The proportion of deposits in the system is difficult to shift for structural reasons detailed earlier.
- **Reducing asset growth.** As shown in Figure 3, this will not increase the level of deposits in the system. A system constrained by NSFR creates a flawed incentive for individual banks to constrain credit growth to improve their individual position. This makes it harder for the system to solve, and is an example of a system-generated negative externality.
- **Increasing term wholesale funding.** Market reality and risk appetite constrain the extent to which increasing term wholesale funding can be used by the system as a solution. Australian banks are already heavily reliant upon offshore markets. Term wholesale senior debt issuance by Australian banks in global markets is already disproportionate to Australia's contribution to global gross domestic product (GDP).

For example, Australia's major banks typically account for ~8% of annual global bank term debt issuance despite Australia accounting for only ~2% of global GDP.

Furthermore, Australia's four major banks are all typically in the top 20 global banks when term debt issuance is measured as a proportion of total assets. It is therefore difficult to consider that Australian banks have significant additional capacity to increase term wholesale senior debt issuance in a sustainable manner.

Extending the tenor of term wholesale senior debt issuance may provide some limited NSFR benefit, however asset managers are increasingly focused on their own liquidity requirements, making meaningful tenor extension challenging.

The introduction of total loss absorbing capacity requirements in Australia may also negatively impact Australian banks' wholesale debt issuance capacity.

<sup>10</sup> Based on APRA banking statistics and NAB economics forecasts for system growth



- **Securitisation.** There is no proven market capacity for this solution, particularly given the volume that would be required to shift the NSFR. Even if there was, over time similar constraints could be expected, as exist for term wholesale funding.
- **Covered bonds.** After collateralisation and encumbrance, this funding solution works against the NSFR. This is illustrated in appendix 1.

An increasing funding gap which ADIs have limited means to resolve, is a structural problem for both industry and the economy. This problem is compounded by persistent current account deficits that will need to be funded from offshore, and tax and superannuation structures, which discourages deposits. Non-repeatable efforts to build adequate buffers in preparation for 1 January 2018 may mask this underlying issue temporarily, but the fundamental economic trends will reassert themselves in time.

There is also a bias towards unencumbered mortgages/household deposits vis-à-vis business credit/deposits. This is unfavourable as it will bias lending away from investment in productive assets across the economy, which will be detrimental to Australia's growth outlook. An IMF Working Paper found that compliance with the NSFR could "have a nontrivial impact on economic growth" in Australia.<sup>11</sup> In addition, current high levels of household debt suggest that there are negative implications for financial stability from a bias towards household credit.

## Managing through a crisis

The structural issues described above occur in an environment of normal market conditions. The issues become more acute during times of wholesale market volatility or closure. Given the limited levers at the disposal of industry to address NSFR, the ABA would expect NSFR metrics generally to decline during times of restricted access to term wholesale funding markets. Disclosing a deteriorating NSFR during a period of market stress runs the risk of compounding an ADI's liquidity position and creating problems for other Australian ADIs. Not disclosing a number the market expects, or extraordinary regulatory action, equally risks compounding volatile market conditions.

Unlike the CLF in the Liquidity Coverage Ratio (**LCR**), there currently is no 'safety valve' in the NSFR metric. This makes it an unsuitable measure during times of stress, as it fails to recognise the liquidity that the Reserve Bank of Australia can generate in times of stress. Arguing that this is a structural measure, and therefore not relevant to a crisis, does little to placate the market in a time of stress.

## ABA recommendations

The ABA recommendations as listed previously now follow in detail.

### 1. Align the treatment of self-securitised assets with funded assets backing the CLF

APRA's proposals require ADIs to meet a 100% NSFR without amending the treatment of self-securitised assets backing the CLF. In order to promote investor confidence in Australia while also addressing the unique characteristics of the Australian financial system, the ABA recommends the following:

- For the purpose of building an NSFR buffer above the 100% minimum, the ABA recommends that APRA allows ADIs to treat self-securitised assets backing the CLF consistently with alternative liquid assets (**ALA**).

<sup>11</sup> Gobat, J., Yanase, M. and Maloney, J. (2014), *The Net Stable Funding Ratio: Impact and Issues for Consideration*, IMF Working Paper, p. 19





The benefits of this approach are that it:

- Addresses the shortage of available HQLA in Australia, which is the reason for the existence of the CLF. Treatment of ALA would be aligned for LCR and NSFR purposes.
- Avoids promoting excessive cross-holdings of bank issued instruments. APRA's proposed rules incentivise banks to purchase and hold securities issued by other banks (10% NSFR RSF) in preference to holding their own self-securitised assets (~65% NSFR RSF) as CLF collateral, despite the fact that this arrangement does nothing to improve NSFR at a system level.
- Enables Australian banks to build buffers sufficiently above the 100% regulatory minimum, thereby supporting investor confidence, reducing the vulnerability of Australian banks to an exogenous market disruption and minimising contagion risks within the Australian financial system.
- Minimises the reported NSFR difference between Australian banks and foreign banks. The ABA notes that in the latest BIS Basel III monitoring exercise<sup>12</sup>, the weighted average NSFR for internationally active banks with a Tier 1 capital base of >EUR3bn was 111.9%.
- Provides regulators with flexibility to respond to a crisis scenario in a timely and effective manner. For example, regulators could, at their discretion, provide LCR and NSFR support to the system in a crisis simply by increasing the size of the CLF, thereby avoiding a pro-cyclical outcome.

## 2. Align the definition of HQLA for the NSFR to the Basel standard

RSF factors are intended to approximate the amount of an asset that would have to be funded because it cannot be monetised through a sale or repurchase agreement over the course of a normal year without significant expense. The NSFR was finalised by the BCBS after the Basel LCR, and with an acknowledgement of the liquidity value inherent in covered bonds, residential mortgage-backed security (**RMBS**), certain corporate bonds and listed equities (i.e. assets that qualify as Level 2A or Level 2B under the BCBS LCR rules). Since these asset classes were deemed liquid over a 30 day severe stress, they were, by extension, deemed liquid in the one year going concern NSFR and hence have RSF factors of 15-50%.

APRA has determined that there are no Level 2A Australian or Level 2B global assets, based on the liquidity characteristics of those security classes in a 30 day LCR stress. The ABA would advocate that the liquidity characteristics of such securities over a one year NSFR horizon is different, but as the NSFR RSF treatment references the LCR, such assets in Australia require a uniform 85% stable funding, placing Australian banks at a material disadvantage to international peers.

Inclusion in the LCR numerator is not taken into account when determining RSF factors in Basel's NSFR. This is demonstrated by the fact that operational restrictions that apply in the LCR do not apply in the NSFR, but rather the NSFR applies RSF factors to the underlying asset type. There is a distinction to draw between the defined range of HQLA securities that are eligible for inclusion in the LCR and the recognition of a broader HQLA definition to which RSF factors are applied in the Basel NSFR. The 85% RSF applicable to many Level 2 qualifying assets under the current APRA approach imply that these securities would only be able to be monetised at 15c in the dollar over the course of a normal year, where there is no need to access the CLF.

The ABA recommends that APRA align its definition of HQLA for the NSFR to Basel and either introduce Levels 2A and 2B assets in Australia's NSFR or reflect the RSF of these assets directly in the NSFR. If not, the proposed super-equivalent treatment will present another hurdle specific to Australian ADIs for implementing the NSFR and create a further barrier to capital markets development.

<sup>12</sup> Basel Committee on Banking Supervision, (March 2016), *Basel III Monitoring Report March 2016*, <https://www.bis.org/bcbs/publ/d354.htm>



In addition, there should not be a need to cap the favourable treatment of ALA to the CLF amount, because under the one year NSFR scenario there is no assumption of the CLF being drawn, liquidity is derived from functioning markets.

Without addressing this super-equivalence, the following occurs under the current APRA proposal:

- Covered bonds have an RSF of 5-15% as Level 1 assets outside Australia and an RSF of 85% in Australia if held outside the CLF.
- RMBS has an RSF of 50% outside Australia and 85% in Australia outside the CLF.
- Exchange traded equities have an RSF of 50% outside Australia and 85% in Australia.
- Corporate debt securities have an RSF of 15-50% outside Australia and 85% in Australia outside the CLF.

In the specific case of listed equities, prior to Basel introducing Level 2B assets as a category in the LCR, non-financial listed equities had their own category in the NSFR that received a 50% RSF factor. These same assets have since been incorporated by Basel into the Level 2B assets definition – a category that receives the same 50% RSF factor. However, since APRA does not recognise the existence of Level 2B assets, all equities held by an ADI now require 85% stable funding by default. Consequently, by Basel including these assets into a more 'liquid' asset category, the net result for Australian ADIs is a 35% increase in the RSF factor attributable to these assets (from 50% to 85%).

### 3. Assigning a stable funding factor to superannuation fund deposits under the NSFR to acknowledge the value of this source of funding

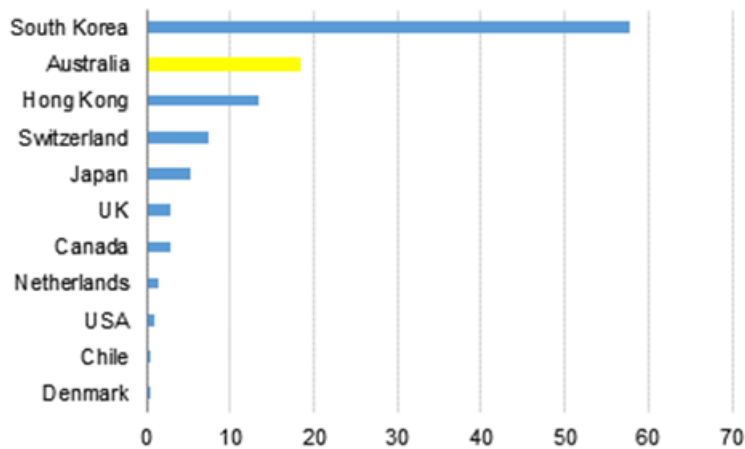
Australia's model of compulsory superannuation means that a larger proportion of household savings is intermediated back into the banking system via financial institutions (i.e. superannuation funds, pension funds and asset managers) than would otherwise be the case. Instead of being deposited directly by households with the banking sector (and qualifying as stable funding), a large proportion of funds end up as deposits from financial institutions, e.g. APRA-regulated registrable superannuation entities (**RSEs**), which are allocated no liquidity or funding value under Basel III.

Figure 4 shows the pension system allocation to deposits in Australia versus other jurisdictions. The high allocation to deposits also compensates for the low allocation to fixed income in terms of the defensive stable part of the system asset allocation. This market dynamic provides a disadvantage to Australian banks in their ability to meet the NSFR. While the repricing term of the deposits is typically less than one year, the stability of these deposits is supported by a growing pool of compulsory contributions and corresponding cash allocations with ADIs.





Figure 4:<sup>13</sup> Asset allocation of pension funds around the world



Source: Financial Services Council, Mercer, February 2014

The ABA recognises the argument that in the LCR's severe 30 day idiosyncratic and systemic stress, the trustee of a super fund, a sophisticated entity, will act in the best interests of members and may withdraw funds at the earliest opportunity. However, the NSFR is not a severe stress scenario, but rather a measure of stability of funding over a one year horizon. Superannuation trustees focus on the long-term decisions and in normal market conditions, trustees do not respond to short-term price or market sensitivities or frequently change investment strategies from cash to other assets. The behaviour of retail fund members themselves also reflects a long-term focus on saving for lasting retirement needs, and resisting making short-term changes in their investment allocations in response to temporary market fluctuations.

Accordingly, the ABA believes deposits received directly from APRA-regulated RSEs<sup>14</sup> are demonstrably stable. Like retail or corporate deposits, they are not as price or market sensitive or concentrated as deposits from other financial institutions or central banks, which are assigned no funding value in the NSFR. The ABA recommends assigning a stable funding factor to super fund deposits under the NSFR to acknowledge the value of this source of funding and not penalise ADIs because of Australia's superannuation system.

#### 4. Allow ADIs to use Basel's standardised risk-weights for the NSFR

The Discussion Paper proposes that the APS 112 standardised risk-weight calculations should be used to determine RSF cut-offs for loans, including mortgages. This has a sizeable negative impact when compared to using Basel standardised calculations which apply a single 35% risk-weight to mortgages (i.e. all mortgages would receive a 65% RSF factor).<sup>15</sup> This effect is magnified given the high proportion of mortgages in Australian ADI's assets. As a result, Australian ADIs have to hold more stable funding because of APRA's more conservative approach to credit risk.

As a result of the scale applied under APS 112, Australian ADIs apply risk-weights in excess of 35% to both non-Lenders Mortgage Insurance (**LMI**) mortgages above 80% of Loan-to-value Ratio (**LVR**) and LMI mortgages above 90% LVR. Risk-weights on such mortgages do not exceed 35% under current Basel Rules. This difference means that this significant portion of mortgages would attract an RSF of 85% in Australia, but 65% under Basel.

<sup>13</sup> Australia includes SMSF deposits. Third party managed super funds allocate c. 13% to deposits based on APRA statistics

<sup>14</sup> The pension funds sub-sector defined in ARF320 Statement of Financial Position is proposed to apply here. It includes all superannuation funds that are regarded as complying funds for the purposes of the *Superannuation Industry (Supervision) Act 1993* and other autonomous funds established for the benefit of public sector employees

<sup>15</sup> Basel is expected to alter its RWA methodology later this year which could drive an even greater differential, depending on whether any subsequent changes are made by APRA to APS 112



APRA should allow ADIs to use Basel's calculation of standardised risk-weights for the NSFR, whether in the current or a future approved form, to ensure comparability with international peers.

## Additional points for consideration

In addition to the four key recommendations, the ABA takes this opportunity to highlight additional issues for APRA's consideration.

### The treatment of derivatives

The ABA recommends that derivatives used to hedge foreign currency denominated funding transactions be excluded from the NSFR derivatives calculation. This approach recognises the high probability of AUD depreciation in a crisis scenario impacting the Australian financial system and the subsequent cash inflows that are likely to be generated for Australian banks when the collateralised cross currency swaps used to hedge foreign currency denominated debt issuance are revalued. This treatment is consistent with APRA's treatment of funding derivatives for the LCR.

The treatment of derivatives in the NSFR is complex, as balance sheet views do not provide a sensible indication of the required amount and tenor of funding for derivatives. Whilst the proposed NSFR methodology is conceptually on the right track, there are some aspects that the ABA believes are overly conservative and could be further refined. These include:

- The qualifying variation margin (**VM**) should include all margin received up to the mark-to-market of the derivative contract, rather than excluding all margin received where the mark-to-market is not fully extinguished. This approach aligns with LCR methodology and reflects the legal arrangements in place for derivative contracts. In the event of counterparty default, the bank can offset any margin received up to the revaluation of the derivative exposure.
- The qualifying VM should not depend on the currency of VM received. The currency does not impact the funding value of the margin and the foreign exchange conversion risk on settlement is already captured by the LCR.
- The qualifying VM should include all HQLA received, subject to appropriate haircuts already in place, and not just restrict qualifying VM to cash.
- The NSFR should recognise the funding value of rehypothecable initial margin received. One approach would be to net this balance against initial margin posted and apply the 85% RSF requirement on the net balance.
- The 20% RSF requirement on derivative revaluation liabilities should be implemented as a floor, rather than an add-on to derivative stable funding requirements.
- The NSFR should recognise the contractual tenor of the derivative portfolio. A methodology similar to lending assets which apply a reduced stable funding factor to <12 month loans based on counterparty type could also be applied to derivatives.

### The NSFR impact on securitisation and covered bonds

APRA's NSFR proposal has a negative impact for securitisation and covered bond issuance compared to senior unsecured.

ADI's that don't meet the NSFR requirement, or are close to the NSFR limit, will be discouraged from undertaking securitisation and covered bonds and will favour senior unsecured because encumbered assets are attributed a 100% RSF factor. Securitisation and covered bonds provide important diversification of an ADI's funding portfolio which provides access to different investors and markets in times of stress.



An example of how securitisation and covered bonds impact NSFR is included in Appendix 1. This is also explained in the European Mortgage Federation & European Covered Bond Council (**EMF-ECBC**) submission<sup>16</sup> to the BCBS, a position which the ABA supports.

The ABA recommends:

- In line with the EMF- ECBC submission which recommends that assets backing RMBS and covered bonds should be treated equivalently with unencumbered assets; the ABA recommends that APRA excludes assets that are encumbered for securitisation and covered bonds from having a 100% RSF factor. This will ensure that securitisation and covered bond issuance is treated on a similar basis to senior unsecured funding in the NSFR calculation.
- That securitisation and covered bonds be included as Level 2 assets in the NSFR as discussed in Recommendation 2.
- That APRA adopts symmetric RSF and ASF factors for the amortisation of the securitised mortgages and amortisation of the funding raised via the issued RMBS, i.e. 0% RSF for home loans < 6 months, in line with the ASF treatment of the amortisation of the funding raised via RBMS.
- That APRA aligns the NSFR's treatment of date based calls for master trust to be consistent with Basel. Date based calls will be included in master trust structures to facilitate foreign currency issuance and diversification of investor base. There are circumstances where an ADI might have an embedded right to redeem funding at a point prior to maturity (for example, to allow for pricing flexibility), but there is absolutely no market expectation that the funding would be redeemed prior to maturity. Under APRA's approach, that funding would need to be profiled at the 'earliest possible maturity date' regardless of market expectations, whereas the Basel rules allow for some flexibility.

## Treatment of swaps with securitisation and covered bond trusts

Securitisation and covered bond swaps are documented under one-way credit support annex. However, the protection offered by the cover pool and the absence of termination (as swaps are designed to survive the insolvency of the issuing institution) should be considered as cash-like collateral, and be treated accordingly in the calculation of the NSFR, i.e. with a 0% RSF weighting.

## Wholesale funding portfolio of an ADI

In relation to an ADI's wholesale funding portfolio, it is difficult for ADIs to track the current holder of bonds, especially where they are traded in the secondary market. Under APRA's proposals, an ADI's wholesale funding will default to being held by "all other legal entities" and this introduces a difference in treatment in the NSFR of funds received from a corporate in a deposit or from holding bonds.

Specifically the investor type impacts the ASF factor where the residual maturity of the funding deal is in the 0-6 month bucket. Unsecured funding from non-financial corporates, and sovereigns, public sector entities, multilateral development banks and national development banks are each afforded an ASF factor of 50%, whereas unsecured funding from central banks and other legal entities (including financial corporates and financial institutions) receive an ASF factor of 0% while non-operational corporate deposits in the 0-6 month bucket receive a 50% factor.

The ABA recommends that APRA considers an alternative approach for an ADI to identify the holder of their bonds when that investor cannot be readily identified. Any revised approach should allow for behaviour modelling of ADI's portfolios to determine a proxy for the percentage of corporates holding their bonds which could be used in the NSFR calculation. This behaviour modelling could be based on the primary issuance holder and be agreed with APRA on an annual basis.

<sup>16</sup> The European Mortgage Federation & European Covered Bond Council, Final EMF-ECBC Position Paper on the Net Stable Funding Ratio (NSFR), (11 May 2016), <http://intranet.hypo.org/docs/1/KNFFJLKBIFOCLMENMCAHIFFIPDWN9DBDGDTE4Q/EMF/Docs/DLS/2016-00040.pdf>



Strong banks – strong Australia

## Treatment of callable term deposits

The process of using the first callable date for the treatment of the 31 day right to break term deposit products seems inconsistent with a structural measure such as the NSFR. In recent years Australian banks have worked to increase the tenor of term deposits which has in turn increased the overall stability and resilience of the banking sector. In recognising the final contractual maturity, APRA preserves an incentive to write term deposits greater than one year which further promotes funding stability.

The amount of term deposits called under the 31 day right to break term deposit products is immaterial, therefore the ABA recommends that APRA acknowledges the final contractual maturity of the term deposit to assist banks to increase tenor in line with the objectives of the NSFR.

## Conclusion

The Australian implementation of the NSFR is of critical importance for both the Australian banking industry and the Australian economy which we serve.

It is crucial that APRA's NSFR policy framework facilitates not only APRA's prudential objectives, but also retains appropriate flexibility for ADI's to manage their balance sheets while avoiding any negative flow-on affects to the economy.

Given the significance of the potential funding task facing Australian ADIs, combined with our need to maintain momentum to ensure we comply on 1 January 2018; the ABA and members would like to engage with APRA ideally this July to discuss the content of this submission. The ABA thanks APRA for the considerable work undertaken to date, and we look forward to future discussions.

Yours sincerely

A handwritten signature in black ink, appearing to read 'Aidan O'Shaughnessy'. The signature is written in a cursive, flowing style.

Aidan O'Shaughnessy  
Policy Director – Industry Policy  
Aidan.O'Shaughnessy@bankers.asn.au



## Appendix 1

### Funding-only RMBS

For a funding-only RMBS of \$1bn, \$900m of AAA rated senior notes are issued and subordinated notes of \$100m are retained.

#### RMBS issued

- The \$900m AAA rated pass through senior notes ASF weightings will be:
  - 100% for notes with an expected life > 1 year
  - 50% for notes with an expected life of 6 months – 1 year
  - 0% for notes with an expected life of < 6 months
- The \$100m subordinated notes are attributed a 0% ASF.

#### Securitised home loans

The \$900m securitised home loans corresponding to the \$900m of the AAA rated senior notes shift from a 65% RSF where > 1 year to an RSF of 100%. The ABA would like APRA to clarify in the revised APS 210 or guidance note that the dollar amount of home loans maturing on the asset side is equal to the forecast dollar amount of pass-through notes repaid.

The \$100m of securitised home loans attributed to the \$100m of subordinated notes that are retained by the ADI remain with an RSF of 65% where > 1 year.

#### Loans < 1 year remain at 50% RSF

This penalises pay down RMBS because this portion of the notes has an ASF of 0% for < 6 months but the home loans have an RSF of 50%.

In summary, the securitised home loans shift from a RSF factor of 65% to 100% and the paydown portion receives asymmetrical treatment, so the overall NSFR benefit of the securitisation is lower compared to senior unsecured.

### Capital-relief RMBS

For a capital-relief RMBS of \$1bn, \$900m of AAA rated senior notes and \$100m of subordinated notes are issued, both attributed a 0% ASF factor and the \$1bn of securitised home loans attributed a 0% RSF.

### Covered bonds

Assume a covered bond pool of \$10bn of home loans and \$5bn of covered bonds outstanding - the minimum required amount of over-collateralisation (**OC**) is 10% = \$500m.

- Actual OC provided = \$5bn (\$10bn - \$5bn).
- Covered bonds issued of \$5bn are attributed a 100% ASF factor (for debt maturing  $\geq$  1 year).
- The covered bond pool of \$5.5bn is attributed a 100% RSF factor (loans that are  $\geq$  1 year). The 'excess' OC of \$4.5bn is attributed a 65% RSF because it can be repaid back to the bank within a day.

The overall impact of covered bond issuance is negative compared to senior unsecured, due to OC. The negative impact is greater the larger the required minimum OC, relative to the outstanding covered bonds.