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Dear Ms Richards

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 comments on APRA's response paper *Basel III liquidity – the net stable funding ratio and the liquid assets requirement for foreign ADIs (response 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 measured approach on how the Net Stable Funding Ratio (**NSFR**) requirements could be applied in Australia, and supports proposals aimed at strengthening the Australian banking system's resilience. The proposals in the response paper are a reflection of APRA's engagement with industry during the policy formation process.

The ABA encourages APRA to continue developing a NSFR framework that caters for features unique to the Australian economy and its banking system in order to strike the critical balance between funding resilience, stability and supporting economic growth through all stages of the economic cycle.

A number of challenges still remain for those banks impacted by the NSFR requirements.

For ease, the ABA has arranged our comments using the numbered headings in APRA's response paper with some further comments on the revisions to the *Prudential Standard APS 210 Liquidity (APS 210)* and the *Prudential Practice Guide APG 210 Liquidity (APG 210)*.

The ABA urges APRA to continue monitoring international developments and interpretations pertaining to NSFR and shape domestic policy outcomes and definitions to ensure Australian banks are not unduly disadvantaged. ABA members welcome the opportunity to work collaboratively with APRA as they operationalise NSFR over the coming year and through the transition phase. The ABA is able to facilitate this as required.



2.2 Use of Basel standardised credit risk weights for NSFR purposes

The ABA notes the emphasis APRA places on alignment with Basel standards and the priority placed on this objective in all but one of the specific issues addressed in Chapter 2. The exception is section 2.2 covering standardised credit risk weights.

Three reasons are provided for the application of APRA's current standardised mortgage risk weights to the NSFR factors, these are:

- 1) Consistency across APRA's prudential standards.
- 2) Prudent management of funding risk.
- 3) The temporary nature of the inconsistency to Basel standards.

Each of these is addressed in turn below.

Consistency across APRA's prudential standards

The ABA accepts that internal consistency across APRA's prudential standards is important, but suggests that this approach should only be applied where *relevant*, and set against the BCBS's overriding objective of *international comparability and harmonisation*.

Firstly, the question of relevance: the ABA would hold that APRA's enhanced standardised risk sensitivity for credit risk provides little insight into funding risk. The argument for internal consistency therefore is not strong.

Secondly, international harmonisation: differences to the Basel standard already exist on standardised credit risk weights. The ABA suggests that this variance should not necessarily lead to a variance in NSFR interpretation. A mechanism to avoid this inconsistency with Basel standards is discussed later.

Risk management

The mortgage factors identified by APRA to enhance credit risk sensitivity in standardised mortgage models are: the presence of lenders mortgage insurance (**LMI**), Loan-to-value Ratio (**LVR**), and standard/non-standard designation. While these factors are relevant for an individual credit risk assessment, when considered on an overall portfolio basis, these factors have much less relevance for funding/liquidity risk. This is particularly so when one considers the ability to securitise mortgages (or use in a covered bond pool) rather than the cost or price at which these loans may be securitised/placed in a covered bond pool.

Recent residential mortgage-back security (**RMBS**) issuance confirms the ability to structure and successfully execute RMBS transactions that have wide ranging portfolio parameters¹. This includes portfolios of loans that incorporate a higher proportion of high LVR loans; higher weighted average LVR's and portfolios that include 100 per cent non-conforming loans. Noting also that the proportion of non-standard loans is a tiny fraction of major banks' mortgage books² and the major bank's LVR composition is well inside RMBS transactions undertaken by the broader market.

In respect of LMI, since 2007, the RMBS investor community sees much less value in LMI coverage. To this end, the major banks' RMBS transactions undertaken for funding purposes from 2008 onwards have been structured to exclude any benefit to LMI. To the extent this investor view changes, the banks can always pay for pool mortgage insurance at the time of issuance and still execute the transaction. The cost of the pool mortgage insurance is not onerous and would just form part of the cost to execute the transaction. So a successful RMBS transaction is not predicated on the need to have LMI in place at origination.

¹ ABA members can provide this information to APRA on request.

² See for example:

Prudent Mortgage Lending Standards Help Ensure Financial Stability, Luci Ellis, 2012 <http://www.rba.gov.au/speeches/2012/sp-so-230212.html>; Some Effects of the New Liquidity Regime, Guy Debelle, 2015 <http://www.rba.gov.au/speeches/2015/sp-ag-2015-12-16.html>;

The Risk Environment and the Property Sector, Malcolm Edey 2015 - <http://www.rba.gov.au/speeches/2015/sp-ag-2015-11-06.html>



In respect of covered bonds, the value placed on LMI by the rating agencies in determining the amount of over-collateralisation required to AAA is nil to negligible. So covered bond issuance is also not predicated on the need to have LMI in place at origination.

As such, the ABA sees little reason to diverge from the Basel standardised risk weights out of concern for the prudent management of funding risk. Basel standardised credit risk weight factors reflect funding risk appropriately when integrated with NSFR.

The temporary nature of the inconsistency to Basel standards

The ABA is hopeful that inconsistencies across Basel jurisdictions may reduce due to the imminent revisions to the committee's standardised approach to credit risk. However, the final form of the BCBS standard, and how APRA will adopt such reforms is yet unknown and the domestic implementation is a number of years away. Until then, Australian ADIs will have a material inconsistency with the international competitors on reported NSFR. The experience of ABA members shows that such inconsistencies are an unhelpful distraction for Australian banks and international investors, and is also likely to add complexity to the important work to ensure Australia's banks are viewed as 'unquestionably strong'.

The ABA also notes that the FSI recommendation on transparent reporting of capital levels seeks to support Australian banks' access to international funding markets. A consistent NSFR metric would assist in achieving this objective.

Proposed solution

The ABA's preferred approach is to either directly reference the relevant Basel standard³ in APS 210, or insert text to that effect into the standard (rather than referencing APS 112). This achieves closer international harmonisation on NSFR, without compromising the management of funding/liquidity risk or impacting APRA's objective of a stable, efficient and competitive financial system.

An alternate approach is to develop an internationally harmonised NSFR, similar to the approach taken by APRA in their 2015 study comparing the capital position of Australia's major banks against a group of international banking peers. Developing a separate internationally consistent NSFR measure is not the approach preferred by members.

The ABA considers that the adoption of the Basel standardised risk weight for NSFR purposes will provide benefits that outweigh concerns around consistency, risk management and timing. In no way will this distract Australian banks from their commitment to continue strengthening stable funding profiles for their entire loan book in a sustainable manner.

2.4 Member-directed superannuation deposits

In regards to APRA's proposals for member-directed superannuation deposits, the ABA believes that the proposals, as they stand, fail to reflect the stable nature of these deposits. Superannuation deposits have demonstrated stable characteristics reflective of the long-term investment allocations and strategies of superannuation funds.

In the ABA's original submission on the NSFR, we noted the size of the superannuation system within the Australian financial system, and the stable long-term investment allocations towards deposits. The ABA continues to believe that superannuation has a positive impact on the availability of high quality retail-like deposits in the system, which is only set to increase. A NSFR treatment that more accurately reflects the stable nature of these deposits is critical to the sustainability of the industry's NSFR, and the improvement of the funding resilience of the broader financial system without any increase in systemic risk. The proposals could have the unintended consequence of discouraging term deposit investments through superannuation which has the potential to increase the risk profile of retail member funds.

³ As set out in the standardised approach for credit risk in Basel II: International Convergence of Capital Measurement and Capital Standards: A Revised Framework – Comprehensive Version, June 2006: refer to <http://www.bis.org/publ/bcbs128.htm>



Strong banks – strong Australia

The ABA requests that APRA reconsiders its decision not to assign a stable funding factor to superannuation fund deposits under the NSFR to recognise the value of this stable source of funding. This change will ensure that ADIs and retail members are not penalised because of the structural features of Australia's ever growing superannuation system.

2.9 Discretion to increase the NSFR requirement

The ABA notes APRA's discretion to increase an ADI's NSFR requirement above the regulatory minimum of 100 per cent. However, exercising that discretion must be done in a manner which avoids the unintended consequence of increasing financial risks to the ADI and across the broader financial system. Any uncertainty within financial markets can quickly escalate into declining market confidence.

For example, any material increase in an ADI's NSFR regulatory minimum above 100 per cent will result in that ADI operating with a smaller buffer to the regulatory minimum (due to system-level constraints on customer deposit growth and wholesale debt issuance in Australia). This in turn would reduce an ADI's flexibility to withstand a period of market dislocation before breaching its NSFR regulatory minimum – noting that such a breach would likely need to be disclosed to the market, thereby exacerbating funding difficulties being experienced at that point in time.

The response paper notes that "APRA would set the NSFR on a bilateral basis with the ADI". One suggested approach, in line with the proposed APS 210 which provides APRA with the required supervisory oversight would be to work with ADIs to ensure that sufficient board and management buffers are established above the 100 per cent NSFR regulatory minimum. Each ADI would be required to notify APRA upon a breach of any agreed trigger level including the ADI's plan for remediation. ABA members would welcome the opportunity to share ideas with APRA on this topic as part of the collaboration as the industry transitions to NSFR.

Draft Prudential Standard APS 210 - Liquidity

Regarding APS 210, the ABA wishes to highlight the following:

Term Deposits

Regarding paragraph 8, *Maturity of funding* in Attachment C: APRA's proposal to use the 31 day maturity (per ASIC Class Order relief on breakability) as the earliest date at which term deposits may be redeemed conflicts with actual experience of early redemptions and places banks' term funding profiles at risk. Such deposits have experienced minimal early withdrawals throughout the cycle. The ABA encourages APRA to engage with members to gain full appreciation of the immaterial rate of early withdrawal, with or without notice.

A 31 day notice term deposit has become a standard feature of the market because of the ASIC regulatory requirement to provide this flexibility to retail customers. The proposed NSFR treatment is likely to be significant for pricing and term deposits of considerably longer maturity than 31 days. The cut-off at the notice period limits banks' ability to reflect the value of term deposits in pricing. For example, the funding value of 3, 6 and 12 months retail term deposits are equivalent (i.e. all at 31 days). This will impact the composition of banks' balance sheets as demand for these deposits falls at the expense of short dated deposits just outside the 30 day Liquidity coverage ratio window. This will not only increase banks' funding risk profiles but also put further pressure on long term wholesale funding as the only avenue to achieve full NSFR relief.

Clarification of the treatment of family trusts

APS 210 is currently silent on the treatment of family trusts and one available interpretation is to apply financial institution treatment. In practice, family trusts bear very little difference to self-managed super funds, as they are set up and managed by related beneficiaries. The ABA would welcome clarification from APRA that family trusts are retail in nature, akin to SMSFs, to the extent they do not manage money professionally (i.e. for non-related beneficiaries).



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Reporting requirements for the NSFR

As banks begin to operationalise the NSFR, the ABA members would greatly appreciate early clarity and finalisation of the reporting requirements for the NSFR, including reporting frequency and external disclosure requirements. As APRA will appreciate, given the nature of certain calculations, this guidance on reporting requirements is critical for minimising costs and finalising the technological work required to build the solutions for NSFR reporting compliance.

The ABA looks forward to continued dialogue with APRA to ensure an efficient and effective implementation of the NSFR.

Yours sincerely

Signed by Aidan O'Shaughnessy

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