Regulation Impact Statement Executive Summary

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

(OBPR ID: 2015/19640)

1. This regulation impact statement has been prepared by the Australian Prudential Regulation Authority (APRA) to inform APRA's proposals on implementing the internationally agreed reforms for liquidity management of banks, including notably the second global liquidity standard – the net stable funding ratio. APRA's prudential framework for ADIs is based on the framework agreed by the Basel Committee on Banking Supervision (Basel Committee). The Basel Committee regularly reports to the Group of 20 (G20) Leaders, which includes Australia's Prime Minister, and to the Financial Stability Board. Since the global financial crisis, G20 Leaders have committed to fully and consistently implement the international framework known as 'Basel III'.

2. The key problem assessed by APRA is how to apply the requirements of the internationally agreed framework to the Australian market. APRA's implementation has sought to capture the benefits of reduced risk while limiting costs where possible. APRA considers it appropriate to mitigate costs for smaller, less complex ADIs that could be unduly burdened by the requirements. Therefore, APRA has made reasonable adjustments to the international framework that maintain consistency while appropriately considering Australian-specific market conditions.

3. For implementation of an additional liquidity requirement in Australia (the net stable funding ratio), APRA has considered two options. Option 1 involves applying the additional liquidity requirement only to larger ADIs, consistent with the Basel framework. Option 2 considers the appropriateness of applying the additional liquidity requirement to all locally incorporated ADIs. The option to not introduce an additional liquidity requirement (the status quo) is not considered viable given the commitment of reforms by all the G20 governments, the high costs to Australian financial institutions of complying with the requirements of multiple foreign jurisdictions that would otherwise apply, as well as the risk to market fragmentation and reduced access to global markets in the absence of the requirement.

4. APRA recommends Option 1, which implements the requirement in a manner consistent

with the internationally agreed Basel framework. This option results in an estimated cost to industry of $23.825 million and affects a small group of larger, more complex ADIs – of which there are currently 15.

5. For the liquid assets requirement applicable to foreign ADIs, APRA has also considered two options: Option 1 being the status quo plus a local operational capacity assessment and Option 2 being an adjusted minimum liquidity holding plus a local operational capacity assessment.

6. As part of the formal consultation process APRA undertook two rounds of consultation and received 26 submissions in response to consultation. APRA also engaged directly with industry bodies and individual institutions to inform the proposals and the recommended responses to them.

7. This second pass final assessment regulation impact statement builds on the first pass statement and feedback from interested parties received as part of the consultation process on the proposals outlined herein.

Regulation Impact Statement

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

(OBPR ID: 2015/19640)

Introduction

1. This Regulation Impact Statement (RIS) has been prepared by the Australian Prudential Regulation Authority (APRA). Its purpose is to assist APRA in making a decision on proposals aimed at strengthening the Australian banking system, specifically with regard to liquidity[1] management.

2. APRA's prudential framework[2] for ADIs is based on the framework agreed by the Basel Committee on Banking Supervision (Basel Committee). In December 2010, the Basel Committee released *Basel III: International framework for liquidity risk measurement, standards and monitoring,*[3] which set out key measures designed to strengthen the liquidity risk profile of banks thereby promoting a more resilient global banking system. APRA implemented the first of these measures, being the liquidity coverage ratio (LCR), with effect from 1 January 2015, informed by a standard-form RIS.[4]

3. This RIS deals with two further key matters. The first is the proposed implementation of the second Basel Committee liquidity measure, known as the net stable funding ratio

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1 Liquidity refers to the ability to convert assets into cash in order to meet financial obligations as and when they fall due.

2 The prudential framework refers to the rules that a regulated institution is required to comply with as a condition of its licence.

3 *Basel III: International framework for liquidity risk measurement, standards and monitoring*, Basel Committee, December 2010

4 Regulation Impact Statement: *Implementing Basel III liquidity reforms in Australia* (OBPR ID:2012/14531), December 2013

(NSFR), which is designed to ensure that authorised deposit-taking institutions (ADIs)[5] fund their activities with appropriate stable funding sources. The second is a review of the liquid assets requirement for foreign ADIs (branches of foreign banks not incorporated in Australia).[6]

4. Implementation of the NSFR would necessitate changes to reporting requirements for affected ADIs. Similarly, the review of the liquid assets requirement for foreign ADIs may also require reporting changes for affected ADIs if the current LCR regime is modified.

5. In addition to the two key matters outlined above, APRA is also proposing to make minor amendments to existing liquidity requirements, for the purposes of clarity and consistency. This will include minor changes to the liquidity prudential standard, prudential practice guide and reporting standard. [7]

6. APRA has prepared this RIS to assist in decisions on the proposals. This RIS provides additional information on those proposals which the Office of Best Practice Regulation (OBPR) advises are likely to have a measurable but contained impact. This RIS has been prepared in accordance with OBPR guidance.[8]

Background

The Basel III liquidity framework

7. APRA's prudential framework for ADIs is based on the framework agreed by the Basel Committee. The Basel Committee regularly reports to the Group of 20 (G20) Leaders, which includes Australia's Prime Minister, and to the Financial Stability Board (FSB). Since the global financial crisis, G20 Leaders have committed to fully and consistently implement the international framework known as 'Basel III'.[9]

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5 'ADI' refers to a bank, building society or credit union so known as they are authorised to conduct banking business including the taking of deposits and the making of loans.

6 Foreign ADIs (overseas banks that operate in Australia as branches) are not allowed to accept retail deposits.

7 Refer to *Prudential Standard APS 210 Liquidity* and *Prudential Practice Guide APG 210 Liquidity*.

8 *Australian Government Guide to Regulation*, March 2014

9 The major Basel III reforms are set out in *Basel III: A global regulatory framework for more resilient banks and banking systems*, December 2010, revised June 2011.

8. The Basel Committee's liquidity standards, known collectively as the Basel III liquidity framework, complement the capital framework[10] for internationally active banks and consist of the:

- *Principles for Sound Liquidity Risk Management and Supervision*[11] which set out high-level guidance for sound governance and management of liquidity risk;
- *Liquidity coverage ratio* (LCR)[12] which requires high-quality liquid assets at least equal to short-term net cash out-flows to build resilience to liquidity shocks; and
- *Net stable funding ratio*[13] which requires funding from stable sources to be at least equal to risk-weighted funding requirements to promote sustainable funding structures over time.

9. A stable funding requirement has been well publicised by the Basel Committee with the original proposed standard released in 2010.[14]

Basel III liquidity framework implementation in Australia.

10. The *Principles for Sound Liquidity Risk Management and Supervision* and the LCR were implemented in Australia with effect from 1 January 2015. The options under discussion in this RIS relate to:

- implementation of the NSFR; and
- a review of the liquid assets requirement that applies to foreign ADIs.

Current Australian liquidity requirements

11. Existing liquidity requirements for ADIs are set out in *Prudential Standard APS 210 Liquidity* (APS 210). APS 210 specifically requires an ADI to:

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10 Refer to APRA's website for details of the capital framework

11 *Principles for Sound Liquidity Risk Management and Supervision*, Basel Committee, September 2008

12 Originally set out in *Basel III: International framework for liquidity risk measurement, standards and monitoring*, December 2010 and revised in *Basel III: The Liquidity Coverage Ratio and liquidity risk monitoring tools*, January 2013

13 Originally set out in *Basel III: International framework for liquidity risk measurement, standards and monitoring*, December 2010 and revised in *Basel III: the net stable funding ratio*, October 2014

14 *Basel III: International framework for liquidity risk measurement, standards and monitoring*, Basel Committee, December 2010

- have a robust framework to manage liquidity risk;
- maintain sufficient liquidity to meet its obligations as they fall due;
- hold a minimum level of high-quality liquid assets (HQLA)[15] necessary to survive a short-term severe liquidity stress. This quantitative requirement involves:
  - a minimum LCR - high-quality liquid assets equal to at least 100 per cent of total estimated net cash outflows over a 30-calendar day period, where APRA has identified the ADI as an 'LCR ADI' considering its size and complexity with respect to liquidity risk;
  - a reduced minimum LCR - high-quality liquid assets equal to at least 40 per cent of total estimated net cash outflows over a 30-calendar day period for foreign ADIs; or
  - minimum liquidity holdings of nine per cent of liabilities in specified liquid assets for all other ADIs;
- maintain a robust funding structure appropriate for its size, business mix and complexity. There is no existing requirement which specifies the calculation for a minimum level of stable funding; and
- inform APRA as soon as possible of any concerns an ADI has about liquidity and plans to address those concerns.

12. Reporting requirements are set out in *Reporting Standard ARS 210.0 Liquidity* (ARS 210).

15 HQLA are the most liquid assets of an ADI. That is, they can be readily converted into liquidity in need with minimal or no loss of value.

Policy problem and need for government intervention

13. A key element of the prudential framework is to ensure that ADIs adopt prudent practices in managing their liquidity risk and maintain appropriate funding arrangements to meet their obligations as they fall due, including during an entity-specific or systemic stress event.

High reliance on less stable funding

14. During the global financial crisis the international banking system came under severe and in some cases prolonged liquidity stress. Short-term wholesale funding became more expensive and availability reduced rapidly at the same time as asset sales became more challenging. Individual banks that relied more heavily on less stable sources of funding faced a rapid deterioration in their liquidity position. The interconnected nature of the banking system severely reduced access to new funding, crystallising liquidity risk which spread across banks. Governments and central banks in many jurisdictions around the world, including Australia, were required to support the capacity of financial institutions to access funding.[16]

15. The events of the global financial crisis highlighted the importance of maintaining a stable funding profile over time. Where a bank's assets and off-balance sheet activities are supported by a funding portfolio that is less likely to face material erosion during times of stress, the likelihood of failure due to a lack of liquidity is reduced. Sustainable funding structures facilitate ADIs being able to meet their financial obligations to deposit-holders and other creditors supporting both the liquidity of an individual ADI and the financial system as a whole. The Financial System Inquiry Final Report noted that Australia's four major banks have a large exposure to offshore funding. This concentration in funding means that Australia 'is susceptible to the dislocation of international funding markets or a sudden change in international sentiment towards Australia'.[17]

16. Although the Australian banking system has moved towards adopting more stable funding sources since the financial crisis, weaknesses in funding remain including significant reliance on short-term offshore wholesale funding. It is this form of funding

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[16] Refer to the Australian Government Guarantee Scheme for Large Deposits and Wholesale Funding.

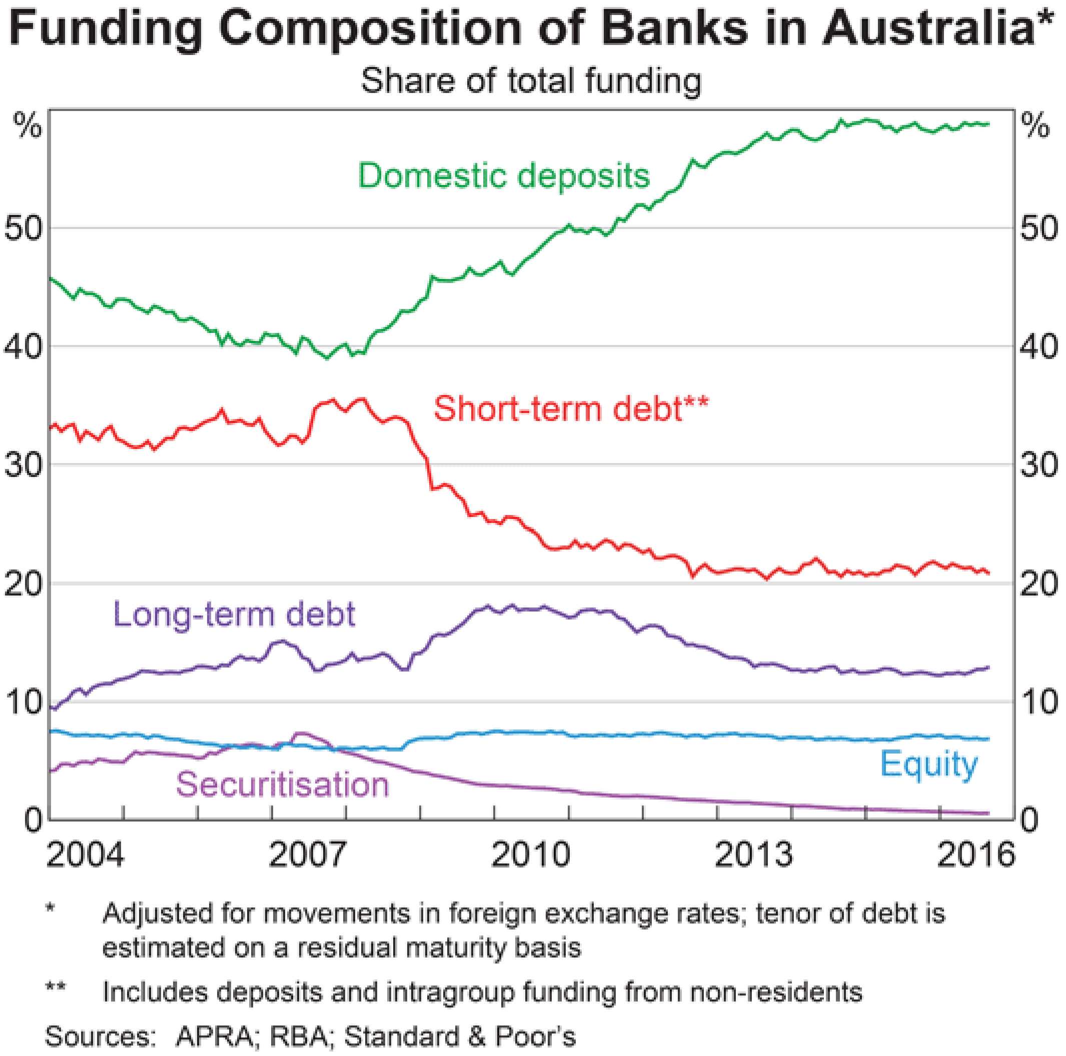
[17] *Financial System Inquiry Final Report*, November 2014, page 22

that is often one of the first funding sources to be withdrawn during periods of stress in financial markets, as was demonstrated during the financial crisis. Where funding is withdrawn, ADIs need to find alternate funding sources in order to continue to meet their obligations. However, during periods of stress, funding comes at a higher cost and is harder to obtain, exposing ADIs to the risk of being unable to secure sufficient funding in time.

17. Graph 1 below shows that the key sources of funding for Australian banks, including domestic deposits, short-term debt, long-term debt and equity. Domestic deposits and long-term debt funding tend to be more stable whereas short-term debt is a less-stable funding source. The stability of these funding sources will also be a function of whether the funding is wholesale or retail funding. Wholesale funding tends to be less stable as wholesale investors are typically larger, more sophisticated investors and are more likely to move their funds around in search of higher yields and will quickly move their funds if they form a view that their investment may be at risk – they are typically in a better position to assess such risks.

18. As shown in graph 1, since the global financial crisis, ADIs have shifted towards more stable sources of funding, particularly deposits. While aggregate short-term debt has fallen as shown in graph 1, graph 2 shows that short-term offshore wholesale funding has increased for the major banks as a proportion of their funding base. It is this type of funding that is most vulnerable and subject to flight risk during a stress event as was demonstrated during the global financial crisis.

Graph 1[18]



19. In anticipation of the new international NSFR standard, ADIs as noted above have been moving to more stable funding sources, but there is still more to do with respect to short-term offshore wholesale funding.

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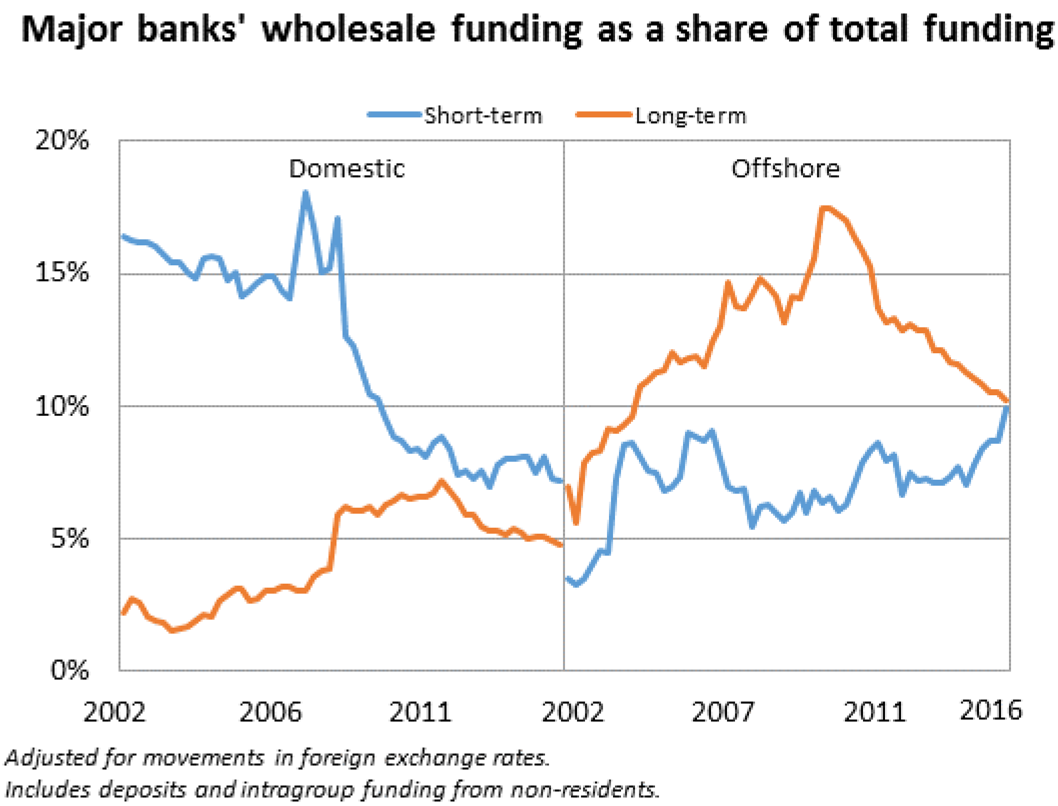
18 This chart has been sourced from Chart pack, Reserve Bank of Australia website.

Graph 2[19]



20. The market provides limited incentive to avoid excessive reliance on less stable funding sources. The return available from accepting the risk associated with short-term wholesale funding can be attractive to ADIs. Short-term wholesale funding can be comparatively cheaper, readily available while normal conditions persist and exposures can be relatively easy to modify over-time compared to other more stable funding options such as deposits. Short-time funding sources can be used to rapidly expand the assets of ADIs and improve the return on those assets. These features mean ADIs' relatively high reliance on short-term wholesale funding will continue unless government intervenes, as there is limited incentive for ADIs to use more stable sources of funding.

21. The elements of the Basel III liquidity framework that have been implemented to date do not specifically target funding mismatches. The *Principles for Sound Liquidity Risk Management and Supervision* inform the approach ADIs should take in managing liquidity risk, while the LCR sets a required level of liquidity to be held for a 30-day period. The issue of stable funding, to be held over a longer duration, has not yet been

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[19] Sourced from the Bulletin, *Development in Banks' funding costs and lending rates*, Reserve Bank of Australia, March 2016.

addressed in the Australian financial system.

22. The objective of government intervention would be to mitigate the risk of future funding stress for individual ADIs, and also to minimise the potential for funding stress to erode financial market stability. Intervention promotes cross-jurisdictional consistency in the regulation of ADIs and ensures that, where there are sound reasons for doing so, the Australian prudential framework remains aligned with international standards. Full implementation of Basel III is consistent with Australia's G20 commitments.

23. The specific decision about how best to implement the Basel NSFR standard, and the options for consideration, requires consideration of the different types of ADIs that operate in Australia. ADIs can be broadly classified as larger, more complex ADIs or smaller, less complex ADIs. The distinction reflects not only size but that fact that at the larger end of the market the business of ADIs tends to be broader and includes operations beyond simple deposit-taking and lending. In addition, the nature of customers an ADI typically deals with will vary with size. The larger end of the market is typically more reliant on wholesale funding from offshore markets given the Australian domestic financial markets tend not to have sufficient liquidity for their purposes. Smaller, less complex ADIs can typically rely, to a large extent, on their deposit base to fund their lending activities. The existing designation of liquidity coverage ratio (LCR) ADIs tends to capture those ADIs that have larger, more complex operations and which typically access international capital markets whereas the minimum liquid holdings approach is appropriate for smaller, less complex ADIs.[20] In considering the options for application of the NSFR, APRA has taken into account that:

- the NSFR is designed to promote financial safety by ensuring that ADIs maintain a stable funding profile relative to their on- and off-balance sheet activities. This reduces the possibility that disruptions to funding could undermine an ADI's liquidity position, and in so doing offers benefits to the Australian community by improving the capacity of ADIs to continue to operate even in stressed conditions;

- for ADIs that access international capital markets, ensuring they meet internationally agreed liquidity standards may be an important consideration when competing for funding with other internationally active banks;

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[20] *Basel III: the net stable funding ratio*, Basel Committee on Banking Supervision, October 2014.

- in the context of the Australian banking system's reliance on funding sourced from offshore, by assisting with improving the resilience of larger, more complex ADIs, the NSFR will help to promote financial stability; and

- the Basel NSFR is at a minimum proposed to apply to larger, more complex ADIs. APRA's options consider application to both larger, complex ADIs as well as extending the NSFR to those ADIs with simpler retail-based business models. APRA is of the view that adopting a proportionate approach to the implementation of the NSFR will result in enhanced efficiencies, and minimise the regulatory burden, in the financial system. Given the funding requirements of smaller ADIs are largely met by more stable retail deposits, the imposition of the NSFR on these ADIs would impose additional regulatory burden without improving financial safety, in this case funding resilience.

24. APRA, in deciding the most appropriate option, seeks to balance the objectives of financial safety and efficiency, competition, contestability and competitive neutrality whilst promoting financial stability taken into account the factors outlined in paragraph 23 above.

Liquid assets requirement for foreign ADIs

25. APRA has applied a reduced LCR to foreign ADIs (a 40 per cent minimum compared to a 100 per cent minimum for other ADIs that need to satisfy an LCR requirement). This concession has been established in recognition of foreign ADIs' difficulties in meeting the 100 per cent liquid assets requirement and noting the nature of their operations is different to locally incorporated ADIs. At the time of implementation, APRA noted the 40 per cent LCR was an interim measure and that it would consult on a permanent liquid assets requirement for foreign ADIs in 2015. A modified liquid assets requirement for foreign ADIs recognises that a foreign ADI is able to place a high degree of reliance on the liquidity of the broader banking group of which it is a part but in a crisis this liquidity may not necessarily be available to the branch. Such recognition promotes a competitive and efficient Australian financial system, without unduly compromising financial safety.

26. The objective of government intervention would be to determine an appropriate ongoing liquid assets requirement that is well suited to the business of foreign ADIs and better prepares them to withstand a severe liquidity stress event.

Policy options and comparative net benefits

27. APRA's options for implementing the NSFR propose targeted changes to APS 210 and ARS 210. Each option and the related net benefits are outlined below.

Status quo option

28. APRA notes that it does not consider the status quo of not implementing the NSFR to be an option. Australia, as a member of the G20, has committed to implement the Basel III framework, including the Basel liquidity framework. Maintaining the status quo would result in Australia not meeting its international obligations as agreed to by the Australian Government as a member of the G20. It would also mean that Australian banks would likely be disadvantaged *vis-à-vis* other banks seeking funding in international markets, including higher funding costs, if they did not meet an internationally agreed framework.

29. APRA's review of the liquid assets requirement for foreign ADIs considers the existing requirement as reflected in APS 210 and ARS 210, and options for potential adjustments to this arrangement. Each option and the related costs, benefits and net impact are outlined below.

30. The net benefits for each policy option are considered in respect of ADIs, deposit-holders and other creditors, other consumers, financial market participants and government. While the proposals have direct business impacts on ADIs, other stakeholders benefit from prudent liquidity management within ADIs and can be indirectly impacted through changes in the service offering and operations of ADIs.

31. APRA requested, as part of consultation, that stakeholders provide information on the compliance impact and associated costs of proposed options. This information would be used by APRA to quantify the change in regulatory burden using the Regulatory Burden Measurement framework and inform final calculations of the net impact of the proposals.

Net stable funding ratio

32. APRA has identified two NSFR options:

- Option 1 – Basel NSFR standard applied to larger ADIs only; and
- Option 2 – Basel NSFR standard applied to all ADIs.

NSFR Option 1: Basel NSFR standard applied to larger ADIs only

33. This option would commence on 1 January 2018, consistent with the commencement date for the Basel NSFR standard. This timing would allow industry sufficient time to make changes to comply with the final form of the NSFR.

34. Under this option, APS 210 would incorporate the Basel NSFR standard. The scope of application under the Basel NSFR standard notes that 'the NSFR should be applied to all internationally active banks on a consolidated basis, but may be used for other banks and on any subset of entities of internationally active banks as well to ensure greater consistency and a level playing field between domestic and cross-border banks'.[21] This option is the assumed base-case scenario.

35. The ADIs that would be required to meet the NSFR under this option would be the 15 locally incorporated ADIs that use the LCR to determine their short-term liquidity requirement. These ADIs have comparatively more complex operations and generally access international capital markets to fund a portion of their funding requirements. This is consistent with the Basel scope of application noted in paragraph 34 above.[22]

36. In order to comply with this proposal, an ADI would most likely need to make changes to its information technology systems to calculate its NSFR and report relevant data to APRA as well as implementing processes and procedures in relation to these functions. In addition, training for staff with responsibility for NSFR-related matters, including risk and compliance staff, would most likely be necessary.

37. This option would involve no additional compliance costs beyond the implementation costs of $23,825,000 for ADIs in complying with the Basel NSFR standard noted in paragraph 40. This reflects the fact that under this option APRA would apply the Basel NSFR standard to larger locally incorporated ADIs only – hence, there would be no deviation from the Basel NSFR standard. The Basel framework is an internationally understood benchmark that allows market participants to understand and place reliance on the nature and standard of regulation to which a bank is subject. Full implementation of the Basel NSFR standard in Australia would have the benefit of providing certainty to

[21] *Basel III: the net stable funding ratio*, Basel Committee on Banking Supervision, October 2014.

[22] As the NSFR is a whole of balance sheet metric, it is not necessary for foreign ADIs that operate in Australia as branches (of an overseas bank) to be subject to an NSFR requirement. In the case of foreign ADIs, the NSFR requirement would apply to the group (as a whole) of which the foreign ADI is a part.

investors and creditors of an ADI including:

- access to capital markets, as overseas market participants prefer to deal with banks which are subject to regulatory systems that are understood and substantially equivalent to their own regulatory frameworks;

- competing pressures on funding costs. ADIs in Australia are able to access overseas capital markets and by meeting an international standard are less likely to face additional risk premiums when raising such funds (ADIs currently source a material portion of their funds in international funding markets)[23]. This point was made by ADIs to the Financial System Inquiry and reflects concerns that Australia is susceptible to changes in investor sentiment in international funding.[24] It is noted, however, that there may be increased costs associated with funding where increased competition for limited pools of funds forces up costs. For example, if there is strong competition for domestic deposits, an ADI may be forced to offer a higher interest rate in order to increase its share of deposit funding. Overall, the cost of funding will depend on an ADI's funding mix, including its composition of deposits and wholesale debt;

- in a future crisis, ADIs in Australia would be less vulnerable to shocks in funding markets and enjoy higher confidence due to their compliance with the Basel NSFR standard and likely reduced exposure to short-term wholesale funding from offshore; and

- funding assets with more stable sources of funding would help to minimise the possibility of liquidity problems for an individual ADI and a reduced risk, in the event of a crisis, of liquidity problems at any one ADI spreading to other banks thereby undermining financial stability.

38. There would be additional indirect benefits for other stakeholders in times of stress. Individual ADIs may have less difficulty in meeting their obligations to stakeholders, and customers are more likely to have continued access to financial products and services. The extent of these benefits for any single ADI would depend on its liquidity profile as

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23 *International Activities of Australian Banks*, Owen Bailey, Luke Van Uffelen and Kerry Wood, Reserve Bank of Australian Bulletin, December 2013

24 *Financial System Inquiry Final Report*, November 2014, page 77

well as that of the system overall.

39. APRA considers the net impact of this option would be to provide a material benefit.

40. The costs of this option are represented in the Regulatory Burden Estimate (RBE) table below. Given this is the baseline option, implementation of the Basel NSFR framework involves no additional annual regulatory costs for ADIs as it is the business as usual option. The actual cost of implementation of this option has been estimated at $23,825,000 ($2.38m per year) for the 15 ADIs that would be required to meet the NSFR requirement. This figure includes costs associated with systems modifications (depending on existing internal IT systems), staffing costs to perform tasks associated with the NSFR and the associated reporting costs through providing regular reports to APRA for NSFR purposes. The compliance costs associated with an ADI changing and maintaining an appropriate stable funding mix is also included.

Table 1 - Average annual regulatory costs (from business as usual)

Change in costs ($ million)	Business	Community organisations	Individuals	Total change in costs
Total, by sector	$0	$0	$0	$0

NSFR Option 2: Basel NSFR standard applied to all ADIs

41. Under this option, the Basel NSFR standard would be applied to all ADIs without regard to their size, liquidity or funding profile or whether they are internationally active.

42. This option would commence on 1 January 2018, consistent with the commencement date for the Basel NSFR standard. This timing would allow industry sufficient time to make changes to comply with the final form of the NSFR, noting though that this timeframe may present challenges for smaller ADIs to comply with.

43. As for Option 1, in order to comply with this proposal, ADIs would need to make changes to systems in order to calculate their NSFR and report relevant data to APRA as well as implementing processes and procedures in relation to these functions. In addition, training for staff with responsibility for NSFR-related matters, including risk and compliance staff would be necessary.

44. APRA expects this option would result in the same costs and benefits for the 15 ADIs identified under Option 1, but additional costs for smaller, less complex ADIs and with limited benefits at the smaller end of the market. This is because the majority of ADIs, other than larger, more complex ADIs, have simple retail-based business models and generally do not access material amounts of wholesale funding, which makes them more likely to meet the NSFR requirements and render additional requirements unnecessary. These ADIs would incur costs associated with putting in place system changes, policies, processes and procedures, without any additional discernible benefit in terms of financial safety or stability.

45. The indirect costs to ADIs and other stakeholders of Option 2 are the same as for Option 1.

46. APRA believes that this option would result in a net cost on an industry-wide basis, with a moderate to material cost for individual smaller, less complex ADIs. These ADIs would be forced to bear the costs of implementation but without any further material benefits, given their funding profiles would generally already be aligned with the funding stability objectives of the NSFR.

47. The costs of this option are represented in the RBE table below. This cost represents the cost of implementing this option being $42,600,000 ($4.26m per year) which would be in addition to the actual cost of implementation of Option 1 – the business as usual option.

Table 2 - Average annual regulatory costs (from business as usual)

Change in costs ($ million)	**Business**	**Community organisations**	**Individuals**	**Total change in costs**
Total, by sector	$4.26	$0	$0	$4.26

APRA's recognition of Australian conditions and exercise of discretion

48. Within each of these options, there are a number of matters where APRA considers there is scope for APRA to exercise its discretion as to how it implements the NSFR standard to reflect Australian conditions. These involve technical aspects of the implementation of the NSFR standard and are not options within themselves, but require the same consideration as part of the two proposed options APRA has set out in this RIS. These

matters were set out in APRA's discussion paper *Basel III liquidity – the net stable funding ratio and the liquid assets requirement for foreign ADIs*, March 2016. Regardless of the final decision in relation to each of these matters, it is expected that the regulatory burden would be unchanged as these are policy decisions within the NSFR framework and the implementation and associated compliance costs of the NSFR would be unaffected regardless of APRA's final decision.

49. The most material of these issues include:

- recognising self-securitised assets that are accepted by the Reserve Bank of Australia as being equivalent to high quality liquid assets for NSFR purposes;
- the use of APRA's credit risk weights for residential mortgages in determining the required stable funding of mortgages; and
- the recognition of member-directed superannuation deposits as a stable source of funding.

Recognition of self-securitised assets as HQLA-equivalent

50. Self-securitised assets are residential mortgages held on an ADI's balance sheet within a securitisation special purpose vehicle solely for purposes of obtaining liquidity through repos with the central bank. Recognition of self-securitised assets, accepted by the Reserve Bank of Australia for its committed liquidity facility, as being equivalent to high quality liquid assets would mean that such assets would be afforded a lower required stable funding factor relative to that which would otherwise apply to such assets. This would have the effect of allowing ADIs to hold less stable funding for such assets. This would also lead to the appearance of a stronger NSFR. However, while an ADI's NSFR may appear to be higher, this would not reflect any underlying improvement in the ADI's liquidity self-reliance or longer-term resilience. This will be likely to lead to a lower cost of funding for the ADI, but a possible weakening of the ADI's longer-term resilience.

Credit risk weights

51. Under the Basel NSFR standard, in order to determine the required stable funding for residential mortgages, standardised risk weights in the Basel Committee's capital framework are used. These standardised risk weights are mapped to required stable funding factors to determine how much stable funding a bank is required to hold against

residential mortgages. APRA's risk weights are a more conservative implementation of the Basel Committee's capital framework, reflecting risk characteristics of Australian residential mortgages held by ADIs. Applying the Basel capital framework rather than APRA' risk weights would lead to ADIs being able to hold less stable funding against residential mortgages with a resultant reduction in their cost of funding. This may mean such assets are not supported by an appropriate level of stable funding, which would become evident during a stress event. Adopting a conservative approach to required funding of mortgages may lead to higher costs but would improve the funding resilience of an ADI. The ADI would be more likely to be able to withstand a stress event, minimising losses to depositors, investors and also reducing the likelihood of financial system instability.

Member-directed superannuation deposits

52. Superannuation funds are considered to be more like wholesale investors in that they are better able to assess and quickly respond to the risks associated with the investments they undertake. Funding from such investors is typically less stable, and stable funding factors for such funding reflect this. This is reflected under the Basel NSFR standard by the fact that the availability of such deposits as a stable source of funding is lower than, for example, retail deposits. The Basel NSFR standard requires a deposit from a financial institution to be treated as such unless it meets the criteria for treatment as a retail deposit. A superannuation fund trustee has a fiduciary duty to the fund's members which would require the trustee to ensure that the members' funds are protected. If there was concern about an ADI's financial condition, the trustee would be expected to remove the members' funds rather than risk funds being lost. Member-directed superannuation deposits are more likely to behave as a more stable source of funding where the member continues to have direct control over the funds or, in the case of the superannuation fund itself, where the fund is contractually unable to move the funds for a specified minimum period of time.

53. APRA has consulted extensively with industry on these and other technical matters and a full discussion can be found in the discussion paper *Basel III liquidity – the net stable funding ratio and the liquid assets requirement for foreign ADIs*, APRA, March 2016 and response to submissions paper *Basel III liquidity – the net stable funding ratio and the liquid assets requirement for foreign ADIs,* APRA, September 2016.

Impact on cost of funding

54. Under each of the two options set out in this RIS, an ADI required to meet the NSFR requirement would incur additional funding costs. These costs represent the additional cost associated with replacing short-term wholesale funding with longer-term wholesale funding and which impacts ADIs' profitability. Longer-term funding generally has a higher cost relative to the short-term funding it replaces. In addition, the size of an ADI and the perceived risk of the ADI, amongst other factors, potentially affect the ADI's cost of funds. Typically, the cost of funds will be higher for smaller ADIs. On this basis, the cost of funding can be broken down into the major ADIs and Regional/other ADIs as set out below. The costs associated with an ADI changing its funding profile for NSFR purposes have been included as part of the cost estimates under each of the options set out above.

	Average increase in cost of replacing short term funding with longer term funding (basis points)	**Average additional longer term funding required for each ADI ($m)**	**Total average additional cost of funding per ADI (i.e. reduction in annual profit) ($m)**
Regional/other ADIs	75-80	1,000	7.5-8
Major ADIs	40-45	15,000	60-67.5

55. Adoption of the NSFR by ADIs that operate in international markets will lead to a lower cost of wholesale funding than would otherwise be the case. This reflects the adoption of internationally consistent standards which leads to competitive neutrality as all internationally active banks are bound by the same (global) liquidity framework. If the NSFR was not applied to internationally active Australian ADIs, the cost of funds would be materially higher and would negatively impact their capacity to compete for offshore funding.

56. The actual extent of the impact on an ADI's profit will depend on the extent to which it

seeks to pass on these costs to its customers. This could take the form of reduced interest rates on deposits products or increased interest costs on loans. ADIs could also cover any additional funding costs would be through reductions in payments to shareholders. The actual extent and impact on funding costs would be specific to each ADI in terms of how it manages these costs.

Summary of policy options and net benefits

Table 4: Summary of the net benefits of each NSFR option

	Option 1: Basel NSFR standard without change	**Option 2: Basel NSFR standard applied to all ADIs**
Compliance costs and indirect costs (indicative)	No change	Minor to moderate net costs for smaller ADIs
Leads to better protection of ADIs' stakeholders	Meets this criteria	Meets this criteria
Consistent with G20 agreements and Basel III	Meets this criteria	Meets this criteria
Overall	Net benefit	Moderate net cost

Liquid assets requirement for foreign ADIs

57. APRA has identified two options:

- Option 1 – status quo plus local operational capacity assessment; and
- Option 2 – adjusted minimum liquidity holding plus local operational capacity assessment

Foreign ADI liquid assets Option 1: status quo plus local operational capacity assessment

58. Under this option, the current 40 per cent liquid assets requirement for foreign ADIs would be retained. APS 210 currently specifies that foreign ADIs:

- are subject to a 30 calendar-day time horizon LCR;
- have a minimum compliance threshold set at 40 per cent; and
- are required to meet the liquid assets requirement using high-quality liquid assets only.[25]

59. This option would include adjustments to APS 210 to introduce a local operational capacity requirement. Where a foreign ADI has outsourcing or offshoring arrangements in place for certain critical functions, the foreign ADI would need to demonstrate both the existence of high-quality liquid assets to meet the 40 per cent LCR minimum and demonstrate its control over those assets should it need to draw on them. A foreign ADI, in establishing its local operational capacity, would need to consider whether it:

- has clear legal ownership of assets that form part of its regulatory liquidity requirement;
- has the authority to liquidate its assets independently of its parent and is able to demonstrate that this is the case; and
- is able to identify, make and receive payments on its own behalf.

60. The LCR and local operational capacity requirement would, if adopted, have effect from 1 January 2018.

61. As the existing liquid assets requirement would continue under this option, there would not be any immediate additional compliance costs for ADIs. Compliance with the local operational capacity requirement would mean that foreign ADIs may need to adjust operational arrangements to demonstrate sufficient control of their liquid assets and

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[25] Locally incorporated ADIs subject to the LCR requirement can access a committed liquidity facility which assists them to respond to an acute stress scenario by accessing an agreed amount of liquidity through repurchase agreements of eligible securities with the Reserve Bank of Australia. Refer to *The RBA Committed Liquidity Facility*, RBA, November 2011

associated compliance processes.

62. The existing compliance costs for foreign ADIs of holding high-quality liquid assets depends on their individual circumstances. The extent and impact of this option for foreign ADIs is limited. Foreign ADIs primarily offer wholesale products to businesses and individuals, and are not permitted to accept small-value deposits. The LCR only applies to larger, more complex ADIs, including foreign ADIs, and it is set at a lower level for foreign ADIs (40 per cent rather than 100 per cent for locally incorporated ADIs). These factors would reduce the number of stakeholders exposed to the compliance burden and the amount of this burden.

63. The key benefit for foreign ADIs of holding a reasonable level of liquid assets in Australia is that they are more likely to be able to meet their obligations in Australia in times of market stress. To fully realise this benefit APRA's view is that the liquid assets requirement requires a quantitative basis and should be applied without exception to all foreign ADIs operating in Australia. This is the business as usual option with the addition of a requirement for a foreign ADI to perform an annual local operational capacity assessment. The cost of the local operational capacity assessment to foreign ADIs would be an addition to business as usual, hence the additional cost of this is reflected in the table below.

Table 4 - Average annual regulatory costs (from business as usual)

Change in costs ($ million)	**Business**	**Community organisations**	**Individuals**	**Total change in costs**
Total, by sector	$0.198	$0	$0	$0.198

Foreign ADI liquid assets Option 2: adjusted minimum liquidity holding plus local operational capacity assessment

64. Under this option, APS 210 would be amended to require a foreign ADI to satisfy an adjusted minimum liquidity holding requirement – known as the foreign ADI liquid assets requirement. This option would be simpler than the LCR requirement with a foreign ADI required to hold a minimum of nine per cent of its external liabilities to unrelated parties in specified liquid assets.

65. In addition, this option would involve adjustments to APS 210 to include a local operational capacity requirement. As for Option 1, this would require foreign ADIs to demonstrate both the existence of liquid assets to cover its liquidity needs under the applicable liquidity assets test (in this case the minimum liquidity holding minimum), and their control over those assets should it need to draw on them.

66. Minor amendments would also be made to ARS 210 to incorporate reporting amendments for foreign ADIs.

67. This option, if adopted, would commence on 1 January 2018. Should the minimum liquidity holding requirement be adopted the proposed changes are not expected to be onerous.

68. APRA anticipates that foreign ADIs subject to the foreign ADI liquid assets requirement would face compliance costs associated with the change, including:

- adjusting their holdings and control of liquid assets;
- adjustments to compliance processes to allow ongoing calculation, monitoring and reporting; and
- possible additional educational, procedural and purchasing costs in order to comply with the proposed requirements, depending on structures and processes.

69. As with Option 1, the extent and impact of compliance costs on foreign ADIs would be limited due to the generally limited scope of operation of foreign ADIs in Australia and concessional application of the liquid assets requirement in comparison to equivalent locally incorporated ADIs. These factors would reduce the number of stakeholders exposed to the compliance burden and the quantum of this burden.

70. The compliance costs under this option would be expected to be limited as it is anticipated to be less complex and better suited to foreign ADIs than Option 1. The application of a minimum liquidity holdings requirement would allow a foreign ADI to hold less liquid assets than if all liabilities are included as is the case for locally incorporated ADIs.

71. APRA's view is that the net benefit of Option 2 is not materially different to Option 1. While a minimum liquidity holding regime is a departure from the status quo, the benefits of a simpler calculation and ability to exclude external liabilities of foreign ADIs are

likely to balance out the minimal costs of adjusting to a revised requirement. This option would have a net benefit for those foreign ADIs with less complex operations vis-à-vis the 40 per cent LCR requirement.

72. The compliance costs associated with this option are set out in the table below, including the costs of moving to the foreign ADI liquid assets requirement from the business as usual approach, and the costs of the local operational capacity assessment.

Table 6 - Average annual regulatory costs (from business as usual)

Change in costs ($ million)	**Business**	**Community organisations**	**Individuals**	**Total change in costs**
Total, by sector	$0.594	$0	$0	$0.594

Summary of policy options and net benefits

Table 7: Summary of the net benefits of each liquid assets requirement option

	Option 1: **status quo**	**Option 2:** **revised concessionary regulation**
Compliance costs and indirect costs (indicative)	Minor net cost (for local operational capacity assessment)	May range from no change to moderate net cost
Leads to better protection of ADIs' stakeholders	Meets this criteria	May or may not meet this criteria
Consistent with G20 agreements and Basel III	Meets this criteria	May or may not meet this criteria
Overall	Minor net cost for local	Moderate net cost

	Option 1: status quo	**Option 2: revised concessionary regulation**
	operational capacity	

Consultation

73. The Basel Committee first consulted on its liquidity framework, incorporating the NSFR requirement, in December 2009.[26] Feedback was received from a range of international financial institutions and their representatives, including the Australian Bankers' Association.[27] Further revisions to the liquidity framework were issued in December 2010[28] and consultation specifically regarding the NSFR was held between January 2014 and April 2014.[29]

74. APRA has also released a number of discussion and response papers concerning the Basel III liquidity framework and related reporting arrangements:[30]

- *Implementing Basel III liquidity reforms in Australia*, November 2011 (discussion paper);
- *Liquidity reporting requirements for ADIs*, November 2012 (discussion paper);
- *Implementing Basel III liquidity reforms in Australia*, May 2013 (discussion paper);
- *Implementing Basel III liquidity reforms in Australia*, December 2013 (response to submissions);
- *Changes to liquidity reporting arrangements*, April 2014 (advice and request for submissions);

26 *International framework for liquidity risk measurement, standards and monitoring - consultative document*, Basel Committee, December 2009.

27 *ABA submission on the Basel Committee's International framework for liquidity risk, measurement, standards and monitoring*, Australian Bankers Association, April 2010.

28 The major Basel III reforms are set out in *Basel III: A global regulatory framework for more resilient banks and banking systems*, December 2010.

29 *Basel III: the Net Stable Funding Ratio – consultative document*, Basel Committee, January 2014.

30 These can all be found on APRA's public web site at *ADI Consultation Packages*.

- *Proposed amendments to liquidity standard and reporting instructions,* September 2014 (response to submissions);

- *Liquidity risk – recent consultations*, November 2014 (response to submissions);

- *Basel III liquidity – the net stable funding ratio and the liquid assets requirement for foreign ADIs,* March 2016 (discussion paper); and

- *Basel III liquidity – the net stable funding ratio and the liquid assets requirement for foreign ADIs,* September 2016 (response to submissions).

75. Specific consultation regarding the NSFR commenced in 2011, but further consultation was deferred until the finalisation of the Basel Committee's final NSFR standard, which occurred in October 2014.

76. In March 2016, APRA released a discussion paper (March discussion paper) which set out details of the proposed implementation of the NSFR and review of the liquid assets requirement for foreign ADIs. That discussion paper proposed options which APRA's current assessment suggest would result in the lowest cost option for the NSFR but the higher cost option for the liquid assets requirement for foreign ADIs. The higher costs associated with the foreign ADI liquid assets requirement reflects the cost of moving to the new approach, with the ongoing costs considered to be lower than the business as usual approach on an ongoing basis. APRA also held numerous meetings with industry bodies and individual ADIs and has consulted with the Reserve Bank of Australia and the Treasury.

Submissions received

77. APRA received a total of 19 submissions in response to its March discussion paper. Eight of these were on the NSFR proposals and 11 on the proposed liquid assets requirement for foreign ADIs.

Net stable funding ratio

78. Overall, submissions supported the objective of the NSFR that, over time, ADIs should continue to improve their stable funding profile. There were, however, a number of specific issues raised relating to the amount of required stable funding for various asset classes with some submissions of the view that APRA's proposed adoption of the Basel

position was too onerous. Other issues raised were generally for the purpose of seeking clarification of the treatment of assets and liabilities under the NSFR, or suggestions that APRA should deviate from the Basel NSFR standard in respect of certain matters. The key material issues are summarised below.

Alignment of stable funding factors with risk weights

79. Two submissions argued that APRA should adopt the risk weights set out in the Basel II standardised approach to credit risk, rather than those set out in Prudential Standard APS 112 Capital Adequacy: Standardised Approach to Credit Risk (APS 112), for the purpose of determining the amount of required stable funding for unencumbered residential mortgages with a residual maturity of one year or more.

80. The alignment of the required stable funding factor for mortgages with APS 112 is, in APRA's view, appropriate. A lower, concessional stable funding requirement is premised on loans being higher quality, liquefiable assets. This is best captured by loans with a lower loan to valuation ratio and those that meet the criteria for standard eligible mortgages as detailed in APS 112.

81. As noted in the September response paper, inconsistencies in risk weights for mortgages across jurisdictions may reduce in the medium term following revisions to the Basel Committee's standardised approach to credit risk, expected to be finalised around the end of 2016. This may materially address the concerns raised in submissions regarding alignment of the amount of required stable funding for unencumbered residential mortgages with those of international peers. APRA will monitor finalisation and implementation of the updated Basel framework and alignment under the NSFR. Should the anticipated alignment not occur APRA will review this position.

Member-directed superannuation deposits

82. Three submissions raised the issue of the treatment of member-directed superannuation deposits, and questioned APRA's decision to only allow such deposits to be given a higher available stable funding factor subject to a superannuation trustee (or other intermediaries) not being able to remove the deposits from an ADI within a defined period of time. Submissions argued that the size of the Australian superannuation system and the stable nature of investment allocations is reason to apply a lower, retail-like available stable funding factor.

83. A key factor in determining the treatment of a deposit under APS 210 is the nature of the depositor. When an individual self-selects where to place their funds the deposit is classified as retail. When a superannuation fund is making the deposit then the deposit is classified as being from a financial institution. In the case of superannuation deposits there is the additional consideration of the fiduciary responsibilities of the trustee. The underlying principle is the distinction between an institution that manages money on behalf of others, and an individual managing their own funds.

84. Member-directed superannuation deposits may be considered retail for the purposes of the LCR if all the conditions in APS 210 are met. This recognises that it is the individual, rather than an intermediary, that has full control over the placement and withdrawal of the funds. For the avoidance of doubt, if such a deposit is considered as being retail under the LCR the deposit may be considered retail for NSFR purposes as well. The requirement in the NSFR that the intermediary cannot remove the deposit from an ADI within a defined period is again to ensure that it is the individual depositor that has control over the funds in the context of the time periods relevant for the NSFR.

85. APRA's approach recognises, in certain circumstances, such funding may be a stable source of funding, notably where such deposits are operational deposits or the trustee is not able to immediately remove the ADI that holds its deposits. This approach strikes an appropriate balance and allows for certain member-directed superannuation deposits to be accorded a higher available stable funding factor than would otherwise be the case.

Liquid assets requirement for foreign ADIs

86. Submissions on the proposals for the application of a liquid assets requirement for foreign ADIs were mixed. Generally, less complex foreign ADIs preferred the modified foreign ADI liquid assets requirement and foreign ADIs with more complex operations preferring the 40 per cent LCR. Importantly, submissions raised numerous issues which indicate that application of a modified minimum liquidity holding requirement would not be as simple as originally intended and that the one-size-fits-all approach, as envisaged, may not be appropriate.

87. Submissions were generally supportive of the proposal for a foreign ADI to conduct an annual local operational capacity assessment. APRA therefore proposes to proceed with this proposal as set out in the March discussion paper.

Conclusion and recommended option

88. APRA issued a response to submissions paper in September 2016 responding to issues raised in submissions to the March discussion paper. APRA has revised a number of its original positions after consideration of further information provided by ADIs on the likely impacts of certain aspects of APRA's proposals. This is the case for proposals concerning both the NSFR and the liquid assets requirement for foreign ADIs.

Net stable funding ratio

89. After consideration of submissions, and further consultation with a number of ADIs, APRA amended its original proposal concerning the amount of stable funding necessary for certain assets that are eligible as collateral to secure funding from the Reserve Bank of Australia. In addition, APRA proposes to allow recognition of certain additional liquid assets for LCR purposes and hence these assets will also be able to be recognised in an ADI's NSFR. Similarly, APRA proposes to allow certain Australian listed equities to be eligible for a lesser amount of stable funding than would otherwise have applied under its original proposals.

90. On the issue regarding the stable funding requirement for residential mortgages, APRA has not changed its position from that set out in the March discussion paper; APRA's position remains consistent with the Basel NSFR standard.

91. In aggregate, APRA's proposed revisions to the NSFR framework will improve the NSFRs of the majority of ADIs proposed to be subject to the NSFR framework. Option 1 is the recommended option for application of the NSFR. Option 2 involving application to all ADIs is not considered feasible for the reasons set out under that option and the additional costs for smaller, less complex ADIs without material additional benefits.

Liquid assets requirement for foreign ADIs

92. In light of issues raised in submissions, APRA proposes to retain the existing 40 per cent LCR as the default liquid assets requirement for foreign ADIs. APRA will, however, consider applications for a foreign ADI to use the existing minimum liquidity holdings regime. In addition, APRA considers there is merit in requiring a foreign ADI to undertake a local operational capacity assessment, a proposal that industry also agreed had merit. On this basis, Option 1 is recommended with the addition of allowing flexibility in that a foreign ADI could apply for consideration to adopt the minimum

liquidity holdings regime where that regime is considered more appropriate to its Australian operation.

93. This approach provides flexibility for foreign ADIs and APRA to choose the most appropriate liquid assets requirement based on an ADI's individual circumstances. Under this option, ADIs would incur no additional costs if they remain subject to the existing 40 per cent LCR. If they seek to use the minimum liquidity holdings regime, they may face minor costs to amend their holdings of liquid assets and to meet different reporting requirements, but would benefit from application of the liquid assets requirement most appropriate to their individual circumstances. ADIs would incur relatively minor costs in undertaking the annual local operational capacity assessment under this option.

Implementation and review

94. Consultation on the current proposals commenced in March 2016 with a discussion paper setting out APRA's initial proposed positions. After consideration of submissions to this consultation, APRA released a second consultation package – including a response to submissions paper along with a revised draft APS 210 and APG 210 in late September 2016. APRA anticipates finalising its position in late 2016 after consideration of further submissions from interested parties. The release of the final standard in late 2016 will provide industry with a year to make any changes necessary to comply with the new requirements with effect from 1 January 2018.

95. As delegated legislation, prudential standards impose enforceable obligations on affected institutions. APRA monitors ongoing compliance with its prudential framework as part of its supervisory activities. APRA has a range of remedial powers available for non-compliance with a prudential standard, including issuing a direction requiring compliance, the breach of which is a criminal offence. Other actions include imposing a condition on an APRA-regulated institution's authority to carry on its business or increasing regulatory capital requirements.

96. Under APRA's policy development process, reviews of new measures are typically scheduled for between two and three years from implementation. Such a review would consider whether the requirements continue to reflect good practice, remain consistent with international standards and remain relevant and effective in facilitating sound risk management practices. APRA will also take action within a shorter timeframe where there is a demonstrable need to amend a prudential requirement.

Compliance with the Australian Government Guide to Regulation

97. APRA has prepared this RIS in accordance with The Australian Government Guide to Regulation. A RIS was prepared at an early stage of the policy development process and informally submitted to the OBPR for consideration. APRA has taken the OBPR's comments into account in preparing this RIS. The issues canvassed in this RIS were considered by APRA at each major decision point in the development of the proposals.

98. Using the Regulatory Burden Measurement framework, it has been agreed that the package will increase compliance costs by $23,825,000 or $2,382,500 per year in relation to implementation of the NSFR and by $1,980,000 or $198,000 per year in relation to proposals on the application of a local operational capacity assessment for foreign ADIs. For all reporting periods, the Treasury portfolio has delivered net compliance costs reductions and there is no reason why the portfolio will not continue to deliver on its red tape reduction target in this period, in line with the Government's regulatory reform agenda.