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APRA Announcement: Basel III liquidity reforms

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Responses to the BIS Announcement of Revisions (January 2013)

APRA has announced its revised policy approach to liquidity risk measurement under the Basel III framework. This follows changes to the formulation of the Liquidity Coverage Ratio (LCR) announced by the Basel Committee in January 2013.

Key APRA decisions on LCR calculations

Description of issue	*APRA decision*
Transitional arrangements permissible starting 2015 and finalised in 2019	• APRA will not adopt. • LCR requirements commence fully as from 1 January 2015. (Consistent with APRA approach to the implementation of capital ratio measurement requirements).
Definition of HQLA. Permissible recognition of HQLA Level 2B assets in addition to Level 2A assets	• APRA will not adopt. • APRA reaffirms its approach of only recognising HQLA Level 1 assets for LCR purposes. (Note that certain HQLA2 assets are repo-eligible with the RBA for normal market operations and so are eligible collateral for the Committed Liquidity Facility).
Application of LCR requirements by legal entity	• LCR requirements will apply at both a Level 1 and consolidated (Level 2) banking group basis. For branches of foreign banks, the LCR must be met on a domestic book basis. • May be permissible for ADIs with material banking subsidiaries to recognise HQLA 2 within their Level 1 LCR calculations for subsidiaries consistent with host regulatory standards.
Revised cash inflow and outflow rates	• APRA will adopt. • Will also apply a lower run-off rate of 25 percent and not its previously proposed 30 percent for less stable retail deposits.
Recognition of head office funds by an ADI which is a foreign bank branch	• No change to previous proposals including that recognition of a head office committed facility as a cash inflow will only be permitted as from Day 16 of the LCR scenario.
Operational requirements for the management of HQLA	• APRA has adopted revised expectations as to functional control. • Expectation is that some previously excluded assets may now become eligible for inclusion in the stock of HQLA.
Use of HQLA during a period of financial stress (including drawing of its CLF with the Reserve Bank)	• Accepted as being permissible. • ADI required to inform APRA of circumstances that will result in a breach of its LCR requirement.
The CLF review process	• No change. • APRA will review each ADI’s liquidity risk management framework and funding practices as the basis for approving the size of the CLF for LCR purposes. It may publish further guidance in due course.

The overall impact of these changes, particularly the revised cash outflow rates, is that calculated LCRs will have risen.

Qualitative requirements: an earlier start date

APRA states it intends the revised APS 210 Liquidity will come into effect from 1 January 2014. At that point, the qualitative requirements for all ADIs and the quantitative requirements for MLH ADIs would apply. For scenario analysis ADIs, the LCR would apply from 1 January 2015 and the NSFR from 1 January 2018.

These qualitative requirements and their timing again highlight the increasing regulatory focus on the effectiveness of risk governance (three lines of defence) and the expected professionalism of boards to provide independent and objective oversight. [Refer to John Laker's speech of 27 February.] The qualitative requirements are many and include:

- Establishment of an ADI's liquidity risk tolerance by the Board.
- Approval of a funding strategy and contingency funding plan that are subject to regular review and updating.
- Establishment of sound processes for identifying, measuring, monitoring and controlling liquidity risk including limits to control vulnerabilities and escalation procedures.
- Development and implementation of a funds transfer pricing processes that addresses liquidity risk.
- Additional stress testing requirements including their regular conduct.

Issues still be finalised

- Calculation of the net stable funding ratio (a 12 months liquidity scenario) which awaits further announcements from the BIS.
- Future Pillar 3 disclosures for liquidity.
- Identification of ADIs which will be subject to LCR requirements and those continuing to be subject to the MLH. APRA has announced modification of its earlier proposals for MLH quantification.
- Announcement by APRA of its revised *Prudential Standard APS 120 Securitisation.*

Issues for ADIs

Use and Experience requirements have become more demanding. Liquidity risk management and the specification of liquidity risk measurements by regulators is one of the key Basel III reforms. These will therefore have a focus not previously experienced in supervisory reviews.

This focus will include the ability of Boards and senior management to demonstrate a "thorough understanding" of the funding and market liquidity risks including their potential interaction with other risks (which APRA identifies as including credit, market, operational and reputation risks). It also requires ADIs to be able to effectively demonstrate compliance with APRA's expectations for minimum operating standards for liquidity risk management.

APRA ratings of risk governance - a continued emphasis. Liquidity risk identification and management clearly has the potential to impact APRA's future assessments of risk governance effectiveness in its ratings of Boards and senior management in determining its minimum regulatory requirements for individual ADIs.

APS 310 requirements will expand. APS 210 will be subject to the requirements of APS 310 including CEO declaration requirements and audit assurance requirements for applicable data collections. These represent significant changes to the scope of current requirements.

Internal Audit responsibilities. The specification of definitional, operational and governance requirements makes likely increased APRA engagement with internal audit on these matters, in part, as a means of assuring itself about the effectiveness of "three lines of defence" risk management frameworks.

Stress testing capabilities. These continue to be re-emphasised by APRA in its proposed prudential standards including its revised APS 210. Stress testing capabilities are one point of emphasis in the Basel III Framework although until now these have focused on capital adequacy and RWA volatility.

Data reporting requirements. Significant changes will occur. Accordingly they become part of the expectations covered in *APRA's PPG 235 Managing Data Risk issued in December 2012.*

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