

Senate Standing Committee on Economics

ANSWERS TO QUESTIONS ON NOTICE

Treasury Portfolio

Additional Estimates

10 – 11 February 2010

Question: aet 46

Topic: Bank Liquidity – New Policy Proposal

Hansard Page: Written

Senator EGGLESTON asked:

1. Can APRA explain its reasons for wishing to implement the new policy with regards to liquidity requirements? Does APRA have a timetable for its implementation?
2. Which other countries have implemented the reforms on bank liquidity as proposed by APRA?
3. Did APRA consider the relative strength of Australia's banking system when compared to banks overseas when designing these proposals?
4. Has APRA completed any modelling with regards to the impact that the proposals will have on individual bank revenue, including that of smaller banks?
5. Will credit unions and building societies be required to also hold the extra liquidity? If so, does APRA believe that mutuals will be able to meet the requirements?
6. Given the profitability of Australian Banks and their high levels of capital adequacy when compared to overseas institutions, how does APRA justify imposing additional prudential requirement that could impact upon Bank revenue?
7. Has APRA considered that banks may push interest rates or fees above market rates in order to recoup funding lost by the additional liquidity requirements? Can APRA guarantee that this will not occur?
8. Banks will be required to hold more Government bonds as proof of their liquidity. Has APRA modelled how this will impact upon the Government bond market in Australia? If so, what were the results?
9. What level of input did the Treasury have into APRA's proposals? Is the Government advocating increased liquidity because the increase in demand and potential revenue that the proposals will give to the Australian Government Bond Market?
10. APRA have announced that they are consulting with the industry. What consultations are taking place with the Banking industry with relation to the proposals, and who from the industry is involved in these consultations?

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Answer:

1. APRA had begun a review of its prudential framework for liquidity risk management before the global financial crisis erupted but had to suspend that work during the crisis. The crisis has highlighted the need for banking institutions to have adequate level of liquidity and robust liquidity risk management systems. Drawing on the lessons from the crisis, APRA's review has concluded that Australia's prudential framework remains appropriate but there are areas for improvement.

APRA's proposed approach anticipated, and is fully consistent with, proposals by the Basel Committee on Banking Supervision (BCBS) released in December 2009 on a global framework to strengthen liquidity risk management and supervision. These proposals respond to a G20 mandate that supervisors develop stronger liquidity buffers in banking institutions.

APRA is continuing to consult with authorised deposit-taking institutions (ADIs) on liquidity standards that are appropriate for Australia whilst maintaining consistency with the global framework that is being developed. APRA's approach will be developed in parallel with the BCBS's proposals, and APRA's next consultation paper will be held over until these proposals take firmer shape. Given the BCBS's timetable, APRA's prudential standards on liquidity are now expected to be finalised around the middle of 2011, with implementation and (if necessary) any transitional arrangements to be considered once the final proposals are clearer.

2. All the G20 countries, through the BCBS, are progressing very similar work in this area. APRA expects that all advanced countries will follow the BCBS's lead.
3. Australian banks were not immune from the breakdown of trust that saw the global financial system virtually freeze-up in September and October 2008. Notwithstanding their strong financial position and high credit ratings, the larger Australian banks were not given a 'free pass' in that dramatic period: they faced the same acute anxieties about the price of wholesale funding, and whether such funding would be available at all, as their global competitors. The dependence of the larger Australian banks on offshore wholesale funding - a greater dependence than other retail banking systems - means that APRA's prudential framework for liquidity risk management cannot be any less robust than the global standards now under development.
4. APRA is currently participating in a global Quantitative Impact Study (QIS) on the potential costs and impact of the BCBS's proposals on liquidity. Until the QIS is completed and the BCBS proposals finally calibrated, it would be premature to discuss cost impacts, although APRA's preliminary work suggests that the impacts are likely to be modest.

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5. Most credit unions and building societies (CUBS) already operate with high levels of liquid assets and conservative liquidity positions. In particular, most CUBS are subject to a simpler prudential regime as befits their more straightforward business models. APRA is not proposing material changes to this simpler regime, other than some additional reporting to APRA.
6. As noted in Question 3, the experience of the global financial crisis is that good profitability and sound capital positions are important from a prudential perspective but are not sufficient, in themselves, to address liquidity risks. These must also be addressed directly, through improved prudential requirements for liquidity.
7. As noted in Question 4, it would be premature to discuss cost impacts of more robust liquidity standards but the impacts are likely to be modest. Any such impact represents the cost of self-insurance by the banking system to make it more resistant to any loss of confidence and to minimise ‘moral hazard’ – the incentives that banking institutions would have to take excessive liquidity notes (as many global institutions did ahead of the global financial crisis) if they know that central banks are standing ready to provide insurance at low cost. Substantial moral hazard now exists in the global financial system as a consequence of the unprecedented central bank and government interventions needed to support funding markets during the crisis, and the G20 is seeking to rein this moral hazard in.
8. APRA is still collecting information from ADIs on the implications of holding higher levels of government bonds in high quality liquid asset portfolios. APRA will consider any potentially negative consequences in its final calibration exercise.
9. APRA regularly consults with Treasury on any proposals to strengthen the prudential regulation framework in Australia. APRA’s proposals are a response to the mandate of the G20, as it is being implemented by the BCBS.
10. APRA has convened formal and informal consultation with the ADI industry on liquidity since early 2007 (including a major conference on this topic in May 2007). These consultations have proceeded with individual ADIs and the major industry groups representing ADIs. Currently, APRA is engaged in a formal public consultation during which all ADIs, and any other interested person, can express their views. Less formal dialogue with individual ADIs and their industry associations is likely to continue throughout 2010. APRA expects to engage in at least one more round of formal public consultation before its prudential and reporting standards for liquidity are finalised.