16 February 2024

General Manager, Policy
Australian Prudential Regulation Authority
GPO Box 9836
Sydney NSW 2001

By email: adipolicy@apra.gov.au

Dear Mr Holland,

Targeted changes to ADI liquidity and capital standards

The Australian Financial Markets Association (**AFMA**) welcomes the opportunity to comment on the Australian Prudential Regulation Authority's (**APRA**) consultation on targeted changes to ADI liquidity and capital standards, including proposed changes to the Prudential Standard APS 210 Liquidity (**APS 210**) and Prudential Standard APS 111 Capital Adequacy: Measurement of Capital (**APS 111**).

AFMA is broadly supportive of APRA's proposed changes to Authorised Deposit-taking Institutions' (**ADIs**) liquidity and capital requirements.

The impact of the proposals is potentially quite meaningful, despite the relatively minor volume of proposed changes. It has not been possible to fully analyse the implications and potential impacts, as the consultation was held over the December-January period. As such, AFMA recommends further analysis be conducted into the potential impact of the proposed changes on the functioning of the relevant financial markets and affected ADIs. As Australia's leading financial markets industry association, AFMA is available to assist APRA with this analysis.

To assist APRA's considerations, AFMA provides the attached comments and observations, including the recommendations that APRA:

1) consider a range of policy solutions to the valuation of held-to-maturity (**HTM)** assets;

2) engage with industry regarding the potential impacts of asymmetric recognition of liquid asset valuation changes and provide greater clarity on how such changes are to be calculated;

3) provide clarity on the applicability of Exceptional Liquidity Assistance for Foreign ADIs and how Foreign ADIs should use the data request template; and

4) consider limited recognition of high-quality bank bills, certificates of deposits and debt securities issued by other ADIs.

Further detail on these recommendations is provided in Attachment A, for APRA's consideration.

For more information or if you have questions in relation to this letter, please contact me on 0411 281 562 or at brendonh@afma.com.au. We look forward to continued engagement on these important changes.

Yours sincerely,

Brendon Harper

Head of Banks and Prudential

Australian Financial Markets Association

About AFMA

AFMA is the leading financial markets industry association promoting efficiency, integrity and professionalism in Australia's financial markets, including the capital, credit, derivatives, foreign exchange, energy, carbon, and other specialist markets.

We have more than 120 members, from Australian and international banks, leading brokers, securities companies and state government treasury corporations to fund managers, energy firms and industry service providers. Our role is to provide a forum for industry leadership and to advance the interests of all these market participants.

Appendix A

1. Accounting for unrealised losses

1.1 Using the market value of liquid assets for ADIs on the MLH regime

AFMA is supportive of APRA's recommendation to require Minimum Liquidity Holding (**MLH**) ADIs to value liquid assets at their market value, rather than based on their accounting treatment. Aligning the approach taken under the MLH regime to that taken under the Liquidity Coverage Ratio regime would provide consistency across ADIs and enhance system resilience, for example by reducing the potential impact and prevalence of 'valuation shocks'.

However, AFMA notes that there are potential material negative implications of extending a market valuation approach, particularly to assets that are expected to be HTM. The Federal Reserve Bank of Boston, in October 2023, noted that:

> *[T]he inclusion of market gains and losses on HTM securities in CET1 capital may penalize banks with predominantly buy-and-hold portfolio strategies. These firms may have to hold additional capital to cushion against losses due to short-term market movements that may never be realized. The effects of this additional capital could be especially punitive during periods of rising interest rates.*[1]

APRA's proposed approach of asymmetric recognition of unrealised losses (but not unrealised gain) would likely exacerbate these impacts. This is discussed further under section 1.2 below.

In conducting its analysis, the Federal Reserve of Boston, considered three potential options for HTM securities accounting. These being:

1) Eliminate the HTM classification;
2) Further restrict use of the HTM classification; and
3) Require banks to include unrealised gains and losses on HTM debt securities in CET1 capital.

Each option provides likely benefits and negative impacts. The negative impacts, as noted above, are likely to be most acute for smaller banks. The Federal Reserve of Boston's analysis concluded that:

> *While requiring fair value accounting for all debt securities may accomplish these goals [of reducing liquidity risk and mitigating the impact of portfolio 'tainting'], it may also present substantial challenges and generate unintended consequences, particularly for community banks. Therefore, <u>it may be preferable for the regulatory agencies to instead issue guidance that allows firms to better</u>*

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[1] Walker, M.J. (2023) *Accounting for Debt Securities in the Age of Silicon Valley Bank*, Federal Reserve Bank of Boston, SRA Notes, Issue Number:2023-01, 5 October, pp.8-9

substantiate their ability to hold investment securities to maturity, particularly during periods of liquidity stress. (emphasis added)[2]

Noting the uneven distribution of costs and benefits, and the potential for unintended consequences, and the likely exacerbating impacts of asymmetric recognition, it is prudent that a range of policy options be considered. This could include providing regulatory guidance or guardrails on the classification of liquid assets as HTM, to ensure there is near certainty in an ADIs "ability" to hold liquid assets to maturity (as required under IFRS 9).

To assist industry in its consideration of this proposal, industry would welcome a discussion with APRA to better understand any analysis that has been conducted into the potential impacts on the expected ADI capital and liquidity levels and volatilities. This would also allow industry to provide more detailed comments on the proposals.

As such, AFMA recommends that APRA consider a range of policy solutions to the valuation of MTH assets.

1.2 Deducting unrealised losses from capital

As noted above, recognising unrealised changes in liquid asset holdings is likely to have an uneven impact on ADIs, which is likely to be exacerbated if asymmetric recognition is adopted.

While AFMA is supportive of recognising unrealised liquid asset valuation changes, the rationale for implementing asymmetric recognition, that is only recognising losses, is unclear. It is unclear to industry, for example, why the APS 111 proposal requires deductions for losses but no credit for gains, inconsistent with the changes proposed for APS 210.

It is also unclear how this approach should practically be implemented, for example, if APRA's proposal requires deductions for each asset that has a cumulative unrealised fair value (**CUFV**) loss be deducted or if the deduction is required at the portfolio level, where some CUFV gains could be used to offset CUFV losses within the portfolio.

As such, AFMA recommends that APRA engage with industry regarding the potential impacts of asymmetric recognition of liquid asset valuation changes and provide greater clarity on how such changes are to be calculated.

2. Exceptional liquidity assistance from the RBA

AFMA is supportive of APRA's proposal that ADIs be prepositioned and ready to access emergency liquidity if needed in a crisis. Having this capability, including the supporting systems, should further assist market resilience.

It is, however, unclear if and how these requirements should apply to Foreign ADIs. For example, paragraph 70 of the draft APS 210 states that "*An ADI under severe liquidity*

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[2] *ibid. p.9*

stress may request Exceptional Liquidity Assistance (ELA) from the Reserve Bank of Australia (RBA)". The information in the template, for example, includes Shareholder Equity, Common Equity Tier 1 ratio and Total Capital Ratio, none of which a Foreign Branch holds locally.

AFMA recommends that APRA provide clarity on the applicability of Exceptional Liquidity Assistance for Foreign ADIs and how Foreign ADIs should use the data request template.

3. Reducing contagion risk

AFMA understands the intent of APRA's proposal that bank bills, certificates of deposits and debt securities issued by other ADIs would no longer be counted as eligible liquid assets for ADIs on the MLH regime. AFMA does have concerns regarding the potential impacts of these changes on the markets of those assets, such as adverse impacts on market depth and liquidity. Reduced liquidity in these markets, for example, could have broader impacts on the ability of ADIs to acquire funding, both in times of stress and in 'BAU'.

A pragmatic approach that would achieve APRA's goals, such as reduced contagion risk, while supporting effective and efficient markets could be to establish a maximum recognised holding of high-quality bank bills, certificates of deposits and debt securities issued by other ADIs. Guidance from APRA could ensure that only assets of sufficiently high quality are recognised, such as highly rated covered bonds, with recognition above, for example, 20% tapered over several years, such as proposed in the current draft APS 210. Should APRA be amenable to considering this approach, AFMA is available to assist in analysing the potential market impacts – again noting that with the consultation period running over December and January, there has been limited opportunity to conduct this analysis to date.

This approach would also assist ADIs in meetings other prudential requirements, such as paragraph 149 in the Prudential Practice Guide APG 210 - Liquidity: "An MLH ADI is expected to ensure that its liquid asset portfolio is appropriately diversified."

As such, AFMA recommends that APRA consider limited recognition for MLH ADIs of high-quality bank bills, certificates of deposits and debt securities issued by other ADIs.