Enhancing Risk Management and Governance in the Region's Banking System to Implement Basel II and to Meet Contemporary Risks and Challenges Arising from the Global Banking System

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Session 5.4

Australian Banking Perspective on Managing Liquidity Risk

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In its recent Annual Report, the Australian Prudential Regulation Authority (APRA) said the immediate and most intense focus of its supervisory activities during 2007/8 was the management of liquidity and funding by ADIs (ie banks, building societies and credit unions) reflecting the substantial disruption to global financial markets.

As part of its response, APRA in early 2008 established a dedicated team to handle liquidity risk management issues including the collection of weekly information on liquidity positions and forward cash flows.

In more recent times, APRA says it has been seeking to ensure that ADIs have realistic approaches to funding planned asset growth of up to 12 months ahead and that such planning should be responsive to changing market conditions.

The Reserve Bank of Australia (RBA) also acted to re-define the manner in which it conducted repo transactions with market counterparties including as to types of acceptable security collateral, haircuts applied and terms of permissible transactions. More recently, governments and regulators have introduced a variety of direct support measures including deposit guarantee arrangements and recapitalisation measures. A close relationship exists between a Central Bank's liquidity operations and regulator assessments about the realism of ADI's internal liquidity-risk management processes and forward planning.

One of the difficulties for a bank with global operations such as NAB is that regulatory requirements and Central Bank initiatives are not consistent across countries. This lack of consistency has the potential to raise issues about transparency of market disclosure and therefore market confidence in understanding reported liquidity risk positions.

2008 has also seen the release of a number of significant reports on liquidity risk management issues including from a business experience perspective. These have come after official reports in the UK concerning the collapse of Northern Rock Bank PLC in 2007. They include:

- FSA DP 07/7: Review of Liquidity Requirements for Banks and Building Societies (December 2007) and Feedback on DP 07/7 (May 2008)
- Senior Supervisors Group: Observations on Risk Management Practices during Recent Market Turbulence (March 2008)
- Basel Committee on Banking Supervision: Principles for Sound Liquidity Risk Management and Supervision (September 2008).

Several supervisors have commenced (or indicated that they soon will be) issuing significantly revised liquidity risk management regulatory standards eg the Reserve Bank of New Zealand Liquidity Policy Consultation Paper.

The release of revised standards may cause new issues about regulatory consistency including permissible and required assumptions of funding withdrawals and renewals, appropriate periods for risk measurement under different assumptions, scenario testing, definitions of liquid assets and required disclosure requirements. It is also unclear what role the Supervisory Colleges now being established for the largest financial institutions will have a role in the determination of best practice expectations for smaller institutions. The balance between a principles based approach and a prescriptive approach to liquidity risk management is still to be determined.

ADIs have been reviewing and revising their liquidity risk management policies. NAB's process of review has included the key areas of:

- Governance / management arrangements
- Funding and liquidity outcome targets
- Limits on funding concentration and restrictions on short-term wholesale funding
- Scenario testing
- The working definition of liquidity
- Escalation triggers and procedures

Important decisions for NAB included the decision to establish a Liquidity Risk sub-committee of the Asset and Liability committee and establishing forward looking outcome targets much longer than required under existing prudential standards. Restrictions on accepting short-term wholesale funding were also imposed.

In its recent annual report, APRA noted experience had confirmed liquidity requirements needed to consider more than a loss of confidence in an individual ADI. They should be supplemented with a broader focus on the risk that key funding markets ceased to operate smoothly even when the individual ADI remains sound. One way of addressing this issue is to establish a variety of contingent funding sources that are accessed by banks as part of their "normal" liquidity risk management operations. NAB has done this during the past year including with respect to utilising the changing requirements of the RBA on acceptable security collateral for repo transactions.

What is less clear at this time is how such a broader focus should in turn influence the assumptions being applied by ADIs about maintaining lending volumes during such periods. This of course has broader implications for economic management.

This past year has seen much more detailed disclosure by Australian ADI's of their liquidity position and how they manage funding requirements and concentration issues. This is of course an important way to maintain market confidence in individual banks and the financial market more generally.

Matters covered in these disclosures include the following:

- Estimates of funding requirements for the current and next financial year and funding completed to date
- Composition of existing funding including by type and by source (geography) as a way of addressing issues of concentration
- Maturity profile of existing funding arrangements
- The amount of "liquid asset holdings" including the major components of their composition

These disclosures have been a focus of annual report presentations by banks' CEOs and market presentations by Chief Risk Officers. This has helped to assure the market about the significance banks place on having well-developed and well-considered liquidity risk management policies.

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MAFC / APEC / AFDC Shanghai Conference: Session 5.4 - Liquidity Risk

8 – 12 December 2008
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nab | Clydesdale Bank | Yorkshire Bank | Bank of New Zealand | nabCapital | MLC

Key points to be covered

- The failure of liquidity risk management
- What is liquidity risk?
- NAB: Key changes in liquidity risk management –
  - Governance
  - Internal Targets
  - Funding Profile
  - Policies and Assumptions
  - Escalation Plan Procedures

The Failure of Liquidity Risk Management

- Liquidity risk has contributed to several bank failures in 2007/8.
  - Inadequate focus on funding concentration risks
  - Inadequate contingency plans
  - Inadequate identification of stress situations: market closures and contingent commitments
- Consequence:
  - Significant re-view / re-writing of banks' liquidity risk management policies
  - Significant revisions to regulatory liquidity risk principles and requirements now occurring. Eg Reserve Bank of New Zealand. Potential for home-host regulatory differences as "national discretions" exercised.
  - Calibration of liquidity risk models to market events. Changing assumptions on product / customer behaviour in light of actual / new behaviours being observed in the global economy.

What is Liquidity Risk?

- Ability to fund increases in assets and meet obligations as due without incurring "unacceptable losses" (BIS September 2008)
- The management of intra-day liquidity requirements are viewed separately to liquidity risk.
- NAB measures liquidity risk on a standalone entity and group basis on a daily basis.
- Branches are viewed as having their own separate set of measurable liquidity risks – primarily for regulatory reporting

NAB: Key changes in liquidity risk management - Governance

- Primary governance committee is GALCO (group asset and liability committee). Regional ALCOs for the separate licensed banking subsidiaries.
- 2008. Establish sub-committee to focus on liquidity risk (chaired by the CFO includes Group Treasurer). Meets daily / weekly and reports weekly to GALCO. Similar committees in other regions.
- 2008. Weekly reporting to APRA on standardised spreadsheet for all majors includes regulatory definitions of terms. Forecast position on a monthly basis for the calendar year.
- 2008. Review escalation procedures including description of triggers: Three levels – Group Treasurer, Board, Regulators.
- 2008. Enhance annual report disclosures about liquidity risk management and funding requirements.
- No additional engagement with internal audit on liquidity risk issues. Audit reviews are part of annual planning process.

NAB: Key changes in liquidity risk management - Internal Targets

Significant expansion of internal triggers and limits :

- The regulatory stress test for name crisis – 5 business days - not sufficient for day to day management.
- Focus on wholesale funding targets (issues of concentration):
  - Maximum refinancing in any one month limited as a % of annual wholesale refinancing requirements.
  - Stop short-term funding of one month or less:
    Preferred minimum 6 months maturity.
  - Targeting higher days cash flow positive
  - Cash flow positive without the impact of central bank support of at least also raised. Regulatory minimum is shorter but includes retail run-off
- Contingent liquidity demand: Assume drawdown % over actual forecast balance sheet growth. Include these drawdown assumptions in reporting to APRA on monthly forecast positions.
- Establish specific escalation triggers for retail funding based on a rising level of funding decline.

NAB: Key changes in liquidity risk management – Funding Profile

	Balance date September 2008 AUD billion	% change on March 2008
Term deposits	161.1	20.2
On demand and short-term deposits	112.9	-2.0
Due to other banks	45.5	-14.1
Short-term borrowings	36.7	5.3
Long-term borrowings	99.0	11.5

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NAB: Key changes in liquidity risk management - Policies and Assumptions

- Review existing policies and assumptions:
  - Establish additional “market disruption” scenarios eg impact of a “name crisis” for a major competitor.
  - Haircuts applied to “liquidity” of paper.
  - Definition of liquid asset reviewed. Focus no longer on the counter-party but eligibility for repo transactions with local Central Banks (and required haircut).

    - Consequently a greater inconsistency in the actual composition of ”defined” liquid assets across the Group.

    - Possible benefits of liquidity transfers across group to capture differences in Central Banks repo practices not captured in calculations.
- Group liquid asset calculations aggregation of local / host regulatory requirements.

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NAB: Key changes in liquidity risk management – Escalation Plan Procedures

- Objectives:
  - Early warning of stressed conditions causing or will cause liquidity position to deteriorate – name and systemic issues
  - Reviewed processes to monitor, identify, escalate and respond.
  - Triggers monitored by liquidity risk committee
- Review Plan: half-yearly or when significant change in the business
- Effectiveness of Plan: Practical use of contingent funding sources eg using assets acceptable as collateral or repo transactions with local Central Banks

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Escalation Procedures (cont.)

Level 1 Significant Incident: *Heightened Monitoring*	**Name Related:** - decline in retail funding over 10 days - spreads on NAB commercial paper widening relative to peers	**Systemic:** - major bank funding spreads increasing across system
Level 2 Severe Incident *Contingent Liquidity Access*	**Name Related:** - loss of multiple counterparty lines over short period. - increased declines in retail funding - widening of CDS levels compared to peers - reduced appetite for NAB paper	**Systemic:** - default of a bank likely to cause systemic problems - key funding markets closing / restricted
Level 3 Critical Incident *Central Bank Special Assistance*	**Name Related:** - run on group or a subsidiary - unable to obtain wholesale funding at any cost	**Systemic:** - All banks experiencing funding difficulties - Reliance on central banks for funding

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  - Internal Targets
  - Funding Profile
  - Policies and Assumptions
  - Escalation Plan Procedures