RESERVE BANK OF NEW ZEALAND

NBDT Consultation Document: Liquidity Policy

Consultation Paper

The Reserve Bank invites submissions on this Consultation Paper by 15th of March 2010.

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1. INTRODUCTION

1 The passing of the Reserve Bank of New Zealand Amendment Act 2008 established a new Part 5D of the Reserve Bank of New Zealand Act 1989 (the Act). Part 5D provides the Reserve Bank with powers to develop a prudential regulatory regime for the purposes of:

(a) promoting the maintenance of a sound and efficient financial system; or,
(b) avoiding significant damage to the financial system that could result from the failure of a deposit taker.

2 Section 157M of the Act, which came into force on 1 September 2009, requires all non-bank deposit takers (NBDTs) to have and comply with a risk management plan which includes procedures for managing liquidity risk. Guidelines released by the Reserve Bank, for the purpose of interpreting risk categories, identify the elements for managing liquidity risk as:

(a) identifying any funding gaps;
(b) managing sources of regular funding; and,
(c) maintaining sources of emergency back-up liquidity.

3 In addition, section 157Z of the Act provides for regulations to be made to require that liquidity requirements are included in trust deeds. The regulations may prescribe one or more of the following liquidity requirements:

(a) assets that qualify as liquid assets for the purposes of the regulations;
(b) minimum amounts of liquid assets relative to liabilities that must be maintained by deposit takers;
(c) requirements concerning matching maturity of assets and liabilities;
(d) requirements in respect of a deposit taker that require the liquidity of the borrowing group of which the deposit taker is part to be taken into account; and,
(e) other measures to better ensure that a deposit taker maintains prudent cash flows and a level of liquid assets sufficient to enable it to withstand a plausible range of liquidity shocks (for example, events that result in it experiencing a significantly reduced inflow of liquid assets).

4 This consultation paper outlines the policy options being considered in relation to section 157Z.

Key matters and principles to take into account in recommending regulations

5 Under section 157F, the Reserve Bank must take into account a number of principles in recommending regulations to the minister under Part 5D of the Act:

(a) the desirability for consistency in the treatment of similar institutions, regardless of matters such as their corporate form;
(b) the importance of recognising–
  (i) that it is not the purpose of this Part to eliminate all risk in relation to the performance of deposit takers or to limit diversity among deposit takers; and,
  (ii) that depositors are responsible for assessing risk in relation to potential investments and for their own investment choices;
(c) the desirability of providing to depositors adequate information to enable them to assess risk in relation to potential investments and to distinguish between high-risk and low-risk deposit takers;
(d) the desirability of sound governance of deposit takers;
(e) the desirability of effective risk management by deposit takers;
(f) the need to avoid unnecessary compliance costs; and,
(g) the need to maintain competition within the deposit taking sector.

6 We will take into account all of these principles when finalising the liquidity policy, with focus on (a), (c), (e) and (f) which we consider particularly relevant.

7 Following consultation, the Reserve Bank intends putting recommendations to Cabinet, and developing draft regulations. The recommendations will include a Regulatory Impact Statement. Therefore, while this consultation paper asks a number of specific questions, we are also interested in receiving compliance cost estimates.

8 The intention is to make policy recommendations to Cabinet in the second quarter of 2010, engaging in further consultation with industry if required.

2. BACKGROUND

Nature of the NBDT sector

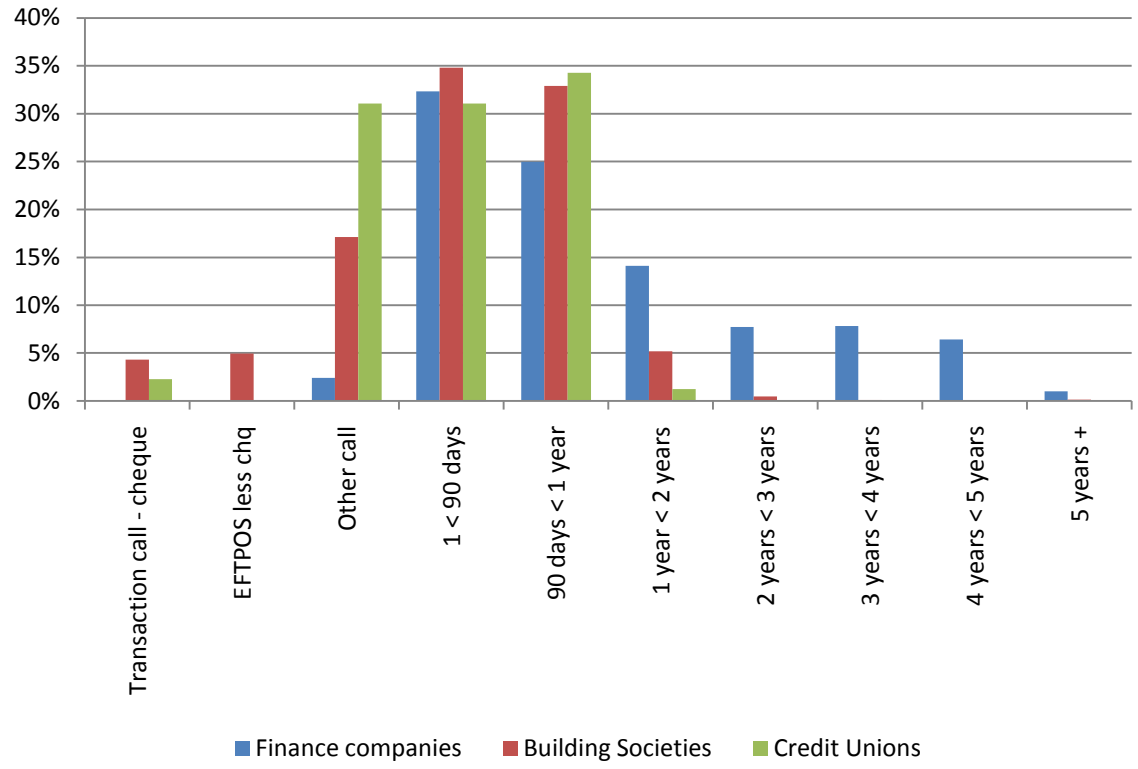
9 The core NBDT sector in New Zealand consists of two separate business models: bank-like savings institutions and deposit-taking finance companies.[1] Savings institutions comprise mainly building societies and credit unions. Like banks, a key part of business for these entities is providing depositors with transaction balances. Consequently they hold significant amounts of funding on call and at short term maturities, and the liquidity risks for these firms are mainly from the excessive withdrawal of call funding. Their liquidity strategy is generally to hold high levels of liquid assets.

10 Deposit-taking finance companies operate a different business model offering longer term savings instruments. As a result, a larger amount of their funding is at longer maturities and the liquidity management strategy is to match the

[1] The NBDT sector as a whole includes entities beyond those primarily referred to in this document.

maturities of funding to that of lending. The liquidity risks that finance companies face is in a maturity mismatch occurring. Before the recent period of stress on finance companies, where short term funding mismatches became evident finance companies were capable of readily raising new deposits to meet outflows. This ability to attract new funding was premised on high levels of investor confidence coupled with seemingly high investment yields being offered. Figure one presents the percentage of total New Zealand Dollar (NZD) funding at different maturities, on aggregate, for building societies, credit unions and finance companies. For credit unions and building societies nearly all funding received is in NZD. For finance companies, on aggregate at least 80% of total funding is in NZD.

Figure 1 Maturity profile of New Zealand Dollar funding within the NBDT sector as at 31 October 2009.



11 The differences in liquidity risks are reflected in the different liquidity requirements in NBDT's trust deeds. Requirements vary from the more traditional liquid asset requirements in bank-like savings institutions' trust deeds, to more indirect liquidity requirements in some finance companies' trust deeds which simply encourage holding liquid assets. Traditional liquidity requirements are usually on the basis of a specified percentage of liquid assets to be held against total tangible assets. For many finance companies, liquidity requirements are not included in their trust deeds.

12 In addition to liquidity requirements imposed on NBDTs through their trust deeds, there are also legislative requirements on trustees and directors. The Reserve Bank of New Zealand Amendment Act 2008 imposes obligations on the trustees of NBDTs to inform the Reserve Bank if the deposit taker is

unlikely to pay its debts as they come due in the normal course of business. Similarly, under securities regulation, directors are required to confirm in prospectuses that the borrowing group of an issuer are able to pay liabilities that are due in the next 12 months. The solvency constraint includes liquidity elements.

13 Liquidity management by NBDTs to some extent reflects the discipline imposed by the existing liquidity requirements outlined above. From the onset of recent finance company failures and subsequent diminishing investor confidence, finance companies' ability to raise new funding was limited and their ability to meet liquidity requirements was predominately dependent on the successful repayment of their loan book assets.

14 During this period, finance companies within the consumer financing sector have shown some success in their ability to meet deposit outflows with matching maturities of their loan book. However, finance companies within the property financing sector have been more vulnerable to liquidity shortfalls as their loan book assets have proven to be highly illiquid in a stressed market. Saving institutions have generally held high levels of depositor confidence and accordingly liquidity has been managed by their reliance on high levels of reinvestment.

15 The introduction of the retail Deposit Guarantee Scheme (DGS) in October 2008 alleviated liquidity pressures in the sector, and encouraged investor confidence. There is some evidence that the availability of the guarantee has had an impact on the funding maturity profile of finance companies, and that some finance companies may not currently be match funded. As a result, there may be increased liquidity risks from exiting the DGS which NBDTs will have to manage in the short term. The liquidity risks will be mitigated by some of the features of the extended guarantee scheme where entities are able to issue both guaranteed and non-guaranteed funding.

16 In this regard, our starting point is to recognise that the problems in the NBDT sector were primarily related to asset quality, rather than liquidity mismanagement. While there were (and to some extent, are) some issues in liquidity management they were not pervasive across the sector and could arguably be addressed by non-regulatory solutions. This situation contrasts with the inadequate capitalisation of some parts of the sector. In light of this, the rationale for proposing liquidity requirements is set out below.

The need for additional liquidity requirements

17 Liquidity risk can be thought of as having two main components: the risk that an entity cannot meet its obligations as they fall due (including risks stemming from both the asset and liability side of the balance sheet); and the risk to an entity's profitability of being able to meet its obligation only at an elevated cost.

18 Although there is no obvious single measure to determine the amount of liquidity risk an entity is exposed to, it is essential that a deposit taker sets up a

number of indicators of liquidity risk to monitor and to limit. At the least, a regulator should be satisfied that all deposit takers have a liquidity risk management framework in place. The requirement for a risk management program under section 157M, and the accompanying guidelines on liquidity risk management, provide some high level guidance to deposit takers.

19 However, there are arguments for the Reserve Bank to go further than simply requiring that there be a liquidity risk management framework in place. The main argument here is that the failure of a deposit taker in benign times due to a sudden large liquidity shock could significantly affect confidence in similar entities. A deposit taker's management would not typically factor this public cost into their decision on how much to spend on liquidity protection, and as a result prescription of liquidity requirements could provide reasonable comfort that the degree of liquidity risk would be lower than it would be without intervention.

20 We can contrast this conceptual situation with the recent sustained period of stress that finance companies experienced, where liquidity management for the most part proved adequate except for vulnerabilities in relation to property financing companies. The main difference here is that, in the recent period, the stress developed over time allowing deposit takers the time to respond and manage stresses as they developed. Another crucial difference is that the stress mainly affected the finance company sector where the long term nature of funding prevented large scale withdrawals of call funding. This argument would suggest that there is potential for NBDTs' appetite for liquidity risk to be higher than socially optimal in normal times (unlike the current period), but it is not immediately obvious that it has been, or if it was, significantly so.

21 Prescribed liquidity requirements can also be justified from the purpose of NBDT prudential regulation more generally, that is, to avoid significant damage to the financial system that could result from the failure of a deposit taker. While NBDTs are not systemic to the financial system, they are systemic to a local group of similar entities. Since similar entities have similar business models (particularly in terms of lending) the failure of an entity would have an impact on the availability of funding to particular segments of the economy.

22 However, as stated above, the economic argument for precise quantitative liquidity requirements is not as strong as the case for capital or related party requirements, and issuing further non-binding guidelines could potentially address some of the current liquidity issues. In this case there are still arguments for prescriptive requirements to be set to achieve consistency across the sector and to prevent liquidity management presenting relative competitive advantages or disadvantages across the sector. Short of prescribing quantitative liquidity requirements, prescribing measurement frameworks could also achieve some amount of consistency across the sector and could fill gaps identified in the current framework.

Liquidity policy developed for locally incorporated banks

23 One approach taken in prescribing liquidity requirements is that of the liquidity policy developed for locally incorporated banks. Briefly stated, the bank liquidity policy has three main elements:

- Quantitative;
- Qualitative; and,
- Disclosure and reporting requirements.

24 The quantitative requirements focus on mismatch positions on one-week, one-month horizons, and on a minimum core funding position at a one-year horizon. The qualitative requirements set out, at a high level, some minimum requirements that should be included in banks' internal structures and toolkits for managing liquidity risk. Quarterly disclosure requirements aim to provide a discipline on banks by making public information about their liquidity positions, performance against requirements, and approach to managing liquidity risk.

Scope of the consultation paper

25 In this consultation paper we propose a series of options for regulating liquidity risk. This includes the potential introduction of new quantitative and qualitative requirements. The risk management requirements already in force and the non-binding guidance which supports them already provide some qualitative requirements for deposit takers.

26 Disclosure requirements are outside the scope of this paper and are being dealt with separately in a review of bank and NBDT disclosure requirements. Material matters will, however, need to be disclosed under existing disclosure requirements.

Policy Issues

27 While there are arguments in favour of imposing additional liquidity requirements on NBDTs, the main issue we face in relation to prescribing quantitative liquidity requirements for NBDTs is the diversity in liquidity needs in the sector arising from the different business models. As a result, it is not clear to us that specifying a single set of precise requirements across the sector is a sensible approach. If the liquidity requirements take the form of minimum requirements across the sector, it could be argued that each NBDT may be less inclined to form its own view of how vulnerable it may be to liquidity risks, and take other necessary steps. However, if liquidity requirements were tailored to the risks of the different business models, consistency and comparability across the sector decreases. Such an approach risks introducing distortions in the sector due to different regulatory requirements.

28 The second issue we face is the question of whether liquidity requirements should be imposed on the deposit taker or the borrowing group which it is a

part of. Our preliminary view is that since the borrowing group guarantees the deposit taker's liabilities and is treated as an economic unit by trustees, that requirements should be imposed on the borrowing group for liquidity purposes too. This would prevent regulatory arbitrage occurring within a borrowing group in relation to liquidity requirements.

- Do you agree with this preliminary assessment of liquidity risk in the NBDT sector?
- Do you agree that it is appropriate to impose liquidity requirements on the borrowing group?

3. POLICY OPTIONS BEING CONSIDERED

29 The policy options on which we are seeking your input can be summarised as follows:

Maintaining approximately the status quo

- In this option the Reserve Bank would not prescribe further liquidity requirements by regulation, other than requiring liquidity requirements to be included in NBDTs trust deeds. As is currently the case, trustees will be responsible for approving liquidity management and setting liquidity requirements for NBDTs on a case-by-case basis. There is also scope under this option to provide more detailed non-binding advice on liquidity risk management.

Prescribing a measurement framework and requiring quantitative liquidity requirements to be included in trust deeds

- Here the Reserve Bank would only standardise definitions and prescribe a measurement framework across the sector, while trustees would determine the quantitative requirements that individual institutions are required to meet. All NBDTs would be required to have the quantitative requirements reflected in trust deeds.

Prescribing precise requirements

- Under this approach the Reserve Bank would specify precise quantitative requirements against a liquidity risk management framework. This could involve prescribing quantitative requirements against liquidity and mismatch ratios. Under a sophisticated approach, this could be achieved through recalibrating the liquidity policy for locally incorporated banks to address liquidity risk specific to NBDTs.

- Are there any other options that the Reserve Bank should consider?

3.1 Maintaining approximately the status quo

30 The main argument for maintaining the status quo is that current issues with liquidity management could be addressed to a certain extent by non-regulatory means. For example, more detailed liquidity risk management guidelines could be issued. At the least, this option should also include requiring liquidity requirements to be reflected in trust deeds so as to increase the transparency of requirements and to enable enforcement action.

31 However, there are still arguments for moving away from the status quo to ensure conservative liquidity management across the sector and to achieve consistency across the NBDT sector and between NBDTs and banks. These benefits include decreasing relative competitive disadvantages from liquidity management and encouraging investor discipline. Given the reliance on retail funding (rather than wholesale funding) by the NBDT sector, arguably investor discipline does not play as big a role as in the case of the banking sector. However the current setup with different frameworks and requirements for liquidity risk likely presents unnecessary complexity for investors. At the micro level, there are benefits to be gained from making small improvements to the current framework from simply defining core liquidity components such as liquid assets.

32 While the DGS is likely to have introduced distortions to the NBDT sector and presents exit challenges, these risks are likely to be transitional in nature. There is also the risk that the presence of the DGS poses a moral hazard complication, but there is reason to believe that industry and trustees will continue to be conservative.

- Are there any other relevant factors that the Reserve Bank should consider in relation to maintaining or moving away from the status quo?

3.2 Prescribing a measurement framework and requiring quantitative liquidity requirements to be included in trust deeds

33 If the Reserve Bank standardises definition and sets measurement frameworks for key liquidity risk components such as liquid assets, maturity matching, or other key components, under this approach trustees and firms would determine quantitative requirements against it.

34 The main benefit is that this approach can ensure effective measurement, and to some extent management, of liquidity risk in the sector while at the same time allowing liquidity requirements to be set to specific entities by allowing trustees to determine the quantitative requirements against the framework. The other benefit is that this approach will achieve consistency across the NBDT sector by prescribing a standard measurement framework across the sector, and could increase consistency with the banking sector. Some of the exit challenges from the DGS could also be addressed.

- Do you agree that consistency of measurement frameworks for key liquidity constructs across the NBDT sector is advantageous?
- Are there any other matters the Reserve Bank should take into consideration when considering prescribing a liquidity risk measurement or management framework?

3.3 Prescribing precise requirements

35 When prescribing liquidity requirements, a natural starting point is liquidity and mismatch ratios to be applied (at potentially different levels) across the sector. A similar approach was recently introduced for locally incorporated banks where three quantitative ratio requirements were defined (see box 1). The one-week and one-month mismatch ratios set off the value of expected cash inflows (including from the sale of liquid assets), against the value of expected outflows, over the respective period. The ratios are defined as the net cash inflow or outflow as a percentage of total funding. The one-year core funding ratio measures the extent to which loans and advances are funded by funding that is stable, either because it has at least a year to maturity or because it is from sources that are less likely to withdraw their money at any sign of problems.

36 Banks must calculate these ratios on the basis of closing balances at the end of each business day. The one-week and one-month mismatch ratios are required to exceed the standard minimum of zero per cent at the end of each business day. The one-year core funding ratio is required to exceed at the end of each business day a standard minimum of 65 per cent initially, increasing to 75 per cent in stages over time.

37 Our preliminary analysis suggests that many of the larger NBDTs would easily exceed the ratio requirements calibrated for locally incorporated banks. This result is unsurprising given NBDTs' reliance on retail funding compared with banks. Other obvious differences between NBDTs and banks which would require different calibrations in the policy are the assumptions around reinvestment rates of retail term funding and the accessibility of committed lines.

38 To calibrate the bank liquidity policy for NBDTs the main issue, as outlined previously, is that of diversity of business models within the sector. Here NBDTs differ from the banking sector where diversity is mostly in terms of size. Theoretically, the bank liquidity policy could be recalibrated to the particular requirements of the different business models of finance companies and bank-like savings institutions. The complexity that arises here is the distortionary effects from varying requirements within a sector, and consequently the basis on which different calibrations should apply. Another option is for the bank policy to be calibrated at a minimum level across the sector. However, this could pose moral hazard where NBDTs could be less inclined to form their own view of how vulnerable they may be to liquidity risks, and take other necessary steps. The presence of trustees somewhat mitigates this risk.

BOX 1 THE RESERVE BANK'S QUANTITATIVE LIQUIDITY REQUIREMENTS FOR LOCALLY INCORPORATED BANKS

One-week mismatch dollar amount =

discounted value of primary liquid assets listed in Appendix A
plus cash inflows contractually due within one week
plus 75% of undrawn committed lines granted to the registered bank available within one week (subject to limits)
minus 100% of "market funding" that can be withdrawn at sight or has residual contractual term within one week
minus "non-market funding" that can be withdrawn at sight or with residual contractual term within one week, where the percentage assumed to be withdrawn varies by size band (see Table 1 in Appendix B)
minus other outflows contractually due within one week
minus 15 % of the undrawn balance of committed lines granted by the bank, other than revolving retail facilities, that can be drawn within one week

One-week mismatch ratio = 100 x (One-week mismatch dollar amount / total funding)

One-month mismatch dollar amount =

discounted value of primary liquid assets listed in Appendix A
plus discounted value of secondary liquid assets listed in Appendix A
plus cash inflows contractually due within one month
plus 75% of undrawn committed lines granted to the registered bank available within one month (subject to limits)
minus 100% of "market funding" that can be withdrawn at sight or has residual contractual term within one month
minus "non-market funding" that can be withdrawn at sight or has residual contractual term within one month, where the percentage assumed to be withdrawn varies by size band (see Table 1in Appendix B)
minus other outflows contractually due within one month
minus 15 % of the undrawn balance of committed lines granted by the bank, other than revolving retail facilities, that can be drawn within one month

One-month mismatch ratio = 100 x (One-month mismatch dollar amount / total funding)

One-year core funding dollar amount =

all funding with residual maturity longer than one year, including subordinated debt and related party funding
plus 50% of any tradable debt securities issued by the bank with original maturity of at least two years, and residual maturity (at the reporting date) between six months and one year
plus "non-market funding" that can be withdrawn at sight or with residual maturity up to one year, where the percentage to be included decreases with size band (see Table 2 in Appendix B)
plus Tier 1 capital

One-year core funding ratio = 100 x (One year core funding dollar amount / total loans and advances)

39 At this stage we do not propose other frameworks that precise liquidity requirements can be set against, but are open to options.

- Do you agree that precise liquidity requirements for the NBDT sector could be set against liquidity and mismatch ratios?
- Do you agree that a simplified bank liquidity policy, with the appropriate calibrations, could be an appropriate framework for liquidity requirements in the sector?
- Do you agree that liquidity requirements should be calibrated at a minimum level across the NBDT sector?
- Do you agree that liquidity requirements should be calibrated separately to suit the different business models of finance companies, and bank-like savings institutions? On what basis would you consider this distinction should be made?
- Do you consider there to be other appropriate liquidity risk management frameworks suitable to the NBDT sector?
- Are there any other relevant factors that the Reserve Bank should consider in relation to this approach?

APPENDIX A

Liquid assets

1. The liquidity policy for locally incorporated banks specifies which type of marketable security (in addition to cash itself) can be treated as liquid assets in the one-week and one-month mismatch calculations. The following is a broad summary of the two classes of liquid asset defined in the policy, primary and secondary:[2]

Primary Liquid Assets

Securities issued by the following –

- New Zealand government
- Reserve Bank of New Zealand
- New Zealand local authorities
- New Zealand state owned enterprises
- NZD securities issued by overseas sovereign, supranational, and quasi-sovereign entities
- Residential mortgage backed securities

Secondary Liquid Assets

- Securities guaranteed by the New Zealand government (NZD and foreign currency)
- Securities guaranteed by AAA-rated sovereign entities (NZD and foreign currency)
- Foreign currency denominated securities issued by AAA-rated sovereign entities
- Lower-rated and un-rated local authority securities
- New Zealand corporate securities
- Asset-backed securities
- Registered bank securities

2. The discount values which adjust for various types of risk are available from the Reserve Bank website at: http://www.rbnz.govt.nz/finstab/banking/

[2] The securities listed must all be denominated in New Zealand dollars except where otherwise noted.

APPENDIX B

Table 1: percentages of non-market funding in each size band to be included as outflows (negative sign) in the mismatch ratio calculations (for registered banks, and for illustrative purposes)

Size band	Up to $5mn	$5mn to $10mn	$10mn to $20mn	$20mn to $50mn	Over $50mn
Percentage to be included	5%	20%	40%	60%	80%

Table 2: percentages of non-market funding up to one year in each size band to be included in core funding

Size band	Up to $5mn	$5mn to $10mn	$10mn to $20mn	$20mn to $50mn	Over $50mn
Percentage to be included in core funding	90%	80%	60%	40%	20%