Reserve Bank response to submissions received on the "NBDT Consultation Document: Liquidity Policy"

Introduction

1 In February and March 2010 the Reserve Bank consulted on a range of liquidity policy options for non-bank deposit takers (NBDTs).

2 All of the options outlined included a minimum requirement for liquidity requirements to be included in an NBDT's trust deed. This could relate to the liquidity of the borrowing group that the NBDT is part of, or it could relate to the NBDT itself. Each option differed in its level of prescription. The options were:

a) Maintaining approximately the *status quo*;
b) Prescribing a measurement framework; and
c) Prescribing precise requirements.

3 The consultation paper was posted on the Reserve Bank's website to reach a broad audience. The Reserve Bank received 16 written submissions from industry and the general public.

Submission responses

4 Consultation submissions were generally supportive of the Reserve Bank's assessment of liquidity risk in the NBDT sector. In particular, submissions supported liquidity requirements being included in an NBDT's trust deed. Submissions also indicated that it was essential for the liquidity of the borrowing group that the NBDT was part of, to be taken into account as well.

5 Broadly speaking, submissions were in favour of the less prescriptive options of maintaining approximately the *status quo* or prescribing a measurement framework (options 1 and 2 above). The main reasons cited were the absence of a fundamental problem in the sector, the benefits to be gained from the less prescriptive options, and the costs associated with the more prescriptive option (option 3).

6 The costs from high levels of prescription would include the difficulty in determining a single appropriate measurement framework across the sector, the risks associated with increased moral hazard, and the risk of spurious accuracy. Nonetheless there were one or two submissions in favour of option 3.

7 Submissions further indicated that for option 2 to achieve the objective of standardisation of liquidity requirements in similar entities, the Reserve Bank would have to go down a more prescriptive route. The Reserve Bank would have to either tailor the measurement framework prescribed to the different classes of NBDT within the sector, or provide detailed advice to trustees on

the bounds within which to exercise their discretion. The Reserve Bank considers that such an approach would take option 2 from being on the less prescriptive side of the spectrum to the more prescriptive side, and therefore incur the same costs associated with a high level of prescription.

Policy decision following industry consultation

8 Following further analysis the Reserve Bank favours an amended design of option 1: maintaining approximately the *status quo*. In this amended option, liquidity regulation will specify that the liquidity requirements to be included in an NBDT's trust deed must be quantitative in nature. Regulation will also require the NBDT and its trustee to take into account the liquidity of the borrowing group that the NBDT is part of, as also that of the NBDT itself.

9 The Reserve Bank will provide guidelines that can assist with the development of the quantitative liquidity requirements that are to be included in trust deeds.

10 This option will impose minimal cost on the industry – in part by largely formalising existing practices and in part by not imposing a one-size-fits-all standard – whilst providing a minimum regulatory backstop, more information for investors and strengthening incentives.

11 The advantages are that it allows the Reserve Bank to convey its views on good practice in the development of liquidity requirements, without requiring the Reserve Bank to issue prescriptive regulations. Once liquidity requirements are included in trust deeds, the disclosure requirements under the Securities Act will come into play so that material breaches of an NBDT's liquidity requirements will have to be disclosed. These disclosures should also allow investors to better understand how different entities are managing their liquidity risk.

12 The costs are anticipated to be low since it is to a large extent a formalisation of the *status quo* and allowing improved enforceability. The costs are also not expected to be great for those NBDTs that do not currently address liquidity in their trust deeds. Existing internal requirements should be readily capable of being incorporated into the trust deed to conform to the new regime.

13 Costs will be additionally mitigated by making the commencement of the liquidity requirements the same date as the commencement of the capital and related party requirements. Thus NBDTs will be able to update their trust deeds in one exercise, to meet all these requirements.

Timeframe

14 The policy outlined above was approved by Cabinet in July 2010. Regulations are now in the process of being developed. Guidelines are also being developed by the Reserve Bank.

15 The liquidity requirements are expected to come into force on 1 December 2010 to coincide with the commencement of the Deposit Takers (Credit Ratings, Capital Ratios, and Related Party Exposures) Regulations 2010.