Reserve Bank of New Zealand
Te Pūtea Matua

Liquidity Policy Review.

Consultation Paper #1 (Issues and Scoping)

28 February 2022

CONSULTATION PAPER

Submission Contact Details

We invite submissions on this consultation paper by 14 April 2022. Please note the disclosure on the publication of submissions below.

Address submissions and enquiries to:

[LiquidityPolicyReview@rbnz.govt.nz]
Subject line: Liquidity Policy Review – C1

(Hard copy)

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Publication of submissions

All information in submissions will be made public unless you indicate you would like all or part of your submission to remain confidential. Respondents who would like part of their submission to remain confidential should provide both a confidential and public version of their submission. Apart from redactions of the information to be withheld (i.e. blacking out of text) the two versions should be identical. Respondents should ensure that redacted information is not able to be recovered electronically from the document (the redacted version will be published as received).

Respondents who request that all or part of their submission be treated as confidential should provide reasons why this information should be withheld if a request is made for it under the Official Information Act 1982 (OIA). These reasons should refer to section 105 of the Reserve Bank of New Zealand Act 1989, section 54 of the Non-Bank Deposit Takers Act, section 135 of the Insurance (Prudential) Supervision Act 2010 (as applicable); or the grounds for withholding information under the OIA. If an OIA request for redacted information is made, the Reserve Bank of New Zealand will make its own assessment of what must be released taking into account the respondent's views.

We intend to publish an anonymised summary of the responses received in respect of this consultation paper.

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1 Executive Summary

1.1 Liquidity Policy Review

The Reserve Bank of New Zealand - Te Pūtea Matua is undertaking a fundamental review of our liquidity policy (BS13), to be known as the 'Liquidity Policy Review' (LPR). This will be the first comprehensive review of our liquidity policy since it was implemented in 2010.

This is the first consultation paper for the LPR, which sets out the proposed issues and scope for the review. It also contains the principles we propose be used to guide the review and our decision-making. We intend to issue at least three more consultation papers as part of the LPR. The second and third consultation papers would seek feedback on a number of fundamental issues related to our liquidity policy, with the fourth consultation paper containing the proposed final liquidity policy text.

Our proposed scope and timeline for the LPR would see the review span approximately three years.

1.2 Liquidity Policy Background

Liquidity is a measure of the cash and other assets that can be quickly sold at a reliable price to pay bills and meet other financial obligations. Liquidity risk is the risk that a business will not be able to meet these financial obligations as they fall due. If liquidity risk crystallises, this can quickly lead to loss of confidence in a business, and in some cases, default or failure.

One of our objectives is to promote the maintenance of a sound and efficient financial system. The objective of our liquidity policy is to promote financial stability by lowering the likelihood of liquidity problems affecting banks, and promoting registered banks' capability to manage such problems. Our liquidity policy applies to all banks incorporated in New Zealand, but does not apply to foreign bank branches.

1.3 It is Time for a Review

The purpose of our review of the liquidity policy is to ensure it remains fit for purpose. We also want to determine whether it would be appropriate and beneficial to adopt, in some form, the international ('BCBS' or 'Basel') liquidity framework, which was finalised and implemented internationally after our existing liquidity policy came into effect.

Our liquidity policy has been in place for over ten years without being comprehensively reviewed and there have been a number of significant developments that support the case for reviewing the policy now, including our recent Liquidity Thematic Review and Liquidity Stress Tests, as well as the COVID-19 pandemic. Over time, it has become apparent that certain parts of the liquidity policy could be updated to provide greater clarity on what is intended by the policy and what is required of banks.

Our liquidity policy has generally functioned well since its introduction in 2010 and served its purpose in helping to ensure that banks adequately manage their liquidity risk. While there are aspects of the policy that we think should be updated, we are not aware of any significant deficiencies in the policy that fundamentally undermine its ability to achieve its objective. In other words, we do not consider the existing liquidity policy to be 'broken'.

1.4 The International (BCBS/Basel) Liquidity Framework

The Basel Committee on Banking Supervision's (BCBS) liquidity framework contains both qualitative principles and quantitative standards. The BCBS's qualitative liquidity principles are contained in its '*Principles for Sound Liquidity Risk Management and Supervision*', published in September 2008.The BCBS also has two minimum quantitative liquidity standards – the Liquidity Coverage Ratio (LCR) and the Net Stable Funding Ratio (NSFR) – published in 2013 and 2014, respectively.

Our existing liquidity policy is generally aligned with the BCBS's qualitative principles, but not the BCBS's quantitative standards (the LCR and NSFR).

1.5 Key Issues for the Review

The LPR will be a comprehensive review of our liquidity policy, so all issues and proposals – however large or small – will be considered. At this time we have identified the following key issues for the review, which will be set out in greater detail in future consultation papers:[1]

- a potential move towards the BCBS's LCR and NSFR standards;
- eligibility requirements for 'liquid assets' in New Zealand;
- the availability of liquid assets in New Zealand;
- current and future arrangements for banks to sell liquid assets to the Reserve Bank;
- how liquidity requirements should be applied across the spectrum of deposit takers;
- whether liquidity requirements should be applied to foreign bank branches;
- whether liquidity requirements should be used as a macro-prudential tool; and,
- the appropriate transition period.

We are proposing to consult on the most fundamental and significant issues related to the policy (potential adoption of the BCBS's LCR and NSFR standards, eligibility criteria for liquid assets, framework for use of our liquidity facilities, and proportionality) in the second consultation paper. The third consultation paper would address the remaining issues. This separation and sequencing of issues will serve to streamline decision-making for the review.

1.6 Proposed LPR Principles

We propose that throughout the review we will have regard to six high-level principles for the LPR, which are set out in Section 8 of this consultation paper. While we do not believe that any of these principles are in direct conflict with one another, we recognise that it may be necessary for us to strike a balance between these principles at times.

1.7 Request for Feedback

We welcome and encourage feedback from all stakeholders on the proposed issues and scope for this review, and all areas raised in this consultation paper.

The comment deadline for this first consultation paper is 14 April 2022. Responses can be submitted to: LiquidityPolicyReview@rbnz.govt.nz (with the subject line: Liquidity Policy Review – C1).

1 Note that this is only a partial list of key issues. A more fulsome list of key issues can be found in Section 7 of this consultation paper.

2 Introduction

2.1 Liquidity Policy Review

The Reserve Bank is undertaking a fundamental review of its liquidity policy (BS13), to be known as the 'Liquidity Policy Review' (LPR). This will be the first comprehensive review of our liquidity policy since it was implemented in 2010.

This is the first consultation paper for the LPR, which sets out the proposed issues and scope for the review. It also contains the principles we propose be used to guide the review and our decision-making.

We intend to issue at least three more consultation papers as part of the LPR. The second and third consultation papers would seek feedback on a number of fundamental issues related to our liquidity policy, with the fourth consultation paper containing the proposed final liquidity policy text.

Our proposed scope and timeline for the LPR would see the review span approximately three years.

2.2 Liquidity Policy Background

What is liquidity and liquidity risk?

Liquidity is a measure of the cash and other assets that can be quickly sold at a reliable price to pay bills and meet other financial obligations. Liquidity risk is the risk that a business will not be able to meet these financial obligations as they fall due.

If liquidity risk crystallises, this can quickly lead to loss of confidence in a business, and in some cases, default or failure.

Liquidity Risk in Banking

Banks play a key role in our financial system. Most lending to households and non-financial corporations in New Zealand is by registered banks. A large portion of this lending is in the form of residential mortgages, which are typically long-term loans.

Banks fund this lending by sourcing a mixture of capital and short and long-term funding from both domestic and offshore markets. The funding (liabilities) is usually of a much shorter duration than the lending (assets), which creates liquidity risk. Liquidity risk can materialise if those that provide funding to the bank wish to withdraw their money and replacement sources of funding cannot be found (or are extremely expensive).

Banks can manage liquidity risk by:

1. ensuring adequate long-term funding;
2. having a diverse range of funding options;
3. holding a liquid asset portfolio which can be sold to raise cash in times of unexpected shortfalls; and,
4. maintaining a strong internal risk management framework.

The GFC and COVID-19 Pandemic Highlighted the Importance of Sound Liquidity Risk Management

The global financial crisis (GFC) that emerged in 2007-2008 and the COVID-19 pandemic highlighted the role liquidity plays in the smooth functioning of global and domestic financial markets. It also showed the importance of prudent liquidity risk management.

New Zealand Banks Were Particularly Vulnerable Before the GFC

The GFC, which had its roots in the US housing market, resulted in large credit losses in many global financial firms and reduced the availability of funding from global markets. Globally, bank funding is mostly from domestic deposits. However, New Zealand has traditionally had a low domestic savings rate which creates a need for banks to obtain funding from offshore, and in the lead up to the GFC, this included a material exposure to offshore short-term (wholesale) funding markets. When global markets were closed to them for a period of time, this put stress on their liquidity positions.

There was also fear that declining confidence in banks could create widespread panic and lead to customers withdrawing their deposits *en masse* - known as a 'bank run' - putting the viability of the banks at risk.

The Reserve Bank – Te Pūtea Matua – Acted Quickly to Restore Confidence and Reduce the Risk of Bank Failures During the GFC, and More Recently During COVID-19

We acted swiftly in response to the GFC, introducing a wide range of emergency liquidity facilities to support and stabilise the local financial sector. Similarly, other central banks around the world introduced emergency measures to restore confidence in domestic and global markets, and to reduce the risk of widespread bank failures.

Similar, although lesser, stresses were experienced in the early stages of the COVID-19 pandemic. As a result, we made special liquidity facilities available to the banking sector again.[2]

Our Liquidity Policy was Introduced in 2010

One of our objectives is to 'promote the maintenance of a sound and efficient financial system'. In the aftermath of the GFC, we prioritised the development of our liquidity policy – which was already underway – recognising that bank liquidity is essential to the smooth functioning of the financial system and to reduce the risk of liquidity stress disrupting the financial system.

The objective of the policy is to promote financial stability by lowering the likelihood of liquidity problems affecting banks, and promoting registered banks' capability to manage such problems.[3]

After consulting with banks in 2009, the policy was introduced on 1 April 2010. The policy applies to all banks incorporated in New Zealand. However, it does not apply to foreign bank branches.

Non-bank deposit takers (NBDTs) are also subject to liquidity requirements set by their trustee supervisor, as required by the Non-bank Deposit Takers Act 2013. These liquidity requirements must include at least one quantitative (minimum ratio) requirement.

The Liquidity Policy Includes Key Requirements and Guidelines

There are three main parts to our existing policy:

2 These special liquidity facilities included the Term Auction Facility and the Term Lending Facility. More information on these facilities can be found here.
3 This objective is stated in paragraph 6 of the Reserve Bank's existing liquidity policy (BS13).

1. **Quantitative requirements:** Banks are required to calculate three liquidity ratios. These are the one-week and one-month mismatch ratios, and the core funding ratio (CFR).

   The mismatch ratios are designed to ensure a bank's liquidity position is robust to a short-term stress or loss of confidence. The one-year CFR measures the level of a bank's longer-term stable funding sources as a proportion of their lending. The basic notion underlying the CFR is a comparison between an estimate of the funding of the bank that is stable, and which can be assumed to stay in place for at least one year ('core funding'), and the core lending business of the bank that needs to be funded on a continuing basis. Requiring banks to maintain a minimum one-year CFR reduces the vulnerability of the banking sector to a period of general market disruption.

   The policy sets out the method to calculate these ratios. Banks are required to maintain minimum levels specified in their conditions of registration.[4]

2. **Qualitative requirements and guidelines:** The policy provides requirements and guidelines that banks are expected to apply to their internal liquidity risk management processes. Guidelines cover governance, implementation, and oversight of these processes, as well as how the risk will be measured and monitored.

3. **Disclosure and Regulatory Reporting:** There are requirements covering public disclosures for material breaches of the policy and separate Reserve Bank disclosures for any other breaches of the policy. Banks are also required to report data on their liquidity positions regularly to us. The liquidity ratios of New Zealand banks are also disclosed publicly on our Bank Financial Strength Dashboard.[5]

4 In most cases, the minimum requirement for the two mismatch ratios is 0% and 75% for the one-year CFR.
5 Our Bank Financial Strength Dashboard can be found here. Banks' liquidity ratios can be found in the 'Liquidity' section of the Dashboard.

3 The Case for Review

3.1 Purpose of the review

The Purpose of our Policy Reviews

The soundness and efficiency of the financial system is fundamental to the overall resilience of the New Zealand economy. To maintain a healthy and vibrant financial system we need our regulated entities – banks, insurers, and NBDTs – to be resilient to financial shocks and support a competitive and diverse financial system.

We are committed to reviewing existing policies on a regular basis, subject to available resources, and undertake such reviews for a variety of reasons. In some cases, our governing legislation contains timelines for review. Changes in international best practice may also prompt a review. Our regular engagement with industry and stakeholders allows us to keep track of when reviews of policies may be beneficial.

The Purpose of this Policy Review

The purpose of this review of the liquidity policy is to ensure it remains fit for purpose. We also want to determine whether it would be appropriate and beneficial to adopt, in some form, the international ('BCBS' or 'Basel') liquidity framework, which was finalised and implemented internationally after our existing liquidity policy came into effect in 2010.[6]

The liquidity policy has been in place for over 10 years without being comprehensively reviewed and there have been a number of other significant developments that support the case for reviewing our liquidity policy now, including our recent Liquidity Thematic Review and Liquidity Stress Tests (described below), as well as the COVID-19 pandemic.

The Liquidity Thematic Review

We launched a thematic review on compliance with our liquidity policy in 2019, and it was completed in September 2021.[7] This was the first detailed review into compliance with the liquidity policy since its introduction in 2010. The thematic review provided us with deeper insights into practices relating to the management and monitoring of liquidity risk in the banking industry.

The report identified several areas of good practice, but also found incidents of non-compliance and areas for improvement. As such, the 10 largest locally incorporated banks have been required to:

- develop a remediation plan to address all the findings set out in their feedback letters; and,
- conduct a materiality assessment of the impacts of the quantitative findings on the liquidity ratios.

All 15 of the locally incorporated registered banks were required to undertake a self-assessment against the findings in this report.

Our supervisors are monitoring the remediation plans and self-assessments.

[6] The Basel Committee on Banking Supervision (BCBS) is the primary global standard setter for the prudential regulation of banks and provides a forum for regular cooperation on banking supervisory matters. Its 45 members comprise central banks and bank supervisors from 28 jurisdictions. The Reserve Bank is not a member of the BCBS.
[7] The full Liquidity Thematic Review report can be found here.

2021 Liquidity Stress Tests

We have been conducting stress tests (hypothetical desktop testing of banks' resilience to adverse economic scenarios) related to banks' solvency (capital) for several years. In 2021, we also conducted stress tests on banks' liquidity for the first time since 2003.[8]

The liquidity stress tests were applied to the ten largest locally incorporated banks and provided valuable insights to us on their resilience to liquidity stresses. This exercise also provided useful lessons for the banks themselves on their potential vulnerabilities and areas for improvement.

The liquidity stress tests demonstrated that banks in New Zealand are prepared to respond to a liquidity stress with a variety of potential actions, such as selling some liquid assets for cash. However, under a very severe liquidity stress scenario, at some point most of the banks that were subject to the test would become illiquid unless they obtained additional liquidity (cash) from the Reserve Bank. While this was not an unexpected outcome and was also consistent with outcomes from liquidity stress tests performed internationally, the test provided helpful insights on when banks may need to request additional liquidity from us.

The Onset of COVID-19 Put Our Liquidity Policy to the Test

The uncertainty that arose from the onset of COVID-19 in March 2020 brought about concerns over banks' liquidity positions. During this period we requested that banks increase the frequency of their reporting of liquidity metrics to us. We also initiated more frequent and detailed discussions with banks over their liquidity positions and potential liquidity stresses. Banks also examined their Contingent Funding Plans – a requirement under the existing liquidity policy – to see what actions could be taken to help address any liquidity stresses.[9]

We responded to potential dislocations in funding markets resulting from COVID-19 – that could have adversely affected credit availability in New Zealand – by reducing the minimum requirement for the CFR from 75% to 50% in April 2020.[10] This change was made to help ensure that banks would not reduce lending to the economy in response to a potential decline in the availability of core funding in order to meet the 75% minimum CFR requirement. In the end, many of the more extreme outcomes that were forecast in the early days of the pandemic did not materialise, largely due to the support measures provided by the New Zealand government and the Reserve Bank, which resulted in additional deposits flowing into the banking system.

The Time for Review is Now

Our liquidity policy has not been comprehensively reviewed since it was implemented in 2010. While some changes to the policy have been made since then, these changes have generally been relatively minor in nature. For example, in May 2021, the liquidity policy was revised to encourage banks to maintain levels of asset encumbrance below a certain level.[11]

While there do not appear to be any fundamental flaws with the existing liquidity policy, our experience with the policy over this time shows that there are a number of areas in the policy that could be improved, possibly through greater elaboration and detail of the policy requirements and policy intent.

8 More information on our 2021 Liquidity Stress Tests can be found here.
9 The Contingent Funding Plan would be deployed in response to a liquidity stress. As noted in paragraph 121 of BS13, the invocation of the plan should be designed to return the bank to a robust position, in line with its risk tolerance, as quickly as possible.
10 This minimum requirement for the CFR was increased back to 75% on 1 January 2022.
11 Paragraph 13 of the Reserve Bank's Liquidity Policy Annex: Liquid Assets (BS13A), states that 'an asset is considered encumbered if it has been pledged to secure, collateralise or credit enhance any transaction in favour of another party, and from which it cannot be freely withdrawn'. In simpler terms, encumbered assets are assets (and their proceeds) that would not be available to the banks' creditors (including depositors), in the event the bank fails and its assets are sold.

Additionally, an international liquidity framework (the BCBS liquidity framework) has since been developed and adopted by regulators in the largest jurisdictions in the world – many of which host the largest and most internationally active banks in the world. Australia is one of the jurisdictions that has adopted this international liquidity framework, a part of which is applied to the four largest banks in New Zealand that are subsidiaries of Australian banks.[12]

With the recent completion of the Liquidity Thematic Review and the 2021 Liquidity Stress Tests, as well as experience gained from stresses brought about COVID-19, now is an appropriate time to undertake a comprehensive review of the liquidity policy itself. Furthermore, forthcoming legislative changes to New Zealand's financial sector framework are expected to move banks and NBDTs into a single regulatory framework for all deposit takers. Given this expected change, we would soon need to consider what liquidity requirements should be applied to NBDTs under this new framework anyway.

Q1 Are there other drivers that are relevant to the case for review?

[12] This part refers to the BCBS's and the Australian Prudential Regulatory Authority's (APRA – Australia's prudential regulator) liquidity coverage ratio (LCR), which is explained in more detail in Section 6.

4 The Reserve Bank's Liquidity Policy

4.1 Our Experience With, and Views On, the Liquidity Policy

The Policy Appears to Remain Largely Fit for Purpose

Our liquidity policy has generally functioned well since its introduction in 2010 and served its purpose in helping to ensure that banks adequately manage their own liquidity risk. This has been achieved through requirements for banks to have appropriate internal structures in place to manage liquidity risk, as well as requirements to calculate and disclose three key liquidity ratios.[13]

While there are aspects of the policy that we think should be updated, we are not aware of any significant deficiencies in the policy that fundamentally undermine its ability to achieve its objective. In other words, we do not consider the existing liquidity policy to be 'broken'.

The IMF Assessed the Reserve Bank's Liquidity Risk Framework as 'Compliant'

The Basel Committee on Banking Supervision's (BCBS) Core Principles for Effective Banking Supervision (Core Principles) are a set of principles considered to be the minimum standards for sound supervisory practices that can be used as a benchmark by supervisors to assess the quality of their supervisory systems.[14] The Core Principles define 29 principles that are needed for a supervisory system to be effective, including a principle on liquidity risk (Principle 24), and contain a set of criteria for assessing compliance with these principles.

In 2017, as part of the International Monetary Fund's (IMF's) Financial Sector Assessment Programme (FSAP) for New Zealand (an assessment of the effectiveness of New Zealand's banking supervisory systems and practices), the IMF assessed New Zealand's compliance with these principles against the relevant criteria, including the principle for liquidity risk.[15] The IMF assessed our framework for liquidity risk as 'compliant' with the BCBS's core principle for liquidity risk.

It should be noted, however, that the Reserve Bank is not a member of the BCBS and is therefore not required to implement the BCBS's liquidity, and other prudential standards.

However, the Policy Would Still Benefit From a Review and Update

Over time, it has become apparent that certain parts of the liquidity policy could be updated to provide greater clarity on what is intended by the policy and what is required of banks. As identified in the Liquidity Thematic Review, there are areas of the policy where banks have taken an interpretation of the policy that is contrary to the policy's intention (e.g., the delayed calculation of mismatch ratios), and areas where banks have made certain assumptions that may not be well supported and are not frequently reviewed and tested.

Providing a greater level of clarity in particular areas of the policy would reduce the need for banks to individually interpret specific parts of the policy (or seek an interpretation from the Reserve Bank on such parts) and therefore increase the level of consistency in how the policy is applied across banks. We acknowledge that some terms used in the current policy are undefined and therefore could create ambiguity.

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[13] The Reserve Bank was the first regulator to implement a liquidity policy after the 2007/08 global financial crisis, as noted in an article from the Economist 'Lord of the ratios'.
[14] The BCBS's Core Principles for Effective Banking Supervision can be found here.
[15] The IMF's FSAP review for New Zealand against the BCBS's Core Principles can be found here.

Since the liquidity policy has been in place, banks have periodically made suggestions to us on how the policy could be clarified and improved. While this feedback has been welcomed by us, it has been held over with the intent of addressing it as part of a comprehensive review of the policy.

The Liquidity Thematic Review highlighted a number of areas where changes would be desirable from our perspective. Additionally, as part of the Liquidity Thematic Review, banks submitted some suggestions for improvement.

Q2 Are there any areas of the current liquidity policy that you believe are not fit for purpose and should be an area of focus for the review?

5 International Liquidity Framework

The Basel Committee on Banking Supervision (BCBS) has Developed a Liquidity Framework That Has Been Widely Implemented Around the World

The International Framework Consists of Both Qualitative and Quantitative Components

The BCBS's qualitative liquidity principles are contained in its '*Principles for Sound Liquidity Risk Management and Supervision*', published in September 2008. In January 2019, the BCBS completed a review of these principles and confirmed that they remain fit for purpose, and advised that banks and supervisors should remain vigilant of liquidity risks in financial markets.[16]

The BCBS also published two minimum quantitative liquidity standards – the Liquidity Coverage Ratio (LCR) and the Net Stable Funding Ratio (NSFR) – in 2013 and 2014, respectively.[17] The LCR has been a minimum requirement for BCBS members since 2015, and the NSFR since 2018. The BCBS frameworks are designed for internationally active banks, primarily focusing on global systemically important banks (GSIBs) and domestic systemically important banks (DSIBs).[18]

In addition, the BCBS's liquidity framework includes a set of liquidity monitoring metrics, which are used to aid supervisors in assessing liquidity risk and include tools that cover contractual maturity mismatch, funding concentration, available unencumbered assets, LCR by currency, market-related monitoring tools, and intraday metrics.[19]

The BCBS's LCR and NSFR Requirements are Similar to our Quantitative Requirements

The LCR is a quantitative metric which promotes the short-term resilience of a bank's liquidity risk profile. Analogous to our one-month mismatch ratio, the LCR is a ratio of a bank's stock of high-quality liquid assets to its total net cash outflows in a stress scenario over 30 days. The LCR framework requires this ratio to be greater than 100%.

While we also have a one-week mismatch ratio (in addition to the one-month mismatch ratio), a similar quantitative metric for this one-week time period does not exist in the BCBS's LCR framework. Banks in New Zealand are generally required to maintain the one-week and one-month mismatch ratios above 0% (in some cases, higher), which is analogous to the LCR's 100% minimum requirement (the difference in the 0% and 100% minimum requirements arises from different calculation methodologies).

The NSFR ensures banks fund their activities with stable sources of funding that are expected to be available over a one-year time horizon, and is analogous to our CFR. The NSFR framework requires the ratio of 'Available Stable Funding' (ASF) to 'Required Stable Funding' (RSF) to be greater than 100%. Banks in New Zealand are required to maintain their CFR above 75%, which is analogous to the NSFR's 100% minimum requirement (the difference in the 75% and 100% minimum requirements arises from differences in methodologies and calibration, including differences in the calibration factors assigned to ASF and RSF categories in the NSFR framework).

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16 The BCBS press release announcing the findings of this review, and the principles themselves, can be found here.
17 The LCR can be found here and the NSFR here.
18 GSIBs and DSIBs are banks whose systemic risk profile is deemed to be of such importance that the bank's failure could trigger a wider financial disruption or crisis and threaten the global/domestic economy.
19 The BCBS's liquidity monitoring metrics can be found here.

Some New Zealand Banks are Subject to the LCR and NSFR Framework

As a member of the BCBS, the prudential regulator of banks in Australia, the Australian Prudential Regulatory Authority (APRA), has adopted the BCBS's LCR and NSFR frameworks. APRA's liquidity policy requires banks with material banking subsidiaries in offshore jurisdictions (such as New Zealand) to maintain an LCR of at least 100% for these subsidiaries.[20] As such, the large four banks in New Zealand – as material banking subsidiaries of Australian banks – are also subject to APRA's LCR requirements. However, APRA does not require the New Zealand subsidiaries of Australian banks to meet its NSFR requirements on a standalone basis.[21]

The policy review will consider a potential move towards the BCBS's liquidity framework

Consistent with our *Statement of policy making approach (October 2020)*, we will consider whether there is merit in aligning with the BCBS's liquidity framework and determine whether such alignment would be beneficial for New Zealand.[22]

It is worth noting that our capital framework is based on the BCBS's capital framework, with modifications for New Zealand-specific circumstances.

Q3	Do you have any initial views on whether we should consider the BCBS liquidity framework as part of the review (noting that views on this question will be sought again in the next consultation paper)?

20 See paragraph 28 (of Attachment A) of APRA Prudential Standard on Liquidity, APS 210, which can be found here.
21 Instead, APRA requires Australian banks to meet NSFR requirements on a standalone (Australian bank only) basis and on a group (Australian bank plus subsidiaries) basis.
22 The Reserve Bank's *Statement of policy-making approach* can be found here. Reference to international alignment can be found on page 14.

6 Key Issues for the Review

6.1 The Liquidity Policy Review will Consider all Proposals and Seek Feedback on a Number of Significant Issues

The LPR will be a comprehensive review of our liquidity policy, so all issues and proposals – however large or small – will be considered. At this time, we have identified the following key issues that will be considered as part of the review, which will be set out in greater detail in future consultation papers.

We are proposing to consult on the most fundamental and significant issues related to the policy (potential adoption of the Basel framework, eligibility criteria for liquid assets, framework for use of our liquidity facilities, and proportionality) in the second consultation paper. The third consultation paper would address the remaining issues. This separation and sequencing of issues will serve to streamline decision-making for the review.

We Will Seek Feedback on a Potential Move Towards the BCBS's Liquidity Framework

Our liquidity policy was introduced in 2010, shortly after the GFC of 2007/08, and prior to the finalisation of the BCBS's LCR and NSFR frameworks. While the existing liquidity policy has served us and the banking system well, and could continue to do so in the years to come, the review of the policy would be remiss in not assessing the BCBS's liquidity framework – which includes the qualitative liquidity principles, the LCR and NSFR frameworks, and liquidity monitoring metrics – and its appropriateness for New Zealand.[23]

The second consultation paper will include background on, and our assessment of, the BCBS's liquidity framework. It will also include a survey of the liquidity policies in both BCBS members and non-BCBS members that are comparable to New Zealand.

At this time, we do not take a view on whether we should move towards the BCBS's liquidity framework, and if so, to what extent, and are therefore keen to obtain views from stakeholders.

Should we decide to retain and revise the existing liquidity policy, the policy would undergo a comprehensive review, which would include both the qualitative and quantitative components of the policy. This would include considering the impact of the forthcoming implementation of a depositor compensation scheme in New Zealand.

We Will Review the Eligibility Requirements for 'Liquid Assets' in New Zealand

Under the Reserve Bank's existing liquidity policy, 'liquid assets', which include both 'primary' and 'secondary' liquid assets, include cash and assets that can, in theory, be quickly sold at a reliable price during a period of stress.[24] The concept of liquid assets (both primary and secondary liquid assets) is analogous to the concept of 'high quality liquid assets' (HQLA) in the BCBS's liquidity framework. Our existing liquidity policy allows banks to classify some assets as liquid assets that are unlikely to be able to be sold at a reliable price into private markets, particularly during a period of stress; instead, these assets would likely be pledged to the Reserve Bank in exchange for cash,

23 The BCBS's liquidity framework, and its components, were discussed in the previous section (Section 6).

24 Primary liquid assets, which are of higher quality than secondary liquid assets, are eligible for inclusion in both the one-week and one-month mismatch ratio calculations. Secondary liquid assets, however, are only eligible for inclusion in the calculation of the one-month mismatch ratio.

which may have undesirable impacts on market discipline.[25] Further, these assets would not qualify as HQLA under the BCBS's liquidity framework.

This issue will be examined in greater detail in the second consultation paper.

We Will Review the Availability of Liquid Assets/HQLA in New Zealand

Banks' existing stock of liquid assets often include a mix of cash, reserves held with us, New Zealand Government Bonds (NZGBs), Kauri bonds (a security in New Zealand dollars issued and registered in New Zealand by a foreign entity), Local Government Funding Agency (LGFA) bonds, and self-securitised (internal) residential mortgage-backed securities (iRMBS).

In comparison to many other developed jurisdictions, New Zealand has historically had a low level of government debt and therefore a relatively low supply of NZGBs. However, the New Zealand government has issued more NZGBs since the onset of COVID-19 to support New Zealanders and New Zealand businesses, therefore increasing the supply of NZGBs.[26]

The review will assess the supply of liquid assets/HQLA in New Zealand, including NZGBs, and provide a view on whether this supply is sufficient to meet the needs of deposit takers in New Zealand.

This issue will also be addressed in the second consultation paper.

We Will Review Current Arrangements for Banks to Sell Liquid Assets to the Reserve Bank

We offer facilities where financial institutions can sell certain assets to us (for cash), on agreement that these financial institutions will repurchase these assets at a future date. The availability and use of these facilities provides these institutions with a source of immediate liquidity, at no charge (i.e., institutions do not pay a fee to us for the ability to access these facilities).

Our purchase of assets under these facilities is discretionary (i.e., there is no formal commitment for us to purchase assets under these facilities). As such, it may be appropriate that there is no standing fee charged to institutions for potential access to these facilities.

Nevertheless, the review will assess current arrangements for Reserve Bank facilities and determine whether these arrangements should be more formally codified, and whether it would be appropriate for us to charge a standing fee for deposit takers' potential access to these facilities (particularly if there is a commitment from us to purchase certain assets upon request). This standing fee would be in addition to any interest charges on actual money borrowed from us.

The BCBS's LCR framework provides an option for central banks, in jurisdictions with a shortage of HQLA, to provide banks with such a liquidity facility (for a fee). Australian authorities introduced such a facility – known as the 'Committed Liquidity Facility' (CLF) – in 2015; however, APRA recently announced that this facility would be phased out by the end of 2022 due to the recent (and

25 However, the sale (or potential sale) of assets to the Reserve Bank may be unavoidable in the event there is an insufficient supply of HQLA in New Zealand, as noted in the section below.

26 New Zealand Treasury's most recent forecast for the 2021/22 New Zealand Government Bond programme, released in December 2021, can be found here.

expected continued) increase in availability of HQLA in Australia brought about by the COVID-19 pandemic.[27] This issue will be included in the second consultation paper.

We will Seek Feedback on How Liquidity Requirements Should be Applied Across the Spectrum of Deposit Takers, Particularly Given Forthcoming Changes to the Regulatory Framework

Our existing liquidity policy applies to all locally incorporated banks in New Zealand, regardless of their size. However, proposed changes to our legislation, which are expected to come into effect in the next few years, would see NBDTs (credit unions, building societies, and finance companies) move into a single regulatory framework with banks. Prior to these changes coming into place, we would need to consider how liquidity requirements for NBDTs might need to change.

While implementation of the new regulatory framework is still several years away, the policy review will consider how liquidity requirements should be applied across the full spectrum of entities under this framework.[28] For example, the liquidity policy could theoretically be applied equally to all deposit takers (banks and NBDTs). Alternatively, it may be possible to apply liquidity requirements in proportion to the size, complexity, and type of deposit taker.

There are a number of possibilities for how liquidity requirements could be applied across deposit takers, and we will seek feedback on these possibilities in the second consultation paper.

We Will Seek Feedback on Whether Liquidity Requirements Should be Applied to Foreign Bank Branches

We consulted on whether to apply liquidity requirements (or at least some requirements) on foreign bank branches in 2012. At that time, we chose not to apply such requirements on foreign bank branches.

The policy review will consult on this issue again in the third consultation paper and will be coordinated with our policy review of our branch framework, launched in October 2021.[29]

We Will Seek Feedback on Whether Liquidity Requirements Should be Used as a Macro-Prudential Tool

We have a defined list of macro-prudential tools or instruments, which includes the CFR.[30] The CFR requirement has been identified by us as a requirement that could be eased in the event of a market dislocation. As noted in Section 4, we responded to potential dislocations in funding markets resulting from COVID-19 – that could have adversely affected credit availability in New Zealand – by reducing the minimum requirement for the CFR from 75% to 50% in April 2020.[31]

We will seek feedback, in the third consultation paper, on whether it remains appropriate to use a liquidity requirement(s) as a macro-prudential tool, and if so, in what manner.

27 More information on APRA's announcement to phase out the Committed Liquidity Facility can be found here.
28 Under the existing regulatory framework, liquidity requirements for NBDTs are set by their trustee supervisors (within certain constraints set by regulations).
29 For more information the review of our branch policy, see Review of overseas bank branches underway.
30 More information on our macro-prudential policy can be found here.
31 This minimum requirement was increased back to 75% on 1 January 2022.

We Will Seek Feedback on Whether the Liquidity Policy Should Contain a Requirement for Deposit Takers to Have an Internal Liquidity Adequacy Assessment Process (ILAAP) or Similar Process

The European Banking Authority (EBA) requires institutions to have an internal liquidity adequacy assessment process (known as the ILAAP). These processes are required to contain information relating to the institution's liquidity and funding risk management framework, funding strategy, strategy regarding liquidity buffers and collateral management, cost-benefit allocation mechanism, intraday liquidity risk management, liquidity stress testing, and liquidity contingency plan.[32] The policy review will consider whether an ILAAP, or similar process, is needed in New Zealand. We note that an ILAAP requirement may not require deposit takers to undertake much, if any, additional work; instead, it may involve the consolidation of deposit takers' existing documentation that is produced to meet other requirements in the liquidity policy. Additionally, the requirement could be applied in a proportional manner.

Consistent with the BCBS's capital framework for banks, the Reserve Bank's capital framework contains an analogous requirement for banks related to capital, known as the Internal Capital Adequacy Assessment Process (ICAAP).[33]

This issue will be examined in the third consultation paper.

We Will Seek Feedback on the Role and Application of Supervisory Overlays to Minimum Liquidity Requirements

Under the existing framework, we set each bank's minimum liquidity requirements – for the three quantitative ratios – individually in the bank's Conditions of Registration (CoR). Under this model, we can increase each bank's minimum liquidity requirements above the standard minimums if we view that these minimums are insufficient relative to the bank's liquidity risk. As we will be moving away from the CoR model in the coming years (and towards regulatory 'standards'), the liquidity policy will need to consider how supervisory overlays to minimum liquidity requirements would be applied.

This issue will be considered in the third consultation paper.

We Will Seek Feedback on Whether Some Liquidity Metrics Should be Calculated on Non-Business Days and Holidays

There is currently a significant payments initiative, led by Payments NZ, to extend the settlement and interchange of financial transactions between banks that would allow for electronic payments between accounts across different banks to occur every day of the year (not just on business days). This project is otherwise known as the 'SBI365' (Settlement Before Interchange 365) project.[34]

Given this pending development, we propose to conduct analysis, and seek feedback on, whether more frequent calculation (and potentially reporting) of certain liquidity metrics should be required.

32 See the EBA's Guidelines on ICAAP and ILAAP information collected for SREP purposes, here.
33 For more information on the Reserve Bank's ICAAP, see Part D of the Reserve Bank's Banking Prudential Requirement (BPR) 100: Capital adequacy, here.
34 More information on this Payments NZ initiative can be found here.

This issue will be considered in the third consultation paper.

We Will Seek Feedback on the Appropriate Transition Period

The appropriate transition period for deposit takers to implement the changes arising from this review will depend on the outcome of, and extent of changes resulting from, the review. It will also need to be coordinated with the transition to the single regulatory framework for deposit takers. We will seek to determine a reasonable transition period and be conscious of the associated compliance costs for deposit takers.

Q4	Is the proposed scoping of this review sufficiently comprehensive? Are there any issues that should be examined that are not mentioned in this consultation paper?

7 Proposed Liquidity Policy Review Principles

7.1 The Policy Review will be Guided by a Set of Key Principles

We propose that, throughout the review, we would have regard to the following high-level principles for the LPR[35]

1. Liquidity requirements should be calibrated using assumptions that reflect stress scenarios to help ensure financial stability.
2. The liquidity policy should encourage banks to make reasonable efforts to maximise reliance on private sector liquidity.
3. Liquidity requirements should have regard to international practice, while reflecting the New Zealand context, and be proportional by taking into account the differing size, nature, and complexity of all deposit takers.
4. The liquidity policy should contain both qualitative and quantitative requirements and encourage banks to take a holistic approach to their management of liquidity risk.
5. Liquidity requirements should be sufficiently prescriptive to promote and facilitate consistent implementation by deposit takers to enhance comparability and market discipline.
6. Liquidity requirements should be practical to administer and seek to avoid any unnecessary complexity and compliance costs.

While we do not believe that any of these principles are in direct conflict with one another, we recognise that it may be necessary for us to strike a balance between these principles at times.

It should also be noted, that while not a proposed principle for the review, we do not wish to see an overall material weakening in liquidity requirements relative to what currently exists, which applies to both qualitative and quantitative requirements.

Q5	Are the proposed principles for the Liquidity Policy Review appropriate? Should any principles be added, removed, or amended? If so, please provide specific feedback on how this should be done.

35 These proposed principles for the LPR are broadly consistent with the proposed principles to be taken into account by the Reserve Bank under the forthcoming Deposit Takers Act. These principles can be found in clause 4 of the Exposure Draft for the Deposit Takers Bill, which can be found here.

8 Proposed Consultation Process and Approximate Timeline for the Review

As this will be a Comprehensive Review, the Timeline Will Depend on What Key Decisions Are Made and the Need for Additional Consultation

We expect that there will be at least four consultation papers released as part of the LPR and intend to conduct a quantitative impact study (QIS) prior to finalisation of the liquidity policy

C1

This first consultation paper (C1) contains our proposed approach for the LPR, the key issues we intend to examine, and the proposed principles for the review.

C2

The second consultation paper (C2) would include, and seek feedback on, the following issues:

- a summary of our existing liquidity policy and the BCBS's liquidity framework, along with a comparison of the two;
- our proposed eligibility criteria for liquid assets and assessment of which assets meet this criteria;
- our initial assessment of the availability of liquid assets/HQLA in New Zealand and need for a CLF;
- our proposed framework to manage deposit takers' ability to access our liquidity facilities (e.g., explicit access for a fee, discretionary/potential access at no charge (status quo)); and,
- a discussion on proportionality, including some potential options for applying liquidity requirements proportionally across deposit takers.

C3

The third consultation paper (C3) would include, and seek feedback on, the following secondary issues:

- our analysis and proposal on whether to apply liquidity requirements to bank branches;
- our analysis and proposal on how liquidity requirements could/should be used as a macro-prudential instrument(s);
- any proposed ILAAP requirements;
- a discussion on how supervisory overlays would be applied;
- our analysis and proposal on whether to require more frequent calculation and reporting of liquidity metrics; and,
- any other secondary issues.

C4

The fourth consultation paper (C4) would provide, and seek feedback on, the proposed draft text for our revised liquidity policy and our proposed transition period.

QIS

After submissions on C4 have been received and reviewed, we would ask deposit takers to participate in a QIS (based on our proposed policy) to ensure appropriate calibration of the policy.

Following the QIS, and after making any necessary adjustments to the policy based on the QIS results, we would finalise the liquidity policy. We expect the final liquidity policy to be published approximately three years from the date of release of C1, which would be followed by a reasonable transition period that incorporates feedback from deposit takers, is conscious of the associated compliance costs, and aligns with the transition to the new single regulatory framework for all deposit takers.

Industry Sessions, Summary of Submissions, and Key Decisions

We intend to hold sessions with industry throughout the review, potentially after the release of each consultation paper, and are open to holding additional sessions as needed.

In addition, we intend to publish a 'summary of submissions' for each consultation paper, which would also contain our decisions (and reasoning for those decisions) on the key issues covered in those consultations.

Approximate Liquidity Policy Review Timeline

Q1 2022	• Release of C1, with submissions due by 14 April 2022
Q2 2022	• Reserve Bank to publish a summary of submissions and key decisions for C1
Q3 2022	• Release of C2[36]
Q4 2022	• Reserve Bank to publish a summary of submissions and key decisions for C2
Q1 2023	• Release of C3
Q2 2023	• Reserve Bank to publish a summary of submissions and key decisions for C3
Q3 2023	• Release of C4
Q4 2023	• Reserve Bank to publish a summary of submissions and key decisions for C4
Q1 2024	• Reserve Bank to launch a quantitative impact study (QIS) on the near-final liquidity policy, to take place over several months
Q2 2024	• QIS results received and analysed by the Reserve Bank • Reserve Bank to amend near-final liquidity policy based on QIS results
Q3 2024 to Q1 2025	• Reserve Bank to undertake further consultations (in addition to the four consultation papers and QIS), either public or targeted, if required • Reserve Bank to publish final liquidity policy

Q6 Is the proposed process and approximate timeline for the review appropriate?

36 For C2, C3, and C4, we will aim to provide a minimum 60 day comment period wherever possible and appropriate.

9 Summary of Questions and Request for Feedback

9.1 We Welcome and Encourage Feedback from all Stakeholders on the Proposed Scope for this Review

We seek feedback on all areas raised in this consultation paper, but feedback may wish to address the following questions.

Summary of Questions

Q1	Are there other drivers that are relevant to the case for review?
Q2	Are there any areas of the current liquidity policy that you believe are not fit for purpose and should be an area of focus for the review?
Q3	Do you have any initial views on whether we should consider the BCBS liquidity framework as part of the review (noting that views on this question will be sought again in the next consultation paper)?
Q4	Is the proposed scoping of this review sufficiently comprehensive? Are there any issues that should be examined that are not mentioned in this consultation paper?
Q5	Are the proposed principles for the Liquidity Policy Review appropriate? Should any principles be added, removed, or amended? If so, please provide specific feedback on how this should be done.
Q6	Is the proposed process and approximate timeline for the review appropriate?
Q7	Do you have any additional feedback on the proposed issues and scoping of the Liquidity Policy Review?

10 Glossary

A short explanation of the terms and acronyms used in this consultation paper can be found below.

What is the...

Australian Prudential Regulatory Authority (APRA)	An independent statutory authority that supervises institutions across banking, insurance and superannuation and promotes financial system stability in Australia.
Basel Committee on Banking Supervision (BCBS)	A committee of international banking regulators that establish best practice and standards for banks.
BS13	The Reserve Bank's liquidity policy (from the 'Banking Supervision' (BS) Handbook).
Core Funding Ratio (CFR)	The ratio of a bank's stable long term funding (e.g., retail deposits) to its loans. Analogous to the BCBS's net stable funding ratio.
Liquid Assets (BS13)/High Quality Liquid Assets/HQLA (BCBS)	A bank's cash and assets (e.g., New Zealand Government Bonds) that can be quickly sold at a reliable price.
International Monetary Fund (IMF)	An international organisation that promotes international financial stability and monetary cooperation.
Liquidity Coverage Ratio (LCR)	The international (BCBS) liquidity metric used to measure a bank's ability to meet its obligations over a 30 day stress period. Analogous to the Reserve Bank's mismatch ratios.
Mismatch Ratio(s)	Ratio of a bank's liquid assets (less net cash outflows) to its total funding, which is calculated over a one week and one month period. Analogous to the BCBS's liquidity coverage ratio.
Net Stable Funding Ratio (NSFR)	The international (BCBS) liquidity/funding metric used to measure the ratio of a bank's stable long term funding to its assets. Analogous to the Reserve Bank's core funding ratio.
Non-bank deposit takers (NBDTs)	Financial institutions that accept deposits but are not banks – includes credit unions, building societies, and finance companies.