# Liquidity Regulation changes should go beyond removing CLF

The RBA's announcement that the Committed Liquidity Facility (CLF) will be wound down by end 2022 makes sense. There is now a vastly increased supply of Australian Government Securities which can serve as High Quality Liquid Assets (HQLA) for meeting the Liquidity Coverage Ratio (LCR) requirement. The CLF was initially introduced in 2015 because of a shortage of such assets, but also reflected APRA's earlier decision to restrict the definition of HQLA to exclude anything other than government securities and deposits at the RBA (which are categorized HQLA level 1 by the Basel Committee).

That decision was questionable, and warrants re-examination. Specifically, the logic behind not giving some weight as liquid assets to residential mortgage backed securities (RMBS), covered bonds, and corporate bonds was, in my view, faulty. The CLF partially offset the effects of that decision, but led to the anomaly of banks being able to use self-securitisations of their own mortgage loans as CLF-eligible assets – effectively violating the Basel Committee limitations on what could be counted as liquid assets.

Allowing covered bonds, RMBS, and corporate bonds to count as HQLA (level 2A or 2B) assets (as specified by the Basel Committee) in meeting the LCR requirement would partly compensate for the removal of the CLF. It would also be likely to improve the liquidity of markets for those assets – with adequate secondary market liquidity being one of the criteria required for HQLA asset status by the Basel Committee. Regulatory arrangements can be an important determinant of an asset's liquidity!

The CLF meant that for a fee, of (initially) 15 basis points, banks were guaranteed the right to access cash (if needed) from the RBA via repurchase agreements using approved securities, such as RMBS, as collateral. The RBA allowed "self-securitisations" of mortgage loans as approved securities, and the banks made significant use of that approach. This despite the Basel Committee having stated that RMBS could be approved as (level 2B) HQLA only if "not issued by, and the underlying assets have not been originated by the bank itself or any of its affiliated entities". The RBA approach is a different form of regulatory avoidance than is usually talked about!

Why was APRA's original decision to exclude HQLA level 2 assets questionable? Because it confused individual bank liquidity problems with system-wide crisis liquidity problems!

In normal circumstances, a bank with a liquidity shortage would be able to access cash by selling HQLA level 2 assets into the market without risking a fire sale and sparking a downward price spiral. In a potential general crisis, the lender of last resort (the RBA) will step in to avert a liquidity crisis by being willing to provide cash via repurchase agreements (loans) using acceptable securities.

And since the Global Financial Crisis, acceptable securities for use in the RBA's daily market operations have included such HQLA level 2 assets. In those operations, and also when operating as a Lender of Last Resort, a margin is applied to the securities accepted as collateral such that the value of collateral held by the RBA exceeds the loan made (protecting the RBA and the tax-payer in case of default on the loan).

So, in normal conditions, HQLA level 2 assets can be used for obtaining cash (via on-market sales) while in a crisis, the RBA will provide cash by loans secured by those assets. Why then shouldn't they be counted in meeting the LCR requirement up to some level, such as 40 per cent of the total as recommended by the Basel Committee? (They specified RMBS as level 2B assets, only eligible to count for 15 per cent of the total, with values measured after a 25 per cent discount applied to face value).

Some part of APRA's original reasoning related to relatively low secondary market liquidity in covered bonds, RMBS and corporate bonds, and this was at a time not long after the freezing of asset markets at the time of the GFC. So, conservatism by APRA was understandable, although that does not explain the confusion of methods of dealing with individual bank liquidity, and system wide liquidity, problems.

Reexamining the exclusion of non-government securities from HQLA assets is warranted.

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