Senate Standing Committee on Economics

ANSWERS TO QUESTIONS ON NOTICE

Treasury Portfolio

Additional Estimates

23 – 24 February 2011

Question No: AET 169

Topic: RBA – Government Bonds

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Senator Bushby asked:

Senator BUSHBY—Some around the table would suggest that the country is doing its best to solve that problem. But the issue is that there are not enough high-quality government bonds in Australia to be able to meet the liquidity requirements. But, if there was, the banks would have to put the money that they hold over to the Commonwealth in return for the assets. Why wouldn't the RBA actually accept that money and hold it instead of the government bonds, in which case there may be other benefits? I am just trying to work that through.
Dr Laker—The banks could place money, if they wanted to, on deposit with the RBA and I think that would count as a high-quality, level 1 asset anyway. They would have a choice between that option and buying government paper.
Mr Littrell—Can I follow up on that. In the work developing the RBA facility between us and the RBA, we did essentially look at whether the banks should just hold a big RBA cheque account. There are a number of technical problems with that which would make it preferable for banks to hold a spread of other securities instead of just having one big cheque account. If you want to ask the question on notice, we can explain that.
Senator BUSHBY—I would be interested in that—strangely, yes, I would be.
Mr Littrell—Put it on notice and we will—
Senator BUSHBY—If you will accept that on notice.
Senator Sherry—Yes.

Answer:

One of the alternatives to the committed RBA liquidity facility that was considered by APRA and the RBA was that the RBA would meet any shortfalls of liquid assets under the Liquidity Coverage Ratio (LCR) requirements by buying securities from the market in order to increase the available pool of Exchange Settlement Account balances. ESA balances would then be counted by authorised deposit-taking institutions (ADIs) as 'Level 1' liquid assets under LCR requirements.

This alternative would have substantially grossed-up the RBA's balance sheet and created issues about what assets the RBA would hold against the ESA balances. The two main options would be:

(a) investing in securities issued by ADIs, including securitisations; or

(b) investing in high-quality foreign currency securities.

Under Option (a), the RBA would take on a substantial direct credit exposure to individual ADIs, exposing the RBA to potential losses if an ADI were to fail. This Option would also result in the bank bill market being largely replaced by transactions on ESA accounts at the RBA. This would be a significant drawback; given the importance of the bank bill market as a reference for interest rate and derivatives markets, maintaining a liquid bank bill market is very important.

Under Option (b), the RBA would invest in high-quality foreign currency securities (such as US Treasury bills) and then hedge the foreign exchange risk. Given the volumes involved, the hedging program would be substantial and would expose the RBA to significant counterparty risk. More fundamentally, it would seem a perverse result for the RBA to generate liquidity for Australian ADIs by investing in sovereign debts of other countries.

In summary, the committed RBA liquidity facility offers the twin advantages of providing banking system liquidity within the RBA's normal repo-eligibility arrangements while minimising distortions to securities markets in Australia.