

Developments in the Financial System Architecture

International agencies are continuing their efforts to improve the regulatory infrastructure in response to the financial crisis. Considerable work is being undertaken, led by the G-20, the Financial Stability Board (FSB) and the Bank for International Settlements (BIS) and their associated committees, on developing policies to strengthen financial systems globally. For financial institutions that are prudentially regulated, this work has continued to be focused on: strengthening capital regulations, including addressing procyclicality; strengthening liquidity requirements; and other 'macroprudential' policies that are designed to prevent the build-up of risk for the system as a whole. For other parts of the financial system and markets, efforts are focused on strengthening the core infrastructure and ensuring that all systemically important activity is subject to appropriate oversight.

The relevant Australian regulatory agencies (APRA, ASIC, the Australian Treasury and the Reserve Bank) are monitoring and contributing actively to this work via their membership of the various international bodies. The Australian agencies continue to co-ordinate their work through the Council of Financial Regulators (the Council), which is chaired by the Reserve Bank.

These reforms will inevitably raise the cost of intermediation above pre-crisis levels, and it will be important to ensure an appropriate balance between this cost and the benefit of financial systems being subject to stronger standards. In order to help policymakers assess this balance, the Basel Committee on Banking Supervision (BCBS) is

undertaking a detailed quantitative impact study (QIS) of the proposed changes during the first half of 2010. The QIS will quantify the cumulative effect of all elements of the capital and liquidity reform proposals and will therefore produce important results on the suitability of the reforms and their calibration as a package. APRA is leading Australia's contribution to this work and is consulting with Australian authorised deposit-taking institutions (ADIs) involved in the study. APRA and the Reserve Bank are also participating in a BCBS exercise that is taking a 'top-down' look at the capital and liquidity proposals by determining benchmarks against which they will be judged, and assessing their likely macroeconomic effects.

In setting the new regulations, it will be important that the international standard-setters provide scope for some tailoring to national circumstances. This is particularly relevant for countries such as Australia, where regulatory arrangements have worked effectively over recent years and severe stress in the financial system was avoided. An area that should not be overlooked is the importance of getting the right balance between more regulation and more effective enforcement of existing regulations and standards.

The key items on the international financial regulatory agenda and some implications for Australia are outlined below, followed by details of other work being progressed by the Council and other financial regulatory developments in Australia.

The International Regulatory Agenda and Australia

Strengthening the Capital Framework for ADIs

The global financial crisis revealed a number of inadequacies in the capital framework for banks globally: the quality and quantity of capital were called into question in many banks; capital was defined inconsistently across countries; and there was a lack of transparency in disclosure, such that market participants could not fully assess the quality of capital and compare institutions. The view that the capital framework needed strengthening was an early and central consensus among national and international regulatory bodies.

The BCBS has been the main driver of international reforms in this area over the past year or so and last December it released *Strengthening the Resilience of the Banking Sector*, a consultative document proposing major changes to increase the **quality, consistency and transparency of the capital base**. These include enhancing a bank's capacity to absorb losses on a going concern basis, such that the predominant form of Tier 1 capital will be common shares and retained earnings; hybrid capital instruments with an incentive to redeem will be phased out. These measures will be introduced in a manner that allows for an orderly transition to the new capital regime. Transparency (and therefore market discipline) is to be improved by requiring all elements of capital to be disclosed, along with a detailed reconciliation to the reported accounts. APRA expects to generally follow the agreed international timetable when implementing the new standards in Australia, which on current planning would see new requirements in place by the end of 2012.

In addition, the BCBS is working to strengthen the **risk coverage of the capital framework**. More capital will be required for counterparty credit risk exposures arising from derivatives, repos and

securities financing activities. This will strengthen the resilience of individual banks and reduce the risk that shocks might be transmitted from one institution to another through the derivatives and financing channels.

The BCBS has been developing a non-risk-weighted simple **leverage ratio** requirement as a supplement to the Basel II risk-weighted capital adequacy rules. This ratio is intended to help contain any build-up of excessive leverage in the banking system and guard against attempts to 'game' the risk-based requirements. To ensure comparability, the details of the leverage ratio will be harmonised internationally. The relevant Australian agencies continue to have concerns that such a ratio could weaken the principle that capital should be allocated against economic risk; in any case, there is no evidence that banking systems in countries with leverage ratio requirements have systematically outperformed those that do not. Nonetheless, its introduction has been agreed at the international level and Australia will work with other BCBS member countries in coming months on settling the various implementation details and, in doing so, seek to minimise the potential for any unintended or otherwise undesirable effects.

Proposals are also being developed by the BCBS that would require banks to increase capital in the good times that can then be run down during a downturn. One such proposal involves the introduction of target **counter-cyclical capital buffers** above the re-designed minimum capital requirements. This could work in the form of a system-wide capital surcharge that would vary in response to specific indicator variables such as the deviation of credit from its longer-term trend. This proposal is currently at a relatively early stage of development and further work is needed to specify operational details. The BCBS will review a fully detailed proposal at its July 2010 meeting. Other proposals designed to lean against the cycle include the use of more forward-looking provisioning based on expected losses, rather than current arrangements that base provisions on losses already incurred. The BCBS is also looking into

a potential role for contingent capital instruments that are triggered to convert to equity in times of crisis.

These more recent proposals follow measures announced by the BCBS in July 2009 (and reported in the September 2009 *Review*) to ensure that the risks relating to trading activities, securitisations and exposures to off-balance sheet vehicles are better reflected in minimum capital requirements, risk management practices and accompanying public disclosures. APRA's proposals to give effect to these changes were released in December 2009, in the discussion paper *Enhancements to the Basel II Framework in Australia*, along with associated draft prudential standards. Subject to consultation, the changes will be implemented from 1 January 2011, though they are not expected to have a significant effect on ADIs in Australia.

Strengthening Liquidity Risk Management by ADIs

The BCBS is also at the forefront of efforts to make banks' liquidity risk management systems more robust to demanding market conditions. At the same time as releasing its proposals on capital, the BCBS released a second consultative document, *International Framework for Liquidity Risk Measurement, Standards and Monitoring*. It proposed to introduce a global minimum liquidity standard for internationally active banks that includes a 30-day liquidity coverage ratio requirement (relevant for stressed funding situations), underpinned by a longer-term structural liquidity ratio. This in turn would be likely to mean that banks would need to hold more cash or highly liquid assets such as government or highly rated private sector bonds.

The BCBS is yet to decide whether the final standard will use a narrow definition of liquid assets (comprising cash, central bank reserves and high quality sovereign paper), or a broader definition, which would also include high quality private sector paper. The QIS will quantify the

effect and trade-offs involved in either definition. The proposed definition of liquid assets is one that is particularly relevant for Australia and other countries with low levels of government debt. In a number of such countries, a narrow definition may be unworkable due to the low levels of public sector securities on issue.

While the liquidity proposals released by the BCBS were broadly anticipated by APRA in its September 2009 discussion paper on this issue, APRA's final prudential standards on liquidity have been postponed to the middle of 2011, given the importance of the results of the QIS. Implementation and, if necessary, transition arrangements are to be finalised once the BCBS's final standards are clearer. APRA has established a working group with Reserve Bank representation to consider the industry feedback on the proposals and finalise robust standards that reflect the realities of the Australian marketplace.

Macroprudential Policies and Oversight

While national prudential regulators have long engaged in the supervision of individual financial institutions – so-called microprudential regulation – it has been argued that the recent crisis exposed the shortcomings of that approach, especially in relation to systemic banks. There has consequently been increased interest in the usefulness of additional, macroprudential policies and approaches to the oversight of financial institutions, with the overall aim of promoting financial system stability. While views differ on the exact definition of macroprudential policy, a general approach is that it covers policies that seek to prevent the build-up of system-wide risk and the often procyclical nature of these risks. Numerous streams of work are underway to address these issues, at various stages of development, largely driven by the FSB and, insofar as they affect deposit-taking institutions, the BCBS.

As noted above, the BCBS has a program of work to address **procyclicality**. While some of these

policies (for example, loan-to-valuation caps for sectors exhibiting excessive credit growth) were in use in several countries before the recent crisis, the difficulties experienced by a number of large, internationally active financial institutions have prompted the FSB and BCBS to undertake further work in this area.

The FSB and BCBS have also been looking at the ‘too big to fail’ problem and the associated moral hazard issues raised by the extensive financial rescue packages implemented globally. One element of the problem is the difficulty in defining which entities are ‘systemic’ or ‘too big to fail’. Whether a particular firm falls into this category or not will depend on the state of the economy and financial system at the time; it will also depend not just on the firm’s size, but on the types of financial services it provides, its complexity and interconnections with the rest of the financial system. These considerations were examined in detail in a joint report released by the IMF, BIS and FSB in November 2009 on *Guidance to Assess the Systemic Importance of Financial Institutions, Markets and Instruments: Initial Considerations*, and are the subject of further analysis in a working group of the BCBS.

Irrespective of the precise definition of systemically important financial institutions (SIFIs), work has commenced on examining policy options to reduce the probability and effect of their failure, and to improve resolution mechanisms, so that failures that do occur can be dealt with in a smooth and timely manner. Related to this work, there are a number of proposals to strengthen core financial infrastructures to reduce the risk of contagion (see below).

One option to reduce the probability that SIFIs might fail is that they could face tougher prudential requirements, both in terms of the capital and liquidity they would have to hold, and the supervisory oversight to which they would be subject. The FSB is also investigating the feasibility of initiatives to simplify the structures of SIFIs. There is also a focus on improving existing practices for supervising SIFIs, including those that have

significant cross-border operations. With this in mind, the FSB has initiated the establishment of supervisory colleges for large internationally active banks and insurers, to promote better sharing of information across jurisdictions.

To improve resolution mechanisms, the FSB is encouraging the development of firm-specific contingency and resolution plans (or ‘living wills’) to mitigate the disruption of financial institution failures and reduce moral hazard in the future. These plans are expected to include funding measures for preserving liquidity and making up cash flow shortfalls in adverse situations, as well as actions to scale down or sell business lines. This initiative is particularly relevant for the large cross-border banks, where inconsistencies between national legal frameworks can otherwise impede resolution.

A preliminary assessment of options for addressing the ‘too big to fail’ issue will be presented by the FSB to the June 2010 G-20 Leaders’ Summit. Given the different types of institutions and national and cross-border contexts involved, a mix of approaches is likely to be necessary. It is too early to ascertain the appropriateness of any of the proposals for Australian ADIs, though the elements of the financial infrastructure which have worked well in Australia to date need to be acknowledged and given appropriate weight. In particular, it will be important to ensure that policies directed at the activities of the top 30 to 40 large internationally active banks do not unduly disadvantage financial institutions focused on regular domestic lending, which generally did not experience the same sorts of troubles.

Financial Market Infrastructure

Efforts are underway by policymakers internationally to strengthen core financial market infrastructures, particularly payment and settlement systems and central counterparties. While such infrastructures generally performed well during the recent financial crisis, the experience has highlighted the importance of ensuring that high standards are maintained and, if necessary, strengthened.

Accordingly, in February 2010 the relevant standard-setting bodies, the BIS Committee on Payment and Settlement Systems (CPSS) and the International Organization of Securities Commissions (IOSCO), launched a review of their standards for financial market infrastructures, namely the:

- *Core Principles for Systemically Important Payment Systems* (issued in 2001);
- *Recommendations for Securities Settlement Systems* (issued in 2001); and
- *Recommendations for Central Counterparties* (issued in 2004).

Revised drafts of all three standards are intended to be issued for public consultation by early 2011. Australian agencies are participating in this review via their membership of the CPSS (Reserve Bank) and IOSCO (ASIC), and both agencies are participating in several working groups established to advance the detailed work of the review.

Separately, the CPSS and IOSCO are already developing guidance on how the *Recommendations for Central Counterparties* (CCPs) should be applied to those CCPs that handle over-the-counter (OTC) derivatives. This guidance will also cover other relevant infrastructures handling OTC derivatives such as trade repositories. This work has been prompted by the recent or imminent commencement of CCPs for OTC derivatives and trade repositories in the United States and Europe. The CPSS and IOSCO will issue a consultation document on the guidance in coming months.

Consistent with these international developments, in Australia the Reserve Bank is working with APRA and ASIC to promote safe, efficient and robust practices in the Australian OTC derivatives market. One aspect of this is promoting the use of CCP clearing and settlement facilities for OTC derivative transactions. Related to this, in October 2009 ASIC released proposed guidance on the *Regulation of Clearing and Settlement Facilities*. This was in part

to provide assistance with the licensing process to entities – typically from offshore – seeking to operate such facilities in Australia. The *Corporations Act* requires that any operator of a clearing and settlement facility in Australia obtains a licence or be granted a Ministerial exemption from the licence requirement. Issues addressed in the proposed guidance include the circumstances in which an Australian clearing and settlement facility licence will be required, and when licensing as an overseas operator, rather than a domestic operator, would be appropriate. This latter point involves, among other things, a judgement on the sufficient equivalence of the overseas regulatory regime under which a non-Australian facility would operate. Following this consultation process, ASIC intends to publish the regulatory guide in due course. The Reserve Bank published guidance on how it assesses sufficient equivalence for this purpose in 2009. The Bank also established arrangements at that time around the reliance it places on the overseas regulator's oversight of foreign CCPs' activities.

Differentiated Nature and Scope of Financial Regulation

Another issue that arose in the crisis was whether all systemically important financial activity was currently subject to appropriate oversight. Following a request by the G-20 and the FSB, in January 2010 the Joint Forum released a *Review of the Differentiated Nature and Scope of Financial Regulation*. The report analysed key issues arising from differentiated financial regulation in the international banking, securities and insurance sectors. It also reviewed gaps in the scope of regulation as it relates to different financial activities, focusing on unregulated or lightly regulated entities or activities, where systemic risks may not be fully captured. The report made 17 recommendations for improvements in financial regulation, grouped in five areas: issues arising from regulatory differences across the three sectors that affect similar financial products;

supervision and regulation of financial groups, focusing on unregulated entities within those groups; residential mortgage origination, focusing on minimum underwriting standards practised by different types of mortgage providers; hedge funds, especially those that pose systemic risk; and credit risk transfer, especially credit default swaps and financial guarantee insurance.

The BCBS, IOSCO and the International Association of Insurance Supervisors are currently considering how best to implement the report's recommendations and APRA and ASIC will consider domestic implementation once this has been completed. The Joint Forum, which is currently chaired by ASIC, is also considering mandates to progress recommendations on conglomerate supervision in the report.

In Australia, APRA has recently released proposals for supervising certain conglomerate groups. In particular, the proposals cover groups containing APRA-regulated entities that have material operations in more than one industry regulated by APRA and/or contain material unregulated entities (financial or otherwise). The objective of the proposals is to ensure that APRA's supervision adequately captures the risks to which APRA-regulated entities within the conglomerate groups are exposed and which, because of the operations or structures of the group, are not adequately captured by the existing arrangements. APRA is accepting feedback on the proposals until June 2010, after which it is expected that draft prudential standards will be prepared.

In September 2009, the IOSCO Task Force on Unregulated Financial Markets and Products (TFUMP) published recommendations for regulatory enhancements in the areas of securitisation and credit default swaps. The recommendations relate to disclosure, alignment of incentives in the securitisation value chain and independence of service providers. ASIC (which is co-chair of the Task Force) is currently in discussions with the Australian Securitisation Forum about developing industry standards to implement the TFUMP

recommendations. IOSCO has also recently published a template to be used by members in gathering information from hedge funds (with a focus on data relevant to systemic risk) with a view to sharing the data with other regulators. The template builds on the data collection recommendations set out in an earlier IOSCO report on Hedge Fund Oversight. ASIC is examining the implementation implications of the report.

Credit Rating Agencies

Following international efforts to improve the regulatory oversight of credit rating agencies (CRAs), led principally by IOSCO, national authorities have begun to introduce reforms in their local markets. In November 2008, the Australian Government announced that ASIC would revoke a licensing exemption for the three major global CRAs and require all CRAs to hold an Australian Financial Services (AFS) Licence. On top of the general licensee obligations set out in the *Corporations Act*, ASIC has imposed special conditions on AFS licences granted to CRAs. Licensed CRAs are required, among other things, to: comply with IOSCO's revised *Code of Conduct Fundamentals for Credit Rating Agencies* (on an 'if not why not' basis to 30 June 2010 and mandatory thereafter); lodge with ASIC an annual report detailing compliance with IOSCO's Code; review ratings affected by material changes to rating methodologies within six months of the change; have in place for credit analysts a training program that has been independently assessed as adequate and appropriate; and refrain from 'notching' credit ratings for an anti-competitive purpose. These improvements will, in substantial respects, align Australia's regulation of CRAs with IOSCO principles and with regulation passed or proposed in major markets such as the United States, Europe and Japan.

A CRA may apply for an AFS licence that either authorises it to issue credit ratings to retail and wholesale investors (a retail licence) or wholesale investors only (a wholesale licence). CRAs that wish

to obtain a retail licence (to give general advice by issuing ratings to retail investors) must comply with general licensee obligations under the *Corporations Act* that afford additional protections to retail investors. One such obligation is to have an internal dispute resolution procedure in place and to hold membership of an approved external dispute resolution (EDR) scheme. An alternative to court actions, EDR schemes provide quick, low-cost and independent resolution of disputes between retail investors and AFS licensees involving claims of up to \$150 000 (increasing to \$280 000 on 1 January 2012). This step, together with the removal since 1 January 2010 of the exemption that protected CRAs from any liability for their ratings published in prospectuses and other documents, is intended to make CRAs more accountable for their ratings.

In the event, while the three major global CRAs operating in Australia each applied for, and received, a wholesale AFS licence, they did not apply for a retail licence. Consequently, since 1 January 2010 none of them are offering ratings to Australian retail investors. In these circumstances, they are required to ensure that their ratings are not disclosed (and to restrict a third party from disclosing those ratings) in a retail prospectus or product disclosure statement. They must also ensure that their ratings are not disclosed in any other manner that could reasonably be regarded as being intended to influence a retail client in making a decision about a particular class of financial product, unless required by law (for example, a disclosing entity's continuous disclosure obligations).

Peer Review Process

Ensuring that the various international regulatory standards are up to date and take on the lessons from the crisis is a significant task. In addition, it is equally important that regulators understand how the standards are being implemented and how effective they are. The FSB has recently launched a

peer review process of its member countries which will aim to evaluate their adherence to international standards for regulation and supervision. This will involve periodic 'thematic' reviews across countries as well as more wide-ranging reviews of single countries. All members of the FSB will be subject to these reviews and non-member countries will be encouraged to undergo similar evaluations. One key aim of the FSB's approach is to encourage a 'race to the top' in the adoption of best-practice international regulatory policies and standards. The process aims to complement existing international reviews conducted by the IMF and World Bank, namely the Financial Sector Assessment Program and the Reports on the Observance of Standards and Codes. The resulting final report of a peer review is expected to be made public. Following publication of the report, countries' implementation of agreed actions will be monitored by the FSB. The FSB aims to complete three 'thematic' reviews and three country reviews in 2010. As a member of the FSB, Australia is participating in the thematic peer review on compensation that is underway currently (represented by the Australian Treasury) and has volunteered to undergo a country peer review in 2011.

Compensation and Incentives

The first of the FSB's thematic peer reviews, which is underway, covers the implementation of its *Principles for Sound Compensation Practices*. The Principles were the international response to the concern that compensation practices in the financial sector had encouraged excessive risk taking. A template was distributed to FSB members in December 2009 so they could seek feedback from financial institutions and other stakeholders on progress and practical experiences in implementing the Principles (or the respective national rules). The FSB expects to complete its review shortly and publish the resulting report. To help supervisors review banks' compensation

practices and assess their compliance with the FSB Principles, the BCBS recently issued *Compensation Principles and Standards Assessment Methodology*.

In Australia, APRA is responsible for the implementation of the FSB Principles by ADIs and insurers. In November 2009, APRA released its final prudential requirements on remuneration, and an associated prudential practice guide, which incorporate modifications resulting from a second round of public consultation during 2009. Firms were expected to begin the transition to meet the new standards from 1 December 2009; they will take effect from 1 April 2010, by which time APRA requires that a Board Remuneration Committee must be established and a suitable Remuneration Policy be in place. APRA-regulated institutions will be expected to conform to the intent and the substance of the standards; if APRA judges that the remuneration arrangements of an institution are likely to encourage excessive risk taking, APRA has several supervisory options, including the power to impose additional capital requirements on that institution.

Other Domestic Developments

Government Guarantees

On 7 February 2010, the Government, acting on the advice of the Council of Financial Regulators, announced the withdrawal of the Guarantee Scheme for Large Deposits and Wholesale Funding for new liabilities from 31 March 2010.⁶ A key consideration behind the Council's advice was that financial conditions had improved such that the Guarantee Scheme was no longer needed. The Council also considered that it would be inappropriate for the Guarantee Scheme to remain in place for a significantly longer period than in most other countries. A number of key G-20 countries have already closed their schemes and market sentiment has been resilient to these closures. Existing guaranteed liabilities of ADIs will continue to

be covered by the Guarantee Scheme until maturity for wholesale funding and term deposits, or to October 2015 for 'at call' deposits. At the same time, the Government also announced that the Guarantee of State and Territory Borrowing would close to new issuance on 31 December 2010.

The withdrawal of the Guarantee Scheme for Large Deposits and Wholesale Funding does not affect the Government's guarantee of deposits up to and including \$1 million under the Financial Claims Scheme (FCS). The parameters of the FCS are to be reviewed by the Government in October 2011. In order to provide policy advice to the Government well ahead of this date, the Council has commenced an examination of various aspects of the FCS, including the future level of the cap. A number of other countries are also examining their deposit insurance coverage, particularly where temporary unlimited caps were implemented at the height of the financial market disruption in late 2008. Further work has also been undertaken on operational aspects of the FCS for ADIs. In January 2010, APRA released, for consultation, proposals for ADIs to provide data to APRA on their deposit account-holders, so depositors can be paid in a timely manner should claims under the FCS be made. Feedback was also requested on how depositors could receive their payments in a timely and secure way. The requirement that ADIs be able to identify the aggregate balance for each account-holder is important, as the FCS cap applies to the total balance of each account-holder at an ADI, not each account.

Financial Crisis Management

Throughout 2009, both APRA and the Treasury examined Australia's prudential framework to ensure that it provides for the effective supervision of prudentially regulated institutions and, where necessary, management of distress at such institutions. This work also considered lessons from public sector interventions internationally through the crisis. As a result, further legislative changes to

⁶ See Schwartz C (2010), 'The Australian Government Guarantee Scheme', *RBA Bulletin*, March, pp 19–26.

ensure that APRA can take appropriate action to assist in the prevention of, and respond to, institutional distress have been developed and included in a draft Bill that has recently been the subject of public consultation. In related work, the Council agencies have prepared joint crisis management plans over the past couple of years and have recently tested those plans through a crisis simulation exercise.

Market Supervision

As discussed in the September 2009 *Review*, the Government announced that ASIC will take over, from market operators including the ASX, responsibility for supervision of real-time trading on all of Australia's domestic licensed financial markets. This includes responsibility for market surveillance and participant supervision. ASIC and ASX are well progressed in arranging the transfer, which is expected to occur during the September quarter of 2010. Legislation giving effect to the transfer has been passed and the regulations setting out details of the proposed supervision arrangements are currently being prepared. ASIC has established a Market Supervision Advisory Panel to advise on its approach to its new responsibilities. The panel includes members from the financial services industry with experience in the legal, compliance, retail and institutional aspects of broking.

In addition, ASIC has begun a public consultation process on the proposed new market integrity rules that are to apply to trading on ASX and SFE markets. The consultation paper released by ASIC states that the proposed new rules will be based on the existing rules of these markets, while clarifying the supervisory responsibilities of ASIC and market operators. The proposed approach to dealing with breaches of the rules, which is very similar to the current ASX disciplinary tribunal, is also set out in the consultation paper.

National Regulation of Consumer Credit

As mentioned in the September 2009 *Review*, the Government introduced legislation in mid 2009 to enhance regulation of consumer credit provision with the commencement, on 1 July 2010, of the National Consumer Credit Protection regime. This new system replaces (and largely replicates) the state-based Uniform Consumer Credit Code, with a consistent national licensing system and consumer protection obligations for all credit providers and credit assistants. Following public consultation, the first set of final regulations was released in March 2010. Further regulations will be issued in coming months, dealing with several issues, including proposed modifications to the securitisation entity exemption and a proposed regulatory framework with respect to pre-existing credit contracts. ❖

