

4. Developments in the Financial System Architecture

At the international level, financial regulatory reform has been progressing on a number of fronts, including: developing a policy framework to deal with the risks posed by shadow banking systems; modifying aspects of the Basel III liquidity standard; addressing the ‘too big to fail’ problem posed by systemically important financial institutions (SIFIs); and reforming over-the-counter (OTC) derivatives markets. There has also been more focus recently on the implementation of agreed reforms at the national level and monitoring the consistency of implementation internationally. In Australia, this has been evident in the finalisation of prudential standards to implement the Basel III capital requirements, which took effect from the beginning of this year, and the passage of legislation that will help meet Australia’s commitment to move towards greater central clearing and reporting of OTC derivative transactions. In late 2012, the International Monetary Fund (IMF) released its Financial Sector Assessment Program (FSAP) report on Australia, which contained a positive overall assessment of the stability of Australia’s financial sector and the quality of domestic financial supervisory and crisis management arrangements.

International Regulatory Developments and Australia

Shadow banking

The Financial Stability Board (FSB) and the international standard-setting bodies have been continuing their work to develop a policy framework to address the risks posed by shadow banking

systems. Preliminary policy recommendations have been developed to strengthen the oversight and regulation of such systems covering five main areas.

- Reducing the risks posed by banks’ interactions with shadow banking entities. Steps include: developing better guidance on the scope of consolidation for prudential purposes; introducing a revised large exposures regime for banks to limit interconnectedness with shadow banking entities; and developing a more risk-sensitive capital treatment for banks’ equity investments in managed funds. Work in this area is being handled by the Basel Committee on Banking Supervision (BCBS) and detailed policy recommendations are to be developed by mid 2013.
- Introducing common standards for the regulation of money market funds (MMFs), including for these funds’ valuation methods, liquidity management and disclosures. The standards also address the issue of MMFs that offer a stable net asset value (NAV), as is common in the United States, which exposes them to the risk of investor ‘runs’ of the kind seen during the crisis. The International Organization of Securities Commissions (IOSCO) released its final policy recommendations on MMFs in October 2012, including that stable NAV funds convert to a floating NAV (which is the main type of MMF in Australia), where workable. Where conversion is not possible, IOSCO recommended that stable NAV funds be subject to additional safeguards to enhance their resilience to significant redemptions and to internalise the costs arising from any associated risks.

- Introducing risk-retention and enhanced disclosure requirements (including standardised templates for asset-level disclosure) for securitisation products. This work was also led by IOSCO, which released final policy recommendations in November 2012.
- Developing a policy framework for shadow banking entities other than MMFs. The FSB's proposed framework has three parts: an assessment by authorities of shadow banking entities based on the economic functions they perform (rather than legal names or forms); a menu of policy tools, tailored to those economic functions, to address the risks posed by these entities; and an information-sharing process to ensure a degree of international consistency in applying the proposed framework. The proposed policy tools cover a range of measures. For example, loan providers (such as finance companies) could face capital and liquidity requirements and, where they take deposits, could be subject to even tighter bank-like regulation. There is expected to be enough flexibility in the framework that tools would only be applied when deemed necessary by authorities.
- A series of recommendations for securities lending and repurchase agreements ('repos'). These include: improved regulatory reporting, market transparency and corporate disclosures; introduction of minimum standards for haircut practices (including possible numerical floors); and evaluation by national authorities of the costs and benefits of introducing central counterparties (CCPs) in securities lending and repo markets.

The policy recommendations for the latter two areas, which are overseen by the FSB, are currently being refined following a public consultation process. The FSB expects to present final recommendations in all five areas to the G20 Leaders' Summit in September 2013.

The shadow banking recommendations will allow for discretion in how countries adopt them. Once

they are finalised, regulators in Australia will need to assess the relevance of the recommendations in the context of Australia's relatively small and declining shadow banking sector (see 'The Australian Financial System' chapter). The failure of an Australian retail debenture issuer and property lender in late 2012, and others like it in recent years, prompted a review of the regulatory framework for these types of finance companies, which are one of the main types of intermediaries considered to be shadow banking entities in Australia. Given that retail debenture issuers are a very small segment of the Australian financial system, they are mainly relevant from an investor protection, rather than financial stability, standpoint. The government asked the Australian Securities and Investments Commission (ASIC) and the Australian Prudential Regulation Authority (APRA) to consult on proposals to strengthen the regulation of finance companies that issue debentures to retail investors and on-lend the invested funds. ASIC recently released its specific proposals, which include mandatory minimum capital and liquidity requirements for issuers, improved ongoing disclosure to investors and measures to enhance the ability of trustees to monitor the financial performance of issuers and compliance with their legal obligations. ASIC's proposals do not involve prudential supervision of debenture issuers, thus maintaining a clear distinction between the regulatory framework applicable to these entities and the more intensive prudential regime which APRA applies to authorised deposit-taking institutions (ADIs). This distinction will be reinforced by APRA's forthcoming proposals to amend the exemption conditions in the *Banking Act 1959* to restrict retail debenture issuers offering 'at-call' investments and using 'bank-like' terms to describe their products.

Basel III liquidity reforms

The Liquidity Coverage Ratio (LCR) is part of the package of reforms to banks' capital and liquidity requirements, known as Basel III, released by the BCBS in 2010. Since then, a number of elements

of the LCR have been subject to review in light of further consideration of the potential implications of the LCR for financial markets, credit extension and economic growth. As a result of this process, the BCBS' oversight body, the Group of Governors and Heads of Supervision (GHOS), agreed a number of changes to the LCR standard in January this year. Overall, the changes represent a relaxation of some aspects of the LCR, which should allow banks globally to more readily meet the requirements.

The main changes to the LCR standard are that:

- the range of assets potentially eligible as high quality liquid assets (HQLA) was expanded and assumed net outflow rates for a range of deposits and liquidity facilities were reduced. The additional assets include highly rated corporate debt securities, certain equities and residential mortgage-backed securities, all with substantial haircuts, and only if these asset classes can meet the fundamental qualifying test of demonstrable liquidity in a crisis. The aggregate of these extra assets, after haircuts, will be subject to a limit of 15 per cent of HQLA;
- the LCR can be subject to a phase-in period. While the LCR will still commence on 1 January 2015, the minimum requirement will now begin at 60 per cent, rising in equal annual steps of 10 percentage points to reach 100 per cent on 1 January 2019. This graduated approach aligns in part with the timetable for the Basel III capital reforms. GHOS noted that introducing the LCR this way should also minimise potential disruptions to recovering banking systems or the financing of economic activity; and
- banks' access to their stock of HQLA in periods of stress was clarified.

In addition, the BCBS is to undertake further work on the interaction between the LCR and the provision of central bank facilities, given that these facilities are the most reliable form of liquidity. A separate BCBS task force has been established to look at this issue, which is being co-chaired by the Reserve Bank's Assistant Governor (Financial System). The

task force is also examining whether the option of using a central bank facility (such as the Committed Liquidity Facility in Australia) should be available to all jurisdictions or continue to be limited to those with insufficient HQLA.

In Australia, APRA had deferred the release of its final Basel III liquidity standard until the outcome of the BCBS' deliberations on changes to the LCR was known. It is currently considering the implications of the recent LCR changes for its own liquidity standard and is expected to publish a revised standard for consultation in April.

Systemically important financial institutions (SIFIs)

The FSB, along with other international bodies and domestic authorities, has continued implementing aspects of the policy framework released in 2010 to address the risks posed by SIFIs. In late 2012, the FSB released an updated list of global systemically important banks (G-SIBs), in keeping with its commitment to update the list each year based on more current data. The list is largely unchanged from that in 2011, with the number of G-SIBs reduced by one to 28 and no Australian-owned bank appearing on the list. The new list also showed, for the first time, the allocation of the G-SIBs to 'buckets' corresponding to the level of additional common equity loss absorbency (ranging from 1 to 2½ per cent of risk-weighted assets) that they will eventually be required to hold if they remain G-SIBs. As noted in previous *Reviews*, these requirements will be phased in from 2016, initially for those banks identified as G-SIBs in 2014.

Progress has been made in implementing several other G-SIB measures. For example, cross-border crisis management groups (CMGs), comprising the home and key host authorities, have now been established for nearly all the G-SIBs designated by the FSB in 2011, and recovery and resolution plans for these firms are also being developed. Under the FSB's *Key Attributes of Effective Resolution Regimes for Financial Institutions* (the *Key Attributes*), firms

are responsible for developing recovery plans to restore their financial viability in the event of distress, while resolution plans are developed by the firms' home and key host authorities and reviewed within CMGs. To allow more time for necessary changes to be made to legal frameworks, the time line for completion of resolution plans for G-SIBs has been extended by six months until June 2013 and the start date of the FSB's resolvability assessment process has been delayed until the second half of 2013. The latter involves a peer review of the feasibility and credibility of putting the resolution plans into operation, which is to be undertaken by officials in the home and key host authorities of each G-SIB.

The FSB and the international standard-setting bodies have continued their work on extending the SIFI framework to non-bank financial institutions. The International Association of Insurance Supervisors (IAIS) issued for consultation policy measures to be applied to global systemically important insurers (G-SIIs). The proposals are broadly consistent with the policy framework for G-SIBs, including enhanced supervision, more effective resolution regimes and higher loss absorption capacity. The IAIS has developed a methodology to identify G-SIIs and the FSB is planning to publish an initial list of G-SIIs, if any, in April 2013. In consultation with IOSCO, the FSB is developing an assessment methodology for identifying globally systemic non-bank, non-insurance firms which is expected to be finalised in late 2013, after a consultation in the second half of this year.

Financial conglomerates and mortgage insurers

The Joint Forum (comprising the BCBS, the IAIS and IOSCO) released revised *Principles for the Supervision of Financial Conglomerates* (the *Principles*) in September 2012. The *Principles* update those issued in 1999 and aim to support consistent supervision of conglomerates, particularly those operating across borders, while capturing a broader range of activities and entities that form part of conglomerate groups.

Several areas in the revised *Principles* are of note. For example, the *Principles* emphasise the importance of a group-level supervisor being assigned, which would be responsible for facilitating coordination between various entity-specific supervisors. A number of principles have been added in the area of corporate governance, for example group governance frameworks are expected to include policies for avoiding conflicts of interest and ensuring that remuneration policies are consistent with the group's risk profile. The risk management principles have also been updated to place greater emphasis on a group's ability to measure, manage and report on all material risks, including those from unregulated entities and activities.

APRA participated in the Joint Forum's review of the *Principles*. Key aspects of APRA's framework for the supervision of conglomerates (referred to as 'Level 3 groups'), which are intended to meet these principles, were issued for consultation in December 2012. APRA's proposals focus on the requirements for group governance and measurement of, and limits on, aggregate risk exposures, including intragroup transactions and exposures. The proposals aim to ensure that APRA's supervision adequately captures the risks to which APRA-regulated institutions within Level 3 groups are exposed and which, because of the operations or structures of the group, might not be adequately captured by existing prudential rules. Underpinning the standards is the view that governance and risk management practices should be consistent across all entities of Level 3 groups that could have a material financial or operational impact on the group, and adequate systems must be in place to monitor intragroup transactions and exposures. APRA anticipates consulting on the other elements of its framework for the supervision of conglomerate groups (i.e. risk management and capital adequacy standards) and on reporting requirements throughout 2013, with the full prudential framework for Level 3 groups to be implemented from 2014.

In February, the Joint Forum released a consultative paper on *Mortgage Insurance: Market Structure*,

Underwriting Cycle and Policy Implications. The paper examines the interaction of mortgage insurers with lenders, particularly in light of the experience since the global financial crisis, which highlighted how mortgage insurance can be subject to concentrated stress in certain extreme events. One of the key recommendations is that policymakers should consider requiring that lenders and insurers align their interests by both sharing in the consequences of a loan not performing. In this way, both parties will have incentives to strengthen lending standards. Other recommendations are directed at supervisors, including that they ensure that both lenders and insurers maintain strong underwriting standards, and that they be alert to and respond to any decline in lending standards. In line with this, it was further recommended that supervisors apply the FSB's *Principles for Sound Residential Mortgage Underwriting Practices* to mortgage insurers. In Australia, mortgage insurers are supervised by APRA and most of the Joint Forum's recommendations are already part of APRA's supervision.

OTC derivatives reform

As noted in previous *Reviews*, the G20 committed to achieving the reforms to OTC derivatives markets (including moving to central clearing of standardised OTC derivatives contracts) by the end of 2012. However, implementation is ongoing in a large number of jurisdictions, with global regulators mindful of the need to minimise unintended consequences that could arise from rapid and significant changes to the functioning of these markets. To better understand the impact of these reforms, it was recently decided that an international macroeconomic impact assessment of the OTC derivatives regulatory reforms would be undertaken by the Bank for International Settlements; a senior Reserve Bank official is on the assessment team.

Policymakers in smaller markets such as Australia have been taking into account the direction of the largest jurisdictions when progressing their domestic reforms. Given the cross-border nature

of many OTC derivatives markets, resolving the remaining cross-border issues has become a priority for many jurisdictions and standard-setting bodies. As international standards and guidance has been finalised, individual jurisdictions have continued to press ahead with implementing these reforms. In many cases, this has involved legislative change so that mandatory clearing, reporting and trading requirements can be imposed on market participants.

Further to the extensive consultation and policy development work undertaken by the Council of Financial Regulators (CFR) over the past two years, several steps have been taken in recent months to progress OTC derivatives reforms in Australia.

- Legislation was passed in December that will allow the government (in consultation with the regulators) to apply mandatory reporting, clearing or platform-based trading requirements to specific classes of OTC derivatives contracts. These requirements would be implemented by supporting rules, which are to be developed and administered by ASIC.
- The new framework will require enhanced consultation and sharing of data among Australian financial sector agencies, so the legislation also included provisions to enhance the Reserve Bank's information-sharing powers. These enhancements will apply to any protected (i.e. institution-specific) information received by the Bank.
- In order to inform any recommendations to the government, the relevant regulators (APRA, ASIC and the Bank) will periodically assess the need for regulatory intervention in the Australian OTC derivatives market. As part of this process, a *Report on the Australian OTC Derivatives Market*, was published in October 2012. It reviewed the risk management practices of market participants in the domestic OTC derivatives market, with a particular focus on how participants are using centralised infrastructure and what scope there might be to increase usage of it. The report

concluded that industry-led uptake of central clearing and trade execution arrangements remains appropriate in the short term. It acknowledged that, although currently there are no licensed entities in Australia offering central clearing of the major OTC derivatives contract classes to Australian-based participants, there are indications that both international and domestic providers may soon begin offering such services. In December, Treasury published for consultation a set of proposals to implement Australia's G20 commitments in line with the conclusions in the assessment report, particularly on mandatory trade reporting.

- To support mandatory trade reporting, ASIC is developing two sets of rules. The first set are Derivative Transaction Rules that will cover the institutional and product scope of mandatory trade reporting obligations, as well as details of how these obligations can be met. ASIC recently initiated a consultation on the second set, Derivative Trade Repository Rules, which relate to the requirements to be met by trade repositories licensed under the new framework in the *Corporations Act 2001*. In developing this licensing regime, ASIC has taken into account elements of the Committee on Payment and Settlement Systems (CPSS)-IOSCO *Principles for Financial Market Infrastructures* that are relevant to trade repositories.

Not all OTC derivatives are sufficiently standardised to be centrally cleared, but their use still requires robust risk management practices. For this reason, international principles are being developed requiring that OTC derivatives that are not centrally cleared be collateralised. As discussed in the previous *Review*, a BCBS-IOSCO working group proposed that non-centrally cleared derivative transactions involve exchanging both variation and initial margin if the parties are financial institutions or systemically important non-financial institutions. Following feedback received during the consultation and the completion of a quantitative impact study to assess the liquidity costs of the proposal, the BCBS

and IOSCO recently consulted on a 'near final' set of principles. The Bank is continuing to monitor the development of these principles and, when they are finalised, will engage with other regulators and market participants on their implementation in Australia.

Supervision and resolution of financial market infrastructures (FMIs)

Adoption of the CPSS-IOSCO *Principles for Financial Market Infrastructures* (the *Principles*) into Australia's legal and regulatory framework proceeded over the past six months. Following consultation in the second half of 2012, the Bank determined revised *Financial Stability Standards* for CCPs and securities settlement facilities that are in line with the *Principles*. ASIC also updated its regulatory guide. The revised *Financial Stability Standards* come into force on 29 March 2013, and the Bank will assess licensed clearing and settlement facilities against them for the first time later this year. The Bank also intends to assess Australia's systemically important payments system, RITS, against the *Principles* in 2013.

As discussed in the previous *Review*, the CPSS and IOSCO released a consultative report, *Recovery and Resolution of Financial Market Infrastructures*, in 2012. This report considered the essential features of recovery and resolution regimes for FMIs and sought views on how the FSB's *Key Attributes* should apply to FMIs. A number of jurisdictions are in the process of developing resolution regimes for FMIs, drawing on this work. In Australia, the CFR recommended to the government in February 2012 that ASIC and the Bank be given the power to appoint a statutory manager to a troubled FMI (also referred to as 'step-in' powers). Work is underway within the CFR to develop legislative proposals that would give effect to this power as part of a comprehensive resolution regime for FMIs, designed in accordance with the *Key Attributes* and along the lines of that in place for ADIs. The results of this work will likely have implications for ASIC's and the Bank's powers and responsibilities in this area.

Credit rating agencies

In the past six months, the FSB has increased its focus again on the use of credit ratings. Credit rating agencies (CRAs), while not a direct cause of the financial crisis, did not adequately alert investors to the risks posed by certain financial products, particularly structured finance products. While the *Principles for Reducing Reliance on CRA Ratings* (the *Principles*) that were released by the FSB in 2010 were intended to reduce the potential for ratings to be relied on in a mechanistic way, progress among FSB members in implementing them has been slow. In response, the FSB developed a 'road map' for accelerating implementation of the *Principles*, which the G20 endorsed in November 2012. The road map consists of two streams of work. The first is to reduce the mechanistic reliance on CRA ratings in regulatory frameworks. Standard-setting bodies and national authorities are to identify and reduce references to credit ratings in standards, laws and regulations. The second is work by authorities to promote and, where needed, require that financial institutions strengthen and disclose information on their own credit risk assessment approaches as a replacement for mechanistic reliance on CRA ratings. In addition to the road map, the FSB recently started a peer review of its members' progress in implementing the *Principles*.

IOSCO is also undertaking work to address weaknesses in CRA business models. In December 2012 it released two reports: one looking at the internal controls designed to ensure the integrity of the credit rating process as well as detailing procedures for CRAs to manage conflicts of interest; and a second that proposed the establishment of supervisory colleges for internationally active CRAs. In addition, IOSCO is currently reviewing its *Code of Conduct Fundamentals for Credit Rating Agencies* that, among other things, seeks to address conflicts of interest.

Peer reviews and implementation monitoring

The FSB has continued with its program of 'thematic' and country peer reviews, as part of its efforts to monitor and strengthen adherence to international standards. A peer review of resolution regimes is expected to be completed soon and, as noted above, a review has recently started on the use of CRA ratings. In February, the FSB published a thematic peer review on risk governance, which took stock of risk governance arrangements in financial institutions as well as national authorities' oversight of these arrangements. The report highlighted the importance of effective risk governance practices in financial institutions, involving boards of directors, the firm-wide risk management function and the independent assessment of risk governance. The recent crisis revealed that without the appropriate checks and balances provided by the board and these functions, a culture of excessive risk-taking and leverage was allowed to permeate in many institutions. The report lists sound risk governance practices and provides several recommendations aimed at helping institutions improve their risk governance and national authorities to assess its effectiveness. Complementing this FSB review (which focused mainly on banks), in February the IAIS launched a peer review of the corporate and risk governance practices of its members. This will assess observance and understanding of the *Insurance Core Principles* related to licensing, suitability of persons, corporate governance, and risk management and internal controls.

In contrast to the cross-country focus of thematic peer reviews, the FSB's country peer reviews focus on the implementation and effectiveness of regulatory, supervisory or other financial sector standards and policies within individual FSB member jurisdictions. A senior Bank official is participating in a team conducting a country peer review of the United Kingdom this year.

The BCBS is continuing to expand its monitoring of implementation of the Basel III reforms, which is built around three levels of assessment.

1. A semiannual review of members' progress in transposing the Basel III minimum requirements into domestic regulations. As at mid February 2013, 11 BCBS member jurisdictions (including Australia) had issued final regulations and the remaining 16 jurisdictions had tabled draft regulations.
2. Peer reviews of members' domestic regulations to ascertain their consistency with the Basel III minimum requirements. All BCBS members will be assessed over time, with priority being given to home jurisdictions of G-SIBs. Reviews of Japan, the European Union and the United States were published in October 2012 and Singapore in March 2013. Australia is scheduled to be assessed in the second half of 2013.
3. Reviews of supervisory implementation of the Basel III minimum requirements to ensure that the outcomes of the BCBS rules are consistent in practice across banks and jurisdictions. The purpose is to investigate whether there are unintended variations in capital ratios and to formulate policy actions, if applicable. The initial focus of this work is on banks' calculation of risk-weighted assets (RWAs, or the denominator of the capital adequacy ratio), distinguishing between differences that reflect actual differences in risk or supervisory discretion, and those that reflect differences in bank practices and modelling.

Over the past year, the BCBS has monitored the impact on banks of the Basel III framework in order to gather evidence on its dynamics. The analysis was based on data provided by 210 banks globally, split between those that have Tier 1 capital in excess of €3 billion (101 'Group 1' banks) and the remainder ('Group 2' banks). While the Basel III framework sets out transitional arrangements to implement the new standards, the latest monitoring exercise assumed full implementation of the final

Basel III package as of 30 June 2012. The results indicated that, applying the Basel III changes to the definition of capital and RWAs, the average Common Equity Tier 1 capital ratio (CET1) of Group 1 banks was 8.5 per cent, compared with the Basel III minimum requirement of 4.5 per cent. However, some banks had a CET1 ratio below 4.5 per cent; in order for *all* Group 1 banks to exceed this minimum, an aggregate increase of €3.7 billion in CET1 would be required. This latter figure rises to €208 billion for all Group 1 banks to meet a CET1 target ratio of 7.0 per cent (which will eventually be the Basel III requirement including the capital conservation buffer) plus any G-SIB surcharge. These capital shortage estimates are significantly less than the results of the previous exercise six months ago, indicating the progress many banks have made in strengthening their capital positions.

Financial Sector Assessment Program (FSAP) review of Australia

As foreshadowed in the previous *Review*, the IMF published the results of its second FSAP review of Australia in November 2012. Overall, the FSAP contained a positive assessment of the stability of Australia's financial system and the quality of domestic financial supervisory and crisis management arrangements. The IMF provided a number of recommendations that the Australian authorities have under consideration. Among these was the recommendation that the Reserve Bank develop a 'top-down' (macro model-based) stress-testing framework to complement the stress testing already performed by APRA. A program of work to investigate the feasibility of developing such a framework for Australia has now been initiated.

The IMF also made a recommendation to increase the transparency of the CFR's work. While many of the issues discussed by the CFR are reported in the *Financial Stability Review*, a dedicated website for the CFR has recently been launched (www.cfr.gov.au) to improve public understanding of the CFR's work. It includes information on how

the CFR operates and highlights some of the key policy initiatives progressed by the CFR in recent years. It is intended that the website would also be a central platform for information during a financial distress event, complementing that provided by the individual member agencies.

Other Domestic Regulatory Developments

Prudential reforms

In addition to finalising the Basel III capital standards for ADIs, APRA recently completed its review of the capital requirements applicable to life and general insurers, which also came into effect on 1 January 2013. As discussed in the previous *Review*, the new requirements aim to improve the risk sensitivity of the loss-absorbing capacity of insurers and better align the capital standards for insurers with those for other APRA-regulated industries. Following public consultation, APRA also finalised its prudential requirements for superannuation funds late last year and has now released prudential standards relating to governance, risk management, 'fit and proper' requirements, conflicts of interest and investments, among others. Most of the requirements in these new prudential standards will take effect from 1 July 2013.

In January this year, APRA released a discussion paper and an amended draft prudential standard as part of its implementation of the payment, reporting and communications requirements of the Financial Claims Scheme (FCS). The discussion paper examines different payment options and the proposed requirements for ADIs to pre-position themselves so that depositors will have timely access to their guaranteed deposits in the event that the FCS is triggered. ADIs will be required to establish systems necessary to 'operationalise' the FCS should it be activated in the future, including the capacity to quickly generate necessary data and payment instructions for ADI customers. APRA

intends to finalise the amended prudential standard by July 2013. ADIs are already required to have in place by 1 January 2014 the 'single customer view' (SCV) measures. (A SCV is a customer profile that aggregates the balances of all FCS-eligible deposit accounts held by each customer of an ADI for the purposes of calculating FCS payouts.) The full pre-position requirements are to be met by ADIs from 1 July 2014.

Regulation of market and payments infrastructure

The CFR, together with the Australian Competition and Consumer Commission, recently completed a review of competition issues in the clearing and settlement of the Australian cash equity market and the CFR's conclusions were released and endorsed by the government in February. While the CFR remains open to competition and would expect competition to deliver efficient outcomes, one of the key conclusions of the review was that changing current arrangements now would raise industry's costs, particularly in the short term, since system changes would be needed to allow participants to access multiple providers. The government accepted the CFR's recommendation that a decision on any clearing and settlement facility licence application from a CCP seeking to compete in the Australian cash equity market be deferred for two years. In the meantime, in accordance with the CFR's recommendations, the government has called upon the Australian Securities Exchange to work with industry stakeholders to develop a code of practice for clearing and settlement of cash equities in Australia, based on a set of principles relating to user input to governance, transparent and non-discriminatory pricing, and access. At the end of the two years, it is proposed that the CFR carry out a public review of the implementation and effectiveness of the code of practice. At the same time, the CFR would review the prospect of granting a licence to a competing CCP, or of pursuing other regulatory options aimed at ensuring

an efficient market. If competition were to be ruled out indefinitely, the CFR considers that a regulatory response might be appropriate.

ASIC released new competition market integrity rules to address issues arising from the operation of multiple exchanges. These rules form part of ASIC's response to a trend towards more frequent, smaller trades away from public markets. Among other things, they are designed to address the impact of 'dark pools' and trading algorithms on market competition. Under the new rules, market operators are required to establish and maintain systems to identify and prevent anomalous orders entering the market by setting minimum and maximum price thresholds for each product quoted on their market. The new rules also seek to address concerns that dark trading undermines transparency and efficient pricing, as well as to encourage trading on exchanges. The package also includes additional data

reporting requirements to assist ASIC in performing market surveillance. Following work by two task forces on the implications for market quality of dark liquidity and high-frequency trading, ASIC released a consultation paper in March, which proposes amended market integrity rules for these activities and seeks input on the likely impacts on costs and competition from the proposals. In a related development, the government recently announced a review of Australia's financial market licensing regime. The review will examine the licensing of dark pools, and whether the market licensing regime is generally 'fit for purpose'. As part of the review, the Treasury released a paper which considers the adequacy of current licensing arrangements and raises possible options for reform. It also reviews the regulation of non-market participant high-frequency traders. ✎