4. Regulatory Developments

The most notable regulatory development in the past half year was the finalisation of reforms to the Basel III capital framework by the Basel Committee on Banking Supervision (BCBS). These reforms are aimed at reducing unwarranted risk weight variability. Global bodies continued efforts to monitor and encourage implementation of reforms to the regulation of financial benchmarks, and to identify the financial stability implications of financial technology ('fintech'). With the design of key post-crisis reforms largely completed, the Financial Stability Board (FSB) and the standard-setting bodies are increasingly focused on monitoring the implementation of the reforms and evaluating their effectiveness. Evaluations of the effects of reforms on financial intermediation and on incentives to centrally clear over-the-counter (OTC) derivatives are under way.

Domestically, efforts to improve the resilience and functioning of the financial system continue. Key legislation providing the Australian Prudential Regulation Authority (APRA) with expanded powers to manage the resolution of distressed financial institutions was passed by Parliament, as was legislation to help ensure robust and reliable financial benchmarks. Several reviews or inquiries into elements of the financial system are also under way, including the International Monetary Fund's (IMF's) Financial Sector Assessment Program (FSAP) review of Australia, the Productivity Commission's inquiry into competition in Australia's financial system and the Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry. The Council of Financial Regulators (CFR) has continued to closely monitor housing lending developments, while also considering the approach to additional loss-absorbing capacity for Australian banks, developments in shadow banking and financial disclosures during periods of financial stress.

International Regulatory Developments

Building resilient financial institutions

The members of the BCBS, including the Reserve Bank and APRA, agreed on a series of changes to the capital framework for banks (see 'Box E: Reforms to the Basel III Capital Framework'). These changes are designed to ensure that the post-crisis Basel III reforms are effective in their original goal of enhancing bank resilience, as well as supporting confidence in the risk-weighted capital framework.

The finalisation of the capital reforms completes a significant program of post-crisis changes to the global regulatory framework for banks. The attention of the BCBS is now increasingly focused on monitoring the implementation of the regulatory reforms agreed to date, evaluating their effects and assessing emerging risks. This will form part of the broader ongoing work of the BCBS to strengthen the regulation and supervision of banks. In October, the BCBS published a progress report on the implementation of the Basel framework. It noted that the Basel III risk-based capital rules and the Liquidity Coverage Ratio (LCR) regulations are now in force in all BCBS member jurisdictions.

Further, it found that banks in these jurisdictions are compliant with the current minimum requirements. The BCBS also evaluates whether the reforms implemented at the jurisdictional level are consistent with the international framework through its Regulatory Consistency Assessment Programme (RCAP). In October, an RCAP assessment of Australia's LCR rules provided the domestic framework with the highest possible grade, 'compliant'.

In addition to Basel III, the BCBS has continued its policy development work on other aspects of the international regulatory framework for banks:

- In October, the BCBS published guidelines on the identification and management of 'step-in' risk. The guidelines seek to mitigate the risk that, in order to avoid reputational damage, banks 'step in' to support unconsolidated but nonetheless related entities (such as 'shadow banks') which could transfer financial distress to the bank. The guidelines outline how banks should assess step-in risk and how supervisors should evaluate this assessment. For instance, the guidelines define the types of entities that need to be assessed for potential step-in risk and the responses that supervisors may consider taking when step-in risk is identified. The guidelines are to be implemented in BCBS member jurisdictions by 2020.
- In December, the BCBS published a discussion paper on the regulatory treatment of sovereign exposures. The paper identifies sources of sovereign risk in the banking system and sets out some potential policy options. The existing regulatory framework allows for a zero risk weight to be assigned to sovereign exposures that are denominated and funded in domestic currency. However, the paper notes that sovereign exposures may generate risks for banks through debt restructuring or outright default, as well as through channels such as increased funding costs and liquidity requirements as a result of a reduction in the value of sovereign collateral.
- Given the increasing importance of stress tests of banks in supervisory and regulatory frameworks, in December the BCBS proposed a new set of principles to act as a guide to sound stress testing practices for banks and supervisors. For example, the principles state that a bank's stress testing framework should be subject to challenge and regular review. The new principles are expressed at a high level so that they do not conflict with developments in stress testing practices over time.
- In February, the BCBS released a consultation paper on an updated 'Pillar 3' framework, which sets minimum regulatory disclosure requirements for banks. The proposed changes mainly involve disclosing information related to the Basel III capital reforms discussed in Box E. For instance, under the proposed Pillar 3 framework, banks that use internal models must disclose their risk-weighted assets (RWAs) as calculated under both the internal ratings-based (IRB) and standardised approaches. This requirement means that information used in calculating the new output floor – which requires the total value of IRB banks' estimated RWAs to be no lower than 72.5 per cent of the RWAs calculated using only the standardised approach – must now be publicly disclosed.
- The BCBS began a consultation in March on revisions to the market risk capital framework. One of the key revisions is to include changes to the measurement of the standardised approach to enhance its risk sensitivity.

Also, the internal models approach has been further revised to enhance the requirements for the use of internal models. The revised framework will come into effect in 2022.

Shadow banking

As discussed in previous *Reviews*, the FSB and the International Organization of Securities Commissions (IOSCO) have worked since the crisis to improve the regulation and oversight of shadow banking, which refers to credit intermediation outside the regular banking system. Three publications by IOSCO in the past half year relate to this work.

In November, IOSCO published the findings from its recent peer reviews of the regulation of money market funds (MMFs), as part of its monitoring of the implementation of its 2012 recommendations for MMFs. IOSCO reviewed implementation of reforms in three areas: valuation practices; liquidity management; and MMFs that offer a stable net asset value (NAV) (the latter can be more vulnerable to redemption runs than MMFs that allow their price, and hence NAV, to vary). IOSCO found that, as it had recommended, MMFs in most jurisdictions now value securities held in their portfolios using the fair value approach (instead of using a method that does not necessarily reflect their market value). In contrast, progress in implementing liquidity management reforms was less advanced and uneven across jurisdictions. IOSCO concluded that further work is also needed to reinforce the resilience of funds in some of the jurisdictions that permit MMFs to offer a stable NAV.

IOSCO has also published its final recommendations for liquidity risk management by collective investment schemes (CIS) such as MMFs and managed funds. This follows earlier FSB recommendations to address the liquidity mismatch in open-ended funds. IOSCO recommendations include that CIS should ensure that: their subscription and redemption arrangements are appropriate for their investment strategy and underlying assets; liquidity risk and the processes for managing it are disclosed to current and prospective investors; the liquidity of the assets held in the portfolio is assessed regularly; and ongoing liquidity assessments under various market conditions, which could include fund level stress testing, are conducted.

IOSCO also released a report on its peer review of national authorities' progress in implementing its 2012 recommendations on aligning the incentives of investors and securitisers, for example, by ensuring that securitisers retain an exposure to the securities that they originate. Progress in implementing these recommendations remains mixed. While only around half the participating jurisdictions have final adoption measures in place, they are in force in the United States, which accounts for around three-quarters of the global securitisation market by size.

Risks and reforms beyond the post-crisis agenda

Regulators have continued work on enhancing the integrity of major interest rate benchmarks following past examples of manipulation. The FSB, in an October progress report, noted that administrators of interbank offered rates (IBORs) are making progress on implementing recommended reforms. These include increasing the extent to which benchmark rates are based on actual transactions and developing alternative benchmarks based on risk-free rates. In January, IOSCO published information for users of benchmarks to consider in selecting an appropriate benchmark. In particular, it focuses on the importance of contingency planning for scenarios in which a benchmark is no longer available. For example, and as noted in the previous *Review*, the UK Financial Conduct Authority is putting measures in place to manage the risk of an unplanned cessation of the London IBOR (LIBOR). In April, the Federal Reserve Bank of New York began publishing three reference rates, including the Secured Overnight Financing Rate. The latter was recommended by a committee comprising public and private sector representatives as the alternative to US dollar LIBOR for use in certain new US dollar derivatives and other financial contracts. In Australia, legislation recently passed Parliament to reform the legal framework for the regulation of financial benchmarks, such as the bank bill swap rate (BBSW). The Australian Securities Exchange (the administrator of BBSW) has developed a new methodology that will measure BBSW directly from transactions. To support this, market participants have been expected to trade bank bills at outright yields since December. The new methodology is expected to commence soon. The Australian Securities and Investments Commission (ASIC) is in legal proceedings with two major Australian banks in relation to 'unconscionable conduct and market manipulation' in setting the BBSW. Similar legal proceedings by ASIC with two other major banks were concluded in November, with the Federal Court imposing penalties on the two banks and those banks also providing ASIC with enforceable undertakings.

The work on interest rate benchmarks is part of broader global and domestic efforts to address misconduct in the financial sector. The FSB will soon publish a toolkit for both firms and supervisors on how governance frameworks can be used to address misconduct risk. It will focus on ways to mitigate the cultural drivers of misconduct, strengthen individual responsibility and accountability, and address the problem of employees who have engaged in misconduct moving to a new firm. In Australia, the legislation establishing the Banking Executive Accountability Regime (BEAR) passed Parliament on 7 February. The BEAR requires banks and their executives to meet certain expectations and enables banks and individuals to be held to account where they fail to meet those expectations. The BEAR will commence on 1 July 2018 for large authorised deposit-taking institutions (ADIs), and one year later for other ADIs. APRA also released the result of its review of remuneration practices at large financial institutions. APRA found that, although the institutions that were considered met the minimum requirements of the prudential standard, variable pay generally placed too little weighting on risk metrics and was not deferred for long enough (for more information on the remuneration review and the BEAR, see 'The Australian Financial System' chapter).

Global and national authorities have been monitoring a wide range of fintech developments. A key focus has been on identifying any nascent risks to financial stability while avoiding actions that could limit the efficiency, financial inclusion and other benefits that can arise from financial innovation. Several papers on fintech were published by international bodies over the past six months:

- In November, the FSB released a report on the increased use of artificial intelligence (AI) and machine learning in financial services. The report noted that, while the use of AI and machine learning by firms and regulators may improve financial system efficiency and regulatory compliance, it may also result in new and unexpected forms of interconnectedness and third-party dependencies within the financial sector.
- The International Association of Insurance Supervisors (IAIS) issued a consultation

paper in February on the use of digital technology in the provision of insurance to excluded or underserved markets. The paper discusses the implications for regulators and the proportionate application of the IAIS's insurance core principles (ICPs) in these markets. The application of the ICPs requires that the nature, scale and complexity of regulatory measures not go beyond what is necessary to achieve the supervisory objectives of a jurisdiction. For example, relief from certain measures could be provided by a 'regulatory sandbox' – where start-ups and other firms can test certain products or services in a limited manner without being subject to the full regulatory framework.

- Also in February, the BCBS published a report on the implications of the growing use of fintech for banks and supervisors over the medium term. A common theme across the various scenarios considered in the report is that banks are likely to find it increasingly difficult to maintain their current operating models. For regulators, the report identified an overarching need to maintain the safety and stability of the banking system without inhibiting beneficial financial sector innovation. Important considerations for banks and regulators include the increasing use of third-party service providers, whether existing regulatory frameworks remain relevant to address the business models and actions of fintech firms, and the operational, cyber and compliance risks posed by fintech.

Domestically, ASIC continues to facilitate fintech start-ups to foster innovative financial products or services, including through the ongoing operation of its regulatory sandbox. Legislation has also been introduced into Parliament to facilitate an enhanced regulatory sandbox for fintech firms, which will allow more businesses to test for a longer time a wider range of new financial and credit products and services without a licence. In January 2018, ASIC licensed the first crowd-sourced funding intermediaries, so that public companies can offer shares to investors via the online platforms of these intermediaries.

A related issue, cyber risk in the financial sector, has been another area of international focus. The FSB published a stocktake of publicly available regulations, guidance and supervisory practices in October, with the aim of identifying effective practices. The report notes that FSB member jurisdictions have been active in addressing cybersecurity, with all member jurisdictions having released regulations or guidance addressing cybersecurity for at least part of the financial sector. Domestically, in November, ASIC published a report that assesses the cyber preparedness, existing good practices and areas for improvement of firms active in Australia's financial markets (such as stockbrokers, investment banks and credit rating agencies). ASIC will continue to assess the cyber resilience of regulated firms and measure their progress as they meet improvement targets.

In response to the growing threat of cyber attacks, in March APRA proposed its first prudential standard on information security. The new standard builds on APRA's principle-based guidance released in 2010 and is to apply to all APRA-regulated entities. It aims to enhance the ability of entities to repel cyber attacks, or respond effectively in the event of a breach. Under the new standard, requirements for entities include: maintaining information security capability commensurate with the size and extent of threats to information assets (including for external service providers); having adequate information security controls in place to protect information assets and undertaking systematic testing of these controls; and notifying APRA of material information security incidents. Following consultation, APRA intends to implement the new standard from 1 July 2019.

The FSB and standard-setting bodies have begun assessing whether the post-crisis reforms are meeting their intended objectives and whether there have been material unintended consequences; this is being guided by an evaluation framework finalised by the FSB last year. As part of the first study, which is evaluating the effects of the reforms on incentives to centrally clear OTC derivatives, in December the Committee on Payments and Market Infrastructures and IOSCO launched a series of qualitative surveys. A report is expected to be completed by the November 2018 G20 Summit in Argentina. The second assessment under the framework is examining the effects of the post-crisis reforms on financial intermediation, with an initial focus on infrastructure financing. To inform this assessment, in March the FSB launched a survey of firms and institutions seeking information on the trends and drivers of, and potential effects of regulatory reforms on, infrastructure financing. A report on infrastructure financing will be published by the G20 Summit.

Domestic Regulatory Developments

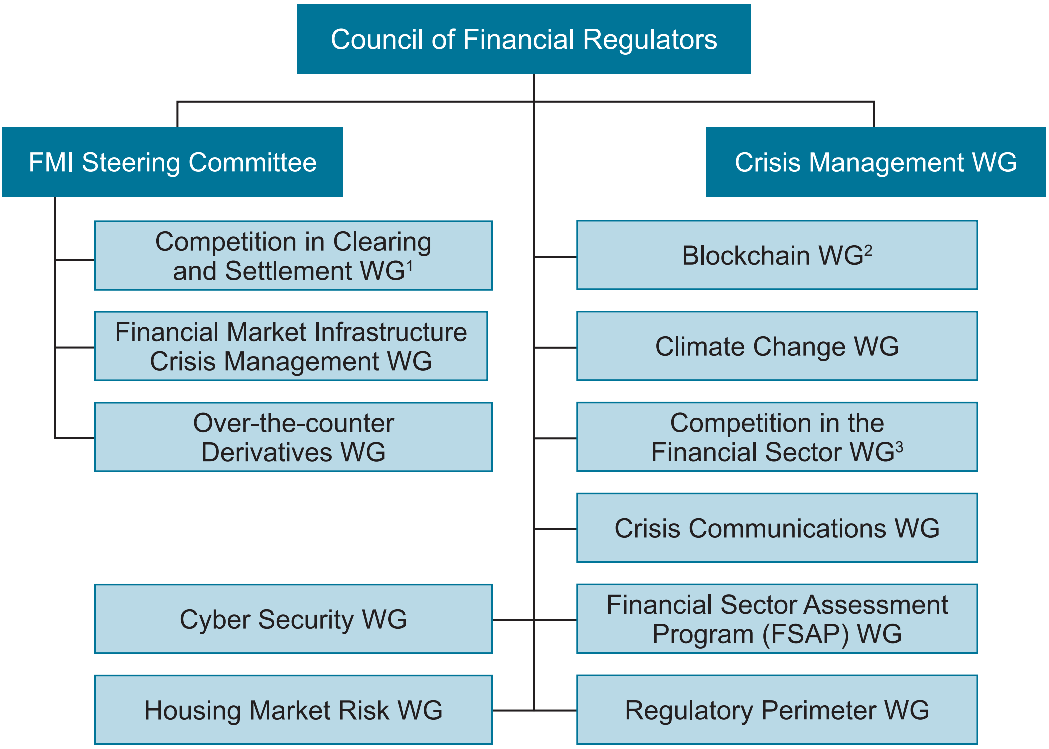
Council of Financial Regulators (CFR)

The CFR is a non-statutory body comprising Australia's main regulatory agencies with financial stability responsibilities: the Australian Treasury, APRA, ASIC and the Reserve Bank, which also provides its secretariat. The CFR is chaired by the Reserve Bank Governor and meets at least quarterly. It engages with other regulatory bodies as appropriate to discuss issues of common interest. As per its charter, the CFR aims to contribute to the efficiency and effectiveness of financial regulation and to promote stability of the Australian financial system. In particular, it acts as a forum for facilitating coordination among its member agencies to ensure threats to financial system stability are identified and addressed effectively.

The work of the CFR is facilitated through various working groups, largely consisting of representatives of the four CFR agencies, though other agencies participate in some groups (Figure 4.1). Key groups include the Financial Market Infrastructure (FMI) Steering Committee, which helps to coordinate monitoring and policy formulation in relation to FMIs and OTC derivatives markets regulation, and the Crisis Management Working Group, which seeks to establish policies and cross-agency processes for the effective management of distressed financial institutions. The Housing Market Risk Working Group has also been active in recent times, providing analysis of developments in the housing market and industry responses to the recent regulatory measures. Other working groups cover issues such as distributed ledger technology, competition and cyber security. Some groups are set up on a temporary basis to address specific topics (e.g. the FSAP Working Group), while others are ongoing. The working groups aid the work of the CFR by providing papers for discussion and developing recommendations where appropriate.

An important aspect of the ongoing work of the CFR agencies is the strengthening of the domestic framework for managing a financial crisis. The CFR has established a process for managing the resolution of a distressed financial institution to ensure a coordinated response. Much of the robustness of this process depends on APRA having effective crisis management powers to resolve its regulated institutions in an

Figure 4.1: CFR Working Groups (WGs)



1 Includes the ACCC but not APRA
2 Includes AUSTRAC
3 Includes the ACCC
All groups include Australian Treasury, APRA, ASIC and the RBA unless otherwise noted
Source: RBA

orderly manner. In February, Parliament passed legislation that will significantly enhance these powers, ensuring that APRA can effectively prepare for, and manage, a distressed bank or insurer, as well as affiliated group entities where relevant. The legislation clarifies APRA's powers to set requirements for resolution planning for banks and insurers (e.g. by developing prudential standards for resolution and recovery planning, supported by formal powers to direct entities to address barriers to their orderly resolution, such as by changing their business, structure or organisation). In addition, the legislation includes the ability for APRA to:

- ensure the effective resolution of the Australian branch of a foreign bank or insurer
- appoint a statutory manager to an expanded set of entities in certain circumstances, such as to the authorised non-operating holding companies (NOHCs) of ADIs, general insurers and life insurers, and domestically incorporated subsidiaries of these NOHCs, ADIs and insurers
- freeze the rights of counterparties of a financial group in specific circumstances, to allow sufficient time to effect a resolution.

CFR agencies are currently working on the design of a similar legislative framework for FMIs, which will ensure that the relevant resolution agency (the Bank for clearing and settlement facilities, or ASIC for trade repositories) has the necessary powers to resolve a failing domestic FMI.

At its meetings in November 2017 and March 2018, the CFR discussed several other issues, as noted below.

- The CFR continued to closely monitor developments in the housing market and the effectiveness of the regulatory measures taken by APRA in 2014 and 2017 to reinforce sound residential mortgage lending practices. Discussions covered analysis of developments in housing markets and lending practices, trends and competition among different types of lenders, and the conditions under which some of the measures could be relaxed.
- APRA updated the CFR on its progress in developing a domestic loss-absorbing capacity framework, in response to the government-endorsed recommendation by the Financial System Inquiry. Although none of the Australian banks are global systemically important banks, which means they are not bound by the FSB's total loss-absorbing capacity standard, the CFR has supported work by APRA to develop a domestic loss-absorbing capacity framework for Australian banks.
- Developments in shadow banking activity, both internationally and domestically, were assessed. Globally, the more problematic forms of shadow banking have declined substantially since the crisis. Domestically, non-ADI lending for housing has grown more quickly than ADI lending over the past year, but its share remains small (see 'The Australian Financial System' chapter). Overall, it was concluded that domestic risks from shadow banking activity remain limited but continued close monitoring is warranted.
- The CFR continued a discussion of the complexities in the management of financial disclosures when an ADI is under stress.
- In November, the CFR established a Climate Change Working Group. The working group will consider and coordinate actions to address the financial risks of changing climate, and society's response to such changes, for the Australian financial system.
- In March, the CFR endorsed the establishment of a working group to consider regulatory perimeter issues related to stored value payment systems.

CFR agencies continue to work with their New Zealand counterparts via the Trans-Tasman Council on Banking Supervision (TTBC) to further strengthen the cross-border crisis management framework. This includes follow-up work to the TTBC crisis simulation conducted in September last year, along with exploring options for early intervention to support the recovery of a financial institution before it becomes non-viable.

Other domestic regulatory developments

Over 2018, the IMF will conduct its third FSAP review of Australia. The FSAP is conducted every five years or so in jurisdictions with systemically important financial sectors. For this review, the IMF will focus on assessing financial sector vulnerabilities and the overall framework for systemic risk oversight. The FSAP will include an assessment of Australia's banking regulatory framework and supervisory practices against the BCBS's *Core Principles for Effective Banking Supervision*. It will also include reviews of the regulation of FMIs and the insurance sector, and crisis management arrangements. Following initial discussions in December on the scope of the review, the IMF FSAP team plans further meetings later in 2018 with CFR agencies, other government bodies, and private sector firms such as banks. A report with the key findings of the review is expected to be published in early 2019. The Bank and other CFR agencies are working closely with the IMF to ensure the FSAP is effective and efficient.

In February, the Productivity Commission released a draft report setting out the preliminary findings of its inquiry into competition in the Australian financial system. One focus of the draft report is the apparent inability of consumers to impose discipline on financial services providers, reflecting factors such as their level of financial literacy and engagement, the complexity of products, and the availability of information. The draft report makes a number of recommendations to address these issues, including: increasing the transparency of mortgage interest rates; imposing a legal duty on lender-owned mortgage aggregators and brokers to act in the best interests of the consumer; enhancing the information that mortgage brokers are required to provide to their clients; and implementing the open banking regime in a way that grants consumers full rights to access and use their digital data. The Bank welcomes and supports the Commission's focus on these areas.

The Commission also makes observations about the impact of regulation on competition. It recommends that one regulator be tasked with formally assessing the effects on competition of planned regulatory interventions in the sector. The Bank provided its perspectives on these issues, and on the Commission's recommendations related to retail payment systems, in a supplementary submission in March. The Commission's final report will be handed to the government by 1 July.

The Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry held its first round of hearings in March, focused on consumer lending practices. The next round of public hearings in April will focus on financial planning and wealth management. The Commission plans to hold further rounds periodically throughout the year, with their focus to be announced at a future date. The Commission may release an interim report before the end of September, and a final report is due to be submitted to the government by 1 February 2019.