4. Regulatory Developments

The impetus for regulatory reform in Australia is currently more domestic than has generally been the case in the post-crisis period. Most of the internationally driven reforms have now been implemented in Australia. Many recent and prospective domestic regulatory changes have instead been in response to recent reviews, such as the Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry (the Royal Commission). Efforts to enhance other elements of the regulatory framework have also continued. Actions taken by regulators have included a proposed new standard to strengthen remuneration requirements for prudentially regulated institutions, enhancing consumer protection in the financial services industry and improving the loss-absorbing capacity of authorised deposit-taking institutions (ADIs).

The main financial regulatory agencies have continued to coordinate on reforms through the Council of Financial Regulators (CFR). The CFR also discusses key developments in the financial system, which have recently included subdued growth in credit to households and small businesses. It has considered the relative importance of weaker demand and tighter lending standards in slower credit growth and has monitored developments in housing markets as indicators of credit conditions. CFR members viewed the risks to date to lenders from the falls in housing prices over the past few years as limited.

Internationally, global bodies have continued to review the implementation of the G20's post-crisis financial sector reforms, and to assess their effects. The Financial Stability Board (FSB) has commenced an evaluation of the effects of the 'too big to fail' reforms. These evaluations are important for determining whether the reforms are achieving their intended objectives, and if there are material unintended consequences that should be addressed. This focus is seen in the recent decision by the Basel Committee on Banking Supervision (BCBS) to change the Basel III leverage ratio standard following an evaluation of the effects of reforms on incentives to centrally clear over-the-counter (OTC) derivatives.

The CFR has closely monitored credit and housing conditions and progressed joint initiatives

The CFR is the coordinating body for Australia's main financial regulatory agencies. A significant focus of its recent meetings has been credit conditions for households and small businesses. While noting the important role of weaker demand for credit, discussions have considered the tightening in lending standards as lenders have adjusted their processes for verifying income and expenses. Tighter standards have extended to small businesses as lenders have been cautious in their treatment of the division between personal and small business finances. The CFR was briefed on the Australian Securities and Investments Commission's (ASIC) review of its responsible lending guidance, along with the Federal Court's recent responsible lending decision.[1] Discussions emphasised that the intent of ASIC's responsible lending review is not

to increase requirements on lenders, but to clarify and update guidance on existing requirements. The Australian Prudential Regulation Authority's (APRA) changes to its guidance on the minimum interest rate used in serviceability assessments for residential mortgage lending were also discussed prior to their announcement (discussed further in 'Chapter 2: Household and Business Finances').

Housing is monitored by the CFR for insights into the dynamics of credit supply and demand, and its value as collateral backing lending. The CFR discussed the recent signs of stabilisation in the Sydney and Melbourne markets. CFR members viewed the combination of a strong labour market, low interest rates and improved lending standards in recent years as limiting the risks to lenders from housing price falls.

The findings and recommendations of the Royal Commission have significant implications for the financial system and regulators. The CFR regularly discussed the Royal Commission proceedings and members' approaches to addressing its recommendations. A large number of these require legislative change. In August, the government released a plan for close to 90 per cent of its commitments to be implemented, or have the relevant legislation before parliament, by mid 2020; by the end of 2020, legislation for all remaining recommendations requiring legislative change will have been introduced into parliament.

Other recent activities of the CFR and its working groups have included the following:

- Member agencies have been working on implementing relevant recommendations from the International Monetary Fund's (IMF) 2018 Financial Sector Assessment Program (FSAP) review of Australia.[2] Work on those that involve several agencies is coordinated by the CFR. For example, in September, the CFR reviewed Australian banks' use of overseas wholesale funding, as suggested by the IMF. It welcomed the progress the banks had made in lengthening the maturity of their offshore term debt, but agreed that a further lengthening would reduce the rollover risk for banks and the broader financial system.
- The CFR considered the design of a crisis management legislative framework for clearing and settlement (CS) facilities, with this work being undertaken by the CFR's Financial Market Infrastructure (FMI) Steering Committee. The framework will ensure that agencies have the necessary powers to resolve a distressed domestic CS facility. A consultation covering both supervisory and crisis management powers is planned for late 2019. The CFR's conclusions will be provided to the government to assist with policy design and the drafting of legislation.

  The FMI Steering Committee has also been working with the Australian Treasury on legislative changes that would support:

  - the CFR's policy framework for competition in the clearing and settlement of Australian cash equities
  - the enforcement of the CFR's regulatory expectations for monopoly providers of cash equity CS services.
- A CFR review of the regulatory regime for stored-value facilities (SVFs) has now been completed. SVFs enable funds to be prepaid into a facility for the purpose of making future payments. The facility therefore maintains a 'float' of stored value. The final reports of both the Financial System Inquiry and the Productivity Commission's Inquiry into Competition in the Australian Financial System recommended a review of the regulation of these facilities. Following a public consultation in 2018, the CFR has been considering how to structure a graduated regulatory framework and ensure adequate consumer protection

arrangements, while supporting competition and innovation. The conclusions of this work will be provided to the government for consideration in the near future.

- CFR agencies in September considered arrangements for managing liquidity at superannuation funds during periods of market stress. They agreed that existing arrangements provide an appropriate incentive for superannuation funds to manage their liquidity. They also agreed that circumstances where a systemic liquidity problem could arise for the superannuation system were highly unlikely. The CFR concluded that no additional measures, including access to liquidity from the Reserve Bank, were warranted.
- CFR agencies and the Australian Competition and Consumer Commission (ACCC) are developing an online tool to provide information on average mortgage interest rates paid on new loans. This follows a recommendation from the Productivity Commission's competition inquiry. The tool will use data from APRA's new Economic and Financial Statistics collection and is expected to be available in 2020.
- A CFR working group coordinates work on the implications for the financial system of climate change. This includes ensuring that Australian objectives and perspectives are consistently represented in international forums. CFR agencies have been engaged in this area in recent months. In particular, APRA and ASIC have been emphasising the need for financial institutions and listed companies to disclose the climate risks they face, including to meet statutory disclosure requirements. For APRA-regulated entities, this includes, for example, the disclosure of climate change-related modelling, stress testing and scenario analysis.

The CFR also engages with other regulators to discuss issues of common interest.

- In July, the CFR held its annual meeting with other Commonwealth regulators that have an interest in the financial sector. This included representatives from the ACCC, the Australian Taxation Office and the Australian Transaction Reports and Analysis Centre (AUSTRAC). Topics discussed included enforcement and data initiatives affecting the financial sector.
- CFR agencies have also been working with their New Zealand counterparts via the Trans-Tasman Council on Banking Supervision (TTBC) to further strengthen the cross-border crisis management framework. The heads and deputies of the seven TTBC agencies met in Sydney in July and will meet again in November this year. The TTBC carried out a cross-border crisis simulation in September, focused on crisis management communication arrangements.

In recent years, the CFR has been considering elements of its role and the way it operates. Outcomes have included the annual meeting with other Commonwealth regulators discussed above and increased transparency via the release of a quarterly statement after each scheduled meeting. At the July 2019 meeting, members agreed to adopt an updated charter. This emphasises the CFR's financial stability objective, while also recognising the benefits of a competitive, efficient and fair financial system. The new charter also highlights the CFR's focus on cooperation and collaboration to support the activities of its member agencies and its engagement with other regulators.

Further necessary actions are being taken to improve the regulatory framework …

Domestic regulators have taken actions to address poor governance and incentives in the

financial system as well as to improve resilience, and the transparency and effectiveness of regulation and supervision.

In light of the findings of an earlier Prudential Inquiry by APRA into the Commonwealth Bank of Australia (CBA), APRA wrote to 36 of the country's largest banks, insurers and superannuation licensees in June 2018. It asked them to assess whether the cultural and non-financial risk management issues identified at CBA also existed within their own organisations. In May 2019, APRA released a report analysing these self-assessments. The report concluded that the issues were not unique to CBA. It identified a number of areas in which financial institutions needed to improve, including non-financial risk management (due to, for example, overly complex and bureaucratic decision-making). It also found that institutions needed to clarify internal accountabilities and enhance their risk culture. APRA concluded that institutions' knowledge of these weaknesses had at times been longstanding, but for various reasons – including, in some cases, a lack of prioritisation – they had not been addressed. In response to these self-assessments, APRA increased the minimum capital requirements of Australia and New Zealand Banking Group, National Australia Bank and Westpac Banking Corporation by $500 million each, and Allianz's capital requirement by $250 million. CBA's capital requirement had already been raised by $1 billion after its earlier prudential review. This extra requirement for the three banks and insurer will apply until each institution has strengthened its risk management and closed the gaps identified in its self-assessment.

Several inquiries, including the Royal Commission and various reviews by APRA, have examined the remuneration arrangements of financial institutions. APRA recently released a discussion paper outlining a draft prudential standard in this area. The standard, covering all APRA-regulated entities, aims to better align remuneration frameworks with the long-term interests of entities and their stakeholders, including customers and shareholders. The proposed reforms:

- introduce a requirement for boards to approve and actively oversee remuneration policies for all employees
- elevate the importance of managing non-financial risks (such as misconduct risk); accordingly, financial performance metrics cannot comprise more than 50 per cent of performance criteria for variable remuneration
- introduce minimum deferral periods for variable remuneration of up to seven years for larger, more complex entities
- ensure that larger, more complex entities have the ability to recover remuneration from executives up to four years after it has been paid (or 'vested').

Some recommendations of the Royal Commission also focused on the regulators themselves, including a call for regular capability reviews. A capability review of APRA was released in July. It concluded that APRA is a high-quality regulator and has been successful in delivering on its core mandate of financial safety and stability. The report made 24 recommendations to further strengthen and better position APRA for the future; 19 were directed to APRA and five to the government. Some key recommendations related to governance, such as changes to APRA's organisational structure and revisions to the role of its chair. Others concerned culture and accountability, cyber risks and enforcement approach, including building on the APRA Enforcement Strategy Review released in April 2019. APRA supports all 19 recommendations directed to it, and the government has agreed to take action on all five recommendations directed to it.

APRA has finalised elements of its loss-absorbing capacity framework for ADIs. This is in keeping with a government-endorsed recommendation of the Financial System Inquiry. The framework aims to increase the ability of ADIs to absorb losses while minimising the need for taxpayer support, to assist with an orderly resolution in the unlikely event of a failure. APRA will require the four major banks to lift their total capital ratios by 3 percentage points of risk-weighted assets (RWA) by 1 January 2024. APRA expects these banks to make up the majority of the increase through issuance of Tier 2 capital instruments. The requirement for the major banks was lower than the 4–5 percentage point increase initially proposed by APRA, reflecting concerns expressed by stakeholders about whether the market could absorb the required issuance. APRA's overall long-term target for additional loss-absorbing capacity remains 4–5 per cent of RWA. For small-to-medium ADIs, extra loss-absorbing capacity will be considered on a case-by-case basis as part of APRA's resolution planning process with ADIs.

In August, APRA announced a strengthening of its prudential standard with regard to contagion risk within banking groups (the risk of negative shocks to one entity spilling over to others). Changes to its prudential standard (to come into effect from 1 January 2021) will:

- reduce the limit on ADIs' exposures to a single related ADI from 50 per cent of total capital to 25 per cent of Tier 1 capital, and exposures to all related ADIs from 150 per cent of total capital to 75 per cent of Tier 1 capital
- modify the definition of a related entity to be broader and more related to the extent of control
- remove the eligibility of ADIs' overseas subsidiaries to be regulated under APRA's Extended Licensed Entity framework
- introduce minimum requirements for ADIs to assess contagion risk.

Additionally, APRA will require ADIs to regularly assess and report on their exposure to step-in risk – the likelihood that they may need to 'step in' to support an entity to which they are not directly related.

In May 2019, ASIC wrote to the chief executive officers of several major financial institutions regarding their level of preparedness for the transition away from using the London Interbank Offered Rate (LIBOR). This was strongly supported by both APRA and the Bank. This follows the UK Financial Conduct Authority's earlier announcement that it will no longer use its powers to sustain LIBOR beyond 2021. LIBOR is deeply embedded in financial markets globally and is used by many Australian financial institutions in their financial contracts and business processes. A disorderly transition away from LIBOR could have implications for short-term financial stability. Accordingly, Australian regulators expect all businesses with an exposure to LIBOR to actively plan for the transition to alternative reference rates. This follows reforms globally (as well as in Australia) in recent years to enhance the robustness of financial benchmarks, including by developing new 'risk-free rates'. These reforms in part reflect past examples of manipulation of LIBOR and other financial benchmark rates.

As discussed in 'Chapter 3: The Australian Financial System', FMIs such as central counterparties (CCPs) and securities settlement facilities (SSFs) occupy a key role in the financial system. Regulators took actions recently in this area.

- The Bank sought to improve the transparency of its supervision of FMIs by publishing two policy statements in June. These included an updated policy statement describing the Bank's approach to supervising and assessing CS facility

licensees against the Bank's Financial Stability Standards, and a new policy statement on oversight and supervision of systemically important payment systems. The changes aim to make the frequency, scope and level of detail of the Bank's assessment of CS facility licensees proportionate with the degree of systemic risk they pose. As CS facilities become progressively more important to the Australian financial system, the frequency and degree of interactions between Bank staff and management at the CS facility is expected to increase, alongside data requirements and assessment obligations. The Bank will continue to place an appropriate degree of reliance on reports and reviews conducted by overseas regulators when conducting its assessments of overseas CS facility licensees.

- While SSFs currently licensed in Australia are not exposed to the same types of financial risks from their participants that CCPs are, if SSFs offer intraday liquidity to participants in order to support more timely settlement of trades, it creates potential liquidity risks for these SSFs. This is true for some international SSFs, and they are required to have arrangements in place to manage these risks under international standards for FMIs. To mitigate these risks if they were ever to arise in Australia, the Bank has recently introduced requirements that make holding an Exchange Settlement Account mandatory for systemically important Australian-licensed SSFs exposed to AUD liquidity risk. This will ensure that, if future Australian-licensed systemically important SSFs were to adopt settlement models involving AUD liquidity risks, they would have backstops to help manage these risks.

… including to enhance consumer protection in relation to financial products and services

Legislation passed by parliament in April 2019 strengthened ASIC's powers to protect consumers. The legislation introduced a 'design and distribution obligations' (DDO) regime and a 'product intervention power' (PIP), both administered by ASIC. The DDO regime will make issuers and distributors accountable for the design, marketing and distribution of financial and credit products to ensure they meet consumer needs. The regime will require issuers to identify in advance the consumers for whom their products are appropriate, and direct distribution to that target market. The DDO regime will commence in 2021. The CFR, in its July statement, encouraged issuers of Additional Tier 1 instruments (a form of bank-issued non-equity capital) to review their practices ahead of the commencement of the new DDO regime. The CFR noted that APRA would continue to treat these instruments as regulatory capital, capable of absorbing losses in the unlikely event of a bank failure.

The PIP gives ASIC the ability to intervene where a financial or credit product has resulted in, or is likely to result in, significant detriment to consumers. ASIC launched a consultation in June on the scope of the power, with a final regulatory guide planned to be released later in 2019. ASIC first used this power in September to address significant consumer detriment in the provision of short-term credit. The intervention targets a business model whereby associates of short-term credit providers charge significant upfront, ongoing and default fees. These fees can add up to almost 1000 per cent of the loan amount. Additionally, in August, ASIC proposed using the PIP to ban the retail sale of certain types of complex financial products, namely 'binary options', and impose conditions on the issue and distribution of 'contracts for difference' to retail clients. ASIC is currently consulting on

using the PIP to reform the sale of add-on financial products by car yards.

A further important enhancement to the protections offered to consumers in their use of financial products is an updated Banking Code of Practice by the banking industry, which was approved by ASIC in June 2019. The code includes a commitment to not charge fees to deceased consumers, as well as changes that reflect updated ASIC requirements for credit card lending practices. A further tranche of changes to the code, commencing in 2020, will primarily address the recommendations of the Royal Commission.

Internationally, monitoring the implementation of agreed reforms remains a priority …

The FSB's update to the G20 on the implementation of post-crisis reforms highlighted continued progress across jurisdictions. Over the year, jurisdictions have made advances with implementing leverage ratio requirements, the large exposures framework, total loss-absorbing capacity (TLAC) requirements, and recommendations on ways to align incentives in securitisation.

However, the report notes that implementation is not yet complete and remains uneven across reform areas. Of note, a number of jurisdictions have yet to implement the Basel III Net Stable Funding Ratio, despite the agreed deadline being January 2018. The FSB acknowledged that challenges and difficulties are faced by some jurisdictions in meeting the agreed dates for some reforms, but reiterated the need to maintain momentum to achieve greater resilience in the global financial system.

The FSB has recently assessed the technical implementation of the TLAC standard. This major reform was designed so that failing global systemically important banks (G-SIBs) would have sufficient loss-absorbing and recapitalisation capacity to allow an orderly resolution.[3] The FSB concluded that implementation is progressing well and that all G-SIBs required to comply by January 2019 now meet or exceed the initial required TLAC ratios. G-SIBs headquartered in emerging market economies (EMEs) have extra time to meet these requirements given the less developed capital markets in EMEs.

The FSB saw no need to modify the TLAC standard at this time. However, it will continue to monitor implementation and issuance of TLAC instruments and report at least annually on progress. The FSB will also review the range of practices in place across jurisdictions regarding pre-positioning of 'internal TLAC' (a G-SIB's TLAC allocated to its subsidiaries) and the management of TLAC that is not pre-positioned. It has identified these as challenges affecting the smooth implementation of the TLAC standard across jurisdictions.

… along with evaluating the effects of these reforms

In recent years, the international community has been undertaking a program of formal evaluations of the effects of the post-crisis reforms. Earlier this year, the FSB launched its fourth major evaluation, which is focused on the reforms addressing 'too big to fail', the systemic and moral hazard risks posed by systemically important banks. The evaluation will assess whether the reforms are achieving their objectives and whether they are having unintended effects – for example, on the functioning of financial markets, global financial integration, or the cost and availability of financing. The FSB will publish a draft report for consultation in mid 2020. The Bank is represented on the FSB working group conducting this evaluation.

A separate FSB evaluation is examining the effects of reforms on the financing for small- and medium-sized enterprises (SMEs). A June

2019 consultative report, incorporating input from earlier public outreach, does not identify material and persistent negative effects on SME financing. It notes that any transitory costs should be set against the wider financial stability benefits that come from reducing the likelihood and severity of financial crises.

The potential for differences in the implementation of reforms across jurisdictions to lead to fragmentation in the market for financial services has also been a concern for the international community. The FSB published a report on this in June 2019. It highlights a possible trade-off between the need to tailor regulations to local conditions and the benefits of standardised rules across jurisdictions, such as increased cross-border activity. It also outlines areas for further work that could allow more effective cross-border cooperation among authorities.[4]

Some adjustments have been made to global standards to improve their functioning

Regulatory frameworks need to be responsive to changing needs and new information. For instance, the BCBS announced a revision to its global standard on disclosure for the Basel III leverage ratio. From January 2022, banks will have to start disclosing their leverage ratios based on daily average values of securities financing transactions in addition to quarter-end values. This follows concerns about 'window-dressing', where temporary reductions in transaction volumes around quarter-end dates increase reported leverage ratios. The BCBS views window-dressing as unacceptable, as it undermines the intended policy objectives and risks disrupting the operation of financial markets.

The BCBS has also revised the leverage ratio calculation to remove a disincentive for participants to clear derivatives for clients. From January 2022, initial and variation margin received by banks from clients will be able to offset the replacement cost and potential future exposure for client cleared derivatives. This revision aligns the leverage ratio treatment of client cleared derivatives with the standardised approach to measuring counterparty credit risk exposures in the risk-based capital framework. The change follows earlier findings that the current rules may be a disincentive for banks to offer or expand client clearing services (undermining the G20 aim of promoting central clearing of standardised OTC derivatives).

The BCBS and the International Organization of Securities Commissions have delayed the full implementation of margin requirements for non-centrally cleared derivatives by one year. The delay recognises that many entities are affected and face challenges in implementing the requirements, and rushed or incomplete implementation could be disruptive. Under the original 2015 plan, all covered entities (financial firms and systemically important non-financial firms) with notional amounts of non-centrally cleared derivatives above €8 billion would have been required to meet the margin requirements by 1 September 2020. Under the revised plan, covered entities with exposures greater than €50 billion will still have to meet the margin requirements by this date, but those with exposures between €8 billion and €50 billion will have until 1 September 2021. In September, APRA announced it will implement equivalent changes in Australia.

Crypto-assets continue to attract attention from international regulators

In a 2018 report to the G20, the FSB concluded that crypto-assets were an emerging issue for regulators, but did not pose material risks to global financial stability at that time. However, crypto-assets raise a number of policy issues (such as money laundering risks) and so continued vigilant monitoring is warranted

given the speed of development and the variety of new products and services being proposed.

Global bodies are also taking steps to address issues raised by crypto-assets. For example, the BCBS is in the process of clarifying the prudential treatment of bank exposures to crypto-assets. The prudential treatment is expected to reflect the high degree of risk from these exposures. Earlier in the year, the BCBS published high-level supervisory expectations for banks engaging in crypto-asset activities. It continues to monitor banks' exposures to these assets. The FSB reported in May 2019 that regulatory approaches to crypto-assets vary across jurisdictions, and highlighted the risk that this could lead to regulatory gaps or arbitrage. The FSB also acknowledged that crypto-assets may not fit easily into existing regulatory frameworks, in part because some crypto-assets have been designed to fall outside the regulatory perimeter.

A recent focus of both domestic and international policymakers has been the potential for the introduction of new stablecoins and associated payment services.[5] A stablecoin is a crypto-asset designed to maintain a stable value relative to another asset, typically a unit of currency or a commodity. One suggested use for stablecoins would be for making cross-border payments. The case for use for domestic payments in advanced economies is less clear, although a stablecoin issued by a platform with a large existing network could see a substantial uptake. If the pool of assets backing a stablecoin became large, some system-wide risks could emerge. Regulators globally, and domestically through the CFR, are coordinating to ensure any implications for the payments system and the financial system are carefully considered and, if necessary, addressed. ✠

Endnotes

[1] Australian Securities and Investments Commission v Westpac Banking Corporation (Liability Trial) [2019] FCA 1244.

[2] RBA (2019), 'Box E: The 2018 Financial Sector Assessment Program Review of Australia', *Financial Stability Review*, April, pp 70–75.

[3] The minimum TLAC requirement, which is composed of both regulatory capital and other eligible debt, is being phased in for G-SIBs headquartered in advanced economies from 1 January 2019. Requirements start at 16 per cent of risk-weighted assets and 6 per cent of the 'exposure' measure used in the Basel III leverage ratio denominator, rising to 18 per cent and 6.75 per cent respectively by 2022.

[4] Two such areas relate to making deference processes in derivatives markets clearer, and strengthening international banks' understanding of supervisory approaches towards pre-positioning of capital and liquidity.

[5] One proposed stablecoin is 'Libra'. An associated digital wallet, 'Calibra', is also proposed.