4. Developments in the Financial System Architecture

The international regulatory bodies have continued their financial reform efforts in several areas over the past six months. Further progress has been made in implementing aspects of the framework for systemically important financial institutions (SIFIs), especially for globally systemic banks, but more recently also for other types of systemic institutions. Improving resolution regimes for SIFIs is an important element of this reform program, with countries encouraged to alter their resolution frameworks to be consistent with a new international standard for them. The Financial Stability Board (FSB) recently initiated a peer review to monitor progress in this area. In a related development, the Committee on Payment and Settlement Systems (CPSS) and the International Organization of Securities Commissions (IOSCO) released a consultation paper on recovery and resolution of financial market infrastructures (FMIs). These two bodies also released new principles for FMIs, which aim to strengthen them and their supervision. These developments have been considered by the Council of Financial Regulators (CFR) in recent discussions on changes to the domestic regulatory framework for FMIs.

Reform of over-the-counter (OTC) derivatives market regulation to meet G-20 commitments is progressing in many jurisdictions, including Australia. Standard-setting bodies released capital rules and proposed margin requirements that support one of these commitments, which is for all standardised OTC derivatives contracts to be centrally cleared. The FSB is continuing to lead work on the regulation of shadow banking; several workstreams have delivered initial reports and are scheduled to deliver policy recommendations regarding specific shadow banking entities and activities by end 2012.

The International Monetary Fund (IMF) has recently undertaken a Financial Sector Assessment Program (FSAP) update of Australia to assess the stability of the financial sector and the quality of domestic regulatory, supervisory and resolution arrangements. CFR agencies prepared background material and held extensive discussions with the IMF on these issues and on banking and financial stability issues more generally. The Australian Prudential Regulation Authority (APRA) has continued to consult with authorised deposit-taking institutions (ADIs) on the implementation of the Basel III capital and liquidity reforms in Australia, and will soon release its final capital standards, with a revised draft liquidity standard due to be released in December 2012. APRA has also engaged with financial sector stakeholders on a range of other draft prudential standards, including those relating to superannuation, conglomerate supervision and capital requirements for insurers.

International Regulatory Developments and Australia

Systemically important financial institutions (SIFIs)

As discussed in the March 2012 *Review*, the FSB, in close coordination with the Basel Committee on Banking Supervision (BCBS), developed a comprehensive policy framework to address the risks posed by SIFIs. Some specific elements of this framework focus on institutions that are systemically important in a global context (G-SIFIs), in particular global systemically important banks (G-SIBs), to reflect the greater risks these institutions pose to the global financial system. The framework comprises a new international standard for resolution regimes, more intensive and effective supervision, requirements for cross-border cooperation and recovery and resolution planning, as well as, from 2016, additional capital requirements for those banks determined to be G-SIBs.[1] In recent months, work has progressed on implementing aspects of this framework. Cross-border crisis management groups led by the relevant G-SIB home authorities have been established for most of the 29 banks identified as G-SIBs by the FSB in 2011. Work is ongoing to develop resolution strategies and cross-border cooperation agreements by the end of 2012, so these G-SIBs can be resolved more easily. As part of an annual process, the FSB plans to publish an updated list of G-SIBs in November.

The FSB and BCBS were tasked by the G-20 with extending the G-SIFI framework to banks that are systemically important in a domestic context (D-SIBs). In response, the BCBS issued a consultation paper in June that sets out a principles-based framework for dealing with D-SIBs, to complement the (more prescriptive) framework for G-SIBs. The framework covers both the methodology for identifying D-SIBs and the measures that should apply to them, including additional capital requirements (higher loss absorbency (HLA)). The Bank and APRA contributed to the development of the framework.

Under the proposed D-SIB framework, national authorities are expected to develop a methodology, and use it to regularly assess the systemic importance of banks in their jurisdictions. The assessment should reflect the potential impact of a bank's distress or failure on the domestic economy and financial system, having regard to factors such as the size, interconnectedness, substitutability and complexity of banks, and any other factors the authorities deem important. The proposal envisages that all D-SIBs will be subject to a HLA requirement in the form of additional common equity Tier 1 capital. However, authorities will have flexibility to determine how much additional capital will be required. In cases where the subsidiary of a foreign bank is assessed as being a D-SIB by a host authority, home and host authorities are expected to coordinate and cooperate on the appropriate HLA requirement to impose on the subsidiary.

National authorities will be expected to publicly disclose information about their assessment methodologies and approaches to setting HLA requirements. The BCBS also intends to introduce a peer review process to scrutinise how different jurisdictions have implemented the principles. A revised framework, updated following feedback received during the consultation, was discussed at a BCBS meeting in September. The final framework will be presented to the G-20 Ministers and Governors in November, for implementation from January 2016 (consistent with the start date of the G-SIB framework).

Unlike the G-SIB regime, which does not apply to any Australian-owned banks, the D-SIB framework will have implications for Australia. APRA will be responsible for developing the assessment methodology (likely with input from the Bank) and for deciding on any HLA requirement and other potential measures. Given the flexibility provided in the proposed framework, APRA will be able to develop an approach that is best suited to Australia's circumstances. In particular, while the consultation document focuses heavily on HLA, it does make the point that other policy tools, particularly more intensive supervision, can also play an important role in dealing with the risks posed by D-SIBs. In this context, APRA's long-established internal risk-rating process – the PAIRS/SOARS framework – is already geared towards more intensive supervisory intervention for larger banks.

1 For further information on the G-SIB framework, and the current list of banks identified as G-SIBs, see RBA (2012), 'Box C: Global Systemically Important Banks', *Financial Stability Review*, March, pp 66–68.

The flexibility provided in the D-SIB framework also accommodates the different approaches to identify domestic SIFIs that have already been adopted in several countries. As noted in the previous *Review*, some of these identification methodologies are based on a single indicator (such as size) while others use multiple indicators, similar to the G-SIB approach. An example of the latter was the approach used by the US Financial Stability Oversight Council (FSOC) to recently designate eight 'financial market utilities' (FMUs) as systemically important. These FMUs will be subject to additional prudential and reporting requirements. These are the first designations by FSOC of systemically important FMUs under the Dodd-Frank Act, and were based on factors such as the value of transactions processed by the FMU, its counterparty exposures, its interconnectedness with other FMUs and the effect its failure would have on critical markets or the broader financial system.

The G-SIFI framework is also being extended to global systemically important insurers (G-SIIs). In May, the International Association of Insurance Supervisors (IAIS) issued for consultation its proposed methodology for identifying G-SIIs. The methodology is similar to the BCBS' approach for identifying G-SIBs. It uses indicators from five broad categories: size, global activity, substitutability, interconnectedness, and non-traditional insurance and non-insurance activities, though with a higher weight on the last two categories. As noted in the previous *Review*, the greater emphasis on non-traditional insurance and non-insurance activities reflects the IAIS' view that traditional insurance business does not normally generate systemic risk. Such risk is more likely to stem from other activities such as financial guaranty (including mortgage) insurance, credit default swaps, derivatives trading and leveraging assets to enhance market returns. The IAIS tested its methodology using 2010 data collected from 48 insurers in 13 jurisdictions. No Australian-owned insurer was included in the data collection. The IAIS is currently reviewing feedback received on its proposals before finalising its methodology. An initial list of G-SIIs, if any, is expected to be published by the FSB in the first half of 2013. The IAIS has also been developing a set of policy measures for G-SIIs, which will be consulted on later in 2012. These measures are expected to be consistent with the FSB's overall SIFI policy framework.

In addition to the G-SII methodology, the IAIS is continuing its work in other areas that will have implications for a wider set of insurers. In July, it released a draft of the *Common Framework for Supervision of Internationally Active Insurance Groups*. This framework is proposed to contain qualitative and quantitative requirements for internationally active insurers, recommendations on the supervisory process aimed at achieving consistent and effective supervision, as well as requirements for greater cooperation and coordination among national authorities in supervising complex cross-border insurance groups. The IAIS expects to finalise the framework by end 2013.

Resolution regimes

A key part of the SIFI framework is the FSB's new standard, *Key Attributes of Effective Resolution Regimes for Financial Institutions* (*Key Attributes*), which sets out the features that countries should have in their resolution frameworks. National authorities are being encouraged by the G-20 and the FSB to amend national resolution regimes to be consistent with the *Key Attributes*. To monitor, and hasten, progress in this area, the FSB recently initiated a thematic peer review of resolution regimes, to review FSB member jurisdictions' existing resolution regimes, and any planned changes, using the *Key Attributes* as a benchmark. The findings of the review will also inform the development of a methodology to assess jurisdictions' compliance with the *Key Attributes*. The review covers banks, insurers, securities firms and FMIs, though it will focus on banks because resolution regimes for them are generally the most advanced. The review is expected to conclude in early 2013.

The Australian Government released a consultation paper in September containing proposals to strengthen APRA's crisis management powers and to better align Australia's resolution framework with international standards, such as the *Key Attributes*. The proposals also seek to harmonise and enhance APRA's regulatory powers across the various Acts it administers. APRA's crisis management powers would be enhanced in several areas, including:

- the ability to appoint a statutory manager to a wider set of institutions, including non-operating holding companies (NOHCs) and subsidiaries of NOHCs and other regulated entities
- resolution powers over the Australian branches of foreign banks, and strengthened business transfer powers over Australian branches of foreign banks and insurers
- directions powers that temporarily override company disclosure requirements
- improvements to the operation of the Financial Claims Scheme
- directions powers over superannuation entities.

Numerous other changes are proposed, including: simplifying and strengthening provisions relating to obtaining information and investigation; streamlining provisions regarding auditors and actuaries; introducing independent experts into the prudential framework; and refining and expanding the legal definition of 'prudential matters', which will be applied on a broadly uniform basis across the Acts. The consultation closes on 14 December, following which the Australian Treasury, in liaison with financial regulators, will advise government of possible reforms to existing arrangements. Separately, the CFR and the Trans-Tasman Council on Banking Supervision have been continuing their work on strengthening cross-border crisis management arrangements.

Other jurisdictions have also recently proposed enhancements to their resolution frameworks and tools, consistent with elements of the *Key Attributes*. In its response to the report by the Independent Commission on Banking, the UK Government stated in June that it will introduce bail-in powers, whereby unsecured creditors could have their claims reduced or converted to shares to help recapitalise a distressed bank. The UK Financial Services Authority recently released proposals which would require foreign banks from non-European countries with national depositor preference regimes to only accept deposits in the United Kingdom through a UK-incorporated subsidiary or implement an alternative arrangement that would ensure that UK depositors would be no worse off than the depositors in the home country if the bank were to fail. Under some depositor preference regimes, domestic depositors have a priority claim on the assets of a failing bank (ahead of UK depositors in a branch of that bank). This is contrary to one element of the *Key Attributes* which states that national regulations should not discriminate against creditors (including depositors) on the basis of their nationality, the location of their claim or the jurisdiction where it is payable. In June, the European Commission (EC) proposed bank recovery and resolution rules for the European Union (EU), to strengthen national resolution powers in key areas, including in regard to bail-in powers. Intervention by the authorities would become more intrusive as the situation deteriorates. In addition, as noted in 'The Global Financial Environment' chapter, the EC recently proposed initial steps towards a European banking union involving more integrated regulation, supervision, resolution and deposit guarantee arrangements.

The CPSS and IOSCO issued a consultation paper in July, *Recovery and Resolution of Financial Market Infrastructures*. The paper calls for robust recovery and resolution arrangements for FMIs, based on the recently released *Principles for Financial Market Infrastructures* (discussed below) and the *Key Attributes*. It also outlines the issues authorities should take into account when assessing recovery plans and establishing resolution regimes in accordance with the FSB's *Key Attributes*. The paper recognises the specific characteristics of FMIs relative to other financial institutions, including that there is often only a sole FMI providing systemically important services in a particular market and hence continuity of service provision is often paramount. Intervention by the relevant authorities, potentially through the appointment of a statutory manager, may therefore be necessary for the resolution of an FMI. Following feedback received during the consultation, CPSS-IOSCO will report on how to incorporate FMI-specific issues into the methodology for assessing compliance with the *Key Attributes*. The issues raised in the consultation paper also have a bearing on proposed intervention powers for Australian regulators of FMIs (see below).

Financial market infrastructures

In April, the CPSS and IOSCO released the *Principles for Financial Market Infrastructures* (PFMIs), a comprehensive set of standards designed to apply to all systemically important payment systems, central counterparties (CCPs), securities settlement systems and trade repositories. The PFMIs, which harmonise and replace three existing sets of standards for FMIs, aim to provide greater consistency in the oversight and regulation of FMIs across jurisdictions. They recognise the critical role of FMIs, and the increasing use of centralised infrastructure, in part in response to the G-20 commitments around central clearing and centralised reporting of OTC derivatives. The PFMIs strengthen existing requirements in a number of areas, including the coverage of credit risk, the management of liquidity risk and governance. They also introduce several new principles, including on segregation and portability of client monies, general business risk and disclosure. Further, the PFMIs include resolution planning requirements, and arrangements for the orderly wind-down or recapitalisation of a failed CCP. Together with the PFMIs, CPSS-IOSCO issued two related consultation documents – an assessment methodology and a disclosure framework for PFMIs – which are due to be finalised later this year.

CPSS and IOSCO members and other relevant authorities are expected to adopt the PFMIs in their legal and regulatory frameworks by end 2012, while FMIs should observe the standards as soon as possible. In accordance with this, and as a CPSS member, the Bank is currently consulting on revisions to its *Financial Stability Standards* for clearing and settlement facilities, to ensure that they align with the PFMIs. The Bank will also apply the PFMIs in its self-assessments of RITS, Australia's real-time gross settlement system, and increase the frequency of these assessments. The PFMIs also affect the Australian Securities and Investments Commission's (ASIC's) supervisory framework. Accordingly, ASIC is also consulting on revisions to its *Regulatory Guide on Clearing and Settlement Facilities*.

OTC derivatives markets

In June, the FSB published a third progress report on jurisdictions' implementation of the G-20 commitments relating to OTC derivatives, namely, that all standardised OTC derivative contracts should be traded on exchanges or electronic platforms, where appropriate, and centrally cleared by end 2012, and that all OTC derivative contracts should be reported to trade repositories. The report noted that jurisdictions with the largest OTC derivatives markets – the EU, Japan and the United States – have made the most progress with their legislative and regulatory programs. Other jurisdictions are generally less advanced in implementing the commitments, although progress has been made by many of them, particularly with respect to central clearing and the use of trade repositories.

As foreshadowed in the previous *Review*, the CFR provided a number of recommendations to the government in March on how best to implement the G-20 commitments in Australia. The government endorsed these recommendations and issued a consultation paper in April proposing a domestic legislative framework for implementing the reforms. Under this proposal, the *Corporations Act 2001* would be amended so that mandatory obligations could be imposed requiring that certain classes of derivatives be cleared by a CCP, reported to a trade repository, or executed on a trading platform. Any mandatory obligation would be imposed via a two-stage process. First, the relevant Minister, with advice from APRA, ASIC and the Bank, would prescribe a class of derivatives as being subject to a given obligation. Second, ASIC would develop rules covering matters such as the parties subject to the obligation and the timing of its introduction. The Bank and APRA would be consulted as part of any decision to issue a mandate. Following the consultation, a Bill setting out amendments to the Act was introduced into Parliament in September. In parallel, the CFR agencies are working on an assessment report on the domestic OTC derivatives market, due to be completed towards the end of the year – similar reports will be undertaken on a regular basis. One purpose of these reports is to assess progress of the Australian market in adopting desired reforms; if progress is insufficient then this could be a factor in determining whether mandatory obligations might be imposed.

To support the G-20 OTC derivatives-related commitments, in July international standard-setting bodies released capital rules and proposed margin requirements to encourage central clearing of OTC derivative contracts by banks and other institutions.

- The BCBS issued interim rules for the capital to be held against bank exposures to CCPs. For derivatives and securities financing transactions that are centrally cleared, the counterparty credit risk for these trades will attract a risk weight of 2 per cent if the CCP is supervised in a manner consistent with the PFMIs (and is thus a 'qualifying' CCP). This risk weight is substantially lower than that applying to counterparty exposures arising out of bilateral transactions, or exposures to 'non-qualifying' CCPs, thereby creating a capital incentive for central clearing through qualified CCPs. The BCBS is to undertake further work on a finalised approach, in collaboration with other standard-setting bodies. APRA recently released proposals for implementing these requirements for Australian ADIs as part of its consultation on counterparty credit risk under Basel III.
- The G-20 commitment that OTC derivative contracts be centrally cleared relates specifically to standardised derivative contracts, since only these are likely to be suitable for central clearing. Non-standardised contracts, which account for a substantial share of the derivatives market, will therefore most likely remain subject to bilateral arrangements. To mitigate some of the risks associated with this segment of the market, and to ensure appropriate incentives to centrally clear trades, the BCBS and IOSCO released for consultation draft margining requirements for non-centrally cleared OTC derivatives. The proposals would require the bilateral exchange of both 'variation' margin and 'initial' margin between all financial institutions, as well as systemically important non-financial institutions. Variation margin provides for the regular exchange of cash between counterparties to meet mark-to-market profits and losses. Initial margin is collateral calibrated to cover, with a high probability, any losses arising should market prices move adversely between the last payment of variation margin and the close-out of exposure to a defaulting counterparty. Variation margin is already typically exchanged for non-centrally cleared trades, but initial margin has been less frequently applied. The BCBS and IOSCO are conducting a quantitative impact study to assess the effect of these proposals, including the likely demand on collateral, and will consider the results when finalising the proposal by end 2012.

In June, IOSCO published *International Standards for Derivatives Market Intermediary Regulation*, which provides international standards for the regulation of market participants in the business of dealing, making a market or intermediating transactions in OTC derivatives ('derivatives market intermediaries' or DMIs). Historically, these entities have, in many cases, not been subject to the same level of regulation as participants in the traditional securities market. The report makes recommendations in several areas, including registration/licensing standards, capital standards or other financial resource requirements for non-prudentially regulated DMIs and business conduct and supervision standards. The recommendations seek to reduce risks to financial stability by helping to manage counterparty risk in OTC derivatives markets. They also aim to protect participants in OTC derivatives markets from unfair, improper or fraudulent practices. The report emphasises the importance of cross-border consistency in the regulation of DMIs given that many operate in multiple jurisdictions.

Assessing implementation of Basel III capital reforms

The BCBS continues to monitor implementation of the Basel capital framework (that is, Basel II, Basel 2.5 and Basel III), to encourage its full, timely and consistent implementation by countries. In a June report to the G-20, the BCBS stated that significant progress had been made, with most of its 27 members having already implemented Basel II and 2.5 (the July 2009 enhancements on market risk and securitisations) and released draft or final rules for the implementation of Basel III in their jurisdictions. However, the BCBS also noted that, based on current plans, some jurisdictions may not implement Basel III according to the agreed time lines. The BCBS will present an updated progress report on Basel III implementation to the G-20 Ministers and Governors in November.

As noted in the previous *Review*, the BCBS is also conducting peer reviews of its members' implementation of all components of the Basel capital framework, to ensure they are consistent with the minimum standards agreed under Basel III. The results of the initial reviews (for the EU, Japan and the United States) are due to be published around the end of September.

Shadow banking

Led by the FSB, work is progressing on strengthening the oversight and regulation of shadow banking systems. The five workstreams noted in the March 2012 *Review* are continuing their work to develop policies to manage the risks posed by: banks' interactions with shadow banking entities; money market funds (MMFs); other shadow banking entities such as finance companies; securitisation; and securities lending and repos. These workstreams are scheduled to provide their policy recommendations by end 2012. IOSCO is leading the workstreams on MMFs and securitisation and released initial reports on these two areas in April and June. The report on MMFs provides a preliminary analysis of the risks that MMFs could pose to financial stability and seeks views on a range of policy options to address those risks, such as imposing capital and liquidity requirements. The report on securitisation includes draft policy recommendations covering risk retention, improvements in transparency and measures to standardise disclosure of securitisation structures. The workstream on securities lending and repos released an interim report in April that provides an overview of these markets and how they are currently regulated. It also discusses how these activities might pose risks to financial stability, for example by contributing to the procyclicality of leverage and interconnectedness (such as through collateral re-use), or possibly sparking a fire sale of collateral assets.

The FSB has also been examining the results of its latest annual monitoring exercise on shadow banking, which was extended this year to cover all of its 24 member jurisdictions. The Bank again contributed information on Australia's relatively small shadow banking system for this exercise, drawing on its own regular monitoring of developments in the sector. In addition to enforcing disclosure, licensing and conduct requirements on shadow banking entities, ASIC also monitors industry trends, with a focus on identifying emerging risks to financial stability. In late March, ASIC released a report on the Australian exchange-traded fund (ETF) market, including details of how the market is regulated. The report concluded that Australia's current regulatory framework is consistent with IOSCO's proposed international principles for the regulation of ETFs, which are due to be finalised soon.

FSB and IOSCO peer reviews

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. As discussed earlier, a peer review on resolution regimes is currently under way. The recommendations of past thematic peer reviews have often led to follow-up activities by the FSB and/or national authorities. For example:

- In response to recommendations from an earlier review of mortgage origination and underwriting practices, the FSB released a report in April, *Principles for Sound Residential Mortgage Underwriting Practices*, which is a principles-based framework to promote sound lending practices. The Bank was represented on the expert team that developed these principles. These principles are already having an effect on national regulatory frameworks: in June, the Canadian banking and insurance regulator issued a guideline that sets out expectations for prudent residential mortgage underwriting, based in part on the FSB principles.
- Following a 2011 review on risk disclosure practices, the FSB recently sponsored the formation of a private sector task force to develop principles for improved disclosures by financial institutions of their risk exposures and risk-management practices. The principles are expected to be published in October. In a related step, the FSB is currently undertaking a thematic review of financial institutions' risk governance.

Earlier this year, IOSCO established a committee, currently chaired by ASIC, to conduct thematic and member country reviews. Similar to the FSB peer review process, the aim is to encourage full and consistent implementation of IOSCO principles and standards across jurisdictions. The first review will cover the implementation of principles related to systemic risk in securities markets.

Other Work of the Council of Financial Regulators (CFR)

Regulation of financial market infrastructures and payments infrastructure

As reported in the previous *Review*, the CFR undertook a public consultation in late 2011 on measures to enhance the regulation of FMIs. Following feedback from industry, the CFR recommended to the government a program of legislative reforms largely in line with its original proposals. The government subsequently released the CFR's recommendations for final consultation in late March 2012. Among its key recommendations the CFR proposed resolution measures for FMIs and powers to ensure adequate regulatory influence over cross-border FMIs.

The resolution measures recognise that the disorderly failure of an FMI could result in financial markets ceasing to operate effectively, severely disrupting the financial system. A key concern of regulators, therefore, is to ensure the continuity of critical services when an FMI is in financial distress, especially given, as noted earlier, there is often only a single FMI providing services in a particular market. If an FMI is unable to recover through its own efforts, regulators may need to intervene to maintain continuity of services while organising a recapitalisation or orderly wind-down of the FMI. The CFR recommendations would give the regulators power to appoint a statutory manager to a distressed FMI. A similar power is available to APRA for ADIs under the *Banking Act 1959*. Under the proposed reforms, the regulators would also have enhanced powers to give directions to, and impose sanctions on, FMIs.

To be able to carry out their oversight responsibilities effectively for overseas FMIs operating in Australia or domestic FMIs that are seeking to outsource their operations, ASIC and the Bank must have sufficient influence over the FMI's activities and risk-management practices. Accordingly, the CFR recommended giving the regulators explicit powers under the Corporations Act to support a proportional and graduated 'location policy' that could require certain elements of a licensed FMI's operations to be located in Australia. To provide further clarity in this area, the CFR issued a paper in July, *Ensuring Appropriate Influence for Australian Regulators over Cross-border Clearing and Settlement Facilities*. This paper sets out a framework within which ASIC and the Bank could impose additional requirements on clearing and settlement facilities with cross-border operations. The framework considers how requirements might be escalated according to the nature and scope of a facility's operations in Australia. ASIC and the Bank are seeking feedback on specific measures within the framework as part of a broader consultation on implementation of the *Principles for Financial Market Infrastructures* discussed earlier.

CFR agencies have continued their work with the Australian Competition and Consumer Commission (ACCC) on the competition aspects of clearing and settlement. In June, the CFR published a consultation paper, *Competition in the Clearing and Settlement of the Australian Cash Equity Market*. The paper takes openness to competition and foreign participation in clearing and settlement services as a starting point. However, it acknowledges that competition can change the operating environment for banks, securities dealers, issuers and investors in ways that could have implications for financial stability and the effective functioning of markets; additional policy measures might therefore be needed. The CFR and the ACCC are currently reviewing feedback from the consultation before advising the government of their conclusions.

In July 2012, as part of the CFR's work on FMI regulation, the Bank amended its Exchange Settlement Account (ESA) policy. Recognising that settlement across central bank accounts and CCP access to central bank liquidity can contribute to financial stability, the new policy clarifies that any Australian-licensed CCP with payment arrangements giving rise to Australian dollar settlements may hold an ESA. Moreover, the policy states that any Australian-licensed CCP of systemic importance in Australia must settle any Australian dollar margin-related, or derivatives-related payments across an ESA in its own name, or that of a related body corporate. The Bank will take into account a number of factors in determining the systemic importance of a CCP, including: the size of the facility in Australia; the availability of substitutes for the facility's services in Australia; the nature and complexity of the products cleared or settled by the facility; and the degree of interconnectedness with other parts of the Australian financial system. Both of the ASX CCPs currently settle Australian dollar obligations arising from their activities via RITS across an ESA held by their parent, ASX Clearing Corporation.

Following the Bank's decision earlier this year to formalise the requirements for reporting significant retail payment system incidents, new reporting standards were released in April. Significant incidents must now be advised to the Bank within one hour, and followed up with a post-incident report. The Bank also intends to gather regular statistics on retail payment system incidents, and will be consulting with the industry on the modalities for doing this.

Financial Sector Assessment Program (FSAP) review of Australia

As noted in the March 2012 *Review*, Australia has this year undergone an IMF FSAP review. This is a follow-up to Australia's first FSAP conducted in 2005/06 and is consistent with a recent commitment of FSB members to undergo an FSAP approximately every five years. The focus of FSAP reviews is to assess the stability of a country's financial sector, the quality of its financial supervisory and crisis management arrangements, and to review progress in addressing recommendations from previous FSAPs. CFR agencies prepared background material for the IMF on aspects of Australia's financial stability and supervisory frameworks. The Bank and APRA published one of these background papers, on the financial stability policy framework, in early September.

Overall, the FSAP found that Australia's financial system was sound and resilient due to several factors: good economic management, prudent and proactive supervision, and effective systemic oversight. Stress testing indicated that the banking sector was likely to withstand even severe macroeconomic shocks. Discussions during the FSAP focused on a number of themes, including issues posed by a concentrated and interconnected banking system, high household debt and elevated house prices, and the banks' use of offshore funding. A combination of low public debt, a flexible exchange rate, positive domestic interest rates and a well-capitalised banking system was seen as providing ample policy space to respond to any stress event. The IMF is in the process of finalising a report containing its detailed assessment and policy recommendations, which is due to be published in late 2012.

Other Domestic Regulatory Developments

Implementation of Basel III capital and liquidity reforms

In late March, APRA released its 'response paper' on feedback received during consultations with the ADI industry on its proposals for implementing the Basel III capital reforms in Australia. While the paper provided detailed further guidance on the application of the new standards, APRA indicated that it does not intend to substantively alter its planned approach from that proposed in its earlier consultation (outlined in the September 2011 *Review*). Australian ADIs will be required to meet the Basel III minimum capital requirements, including regulatory adjustments, in full from 1 January 2013 and the Basel III capital conservation buffer requirement from 1 January 2016. Alongside the response paper, APRA released for consultation draft prudential standards which, together with additional proposals released in August on counterparty credit risk and other limited changes, will give effect to the full implementation of the Basel III capital reforms in Australia. Following industry feedback on these proposals, APRA is expecting to release its final capital standards soon. It is also looking to release a further draft revised liquidity standard in December 2012.

Other prudential standards

As foreshadowed in the previous *Review*, APRA has recently consulted on a draft set of prudential standards for the superannuation industry. These prudential standards would be the first for the superannuation funds regulated by APRA (following the recent passage of legislation giving APRA standards-making powers for this sector) and are aimed at strengthening the regulation of these funds, as well as putting their regulatory framework on a similar footing to ADIs and insurers. The standards cover areas such as: risk management, outsourcing, business continuity management, audit and governance. APRA is currently reviewing submissions to the consultation and intends to finalise the prudential standards by end 2012, with most of them to take effect from July 2013. To support these new prudential standards and implement the transparency and accountability recommendations of the government's Stronger Super reforms, APRA proposed in September substantially expanded data reporting requirements for APRA-regulated superannuation funds, including on investment allocation, costs and returns.

As part of a long-running review which is nearing completion, APRA published final versions of its capital standards for life and general insurers in May. The revised standards aim to increase the loss-absorbing capacity of insurers by improving the risk-sensitivity of the capital framework applying to them. For example, the reforms will require insurers to better account for the risk of incurring multiple or unusually large losses in a year, such as from multiple natural disasters, a pandemic, or higher-than-expected volatility in credit spreads as was experienced internationally during the global financial crisis. The reforms will also continue APRA's practice of aligning capital standards across APRA-regulated industries where appropriate; in particular, they will maintain the consistency of insurers' capital standards with APRA's proposed Basel III capital standards for ADIs. This in turn should help simplify the supervision of conglomerate groups that include banking and insurance entities. APRA also released draft prudential standards covering some remaining capital matters as well as audit, actuarial and risk management issues. The overall framework will come into effect on 1 January 2013.

APRA announced in May that its implementation of a proposed prudential framework for the supervision of financial conglomerates, outlined in an earlier discussion paper, will be deferred to January 2014. The additional time will allow APRA to refine the framework through a consultation on draft prudential standards planned for later in the year, and to ensure consistency with ongoing domestic and international regulatory developments, as well as allowing time for ADIs and insurers to adapt to the new Basel III and insurance capital standards. In a related development, as discussed earlier, the government recently proposed enhanced crisis management powers for APRA, including for the resolution of financial conglomerates.

APRA's new prudential standard for covered bonds took effect from 1 August 2012 and applies to all Australian ADI covered bond programs involving Australian assets. A key requirement of the standard is that ADIs identify on registers the assets transferred to a covered bond special purpose vehicle and those that form part of a cover pool. APRA views this asset identification as a key safeguard to ensure that there is clarity about which assets support depositors and which support covered bondholders.

Credit reporting

In May, the government introduced legislation to amend the *Privacy Act 1988* to, among other things, allow more comprehensive credit reporting. The changes are in response to an earlier Australian Law Reform Commission inquiry into the application of the Act. As discussed in the September 2007 *Review*, credit reporting is the practice of providing information about an individual's creditworthiness to banks and other credit providers through credit reporting agencies (CRAs). The Act governs the information that CRAs are permitted to keep on individuals' credit files and regulates the storage and provision of this information. Currently, an individual's credit file is limited to basic personal and employment details, a record of credit applications made and 'negative' information regarding any defaults, dishonoured cheques, bankruptcy orders or relevant court judgments in the past five years. The proposed changes to the Act would allow CRAs to record additional 'positive' information such as current credit accounts held, available limits, account types and repayment histories. The reforms aim to allow credit providers to build a fuller picture of an individual's financial circumstances when determining their eligibility for credit, thereby enabling more accurate assessments of creditworthiness. The reforms also improve consumer protection under the Act, by making it easier for individuals to dispute and correct any errors on their credit file. The Bill is currently being considered by Parliament.