4. Regulatory Developments

Since March, the economic and financial effects of the COVID-19 pandemic have been the central focus of Australia's financial regulators as well as key overseas bodies. Domestically, the agencies on the Council of Financial Regulators (CFR) met frequently to exchange information, assess developments and coordinate policy actions. As conditions in financial markets have normalised and physical restrictions eased, the focus of the CFR has shifted from the initial policy response to how the financial system can support the economic recovery. Key elements of a successful transition will be the continued supply of credit by financial institutions and careful management of the end of loan repayment deferrals offered by Australian authorised deposit-taking institutions (ADIs). The CFR has also recently resumed its work on other key focus areas, including cyber and climate change risk.

Globally, key bodies such as the G20 and the Financial Stability Board (FSB) continued to focus on the effects of the pandemic on the global economy and financial system. This work has mainly related to exchanging information, including on the design and effectiveness of support measures used by countries and coordinating appropriate policy responses to the pandemic. Global bodies and national authorities had deferred implementing or progressing selected earlier agreed reforms, so as to reduce the burden on financial institutions, allowing them to focus on mitigating the effects of the pandemic. However, work has continued on more pressing reform areas, including encouraging the transition away from the London Inter-Bank Offered Rate (LIBOR) ahead of its cessation at the end of 2021. Work on other reform areas will likely resume or intensify in coming months as conditions further normalise.

Cooperation through the CFR has focused on assessing and mitigating the pandemic's effects, and supporting a return to economic growth

The fast pace of developments since the onset of the pandemic has made it crucial that regulatory agencies communicate effectively on key developments and their own activities. This helps agencies to better tailor and coordinate their responses, as well as to anticipate emerging issues. For Australia's main financial regulatory agencies, this coordination occurs primarily through the CFR – which brings together the agency heads of the Australian Prudential Regulation Authority (APRA), the Australian Securities and Investments Commission (ASIC), the Reserve Bank and the Australian Treasury.

The frequency of CFR meetings at agency head level, and engagement at other levels within the CFR agencies, have increased substantially since March. This has included high frequency meetings at the Deputies level, new ad hoc working groups and increased bilateral cooperation between agencies. The CFR has met with the Treasurer and, in June, met with executives from the Australian Competition and Consumer Commission (ACCC), the Australian Taxation Office (ATO) and the Australian

Transaction Reports and Analysis Centre (AUSTRAC) – with these meetings also focused primarily on pandemic-related issues.

Early in 2020 the CFR's focus was on rapidly unfolding events, including the substantial disruption that had occurred in financial markets, the effects of shutdowns on households, businesses and financial institutions, and the design and implementation of public and private sector support initiatives. Its public statements during this time emphasised the strength of the financial system and the coordinated actions being taken to deal with the crisis. Members highlighted their willingness to provide relief or waivers from regulatory requirements where appropriate and to adjust the timing of regulatory initiatives to allow financial institutions to focus on their businesses and assisting customers.

After this initial phase, the CFR's focus shifted to monitoring potential pressure points in the financial system. This included, for instance, the impact on markets and superannuation funds' liquidity of the early withdrawal of superannuation. In the event, superannuation funds have managed these withdrawals in an orderly way, with little impact on markets. The CFR also discussed the functioning of capital markets and the capacity of Australian firms to raise funds. Members concluded that maintaining open markets and robust disclosure arrangements had contributed to confidence in capital markets in Australia. The CFR also discussed the effects of the pandemic on the commercial property market and risks arising from legal uncertainty facing providers of business interruption insurance. The latter is currently the subject of a test case in the courts being run by the industry.

Financial institutions have played an important role in cushioning the effects of the pandemic. In recent months, CFR members have discussed factors likely to affect ADIs' capital buffers, including reduced credit quality of borrowers (and the impact this has on risk weights), loan losses and dividend policies. In its June quarterly statement, the CFR highlighted ADIs' large capital buffers and encouraged institutions to be prepared to make use of those buffers in order to continue supporting businesses and households through the supply of credit. CFR members have also discussed APRA's stress testing analysis, which provides insights into the possible effects of a range of economic scenarios on ADIs' capital. This analysis will assist APRA in considering its supervisory approach in the period ahead.

The CFR has increasingly focused on the period of transition as more physical restrictions are eased and support measures adjusted. Loan repayment deferrals are a key component of this, given their importance to both borrowers and financial institutions. As noted in 'Chapter 2: Household and Business Finances in Australia', deferrals started expiring in late September with most due to expire before the end of October, but lenders have agreed to extend them for some borrowers and APRA has extended its concessionary capital treatment of those loans. The CFR is continuing to closely monitor this transition and the implications for households, businesses and financial institutions.

While the pandemic has been the main focus of the CFR this year, the CFR has also addressed several other critical issues. In September, the CFR met with the Department of Home Affairs to discuss the government's strategy for protecting critical infrastructure and how this will interact with financial sector regulation. It also discussed APRA's Cyber Security Strategy, which includes additional areas of collaboration between CFR agencies on managing and responding to cyber risk. The CFR has also continued its work on reform of the regulatory framework for financial market infrastructures (FMIs). The proposed reforms seek to strengthen the regulators' powers, streamline decision-making authority and introduce a crisis

management regime to resolve a distressed clearing and settlement facility. Following a public consultation period, the CFR has provided proposals for enhancements to the regulatory regime for FMIs to the Australian Government.

In September, the CFR discussed the annual stocktake undertaken by its Climate Change Working Group. This highlighted the range of activities undertaken by CFR agencies to understand climate risks and to promote understanding and management of those risks by regulated financial entities. A key focus in the period ahead will be the climate change financial risk vulnerability assessment announced by APRA in February. The assessment will involve ADIs estimating the potential physical impacts of a changing climate on their balance sheets, as well as the risks that may arise from the global transition to a low-carbon economy. (The potential effects of climate change on financial stability are discussed further below.) This work is being coordinated by APRA in conjunction with the CFR. The CFR also maintains an interest in international financial risk and policy developments and has recently enhanced its coordination arrangements to allow more effective representation and input by Australian agencies on international policy issues.

Cooperation has extended to other government agencies in Australia and New Zealand

CFR members engage with other regulators with an interest in the financial sector, both domestically and in particular in New Zealand. Since 2017, the CFR agencies have been meeting annually with the agency heads of the ACCC, the ATO and AUSTRAC. The June 2020 meeting covered the responses of regulatory agencies to the pandemic, the role of financial sector competition in supporting economic recovery, and the operational resilience of regulated entities. Discussions also highlighted the importance of robust consumer protection mechanisms during the pandemic, particularly in light of increased susceptibility to scams, false and misleading advertising and inappropriate financial advice. Participants discussed other areas for further cooperation and joint work, including effective systems for establishing and verifying digital identity.

The CFR recently formed a working group with the ACCC and the Australian Registrars' National Electronic Conveyancing Council (which comprises the state and territory registrars) to review elements of the regulatory framework for e-conveyancing platforms. The review reflects the shift towards e-conveyancing, with a number of states now mandating its use. It highlights the importance of having an appropriate regulatory framework that promotes a safe, competitive and efficient market for the conduct of property transactions, including strong consumer protections.

As with the CFR, the frequency of meetings of the Trans-Tasman Council on Banking Supervision also increased during the pandemic. This grouping includes the CFR agencies, the Financial Markets Authority of New Zealand, the Reserve Bank of New Zealand and the New Zealand Treasury. The focus of discussions has shifted from longer-term issues to issues of common interest during the pandemic, including stress testing, household balance sheets and managing consumer hardship.

International focus on assessing COVID-19 related vulnerabilities continues

There has been significant work at the global level to assess cross-border vulnerabilities, coordinate policy responses and exchange information. The FSB has been a key part of this global effort, given its mandate to assess vulnerabilities in the global financial system.

In the initial stages of the crisis, the FSB focused on the resilience of four key nodes of the global financial system. Weaknesses in these nodes could disrupt the provision of financial services and lead to financial instability. The four critical nodes are the ability: of the financial system to finance the real economy; of market intermediaries to obtain US dollar funding; of financial intermediaries to meet liquidity needs without forced assets sales; and of market participants, in particular central counterparties (CCPs), to effectively manage counterparty risks. The work broadly found that the impact of COVID-19 on new and pre-existing vulnerabilities, including elevated asset price levels, and greater interconnectedness between banks and non-banks, was cause for concern. The FSB also suggested that authorities needed to prepare for more severe shocks. The FSB continues to monitor developments in these four critical areas. As a member of the FSB, and in particular its committee assessing vulnerabilities, the Bank has been contributing to these recent assessments. As a member of the International Organization of Securities Commissions (IOSCO), ASIC has been contributing to the FSB's assessments around liquidity and CCP risk. (The FSB's work in these areas benefited from input from IOSCO.)

In a July 2020 report to the G20, the FSB outlined its more recent focus on three new areas of concern.

- Ratings downgrades to financial and non-financial firms could have procyclical effects and magnify downside risks in the current environment. The COVID-19 pandemic has seen both deteriorating credit quality and rising credit demand in the period after the peak market turmoil in March. This combination makes credit ratings downgrades highly likely. Firms facing ratings downgrades face higher funding costs, and downgrades could lead to forced selling of debt, especially the debt of firms downgraded from investment grade to non-investment grades.
- The acute liquidity stress from the initial COVID-19 outbreaks was characterised by low trading volumes and price dislocations. Due to large-scale policy actions, these initial stresses have largely subsided. However, the global financial system remains vulnerable to another round of liquidity strain.
- The pandemic has resulted in the largest contraction in global economic activity in decades. This will drive a substantial deterioration in the solvency of non-financial firms, particularly in industries where customers ordinarily congregate in large numbers and those affected by restrictions on movement (such as airlines and international tourism-reliant businesses). This in turn will likely create losses for banks and other lenders. The Bank participates in the working group conducting this work.

The standard-setting bodies and the FSB are also focusing on other potential areas of stress.

- The Basel Committee on Banking Supervision (BCBS) continues to monitor the impact of the pandemic on banks. It has urged banks and supervisors to remain vigilant to the risks and vulnerabilities stemming from the pandemic to ensure that the global banking system remains financially and operationally resilient. It has also responded directly to the crisis by implementing certain measures (such as clarifying that loan repayment deferrals do not count as defaults) and it has encouraged banks to use capital buffers to absorb losses while still maintaining credit (see below).
- The FSB and IOSCO are examining potential sources of broader stress in the non-bank sector, with investment fund vulnerabilities – such as leverage and liquidity mismatches – being particular focus areas given the volatility seen in this sector during March

(see 'Box A: Risks from Investment Funds and the COVID-19 Pandemic'). As a member of IOSCO, ASIC is contributing to this work.

Relatedly, ASIC is on an FSB working group mapping the interconnections between the banking and non-banking sectors. This work aims to identify vulnerabilities and potential routes of contagion. This is part of ongoing work by the FSB to improve the resiliency of the non-bank financial sector.

- The Committee on Payments and Market Infrastructures (CPMI) and IOSCO have been discussing international policy responses to COVID-19 for FMIs, especially CCPs. The CPMI and the CPMI-IOSCO Steering Group have been meeting more regularly to discuss matters including business continuity, operational resilience and credit and liquidity risk management by FMIs, as well as to consider a work plan to focus on some of the short-term risks and policy implications, while seeking to reduce lower-priority demands on industry stakeholders. In related work, during the market stress and volatility caused by the crisis, IOSCO was examining margin and other risk management aspects of central clearing for financial derivatives and other securities.

As in Australia, financial regulators and standard-setting bodies globally have taken steps to support the financial system and wider economy

Complementing the extensive global monetary and fiscal stimulus in response to the pandemic, prudential authorities have also taken a range of actions to enhance bank resilience and to support the economy. An early measure involved some authorities lowering the countercyclical capital buffer (CCyB) requirement where the CCyB had previously applied with a non-zero rate, thereby releasing capital to support the flow of credit to the economy.[1] Many prudential regulators, including in jurisdictions – such as Australia – where the CCyB could not be lowered as it was already at zero, also released guidance stating that capital buffers are designed to be drawn on during times of stress – such as now – in order to maintain lending to the real economy. Some authorities have applied comprehensive restrictions on banks' discretionary distributions such as dividends, share buybacks and executive bonuses. These issues are discussed further in 'Box C: The Use of Banks' Capital Buffers'. Prudential authorities have also sought to mitigate some of the procyclical effects of the pandemic-induced downturn by issuing guidance on certain accounting standards, particularly the treatment of expected credit losses, definition of default and calculation of regulatory capital.

Many jurisdictions have also introduced deferrals or holidays on loan repayments, which allow a borrower to stop making repayments on their loan for an agreed period of time. During the holiday, interest generally continues to accrue, but the borrower's credit rating is not affected. The objective is to prevent large-scale defaults and provide cash flow relief for households and businesses until more normal conditions are restored. In many cases regulators have clarified the prudential treatment of loans which are currently covered under the deferrals, typically concerning whether loans are classified as non-performing.

Securities markets regulators have also worked to ensure financial markets remained resilient and that any disruptions were minimised. Domestically, ASIC has also stressed the importance of correctly valuing managed fund assets given increased economic and financial uncertainties due to the COVID-19 pandemic. Valuations of managed fund assets, including illiquid assets, should be regular, robust and reasonable notwithstanding the difficulties that arose due to the pandemic. ASIC has provided some relief for managed funds to assist with

withdrawals by members that are facing financial hardship. It has also been engaging with ASX about managing the trading and settlement load at ASX and to facilitate capital raising relief. ASIC has provided relief to companies about holding annual general meetings and some aspects of financial reporting by companies. In addition, it issued additional guidance about responsible lending guidance as well about its expectations of financial firms when dealing with hardship matters and consumer complaints.

In taking these measures, global and national bodies have generally worked within the flexibility already built into international standards (such as those applying to capital buffers). Indeed, in April, G20 countries agreed to act consistently with international standards and not roll back reforms or compromise the underlying objectives of existing global standards. Nonetheless, the FSB in cooperation with the standard-setting bodies, has work underway to monitor the consistency of COVID-19 related policy measures with international standards, especially those agreed and implemented in response to the global financial crisis. A further review of policy measures will be carried out ahead of the November 2020 G20 Leaders' Summit. G20 members also agreed to coordinate on the future timely unwinding of the temporary measures taken in response to the pandemic.

Selected other regulatory developments

As noted in the April 2020 *Review*, global standard-setting bodies and national regulators had delayed policy implementation timelines for selected global reforms and/or given banks and other financial entities waivers or regulatory relief. This was to reduce the operational burden on banks and financial market participants as they respond to the pandemic. However, work has continued in selected key areas, including the following.

LIBOR transition

The UK Financial Conduct Authority, the Bank of England and the Working Group on Sterling Risk-Free Reference Rates have reiterated that, despite the disruption caused by COVID-19, the earlier stated timeline of no longer sustaining LIBOR beyond the end of 2021 remains in place. Given this timeline, the G20 and the FSB have stressed in recent statements the importance of entities transitioning away from LIBOR to alternative reference rates. The G20 has stated that 'urgent work' is needed by the private sector, supported by the public sector, to manage this transition, given the risks that may arise if parties are insufficiently prepared for the scheduled discontinuation of widely used LIBOR benchmarks. The G20 noted that the impact of COVID-19 has highlighted that the underlying markets that LIBOR seeks to measure are no longer sufficiently active.

A recent report by the FSB and the BCBS assessed the readiness of market participants and authorities regarding the transition away from LIBOR. It found that, while most FSB jurisdictions have a strategy in place to address the transition, only half of the surveyed non-FSB jurisdictions do. Authorities in jurisdictions which commonly reference LIBOR, such as the euro area, Japan, Switzerland, the United Kingdom and the United States, are relatively more advanced in facilitating and monitoring benchmark transition, although significant challenges remain, including the need to develop products referencing alternative reference rates and increasing liquidity in these products. The report proposed recommendations for addressing these and other challenges.

The Bank, ASIC and APRA are engaged in the international official sector's work on LIBOR transition and benchmark reform more

generally. In Australia, APRA and ASIC continue to monitor progress on LIBOR transition by supervised entities and other relevant stakeholders and engaging to ensure that appropriate progress is being made. Including robust fallback provisions in contracts is an important step towards an orderly transition away from LIBOR. Accordingly, Australian financial and non-financial firms are expected to adhere to the forthcoming International Swaps and Derivatives Association (ISDA) IBOR Fallback Protocol. As well as covering LIBOR, the protocol covers the Australian credit-based benchmark, the bank bill swap rate (BBSW). While BBSW remains a robust benchmark, the inclusion of robust fallbacks in contracts is an important contingency. Accordingly, once the ISDA IBOR Fallback Protocol is published, the Bank will be requiring newly issued floating rate notes that reference BBSW to include the relevant ISDA fallback provisions in order to be eligible collateral in the Bank's market operations. The implementation of this requirement will be determined with input from industry.

Stablecoins

As discussed in recent *Reviews*, global and national bodies have been assessing the implications of 'stablecoins', which are crypto-assets designed to maintain a stable value relative to another asset, typically a unit of currency or a commodity. While the risks associated with stablecoins are currently limited by the small scale of existing arrangements, they may pose financial stability, consumer and other risks if they became widely adopted, particularly across jurisdictions. In April, the FSB issued for consultation several recommendations to address challenges raised by 'global stablecoin' (GSC) arrangements. The recommendations call on relevant authorities to, where necessary, clarify regulatory powers and address potential gaps in their domestic frameworks to adequately address the risks posed by GSCs. They also stress the importance of regulatory responses being technology neutral and proportionate to the risks, and incorporating appropriate cross-border cooperation and information-sharing arrangements that account for the global reach of stablecoin arrangements. The report also highlighted key international financial regulatory standards that could apply to GSCs, including banking and anti-money-laundering standards. The final recommendations, taking on board feedback from the consultation, will be published soon.

Climate change

There is ongoing work to assess the implications of climate change for the financial system. In April 2020, IOSCO published a report on sustainability and climate change which found that many issuers and asset managers operating cross border may be subject to different regulatory regimes or participate in multiple regional or international third-party initiatives. This wide variety of regulatory regimes and initiatives, often with inconsistent objectives and requirements, may prevent stakeholders from fully understanding the risks and opportunities that sustainable business activities entail. One of IOSCO's objectives is to improve the quality of climate-related disclosures. Also in April, the BCBS issued a stocktake report on the regulatory and supervisory initiatives on climate-related financial risks being undertaken by BCBS member and observer jurisdictions. These included the measurement of climate-related financial risks and raising awareness with banks and external stakeholders. In July, the FSB also published a stocktake report which drew on the results of a survey of 24 members, the Network for Greening the Financial System (NGFS, see below) and international organisations, as well as information from a workshop with the private sector. While the BCBS stocktake examined how regulators and banks account for, and manage, climate-related financial risks, the focus of the

FSB stocktake was more on how authorities are including climate-related risks in their financial stability monitoring. Three-quarters of FSB survey respondents consider, or are planning to consider, climate-related risks as part of their financial stability monitoring, with most focusing on the implications for asset prices and credit quality. The implications of climate change for underwriting, legal, liability and operational risks are also being considered by some authorities. A key challenge is quantifying climate-related risks, which is hampered by a lack of consistent data on financial exposures to climate risks and difficulties translating climate change outcomes into changes in those exposures.

The NGFS is a group of supervisors and central banks (including the Bank), which aims to contribute to the development of environmental and climate risk management in the financial sector and to support the transition to a sustainable economy. In June, the NGFS published a set of climate scenarios for climate risks assessment, and a report on the potential impact of climate change on monetary policy. The scenarios have been developed to provide a common starting point for analysing climate risks. The three scenarios are classified as orderly, disorderly and finally a 'hot house world' scenario which has significant global warming. Accompanying the climate scenarios is a guide which provides practical advice for central banks and supervisors on using scenario analysis to assess these risks to the economy and financial system. The report on monetary policy describes how climate change affects key macroeconomic variables and the effects on monetary policy transmission. It also suggests that climate change could obscure the assessment of correct monetary policy settings. To address these risks, the report recommends that central banks strengthen their analytical toolkits and enhance their communication strategies to help accustom households, firms, governments and financial market participants to the risks of climate change for the economy and the financial system.

In May 2020, the NGFS published a guide for supervisors which sets out five recommendations to integrate climate-related and environmental risks into their work. These include to:

- determine how climate-related and environmental risks transmit to the economies and financial sectors in their jurisdictions and identify how these risks affect supervised entities
- develop a clear strategy, establish an internal organisation and allocate adequate resources to address climate-related and environmental risks
- identify the exposures of entities that are vulnerable to climate-related and environmental risks and assess the potential losses should these risks materialise
- set supervisory expectations to create transparency for financial institutions in relation to the supervisors' understanding of a prudent approach to climate-related and environmental risks
- ensure adequate management of climate-related and environmental risks by entities and take mitigating action where appropriate.

The NGFS has also released a report on financial institutions' experiences with 'green', 'non-green' and 'brown' financial assets.[2] This noted positive trends among financial institutions to better account for climate-related risks but also that there are some challenges in the classification of green assets, with definitions differing by jurisdiction. In September the NGFS released a report on environmental risk analysis (ERA) in the financial services industry. The report makes a number of recommendations to help mainstream ERA within financial services

including enhancing awareness and developing a taxonomy of economic activities. ✠

Endnotes

[1] For more detail on the countercyclical capital buffer, and its use during the COVID-19 pandemic, see Stojkov K (2020), 'Different Approaches to Implementing the Countercyclical Capital Buffer', Reserve Bank of Australia *Bulletin*, September.

[2] 'Green' and 'brown' assets are classified as such by their impact on the environment. Green assets are seen as having less environmental impact and brown assets more. However, the report notes significant definitional challenges.