4. Developments in the Financial System Architecture

Reports to the G20 Leaders' Summit in early September highlighted that international financial regulatory reform work had advanced substantially but was not yet complete. The Financial Stability Board (FSB), the main body coordinating these reform efforts, considered that global policy development was generally on track with agreed time frames, but that some jurisdictions were facing difficulties in meeting implementation objectives and time lines. Accordingly, international regulatory efforts are increasingly focused on implementing reforms across a range of areas, including: addressing the 'too big to fail' problem arising from systemically important financial institutions (SIFIs); reducing the risks posed by the shadow banking system; limiting the scope for contagion arising from over-the-counter (OTC) derivatives markets; and strengthening prudential regulatory standards through the Basel III banking reforms.[1]

In Australia, recent implementation actions across these reform areas include steps taken by the Australian Prudential Regulation Authority (APRA), the Australian Securities and Investments Commission (ASIC) and the Reserve Bank around OTC derivatives market reforms relating to trade repositories and central clearing. APRA has also progressed further on Basel III reforms, including issuing a revised draft liquidity standard to implement key elements of the Basel III liquidity framework in Australia.

1 For further details, see Schwartz C (2013), 'G20 Financial Regulatory Reforms and Australia', RBA *Bulletin*, September, pp 77–85.

International Regulatory Developments and Australia

Systemically important financial institutions

The FSB's policy framework to reduce the probability and impact of SIFIs failing has continued to be a focus of international regulatory reform efforts. As discussed in previous *Reviews*, key elements of the framework include additional loss absorbency requirements for SIFIs, more intensive supervision and enhanced powers to resolve them if they should fail. Implementation of policies in these areas, as well as their refinement, has progressed in recent months.

In its report to the G20 Leaders, however, the FSB identified cross-border crisis management preparation as an area where implementation is not making adequate progress. This finding reflected a peer review on resolution regimes, released in April, which concluded that despite reforms undertaken to date, implementation of the FSB's *Key Attributes of Effective Resolution Regimes for Financial Institutions* (the *Key Attributes*) – the new standard on resolution arrangements – is still at an early stage. The report considered that legislative action is necessary in some FSB jurisdictions to fully align resolution regimes with the *Key Attributes*. In addition to cross-border crisis management, areas noted for particular attention included providing authorities with powers to: write down the liabilities of a failing institution or convert them to equity ('bail-in'); impose a temporary stay on the exercise of financial contracts; resolve the parent company or affiliates of a failed institution; and

resolve non-bank institutions that could be systemic upon failure, such as central counterparties (CCPs) and other financial market infrastructures (FMIs). Legislative amendments are also necessary in many countries to enhance cross-border cooperation during resolution, especially to allow for the effective sharing of confidential information.

To assist authorities in implementing the *Key Attributes* in these and other areas, the FSB is currently consulting on:

- further guidance as to how the *Key Attributes* can be applied to FMIs (such as CCPs, central securities depositories and securities settlement systems), insurers and firms that hold client assets
- an assessment methodology to assist national authorities and international organisations to determine compliance with the *Key Attributes* (this will enable the *Key Attributes* to be used, *inter alia*, in Financial Sector Assessment Program reviews by the International Monetary Fund and World Bank)
- principles for sharing confidential information across borders for the purpose of resolving internationally active banks.

These steps will complement finalised guidance, released by the FSB in July, on recovery and resolution planning. The guidance, which incorporates feedback from an earlier consultation, aims to help authorities and firms implement the recovery and resolution planning requirements in the *Key Attributes*. Guidance was issued in three areas: developing effective resolution strategies; identifying critical functions and critical shared services; and designing recovery triggers and stress scenarios. The FSB's work on resolution has been supported by input from standard-setting bodies to develop sector-specific resolution guidance. This input is continuing, especially by the Committee on Payment and Settlement Systems (CPSS) and the International Organization of Securities Commissions (IOSCO) in the area of formulating standards for FMI resolution regimes.

At their meeting in September, the G20 Leaders announced that the FSB, in consultation with standard-setting bodies, will, by the end of 2014, assess and develop proposals on the adequacy of global SIFIs' (G-SIFIs') 'gone concern loss absorbing capacity' (GLAC) in resolution. Depending on its group structure and the nature of its cross-border operations in multiple countries, the resolution of a G-SIFI may entail regulatory action at the top of the group and/or on multiple entities in different jurisdictions within the group. Given this, the FSB will develop proposals on the nature, amount, location within the group structure, and possible disclosure of GLAC. This measure is intended to increase the amount of loss absorbency available during a recapitalisation and also to promote market confidence in the effectiveness of authorities' resolution strategies.

Work on the assessment and designation of SIFIs has continued in recent months, in particular in the area of G-SIFIs. In July, the Basel Committee on Banking Supervision (BCBS) released an updated methodology for identifying global systemically important banks (G-SIBs), which adjusted the framework for technical issues raised during the initial designations of G-SIBs. The BCBS is also bringing forward by one year (to November 2013) its disclosure of specific quantitative elements of the framework, which will allow banks to calculate their scores and see their positions within the capital surcharge 'buckets' prior to the higher loss absorbency requirements coming into effect from 2016. This provides banks with additional information should they seek to reduce their global 'systemicness' (which is a goal of the G-SIFI framework). Also, starting from 2014, banks which are identified as the 75 largest global banks, as well as banks that have been designated as a G-SIB in the previous year, will need to make publicly available the 12 indicators used in the assessment methodology. This latter disclosure requirement will be relevant for the four large Australian banks as they are among the 75 largest global banks.

In July, the International Association of Insurance Supervisors (IAIS) published its methodology for identifying global systemically important insurers (G-SIIs) and, in the same month, the FSB, in consultation with the IAIS and national authorities, published an initial list of nine G-SIIs using this methodology. As with the overall G-SIFI list, which currently includes 28 G-SIBs, the list of G-SIIs does not contain any Australian-owned institutions. The G-SII list will be updated in November each year, starting from 2014. G-SIIs will be subject to policy measures similar to those applying to other G-SIFIs – that is, effective resolution and recovery planning requirements, enhanced group-wide supervision and higher loss absorbency requirements. In the absence of a global capital standard for insurers, the IAIS will initially develop a simple capital 'backstop' for G-SIIs, to be presented to the G20 Leaders in 2014. Separately, the FSB expects to issue for consultation assessment methodologies for identifying non-bank non-insurance G-SIFIs by the end of the year.

In Australia, as discussed in previous *Reviews*, resolution regimes have been subject to ongoing reform in recent years, partly in response to the *Key Attributes*. The FSB's peer review of resolution regimes found that Australia's resolution arrangements for authorised deposit-taking institutions (ADIs) and insurers were generally consistent with international best practice, and compared well to many other jurisdictions. The peer review finding on FMI resolution arrangements, however, revealed that considerable work is required – as in many other jurisdictions. The agencies on the Council of Financial Regulators (CFR) are currently working on further refinements to the resolution regimes for prudentially regulated entities and for FMIs (discussed further below), taking into account the findings of the peer review and the additional guidance provided by the FSB and the standard-setting bodies.

Following the release in late 2012 of the BCBS' framework for domestic systemically important banks (D-SIBs), APRA is developing a methodology for D-SIBs in Australia, which is expected to be released publicly in the coming months. D-SIB frameworks are also being introduced in other countries. For example, in March the Canadian prudential regulator designated the six largest Canadian banks as being domestically systemic. In addition to continued supervisory intensity, these Canadian banks will be subject to enhanced disclosure requirements and a 1 per cent risk-weighted capital surcharge by 2016.

Shadow banking

The FSB presented a package of policy recommendations to the G20 Leaders' Summit in early September, detailing measures to address the risks posed by shadow banking – which the FSB defines as credit intermediation involving entities and activities outside the regular banking system. The recommendations are largely unchanged from preliminary proposals detailed in the March 2013 *Review*, comprising: (a) measures to reduce the risks posed by banks' interactions with shadow banking entities; (b) common standards for the regulation of money market funds (MMFs); (c) a policy framework for shadow banking entities other than MMFs; (d) risk retention and enhanced disclosure requirements for securitisation products; and (e) policies relating to securities lending and repurchase agreements (repos). Overall, the recommendations seek to reduce the systemic risks arising in these five areas that were apparent during the crisis, namely maturity/liquidity transformation, imperfect credit risk transfer and leverage. In addition, the FSB is continuing to conduct annual data monitoring exercises, to assess global trends and broader risks emanating from shadow banking; its next global report is due to be released in November.

While the recommendations relating to MMFs, other shadow banking entities and securitisation have largely been finalised, policy development is continuing in the remaining two areas.

- The BCBS is working on proposals to ensure that all activities of banks, including their interactions with the shadow banking system, are captured within the scope of consolidated (i.e. group-wide)

supervision and regulatory reporting. This work is expected to be completed in 2014 as are proposals for risk-sensitive capital requirements for banks' equity investments in funds (which were issued for consultation in July). Also, as discussed below, the BCBS will finalise by the end of 2013 its proposed supervisory framework for banks' large exposures to single counterparties (including to shadow banking entities).

- In August, the FSB released proposals to improve regulatory reporting and market transparency requirements relating to securities lending and repos. In addition, the FSB is proposing:
  - a framework of numerical collateral haircut floors that will apply (a) to transactions that are not centrally cleared; and (b) where entities not subject to prudential capital and liquidity regulation receive securities financing from regulated financial intermediaries. The proposed minimum haircuts would not apply to government securities
  - minimum qualitative standards for methodologies used by all market participants to calculate collateral haircuts.

  The proposal for haircut floors is based partly on the results of the first stage of a quantitative impact study (QIS) which included a group of large financial institutions providing detailed historical data on haircut levels. The FSB will conduct the second stage of the QIS later in 2013, which will assess the effectiveness and impact of the proposed framework more comprehensively. The recommendations on haircut floors and minimum standards are expected to be finalised by mid 2014.

As the bulk of the policy development phase of the shadow banking recommendations is nearing completion, the FSB and the standard-setting bodies are now focusing more on reviewing implementation, to ensure a degree of consistency in the adoption of the recommendations. In 2014, IOSCO will commence peer reviews of national implementation of its recommendations relating to MMFs and securitisation. And as part of its policy framework for the oversight of shadow banking entities other than MMFs, the FSB will develop a process for information sharing by March 2014. This would involve national regulators detailing the entities or entity types they have identified as being shadow banks, and the measures that they may have chosen from the FSB's policy 'toolkit' to address the risks, if any, they pose. Information gathered this way will allow the FSB to start a review program for assessing national implementation of the framework by 2015.

In Australia, non-prudentially regulated financial institutions, which include entities commonly viewed as shadow banks, account for a relatively small and declining share of financial system assets. Nonetheless, the authorities monitor developments in this sector on an ongoing basis as well as taking regulatory actions. An example is the regulatory response to the failure of a number of small finance companies in recent years that were issuing retail debentures. In April, APRA released proposals to restrict registered financial corporations (which include finance companies and money market corporations) from issuing retail debentures with maturities of less than 31 days and from using words such as 'deposit' and 'at-call' to market their products to retail investors. APRA's proposals re-emphasise the distinction between the regulatory framework for these entities, which are not prudentially regulated, and the more intensive supervisory regime applicable to ADIs. These proposals complement those released by ASIC earlier in the year, which included possible capital and liquidity requirements for retail debenture issuers.

OTC derivatives reform

In September, the FSB updated the G20 Leaders on progress on OTC derivatives reform, drawing in part on its latest progress report on national implementation of these reforms. In the report, the FSB noted that while most member jurisdictions are making some progress towards adopting reforms that would fulfil

the G20 commitments, scope remained for increases in trade reporting, central clearing, and exchange and electronic platform trading in global OTC derivatives markets. To ensure that the G20 commitments are fully met the FSB reiterated that necessary reforms to regulatory frameworks should be made 'without delay'.

In August, a group coordinated by the Bank for International Settlements released its assessment of the potential global macroeconomic impact of OTC derivatives reforms. The report compared the expected path of economic growth with and without the reforms and concluded that they would yield a net positive benefit in the long run. The costs of the reforms arising from higher capital and collateral requirements were estimated to be more than offset by the benefits flowing from a lower occurrence of financial crises.

The cross-border reach of some jurisdictions' OTC derivatives regulation has continued to be a concern for several countries, including Australia. In August, a group of securities market regulators (including ASIC) announced a number of understandings on ways to resolve remaining cross-border conflicts, inconsistencies, gaps and duplicative requirements. Most of the focus has been on the cross-border reach of US and EU rules, as foreign counterparties dealing with US and EU entities will be affected by those rules. Authorities in these and other jurisdictions are working on an approach – endorsed by the G20 – whereby regulators would be able to defer to each other when it is justified by the quality of their respective regulations and enforcement regimes. Under this approach, for example, a foreign counterparty to a transaction with a foreign branch of a US entity would comply with its home regime where this was declared to be equivalent to that in the United States. A challenge arises in assessments of regulatory equivalence if one jurisdiction has a principles-based regime, such as Australia, while another imposes more detailed rules. The European Securities and Markets Authority (ESMA) recently completed an assessment of the equivalence of Australian regulation of CCPs. Since ESMA's rules are more detailed than those in Australia, the Reserve Bank issued supplementary interpretative guidance to assist in demonstrating equivalence.

In Australia, progress has been made over the last six months to further implement the G20 commitments on OTC derivatives reform.

- In July, APRA, ASIC and the Reserve Bank published a report on the Australian OTC derivatives market. The report is the second assessment prepared by the regulators on the need for regulatory intervention in the domestic OTC derivatives market (the first was released in October 2012). The report recommends the government consider a central clearing mandate for interest rate derivatives denominated in US dollars, euro, British pounds and Japanese yen, primarily on international consistency grounds. Initially, only dealers with significant cross-border activity in these products would be subject to the proposed mandate. The report also noted that the regulators will continue monitoring Australian banks' progress in implementing appropriate clearing arrangements for Australian dollar-denominated interest rate derivatives, before recommending mandatory central clearing.
- Also in July, ASIC finalised rules requiring the reporting of OTC derivatives to trade repositories. In developing these rules, ASIC sought to ensure broad consistency with requirements in other jurisdictions. Recognising the cross-border nature of many derivative transactions, ASIC has established a regime of alternative reporting under which entities that are subject to substantially equivalent overseas reporting regimes may report according to those regimes. The requirements will be introduced initially for major financial institutions (which are required to start reporting in October 2013) before being expanded to other institutions. At the same time, ASIC finalised a licensing regime for trade repositories. This licensing regime is based on principles developed by the CPSS and IOSCO,

so as to ensure consistency with overseas frameworks. This regime will enable Australian licensed trade repositories to more readily seek recognition or licensing overseas, while also facilitating the licensing of overseas trade repositories in Australia.

In parallel with these regulatory developments, Australian financial market participants have been increasing their use of CCPs (see 'The Australian Financial System' chapter for further discussion). This trend, which is expected to continue, should yield benefits in terms of reduced contagion risks arising from the interconnections between financial institutions.

The CPSS and IOSCO released a report in August setting out a framework to determine the scope of regulators' access to data in trade repositories. The framework maps the scope of data access to individual regulators' functions and establishes safeguards to ensure appropriate data confidentiality. Also, the FSB has launched a feasibility study on how information from trade repositories can be aggregated, to provide a comprehensive and accurate view of the global OTC derivatives market. The FSB expects to complete the study in 2014.

In addition to promoting greater use of centralised infrastructure, the G20 has committed to developing international standards for the margining of OTC derivatives that are not centrally cleared. Margin requirements, in combination with higher capital requirements set by the BCBS for non-centrally cleared exposures, are expected to create an incentive for banks to centrally clear OTC derivatives. Following a second round of consultation, the BCBS and IOSCO published the final framework in September. In response to concerns about the increase in demand for collateral that would arise from the requirements and the potential implications for market functioning, physically settled foreign exchange forwards and swaps will be exempt from initial margin requirements. For consistency, the foreign exchange component of cross-currency swaps will also be excluded from initial margin calculations. This is important in the Australian context, given the widespread use of cross-currency swaps by banks and large non-financial corporations to hedge the currency risk associated with their offshore wholesale funding. Had the regime failed to treat cross-currency swaps and physically settled foreign exchange instruments consistently, firms could have faced adverse incentives. In particular, high margin requirements could have encouraged firms either to leave their positions unhedged, or to use less effective and more complex hedging strategies.[2]

The BCBS is currently consulting on an updated methodology for assessing the counterparty credit risk arising from banks' capital exposures to 'qualifying' CCPs. APRA has implemented BCBS requirements applying to such exposures and will consider the implications of the updated methodology once it is finalised. In April the regulators confirmed that APRA considers ASX Clear and ASX Clear (Futures) – the only Australian-licensed domestic CCPs – to be qualifying CCPs. And in June, APRA outlined its policies regarding ADI membership of CCPs. The policies emphasise that ADIs must have an appropriate risk management framework to cover their activities as a CCP member and set threshold conditions that membership must not expose the ADI (or a group member) to an unlimited contingent liability to support the CCP.

Financial market infrastructures

A CPSS–IOSCO task force is monitoring national implementation of the *Principles for Financial Market Infrastructures* (the PFMIs), which were discussed in the September 2012 *Review*. In the first phase of this work, the task force surveyed jurisdictions' progress in implementing the PFMIs within their legislative and regulatory frameworks. Its report, released in August, reveals considerable disparity in the degree of progress across jurisdictions and across FMI types. Australia was found to have fully implemented

2 This matter is discussed further in Arsov I, G Moran, B Shanahan and K Stacey (2013), 'OTC Derivatives Reforms and the Australian Cross-currency Swap Market', RBA *Bulletin*, June, pp 55–63.

the PFMIs for all FMI types with the exception of trade repositories, for which, as noted above, the regulatory regime was finalised shortly after the April 2013 assessment date.

A CPSS–IOSCO working group has been developing guidance to support the PFMI requirement that FMIs prepare recovery plans. These plans document the measures to be taken by an FMI to restore itself to financial soundness in the event that it faces a threat to its solvency. The group released a report in August seeking feedback on a menu of potential actions that may be included in an FMI's recovery plan (such as measures to address liquidity shortfalls or to replenish financial resources). The work is expected to be finalised by the end of the year.

Financial benchmarks

Following revelations that some widely used financial benchmarks such as the London Interbank Offered Rate (LIBOR) have been subject to past abuses, standard-setting bodies have been examining ways to improve the governance and oversight processes for financial benchmarks more generally. Under the auspices of the G20, the FSB has been coordinating this work and it issued a report in August on progress to date and planned next steps. These international efforts have been complemented by a number of initiatives in several jurisdictions to improve the robustness of financial benchmarks.

In July, IOSCO released the final version of its *Principles for Financial Benchmarks* (the *Principles*), which establish guidelines for administrators of benchmarks. The IOSCO report seeks to address the concerns raised in recent years regarding financial benchmarks through high-level principles intended to apply to all benchmarks, as well as more detailed principles aimed at those benchmarks with designs thought to carry specific risks. Examples of the latter are benchmarks that rely on submissions from a panel of market participants for their calculation. For these benchmarks, a range of governance measures are outlined that seek to enhance the integrity of such submissions and address any conflicts of interest that may arise for panellists.

Reflecting concerns that benchmarks may not always have been representative of an underlying market, the *Principles* stress that benchmarks should be anchored in an active market having observable, arms-length transactions, such as transactional data or other representations of an active market, for example executable quotes. The FSB has endorsed the *Principles* and established an Official Sector Steering Group that will consider potential alternatives to the major international benchmarks and strategies for transitioning to new benchmarks should that be necessary. The Reserve Bank is represented on this group.

The Australian Financial Markets Association (AFMA) has recently announced major changes to its process for calculating bank bill swap (BBSW) reference rates, which are important benchmark interest rates within the Australian dollar market. AFMA will soon begin deriving BBSW rates from executable quotes posted from designated trading venues in the market for 'prime' bank bills and certificates of deposit (CDs), consistent with the *Principles*. To date, AFMA has relied on panellists to report their estimates of rates on prime bank bills and CDs.

Basel capital framework

The BCBS continues to review national implementation of Basel III, and the broader capital framework, through its Regulatory Consistency Assessment Programme (RCAP). In its most recent monitoring report to the G20 Leaders, released in August, the BCBS noted that 25 of its 27 member jurisdictions have now issued final rules for implementing the Basel III capital reforms, with 11 jurisdictions' rules now legally in force. APRA's prudential standards implementing the Basel III capital reforms in Australia came into force on 1 January 2013. (For further information, see 'Box B: The Basel III Capital Reforms in Australia'.) Australia is currently undergoing a 'Level 2' peer review as part of the RCAP process, which comprises a more detailed assessment of Australia's compliance with Basel capital requirements and measures. The review,

which is being undertaken by a team drawn from international regulators and standard-setting bodies, is due to be finalised next year.

The BCBS has recently been reviewing the Basel capital framework with the aim of removing undue complexity and improving the comparability of regulatory capital ratios. Recent reviews by the BCBS found material variation across banks' risk-weighted assets that could not be fully explained by underlying differences in the risk composition of banks' assets. Partly reflecting this, the BCBS issued a discussion paper in July seeking feedback on how its principles of risk sensitivity, simplicity and comparability can be better balanced within the Basel capital framework. A range of policy options were proposed for consideration, including: increasing disclosure requirements; constraining internal modelling practices; and limiting the discretion afforded to national supervisors in how they apply the standards domestically.

In June, the BCBS released for consultation further refinements to the leverage ratio that will supplement the risk-based capital requirements. These define the 'exposures measure' (the denominator of the leverage ratio), and clarify how derivatives and related collateral will be treated. Also part of the consultation were proposals to harmonise banks' disclosure practices for the main components of the leverage ratio, to help facilitate greater comparability of the regulatory ratios of banks operating in jurisdictions with different accounting frameworks. The BCBS intends to conduct a QIS to assess the calibration of the leverage ratio before it is implemented, and to ensure its relationship with the risk-based capital framework remains appropriate. Banks in jurisdictions which have introduced the Basel III capital reforms began reporting their leverage ratios to national supervisors from January 2013. Under Basel III time lines, banks are due to commence publicly disclosing their leverage ratio in January 2015, with full implementation of the requirement taking place in January 2018.

Banks' large exposures

In March, the BCBS issued for consultation a revised framework for measuring and controlling banks' large credit exposures. Large exposure limits are designed to ensure that the failure of a single counterparty would not impose excessive strain on a bank's capital position. While the risks posed by large exposures have long been recognised by the BCBS, a review of measures in place in member jurisdictions to address these risks identified material differences in practice, including in the scope of application, the large exposure limits imposed, the definition of capital on which limits were based and methods for calculating large exposure values.

The proposed framework introduces a new international standard for the definition of a 'large exposure', set at 5 per cent of a bank's eligible capital base, which all banks must report to their supervisors. It is proposed that the definition of the capital base include only common equity Tier 1 capital or Tier 1 capital, rather than total capital, as is currently used in some jurisdictions. In addition, banks will be required to assess their aggregate exposure to a 'connected group' of entities which may pose a 'single risk'. A group will be considered connected where there is a relationship of control or the entities are economically interdependent. Banks are also required to look through investments in shadow banking entities to identify underlying exposures to counterparties and assess the additional risks they may pose. Banks must ensure that their exposure to any single counterparty or connected group does not exceed 25 per cent of their eligible capital base at all times. Where the bank is a G-SIB, an exposure limit of 10–15 per cent is proposed for exposures to other G-SIBs. Authorities have the discretion to impose stricter limits on banks active in their jurisdictions. It is intended that the proposals be implemented by January 2019, in line with when the Basel III capital reforms and the G-SIB framework are due to be fully implemented. APRA will consult on proposed changes to its existing large exposures framework once the BCBS' proposals are finalised.

Other Domestic Regulatory Developments

Implementation of Basel III liquidity reforms

In May, APRA released for consultation a revised set of proposals to implement key elements of the Basel III liquidity framework in Australia. This followed feedback on an earlier consultation paper, as well as revisions to the international liquidity framework announced by the BCBS in January (which were discussed in the March 2013 *Review*). Consistent with the BCBS' changes, APRA's revised draft standard reduces the assumed outflow rates applicable to certain deposit and liquidity facilities for calculation of the Liquidity Coverage Ratio (LCR) requirement. It will also permit ADIs to temporarily draw down their stock of high-quality liquid assets (HQLA) in periods of stress such that their LCR falls below the 100 per cent minimum requirement, recognising that HQLA should be available for use in periods of financial stress. APRA will require larger, more complex ADIs to meet the LCR requirement in full on 1 January 2015, ahead of the BCBS' amended timetable, which allows banks until 2019 to fully meet the standard. APRA is expected to release its final standard on liquidity incorporating the LCR requirement in the coming months. Smaller ADIs will continue to operate under APRA's simpler minimum liquid holdings regime.

The Reserve Bank and APRA continue to make arrangements for ADIs to meet their LCR requirement through access to the Committed Liquidity Facility (CLF) established by the Bank. (Such a facility is permitted under the Basel III rules as an alternative way for banks to meet the LCR requirement in countries, such as Australia, with insufficient supplies of government securities and other HQLA.) In August, APRA issued further background on the intended approach of both agencies to the operation of the CLF. To access the CLF, eligible ADIs will need to submit to APRA a three-year funding plan on an annual basis, and demonstrate that they have taken 'all reasonable steps' to improve their liquidity risk profile by, where possible, using stable, long-term sources of funding. The size of the CLF for each ADI will be limited to a percentage of their target net cash outflows, as determined by APRA, taking into account the aggregate outflows of all ADIs and the aggregate amount of HQLA that ADIs can reasonably be expected to hold without disrupting financial markets, as assessed by the Bank. APRA is currently undertaking a trial exercise with relevant ADIs, involving their proposed liquidity management strategies and use of the CLF, and will provide further detail on the operation of the CLF on completion of the exercise. In preparation for its use, the Bank has introduced new information reporting requirements for repo-eligible residential mortgage-backed securities, which will likely comprise a significant share of the securities ADIs will pledge as collateral to access the CLF.

Other prudential standards

In May, APRA issued draft prudential standards on the capital adequacy and risk management components of its new supervisory framework for financial conglomerates ('Level 3' groups). Under the proposed new rules, conglomerates would be required to:

- have eligible capital in excess of their prudential capital requirements and have enough unrestricted surplus capital to offset any shortfalls in unregulated parts of the group. Capital requirements for Level 3 groups will be determined by aggregating the requirements of ADIs, insurers and superannuation funds, as well as for funds management and other activities, which are not regulated by APRA
- develop and maintain group-wide risk management frameworks that encompass material risks in both APRA-regulated entities and other parts of the group.

These requirements are in addition to earlier group governance and risk exposure measures that were discussed in the previous *Review*. The new framework will be finalised by January 2014 and take effect in 2015.

Also in May, APRA proposed prudential amendments to reinforce sound governance and risk management processes at APRA-regulated institutions. A new harmonised prudential standard will be introduced to consolidate and replace existing standards and requirements on risk management for ADIs, insurers, Level 2 (i.e. single industry) groups and Level 3 groups. Revisions are also proposed to existing cross-industry standards on governance. Under the amendments, APRA-regulated institutions will be required to:

- designate a Chief Risk Officer (CRO) to head the institution's risk management function and to be involved in, and provide 'effective challenge' to, activities and decisions that may materially affect the risk profile of the institution
- establish a Board Risk Committee to oversee and assess the institution's risk management framework and ensure its proper implementation.

CROs and Board Risk Committees will be required to meet certain conditions to maintain their objectivity and independence and to minimise the potential for conflicts of interest. APRA anticipates finalising both prudential standards by the end of 2013, with affected entities expected to meet the standards by January 2015. APRA's proposed standards broadly reflect the FSB's *Principles for An Effective Risk Appetite Framework*, which were released for consultation this year following a thematic peer review in 2012.

Regulation of market and payments infrastructure

As noted in the March 2013 *Review*, following a report by the CFR and the Australian Competition and Consumer Commission, the government called on the Australian Securities Exchange (ASX) to work with industry to develop a code of practice for the clearing and settlement of cash equities in Australia. In response, the ASX released in July its final *Code of Practice for Clearing and Settlement of Cash Equities in Australia* (the Code). In line with the CFR's recommendations, the ASX commits in the Code to: enhance user engagement by establishing an advisory forum comprising senior representatives of users and other stakeholders; ensure transparent and non-discriminatory pricing; and ensure transparent and non-discriminatory access to the ASX's clearing and settlement services.

The CFR has been closely engaged with the ASX during the development of the Code and considered it at its July 2013 meeting. After a two-year period, the CFR intends to carry out a public review of the Code's implementation and effectiveness. At the same time, the CFR will reconsider the case for recommending that competition in clearing be permitted, or if competition were to be ruled out indefinitely, consider whether a regulatory response would be appropriate. Implementation of the access provisions of the Code will be reviewed particularly closely by the CFR agencies. ✠