

4. Developments in the Financial System Architecture

Addressing the risks posed by systemically important financial institutions (SIFIs) has continued to be a priority of the international regulatory reform agenda. The G-20 recently endorsed a policy framework for SIFIs, with the focus initially being on the large global banks. The framework includes higher capital requirements for these banks as well as improved resolution regimes. Work is underway to extend the framework to other SIFIs, including banks that are systemically important in a domestic context. The Financial Stability Board (FSB) is continuing to lead work on shadow banking: it recently developed a framework for strengthening the oversight and regulation of shadow banking systems, which includes an annual global monitoring exercise.

Reform of over-the-counter (OTC) derivatives markets is continuing as jurisdictions work to meet the G-20 commitment that all standardised OTC derivative contracts be centrally cleared by the end of 2012. The FSB has intensified its monitoring and coordination of developments in this area in order to accelerate national efforts and promote adequate safeguards for the use of central counterparties across borders. In Australia, the Council of Financial Regulators (CFR) continued to develop policy proposals on the regulation of OTC derivatives markets. The CFR has also reviewed aspects of the regulatory arrangements for financial market infrastructures. The CFR agencies are preparing for an International Monetary Fund (IMF) Financial Sector Assessment Program (FSAP) review that Australia has agreed to undergo in 2012.

The Australian Prudential Regulation Authority (APRA) has been engaging with authorised deposit-taking institutions (ADIs) on the implementation of the Basel III capital and liquidity standards in Australia, which are due to be phased in over the coming years. Associated with this, the Bank has provided further detail on the Committed Liquidity Facility it will provide as part of Australia's implementation of the Basel III liquidity reforms. Along with other countries, Australia's implementation of the Basel III capital reforms will eventually be reviewed by the Basel Committee on Banking Supervision (BCBS) under its recently established assessment framework. This framework is aimed at ensuring timely and consistent implementation of the Basel capital framework across jurisdictions.

International Regulatory Agenda and Australia

Systemically important financial institutions (SIFIs)

At their November 2011 Summit, the G-20 Leaders endorsed a policy framework for SIFIs developed by the FSB. Some specific measures focus on institutions that are systemically important in a global context (so-called G-SIFIs) to reflect the greater risks these institutions pose to the global financial system. This is a key part of the international policy response to the crisis, aimed at addressing the moral hazard and externalities associated with financial institutions that are perceived to be 'too-big-to-fail'.

The policy framework comprises:

- a new international standard setting out the responsibilities, instruments and powers that all national resolution regimes should have, to enable authorities to resolve failing financial firms in an orderly manner and without exposing the taxpayer to the risk of loss;
- requirements to develop resolvability assessments and for recovery and resolution planning for G-SIFs, as well as institution-specific cross-border cooperation arrangements so that home and host authorities of G-SIFs are better prepared to deal with crises;
- requirements that global systemically important banks (so-called G-SIBs) have additional loss absorption capacity above the Basel III minimum; and
- recommendations for more intensive and effective supervision of all SIFs, including through stronger supervisory mandates, resources and powers, and higher supervisory expectations for risk management functions, data reporting capabilities, risk governance and internal controls.

To support this policy framework, the BCBS recently finalised a methodology to identify G-SIBs, along with a graduated system of capital requirements (above Basel III) that will apply to them (see 'Box C: Global Systemically Important Banks'). An initial list of 29 G-SIBs based on the methodology was published by the FSB in November. The higher capital requirements for G-SIBs aim to reduce the probability of their failure and provide incentives for them to become less globally systemic.

The new international standard on resolution regimes, *Key Attributes of Effective Resolution Regimes for Financial Institutions (Key Attributes)*, was released by the FSB in November. It aims to improve the capacity of authorities to restructure and resolve troubled SIFs in an orderly and effective manner. The final version of the *Key Attributes* is broadly the same as the consultation version described in the previous *Review*.

The key elements are:

- ensuring a designated resolution authority has a broad range of powers and tools to intervene and resolve a financial institution that is no longer viable;
- removing any impediments to cross-border cooperation between resolution authorities and providing authorities with incentives, statutory mandates and powers to share information across borders to help facilitate cross-border resolutions;
- ensuring that all G-SIFs have recovery and resolution plans ('living wills'), which are regularly reviewed and updated and are informed by rigorous annual resolvability assessments of each firm; and
- establishing crisis management groups for all G-SIFs, comprising home and key host resolution authorities and underpinned by cooperation agreements.

The G-20 and the FSB have called on countries to undertake the reforms, including any legislative changes, needed to conform to the *Key Attributes*. Together with the IMF and other standard-setting bodies, the FSB is developing a methodology to assess jurisdictions' compliance with the *Key Attributes*. In due course, the FSB will use this methodology to undertake a peer review of all member jurisdictions. The FSB is also establishing a Peer Review Council to monitor the implementation of the G-SIFI policy measures and associated changes to national resolution regimes. Resolvability assessments, recovery and resolution plans, and cross-border cooperation agreements are required for all G-SIBs by the end of 2012.

FSB members were recently asked to provide a self-assessment of how their national resolution regimes compared to the *Key Attributes* and their plans to address any gaps. Significant parts of the *Key Attributes* do not apply to Australia as no Australian-owned banks are identified as G-SIBs and Australia is not a key host jurisdiction for any

G-SIBs. Furthermore, Australian law and resolution arrangements do not distinguish between SIFIs and other prudentially regulated entities. Nonetheless, Australia's response to the FSB noted that the domestic resolution regime for financial institutions was largely compliant with the *Key Attributes*, reflecting the substantial legislative and administrative steps that had been taken in recent years to strengthen the resolution framework.

Even though they are only required of G-SIBs at this stage, APRA has begun preliminary work on living wills in Australia, focusing initially on recovery planning in the ADI industry. In 2011, APRA established a pilot program on recovery planning for a number of the larger ADIs. This requires the ADIs to prepare a comprehensive recovery plan that sets out the specific actions they would take to restore themselves to a sound financial position in the face of a major depletion of their capital and associated liquidity pressures. APRA is currently reviewing the draft plans that the ADIs submitted late last year; the finalised plans are to be signed off by the ADIs' boards by mid 2012. Drawing on the results of the pilot program, APRA intends to extend the recovery planning to a wider set of ADIs in 2012/13, and will be considering the appropriate extension of recovery planning to general and life insurance companies in due course.

Given the significant presence of Australian banks in New Zealand, the CFR agencies and their New Zealand counterparts have long recognised the need for effective cooperation and coordination on crisis resolution while recognising that each country has its sovereign interests to protect. Through the Trans-Tasman Council on Banking Supervision, a number of steps have been taken in recent years to strengthen the cross-border crisis management framework. The authorities from both countries recently conducted a cross-border crisis simulation exercise to test the framework and determine the scope for further refinements to the crisis management arrangements.

Beyond the elements of the SIFI policy framework described above, there are further measures being developed to address the risks posed by SIFIs other than G-SIBs. The International Association of Insurance Supervisors (IAIS) is expected to finalise a methodology for identifying global systemically important insurers and associated policy measures during 2012. The broad indicators being considered by the IAIS to judge the global systemic importance of insurers are similar to the G-SIB approach, including measures of size, global activity, substitutability and interconnectedness. Measures of non-traditional insurance business are also likely to play a key role: the IAIS considers that insurers engaged in non-traditional activities, such as credit default swap transactions for non-hedging purposes, are more likely to contribute to systemic risk. The FSB, in consultation with the International Organization of Securities Commissions (IOSCO), is separately looking at developing a framework for identifying the systemic importance of other non-bank financial institutions such as securities firms. The Committee on Payment and Settlement Systems (CPSS) and IOSCO are continuing their work on systemically important market infrastructures and are close to finalising a stronger set of international standards for these entities aimed at minimising the risk of their failure and reducing contagion risks if participants fail. As discussed in the March 2011 *Review*, these standards will apply to all systemically important market infrastructures including payment and settlement systems and central counterparties.

Now that the design of the international framework for G-SIBs is largely completed, the FSB and BCBS have recently begun work, at the request of the G-20, to consider how to extend it to domestic systemically important banks (so-called D-SIBs). The two bodies are scheduled to deliver a progress report on this work to the G-20 Finance Ministers and Central Bank Governors in April. The Bank and APRA have been contributing to the BCBS workstream developing the D-SIB framework. This work will have implications for a broader range of countries than

the G-SIB framework. Unlike the G-SIB framework, the D-SIB framework is currently envisaged as taking the form of a set of guiding principles for national authorities. Given the large differences in jurisdictions' financial structures and the fact that D-SIBs have, by definition, mainly domestic impacts, there is a strong case for a high degree of national discretion and flexibility in how D-SIBs are identified and their risks addressed.

Indeed, a number of jurisdictions are already developing their own approaches for identifying SIFIs and associated policy responses. Identification methodologies vary from those based on single indicators, such as size, to those that more closely resemble the multiple-indicator approach used to identify G-SIBs. Some of these jurisdictions, including China, the Netherlands, Sweden, Switzerland and the United Kingdom, have also announced, but not necessarily formalised, additional loss absorbency requirements for their D-SIBs.

In the United States, the Financial Stability Oversight Council recently released its methodology for identifying systemic non-bank financial companies. This includes an initial filter comprising several quantitative thresholds, to be followed by a more detailed analysis of individual firms where this is warranted. This builds on the measures for systemic banks prescribed in the 2010 Dodd-Frank Act, where any US bank holding company with US\$50 billion or more in total consolidated assets is to be subject to enhanced prudential standards and supervision by the US Federal Reserve. The proposed prudential standards for systemic institutions include stronger risk-based capital, leverage and liquidity standards, and more intensive stress-testing. US regulatory agencies have also recently released detailed guidance on the implementation of the so-called Volcker Rule, which prohibits banks in the United States carrying out proprietary trading and from having an ownership interest in hedge funds and private equity funds. The draft rules define which activities are prohibited and specify a compliance regime and reporting requirements.

Assessing implementation of Basel III

As noted in the previous *Review*, many countries, including Australia, are in the process of implementing the Basel III standards. To help ensure full, timely and consistent implementation, the BCBS has recently established a framework to monitor and review its members' adoption of the globally agreed Basel capital rules. As part of this process, each BCBS member has committed to undergo a peer review of its implementation of all components of the Basel capital framework, including Basel II, Basel 2.5 (the July 2009 enhancements on market risk and securitisations) and Basel III. These peer reviews will assess the compliance of members' domestic rules or regulations with the international minimum standards in order to identify differences that could raise prudential or level playing field concerns. The BCBS will also review how risk-weighted assets are measured, to ensure practices are consistent across jurisdictions. Initial peer reviews are assessing implementation in the European Union (EU), Japan and the United States, with other BCBS members to be assessed in due course. A senior official from APRA is leading the peer review of the EU. Australia is well placed in its implementation of the Basel capital framework: APRA has fully implemented the Basel II and 2.5 reforms and is in the process of consulting with the ADI industry on the implementation of the Basel III reforms.

Supervisory principles

Two international standard-setting bodies recently issued for consultation revised supervisory principles relating to financial institutions. In December, the BCBS issued its revised *Core Principles for Effective Banking Supervision* for consultation. Updating the 2006 version, the revised principles build on the lessons of the recent financial crisis by enhancing supervisory practices and supervisory expectations relating to risk management within banks. For similar reasons, they also recognise the need for greater supervisory intensity and resources to deal effectively with systemically important banks; the

importance of applying a system-wide, macro perspective to the supervision of banks to assist in the control of systemic risk; and the increasing focus on effective crisis management, recovery and resolution measures in reducing both the probability and impact of a bank failure.

The Joint Forum (comprising the BCBS, IAIS and IOSCO) released a consultation paper on a revised set of *Principles for the Supervision of Financial Conglomerates*. The principles are designed to support consistent and effective supervision of financial conglomerates, particularly those that are active across borders. They also address risks arising from unregulated financial activities and entities, including the complexities and gaps resulting from cross-sectoral activities.

The consultation for both sets of principles closed in March, and they are expected to be finalised in coming months.

The IAIS revised its 2003 *Insurance Core Principles, Standards, Guidance and Assessment Methodology*, which provides a globally accepted framework for the supervision of the insurance sector. This revised framework, which came into effect in October 2011, incorporates recent developments in insurance markets and supervision, as well as recommendations from the G-20 and the FSB. Like the BCBS, the IAIS has increased the focus on systemic stability, as evidenced by the inclusion of a new principle in the area of macroprudential surveillance, which aims to identify and mitigate systemic risk within the insurance sector.

FSB peer review process

The FSB has continued with its program of 'thematic' and country peer reviews, as part of its efforts to strengthen adherence to international standards. As foreshadowed in the previous *Review*, a country peer review of Australia was published in September 2011. The report concluded that the Australian financial system had weathered the financial crisis well, largely reflecting strong macroeconomic fundamentals supported by a sound regulatory

and supervisory framework. It also concluded that Australia had made significant progress in addressing key recommendations from the 2005/06 IMF Financial Sector Assessment Program report.

The FSB also recently published a second thematic cross-country review on financial sector compensation practices and one on deposit insurance systems. In 2012, the FSB is intending to undertake peer reviews on risk governance of financial institutions and on resolution regimes. The latter will evaluate the resolution regimes of FSB member jurisdictions against the FSB's *Key Attributes*, as discussed earlier. Based on a recommendation of an earlier thematic review of mortgage underwriting and origination practices, the FSB has developed draft *Principles for Sound Residential Mortgage Underwriting Practices*, which was subject to a consultation process late last year and which will be finalised shortly. The Bank was represented on the group that developed these principles.

Shadow banking

The FSB has been continuing its work on strengthening the oversight and regulation of shadow banking systems. In October 2011, it published a report that contained high-level principles for monitoring shadow banking systems, and more detailed guidance on monitoring the risks within individual shadow banking entities and activities. Drawing on this enhanced monitoring framework, the FSB is aiming to strengthen its assessment of global trends and risks in shadow banking, with the results to be reported to the FSB Plenary and G-20 each year. The FSB report also identified a number of areas where further work on regulatory measures may be warranted to address risks posed by shadow banking systems. A number of international workstreams have subsequently been established, led by relevant standard-setting bodies or the FSB itself, to assess the case for additional regulatory action in several areas: banks' interactions with shadow banking entities; money market funds; securitisation; securities lending and repos;

and other shadow banking entities such as finance companies and hedge funds. These groups are expected to provide policy recommendations in the second half of the year. The Bank is involved in some of these workstreams, and has been keen to ensure that any regulatory response to shadow banks is proportionate to the risks they pose. Institutions that could be considered part of the shadow banking system account for a small and declining share of the financial system in Australia (see 'Box D: A Closer Look at the Shadow Banking System in Australia').

OTC derivatives markets

The FSB is continuing to coordinate and monitor implementation of reforms to OTC derivatives markets. Recently the FSB expressed concern that while there had been some progress, few FSB members have the legislation or regulations in place to implement the G-20 commitment that all standardised OTC derivative contracts are to be traded on exchanges or electronic trading platforms, where appropriate, and cleared through central counterparties (CCPs) by the end of 2012. A number of smaller jurisdictions have been waiting for regimes in the United States and EU (the two largest OTC derivative markets) to be finalised before putting their own in place, especially in the area of central clearing. Further clarity is emerging on both the US and EU regimes. In the United States, regulators are well advanced in implementing the Dodd-Frank Act requirements on central clearing of OTC derivatives, with the rules likely to take effect in the second half of 2012. In the EU, new rules on OTC derivatives regulation were issued in February as part of the broader *European Market Infrastructure Regulation* and European regulators have begun consultation on their implementation.

The FSB recently established a new group comprising the chairs of relevant standard-setting bodies, to ensure closer coordination of the different international OTC workstreams. Its initial focus will be on establishing adequate regulatory safeguards for a global CCP framework. To the extent that smaller

markets, such as Australia, may be reliant on CCPs in offshore jurisdictions, it will be important that the FSB's work in this area addresses the potential risks associated with an increasing global reliance on a small number of large CCPs. Australian agencies are also working to ensure satisfactory outcomes are reached internationally on issues such as membership of, and criteria for access to, offshore CCPs as well as information sharing, which are particularly relevant for smaller markets.

Domestically, the Council of Financial Regulators (CFR) has continued to consider how best to implement reforms to the regulation of OTC derivatives markets in Australia, following its consultation with industry during the second half of 2011. The CFR's conclusions will be published shortly.

Domestic Regulatory Developments

Implementation of Basel III capital and liquidity reforms

As discussed in the previous *Review*, APRA is in the process of consulting with the ADI industry on the implementation of the Basel III capital reforms in Australia. APRA issued a consultation paper in September 2011, and following consideration of submissions received during this consultation, will issue draft prudential standards for industry consultation in the near future.

Separately, APRA issued a consultation paper late last year on how it intends to implement the Basel III liquidity reforms in Australia. APRA is proposing to introduce the two new quantitative liquidity standards – the Liquidity Coverage Ratio (LCR) and Net Stable Funding Ratio (NSFR) – broadly in line with the Basel III recommendations. These standards will apply to the larger, more complex Australian ADIs which already use scenario analysis for their liquidity requirements. The smaller ADIs will continue to be subject to APRA's simpler minimum liquidity holdings regime. APRA is proposing to follow the BCBS timetable for introducing the new global liquidity standards: the LCR requirement will

become effective from 1 January 2015 and the NSFR requirement from 1 January 2018. APRA's liquidity reforms will also incorporate enhanced qualitative requirements, which are broadly consistent with the BCBS' 2008 *Principles for Sound Liquidity Risk Management and Supervision*. These will apply to all ADIs in Australia once APRA publishes its final liquidity prudential standard, expected around the middle of 2012.

In conjunction with APRA's liquidity consultation paper, the Bank published further detail on the Committed Liquidity Facility (CLF) it will provide as part of Australia's implementation of the Basel III liquidity reforms. As was discussed in the March 2011 *Review*, this facility is required because of the limited amount of government debt in Australia, which means there are insufficient high-quality liquid assets for ADIs to meet their LCR requirement by holding these assets alone. Under the CLF, participating ADIs will be able to access a pre-specified amount of liquidity by entering into repurchase agreements of eligible securities outside the Bank's normal market operations. The Bank's commitment to provide the liquidity will be contingent on the ADI having positive net worth in the opinion of the Bank, having consulted with APRA. The facility will commence from 1 January 2015, concurrently with APRA's implementation of the LCR. A commitment fee of 15 basis points will be charged for the facility, applying to both drawn and undrawn amounts. All securities eligible for the Bank's normal market operations will be able to be used for the facility as well as certain related-party assets issued by bankruptcy remote vehicles, such as self-securitised residential mortgage-backed securities. This reflects a desire from a systemic risk perspective to avoid promoting excessive cross-holdings of bank-issued instruments. Should a participating ADI lack a sufficient quantity of residential mortgages, other self-securitised assets may be considered, with eligibility assessed on a case-by-case basis. APRA will be reviewing each ADI's liquidity risk management

framework as the basis for approving the amount of the facility that can be recognised for LCR purposes.

At a recent meeting, the BCBS reviewed aspects of the LCR standard and confirmed that liquid assets accumulated in normal times are intended to be used in times of stress, so that banks can temporarily fall below the minimum 100 per cent LCR requirement if necessary. This was motivated by the concern that if the 100 per cent LCR was a 'hard floor', then banks would have to hold additional liquid assets above this requirement as a buffer against unexpected events. The BCBS is also intending to provide additional guidance on the circumstances that would justify the use of the pool of high-quality liquid assets, and to examine how central banks interact with banks during periods of stress so that the workings of the LCR do not hinder or conflict with central bank policies.

Other prudential standards

In late September, APRA released a discussion paper on its proposals for prudential standards for superannuation funds. This follows a decision of the Australian Government, as part of its 'Stronger Super' reforms, to enable APRA to make and enforce prudential standards for the superannuation entities it regulates. APRA intends to introduce prudential standards covering matters common to other APRA-regulated industries, such as governance and risk management, as well as superannuation-specific matters such as conflicts of interest, insurance in superannuation and defined benefit fund solvency. The standards will not detract from trustees' responsibility for prudent management of superannuation funds. Submissions on the discussion paper closed in December and APRA is now considering the feedback received and will be issuing draft standards for consultation in the near future.

APRA also released a discussion paper outlining its proposals to introduce a new prudential standard relating to the issuance of covered bonds by

ADIs. As discussed in the previous *Review*, this follows legislative changes in late 2011 which allowed such issuance. As noted in the chapter on 'The Australian Financial System', the large Australian banks have issued a sizeable amount of covered bonds in the past few months.¹ APRA's proposed prudential standard aims to ensure that ADIs adopt prudent practices when issuing covered bonds and carefully manage the risks associated with their exposures to covered bond special purpose vehicles. The discussion paper also proposes changes to APRA's prudential standards on securitisation, including clarifying the capital treatment of ADIs' holdings of subordinated tranches of securitisations where they are not the originator of the loans. APRA envisages these prudential standards will take effect in the first half of 2012.

APRA has also continued consultation on its proposals for revising the capital standards for general and life insurers, releasing a response paper and draft prudential standards for consultation in December. Submissions on this consultation closed in late February and APRA expects to release final revised capital standards in May 2012. The new capital framework will be effective from 1 January 2013.

Financial market infrastructures

As discussed in the previous *Review*, the CFR was asked by the Australian Government in April 2011 to consider possible changes to the regulation of financial market infrastructures (FMIs) to strengthen regulators' ability to provide effective oversight and manage risks to stability and market integrity. The CFR issued a consultation paper in October 2011 with various proposals to enhance the regulation of FMIs. Since the CFR considered that FMIs are as systemically important as many ADIs, several of the recommendations were developed with

reference to APRA's powers in respect of ADIs. The recommendations most relevant to financial stability were:

- introduction of 'step-in' powers to enable regulators to intervene in the event of a domestic FMI experiencing substantial difficulties;
- introduction of powers to require certain systemically important FMIs to have key aspects of their operations located in Australia and overseen by 'fit and proper' persons; and
- strengthening of regulators' directions-giving powers and sanctions in respect of FMIs.

Since the consultation process, the CFR has developed policy recommendations that are expected to be published shortly. As flagged in the consultation paper, work is ongoing on issues relating to competition in clearing and settlement systems and the segregation and portability of customer accounts of participants of CCPs.

Financial Claims Scheme

Following an announcement by the Australian Government in September 2011, coverage under the Financial Claims Scheme (FCS) was lowered from \$1 million to \$250 000 per depositor, per ADI from 1 February 2012 (with grandfathering arrangements in place for term deposits existing as at 10 September). This is still at the higher end of the range of deposit insurance caps – relative to per capita GDP – in other countries.² The change in cap has not had any discernible impact on ADI deposit flows. A number of initiatives are now underway to improve public awareness of the FCS, including the introduction of a government-guaranteed deposits seal and updating website material on the FCS. In the meantime, APRA has been continuing to develop its pre-positioning requirements for the FCS. It recently introduced a prudential standard that, among other measures, requires all locally incorporated ADIs to be able to

¹ For more information, see also RBA (2012) 'Box D: Covered Bond Issuance by Australian Banks', *Statement on Monetary Policy*, February, pp 57–58.

² For more information, see Turner G (2011), 'Depositor Protection in Australia', *RBA Bulletin*, December, pp 45–55.

produce a 'single customer view' that aggregates the balances of all FCS-eligible deposit accounts held by each customer.

Financial Sector Assessment Program (FSAP) review of Australia

The Australian Government has agreed to undergo an IMF FSAP in 2012. This will be a follow-up from Australia's first FSAP conducted in 2005/06 (discussed in the September 2006 *Review*) and is consistent with a recent commitment of FSB members to undergo an FSAP every five years. The focus of FSAP assessments is on the stability of the financial sector and the quality of financial supervisory and crisis management arrangements. The CFR agencies have begun initial work for the FSAP, including preparing

background material for the IMF on Australia's financial regulatory framework, financial crisis management arrangements and financial stability policy framework. APRA and the Australian Securities and Investments Commission are also in the process of completing detailed self-assessments of their banking, insurance and financial market supervisory arrangements against international standards. The FSAP is also expected to focus on a financial stability assessment in which the Bank is likely to be heavily involved. Stress testing is another key element of the FSAP process: APRA is currently undertaking one of its regular stress tests of the ADI industry, the results of which are likely to be examined as part of the FSAP.