4. Developments in the Financial System Architecture

The G20 and international regulatory bodies have continued to focus on implementing the agreed post-crisis reforms with an increased emphasis on assessing their effects. In particular, work continues on addressing 'too big to fail', especially in a cross-border context, as well as enhancing the regulatory framework for financial market infrastructures (FMIs). The Financial Stability Board (FSB) presented its second annual report to G20 Leaders on the implementation and effects of financial regulation reforms, which found that the effects of the reforms implemented to date have been generally positive. Evolving new issues, such as the risks posed by the asset management industry and the implications of financial technology ('fintech') for financial stability, also remain on the reform agenda.

Domestically, authorities have progressed work on internationally agreed reforms, including in the area of financial benchmarks. They have also issued policy statements to support competition in the clearing of cash equities. In addition, the Reserve Bank released the conclusions of its Review of Card Payments Regulation, with reforms announced that relate to surcharging, interchange fees and competition.

International Regulatory Developments and Australian Response

Addressing 'too big to fail'

A key reform area since the financial crisis has been 'ending too big to fail' – that is, addressing the risks posed by systemically important financial institutions (SIFIs). This work has several elements, including improving the resilience of SIFIs and enhancing resolution regimes.

Over the most recent period, international regulatory bodies have shifted their focus toward the implementation of key 'too big to fail' policies, including the FSB standard on the total loss-absorbing capacity (TLAC) of global systemically important banks (G-SIBs). The TLAC requirement is intended to ensure that G-SIBs have sufficient capacity to absorb losses in resolution, and enable resolution authorities to implement a strategy that minimises the impact on financial stability and ensures the continuity of critical economic functions. TLAC-eligible liabilities can include both capital instruments (such as Common Equity Tier 1) and long-term unsecured debt (both subordinated and senior debt) provided it meets eligibility criteria. A majority of G-SIB home regulators are also putting in place a range of domestic TLAC frameworks.

In October, the Basel Committee on Banking Supervision (BCBS) released its final standard on the regulatory capital treatment of banks' investments in TLAC instruments. The standard applies to both G-SIBs and other banks and aims to reduce the risk of contagion within the financial system should a G-SIB enter resolution. A key feature of the standard is that, starting from 2019, banks are required to deduct, subject to a threshold, holdings of TLAC instruments that are not already included in regulatory capital from their own Tier 2 capital.

Australian banks are not directly captured by the FSB TLAC standard because they are not G-SIBs. However, following a government-endorsed recommendation by the Financial System Inquiry, the Australian Prudential Regulation Authority (APRA) continues to explore options for a loss-absorbing and recapitalisation capacity framework in Australia, in consultation with the Bank and other Council of Financial Regulators (CFR) agencies. With TLAC approaches still emerging internationally, APRA has noted that it will be 'hastening slowly' on this issue given the importance of getting the policy settings right.

The FSB is continuing its work on enhancing resolution frameworks and in August issued two guidance documents.

- One, on temporary funding in resolution, seeks to encourage reliance on private sources of this funding, for instance through a pool of industry funds, and to minimise moral hazard risks if public sector funding is temporarily required.
- The other, to support financial institutions' resolution planning, is designed to ensure that critical functions and services can continue.

The orderly resolution of large banks with cross-border operations is of ongoing concern to the FSB and G20. As discussed in the previous *Review*, in November 2015 the FSB published a set of principles that jurisdictions should consider including in their legal frameworks in order to give cross-border effect to resolution actions. This work aims to remove obstacles in implementing orderly group-wide resolution plans by allowing resolution measures taken by one jurisdiction to be promptly recognised by other jurisdictions. The FSB is to conduct a stocktake of jurisdictions' plans to implement these principles by end 2016.

Cross-border recognition of resolution actions continues to be progressed via the International Swaps and Derivatives Association (ISDA) resolution stay protocols (the ISDA 2015 Universal Protocol for G-SIBs and jurisdictional protocols for G-SIB counterparties). Adherents to the protocols agree to 'opt in' to laws that govern temporary stays in protocol-eligible foreign jurisdictions, thus mitigating the risk of disruptive early terminations of financial contracts. Following the passage in May of legislation on financial system resilience and collateral protection, Australia can apply to ISDA to have its temporary stay regime recognised under the protocols. However, further regulatory change may be required before an Australian jurisdictional protocol can be put in place.

While the post-crisis 'too big to fail' reforms have focused on enhancing bank resilience and resolution regimes, efforts also continue to address risks posed by non-bank financial institutions.

- In June, the FSB released final guidance on resolution planning for systemically important insurers. It highlights factors that should be taken into account when considering the appropriate resolution framework, as well as the elements needed to ensure the resolution strategy can be credibly implemented.
- The International Association of Insurance Supervisors (IAIS) released midyear:
  - its revised assessment methodology for global systemically important insurers (G-SIIs). Among other things, the revised methodology modifies certain indicators of systemic importance
  - final guidance on insurance product features that could pose systemic risk. The guidance focuses on determining whether product features expose insurers to substantial macroeconomic risk (for instance if their exposures are highly correlated with the market) and/or liquidity risk. This guidance has been incorporated into the assessment methodology for identifying G-SIIs that was noted above, and will also lead to changes to the design of higher loss absorption requirements for G-SIIs

- a second consultation paper on the Insurance Capital Standard for internationally active insurance groups. The paper seeks to improve the comparability of capital ratios by narrowing the approaches these insurers can use in calculating elements of the capital standard, for instance by increasing the comparability of valuation methods used. A final standard is due in mid 2017.

- In August, the FSB released a discussion paper seeking feedback on essential aspects of central counterparty (CCP) resolution planning, which will be used to develop standards or guidance on CCP resolution strategies and resolution tools. This work is part of broader international efforts to promote CCP resilience, recovery and resolvability, mainly involving the FSB, the Committee on Payments and Market Infrastructures (CPMI) and the International Organization of Securities Commissions (IOSCO).

  In related work, the CPMI and IOSCO published in August an assessment of the implementation of the financial risk management and recovery aspects of the *Principles for Financial Market Infrastructures* (PFMI) at a sample of 10 derivatives CCPs. The scope of this review included ASX Clear (Futures) and both of the overseas CCPs licensed to clear over-the-counter (OTC) derivatives in Australia. While CCPs have made good progress in implementing the PFMI, the report identifies several areas in which some CCPs' implementation measures are not fully consistent with the PFMI. CPMI and IOSCO have committed to conducting a follow-up review in early 2017 of CCPs' progress in addressing the most important of these areas. The results of the CPMI-IOSCO assessment were also an input to additional guidance released concurrently on the governance of CCPs' risk management processes, and stress testing and margin methodologies.

Domestically, CFR agencies continue to collaborate on strengthening Australia's resolution and crisis management arrangements. APRA is currently reviewing and benchmarking recovery plans submitted by large authorised deposit-taking institutions (ADIs), and developing its resolution planning framework, to ensure it is able to use its resolution powers when needed. Work continues on preparing legislative reforms to strengthen APRA's crisis management powers, as well as to introduce a resolution regime for FMIs.

- As described in the previous *Review*, the reforms to APRA's crisis management powers will broaden its ability to respond to the distress or failure of a financial group or foreign bank branch and give binding directions. The changes will also enable APRA to appoint, and provide more robust immunities to, a statutory or judicial manager.
- The resolution regime for FMIs is expected to be appropriately aligned with the FSB's *Key Attributes of Effective Resolution Regimes for Financial Institutions*. It will cover all domestically incorporated FMIs and will also empower the Australian authorities to support overseas authorities resolving FMIs licensed to operate in Australia.

Shadow banking

Since the crisis, the FSB and other international and national bodies have worked to address the risks posed by shadow banking, i.e. entities and activities involved in credit intermediation outside of the regular banking system, such as money market funds (MMFs), finance companies and securities lending. With the bulk of policy development now finalised, regulators' focus has largely turned to implementation and monitoring.

In May the FSB published a peer review on the implementation of its policy framework for shadow banks other than MMFs. The framework includes recommendations that jurisdictions enhance the oversight and regulation of their shadow banking

sectors by establishing systematic processes for assessing shadow banking risks, imposing or enhancing regulations where necessary, increasing data collection and ensuring an adequate public disclosure regime. The peer review found that, while jurisdictions have made some progress, implementation is at a relatively early stage and recommended that jurisdictions work towards full implementation of the framework.

Australia is already largely compliant with the framework. As discussed in 'The Australian Financial System' chapter, the shadow banking sector accounts for a relatively small share of financial system assets in Australia. Nonetheless, the authorities monitor developments in this sector on an ongoing basis, including in an annual update on Australia's shadow banking sector provided by the Bank to the CFR.

Building resilient financial institutions

Most of the international post-crisis policy development aimed at building resilient financial institutions has been completed, with the focus now largely on implementation.

- In its report to G20 Leaders in August, the BCBS indicated that key components of the Basel III reforms, including the risk-based capital standard and the Liquidity Coverage Ratio (LCR), have been incorporated into the regulatory framework of all member jurisdictions.
- In its September monitoring report, the BCBS found that all large internationally active banks met the fully phased in Basel III common equity capital requirements as at end 2015 (which is ahead of the fully phased in schedule of 2019). The BCBS also found that around 90 per cent of banks for which data were available met the full LCR requirement and around 80 per cent already met the Net Stable Funding Ratio requirement (which is only due to be implemented from January 2018).

In addition to implementation monitoring, the BCBS is also continuing to work on finalising the outstanding Basel III reforms by end 2016. These include the leverage ratio, revised standardised approaches for credit and operational risk, and additional restrictions on banks' internal modelling of credit risk to address excessive variability in risk-weighted assets. The BCBS aims to finalise this work without significantly increasing overall capital requirements across the banking sector.

Separately, the BCBS recently published several papers to enhance supervisory standards for banks.

- In April, the BCBS released a consultation paper on the definitions of non-performing exposures and forbearance. The paper proposes definitions that complement the existing accounting and regulatory frameworks, with the aim of establishing a consistent international standard for categorising problem loans.
- Also in April, the BCBS updated its framework for managing interest rate risk in the banking book, to reflect improved market and supervisory practices. The updated framework contains more extensive guidance on the expectations of a bank's processes for managing this risk, as well as enhanced disclosure requirements.
- In July, the BCBS finalised its framework for the regulatory capital treatment of 'simple, transparent and comparable' (STC) securitisations. Compliance with the STC criteria, published in 2015 by the BCBS and IOSCO, provides additional confidence in the performance of these securitisations and therefore warrants reduced capital requirements under the updated framework.

As discussed in 'The Australian Financial System' chapter, an APRA requirement came into force on 1 July under which ADIs using the internal ratings-based approach to credit risk are required to raise the risk weights on Australian residential mortgages to an average of at least 25 per cent. This is an interim measure, with APRA awaiting the finalisation of the BCBS reforms before settling on a final requirement domestically.

As jurisdictions implement the post-crisis reforms, there is increasing focus on assessing their impact. To that end, in August the FSB published its second annual report to G20 Leaders on the implementation and effects of post-crisis reforms. While it is too early to assess the impact of many reforms, the FSB suggests that those implemented to date have increased banks' resilience, without significantly reducing the supply of credit to the economy. It also notes that banks' returns have fallen relative to pre-crisis levels, driven by a number of factors including weak economic growth, lower interest rates, high non-performing loans, large misconduct fines and regulatory reforms. In addition, the report explores the potential impact of reforms on specific areas, including market liquidity. The FSB found, as in its first annual report, little evidence of a broad deterioration in market liquidity in normal times. Nonetheless, it noted a decline in depth in some secondary fixed income markets, which could reduce the resilience of liquidity in stressed market conditions. A possible cause of this highlighted in the report is reduced market making by dealers due to the increased costs associated with regulatory reforms. However, the reforms have also enhanced market resilience as they have reduced the likelihood that a deterioration in market liquidity could result in wider financial stability issues. The FSB is continuing to monitor market liquidity and intends to report further findings on market depth and funding liquidity to the G20 early next year.

Risks and reforms beyond the post-crisis agenda

In addition to the key post-crisis reforms, work has continued in several other areas.

- In June, the FSB released proposals designed to address the risks arising from asset management activities. The majority of the proposals target liquidity mismatch, which is the potential for open-ended funds to invest in less liquid assets while offering relatively rapid redemptions. The proposals also address leverage within investment funds, securities lending activities and operational risk. The proposals have a degree of flexibility, which is appropriate given that the risks associated with these activities vary across jurisdictions. The FSB intends to finalise the proposals by end 2016, with IOSCO expected to operationalise the proposals on liquidity mismatch by end 2017.
- In August, the Bank for International Settlements (BIS), the FSB and the International Monetary Fund released a report to G20 Leaders on international experiences with macroprudential policies. The report is largely a stocktake of the experiences that jurisdictions have had with macroprudential policies to date. It acknowledges that there is no 'one-size-fits-all' framework in the design and implementation of macroprudential policy, and highlights the tentative nature of lessons drawn from recent country experiences.
- In September, the FSB released a progress report on its work plan to reduce misconduct risk in financial institutions, which focused on the three primary areas of ongoing work:
  - *The role of incentives in reducing misconduct*. The FSB plans to publish supplementary guidance to its *Principles for Sound Compensation Practices*, covering the connections between misconduct and compensation. In addition, the FSB recently established a working group, of which APRA is a member, to explore how governance frameworks can reduce misconduct risk and consider whether further guidance in this area is necessary.
  - *Improving global standards of conduct in financial markets*. In May the BIS released the first phase of the Global Code of Conduct for the foreign exchange market, which covers areas such as ethics, information sharing, trade confirmation and settlement, account reconciliation processes and

certain aspects of execution. The final code – which will cover a broader range of aspects of execution as well as governance, risk management and compliance – is scheduled to be released in May 2017. The BIS is working closely with market participants to develop market-based mechanisms to embed the Global Code within firms' cultures and practices. The Bank has been heavily involved in this work, chairing the BIS working group that is developing the Global Code.

– *Reforming financial benchmarks*. In July the FSB issued its second progress report on the implementation of reforms affecting the major interest rate benchmarks. The report found that the administrators of interbank rates, such as the London Interbank Offered Rate, have made progress in using transaction data to underpin benchmarks and have also been working to adopt nearly risk-free benchmark rates where possible. However, work is still required to fully implement the reforms.

  Domestically, the CFR has recently completed two consultations related to financial benchmarks: one on the evolution of the methodology for the bank bill swap rate (BBSW) benchmark, and the other on options to reform the regulation of financial benchmarks. Following these consultations, a new methodology for the BBSW has been designed to support the production of a trusted, reliable and robust benchmark and, as announced by the Australian Financial Markets Association in July, transitional steps towards the implementation of that methodology are currently underway. Also, the government announced in October its support of the CFR's recommendations for a reform package for financial benchmarks, which will regulate the administration of, and the making of submissions to, a significant financial benchmark as well as creating a specific offence of benchmark manipulation.

- The FSB has been exploring the possible financial stability risks that may arise from operational failures at financial institutions. The potential for a cyber attack to cause the failure of a financial institution has received increasing international regulatory attention. In June CPMI-IOSCO finalised guidance on cyber resilience for FMIs, and in August the IAIS published an issues note presenting the potential risk posed by cyber attacks to insurers and possible supervisory approaches for addressing the risk. Domestically, APRA in October released the results of its Cyber Security Survey, which covered selected banks, superannuation funds, insurers as well as four significant service providers. The survey results indicated that entities experienced a range of cyber security incidents. APRA noted that, as cyber incidents can be expected to increase in sophistication, frequency and potential impact, regulated entities need to continue to enhance their cyber resilience.

- International bodies are studying the financial stability implications of 'fintech', such as 'blockchain' and distributed ledger technology. The FSB has developed a framework for categorising and assessing the impact of new innovations, which is intended to help ensure that systemic risks that arise from technological change are appropriately managed, without deterring innovation. The FSB is in the process of applying this framework to specific innovations and intends to publish its findings by early 2017.

  Domestically, a CFR working group that includes the Australian Transaction Reports and Analysis Centre continues to consider the implications of distributed ledger technology for the financial system and regulation. In addition, in June the Australian Securities and Investments Commission released a consultation paper

outlining proposals to encourage 'fintech' innovation, including the establishment of an industry-wide exemption or 'sandbox' that would allow new businesses to test certain financial services for six months without the requirement to first have an Australian Financial Services Licence.

Other Domestic Developments

OTC derivatives markets reforms

As noted in previous *Reviews*, authorities have worked on implementing internationally agreed OTC derivatives-related reforms in Australia, such as the central clearing of standardised OTC derivatives. Implementation is largely complete, with the main areas of ongoing work relating to margining and risk management requirements for non-centrally cleared derivatives. Margin is collateral designed to reduce the potential for contagion from the default of a market participant. Legislation was passed in May that enables Australian entities to exchange margin in line with APRA's prospective final Prudential Standard imposing BCBS-IOSCO margining and risk management requirements in Australia. APRA previously set an implementation date of 1 September 2016 for the Standard; however, this date was deferred by APRA in August, given delays in implementation of the internationally agreed framework in other major derivatives markets. APRA continues to monitor progress in other jurisdictions ahead of releasing its finalised standard, and it will advise its implementation date in due course.

Clearing and settlement facilities

Following the government's earlier endorsement of recommendations by the CFR and the Australian Competition and Consumer Commission relating to competition in clearing Australian cash equities, these agencies released in October:

- a set of Minimum Conditions that support competition in the clearing of cash equities, while also ensuring the safety and efficiency of the market
- Regulatory Expectations for the conduct of the Australian Securities Exchange (ASX) in operating its cash equity clearing and settlement services until such time as a competitor emerged.

Consistent with the Regulatory Expectations, the ASX has issued an updated Code of Practice for the clearing and settlement of cash equities.

Review of card payments regulation

In May, the Bank published the conclusions to its Review of Card Payments Regulation. This was a comprehensive examination of the regulatory framework for card payments, guided by the mandate of the Bank's Payments System Board (PSB) to promote competition and efficiency in the payments system. The key decisions taken by the PSB related to surcharging, interchange fees and competitive neutrality.

- Under the reforms, merchants will continue to be able to surcharge for more expensive payment methods. However, consistent with the government's recent amendments to the *Competition and Consumer Act 2010*, the new standard will ensure that merchants cannot surcharge in excess of their costs of accepting the (designated) card system being used. The Bank's new surcharging standards commenced operation on 1 September for card transactions at 'large' merchants (meeting certain turnover and size criteria); for other merchants the implementation date will be 1 September 2017.
- The PSB also determined that new interchange standards will keep the weighted-average interchange fee benchmark for credit cards at 0.50 per cent, but lower the benchmark for debit cards from 12 cents to 8 cents per transaction. The benchmarks will be supplemented by ceilings on individual interchange rates that will reduce costs for smaller merchants. The new standards

also require more frequent observation of compliance with the benchmark, which will reduce the tendency of interchange rates to drift upwards between compliance dates. The new interchange standards will be effective from 1 July 2017.

- To address issues of competitive neutrality, interchange-like payments to issuers in the American Express companion card system will be regulated equivalently to the MasterCard and Visa credit card systems. More broadly, to prevent circumvention of the interchange standards, there will be limits on any scheme payments to issuers that are not captured within the benchmarks. ✠