4. Regulatory Developments

Financial regulators in Australia have continued to monitor financing conditions and the housing sector, as well as assessing the implications of the findings of several major reviews of the financial sector. Internationally, the focus has continued to shift away from reform towards monitoring its implementation and evaluating its effects.

The Council of Financial Regulators (CFR) has closely monitored the impact of measures taken over the past few years to improve lending standards and asset quality.[1] While these measures have reduced the accumulation of risk in the financial system, the tighter financing conditions appear to have played some role in the recent decline in housing credit and price growth. While the price falls to date have not been considered a material risk to financial stability, the CFR has stressed the importance of lenders continuing to supply credit to the economy while they adjust lending practices.

The CFR has also discussed the findings of several major reviews of Australia's financial sector. The Final Report of the Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry (the Royal Commission) identified serious cases of misconduct by financial institutions and other participants in the financial services industry, and made a range of recommendations. These have broad political support. The International Monetary Fund's (IMF's) Financial Sector Assessment Program (FSAP) review of Australia was generally positive about the resilience of domestic financial institutions, and the quality of Australia's regulatory and supervisory oversight framework. Nonetheless, the IMF made several high-level recommendations to improve current arrangements. The CFR agencies are carefully considering the recommendations in both reviews. The Final Report of the Productivity Commission's Inquiry into Competition in the Australian Financial System was delivered in mid 2018; the CFR has examined options for implementing some recommendations.

International bodies have been monitoring the implementation of key post-crisis G20 reforms globally, and evaluating their effects. These evaluations are important to assess whether major reforms are meeting their intended objectives. A current assessment is looking at the effects of reforms on financing for small and medium-sized enterprises. In addition to the ongoing focus on the banking sector, international bodies have recently considered the risks posed by insurers, central counterparties (CCPs) and crypto-assets.

The CFR has focused on financing conditions and the housing sector, along with major reviews of the financial sector

A major focus of the CFR since the last *Review* has been credit conditions – both for households and small business – and related developments in the housing market. Credit conditions for both

1 The CFR is the coordinating body of Australia's main financial regulatory agencies. For further details on the CFR, see RBA (2018), 'Box E: The Council of Financial Regulators', *Financial Stability Review*, October, pp 69–73, and the CFR's website <www.cfr.gov.au>.

sectors tightened through 2018 due to a range of factors. The tightening of lending standards over recent years has been warranted and has resulted in a clear reduction in higher-risk housing lending and improvements in balance sheet resilience among authorised deposit-taking institutions (ADIs). But the CFR has also noted that an overly cautious approach by some lenders may be affecting lending decisions and in recent statements has stressed the importance of lenders continuing to supply credit to the economy.

One potential offset to any tightening in credit supply by banks has been the growth in housing lending by non-ADIs (see 'Box D: Non-bank Lending for Property'). Developments in this sector are also monitored by the CFR. Non-ADIs' share of total lending remains small but it is important that data covering lending by non-ADIs be expanded. The Australian Prudential Regulation Authority's (APRA's) new data collection powers in this area will help to provide a better picture of lending outside the banking system.

Housing credit growth and prices have been a focus of CFR discussions. Reduced demand has significantly slowed housing credit growth with demand from investors in particular slowing noticeably, reflecting lower expected price growth. The CFR has been closely monitoring housing market developments, including the falls in housing prices, particularly in Sydney and Melbourne. These declines have followed much larger increases in the preceding years, as noted in the 'Household and Business Finances' chapter. The CFR agencies have noted that the adjustment in housing prices and activity has been orderly to date and does not raise material financial stability concerns.

Related to this, the CFR has been monitoring the effects of the prudential measures related to housing lending. While these measures fall within APRA's remit, they can be relevant to the soundness of the financial system more broadly and are therefore often discussed by the CFR. One measure discussed has been the 30 per cent benchmark on the share of new loans that could be interest only, which was introduced in March 2017. In December 2018, APRA announced that it would remove this benchmark for ADIs that were no longer subject to the separate investor lending benchmark (the majority of ADIs).

Over the past year, there have been a number of inquiries into, and assessments of, the Australian financial system. These have included the Royal Commission, the Productivity Commission's competition inquiry and the IMF's FSAP assessment of Australia. The CFR has discussed the implications of each of these inquiries and assessments as they have progressed, and is undertaking further work in several areas.

- The Royal Commission's final report identified significant misconduct and failings by financial institutions. It underscored the need for the financial services industry to re-establish trust with its customers and the wider public. Its recommendations will also significantly affect the activities of some CFR agencies. The CFR has been asked by the government to consider the implications of changes to the commission structure for mortgage brokers. The CFR has also discussed possible further changes to the definition of small business in the Banking Code of Practice recommended by the Royal Commission. Because significant changes to the code are already due to commence on 1 July 2019, and in light of a tightening in credit conditions for small businesses, CFR members supported maintaining the current $3 million total credit exposure threshold for the time being. As required by the Australian Securities and Investments Commission (ASIC), an independent review of the definition will be undertaken within 18 months of the commencement of the revised code.

- The CFR is undertaking work in response to the Final Report of the Productivity Commission's Inquiry into Competition in the Australian Financial System. The CFR strongly supports the Productivity Commission's recommendation for improved transparency of mortgage interest rates. A working group is examining options for the provision of an online tool that will allow consumers to better understand the interest rates being paid by different types of borrowers. Following an earlier recommendation of the Financial System Inquiry (FSI), the Productivity Commission also proposed a review of the regulation of payment providers that hold stored value, or purchased payment facilities. This review is now underway. The aim of this work is to provide a clearer and more graduated regulatory framework. The CFR released an issues paper on stored value facilities in September 2018 and held an industry roundtable in November. The CFR will consider recommendations from the review in mid 2019.
- The CFR has discussed the IMF's main recommendations from its FSAP assessment (see also 'Box E: The 2018 Financial Sector Assessment Program (FSAP) Review of Australia'). One recommendation was that the CFR should increase the transparency of its discussions. This aligned with a recommendation of the Productivity Commission and with work already underway within the CFR to improve transparency. Since December 2018, the CFR has released a statement after each quarterly meeting, outlining the main issues discussed. It has also launched an improved website containing new explanatory content along with the quarterly CFR statements. These arrangements complement those of the individual member agencies, which have ultimate responsibility for financial system regulation.

The CFR responds to occasional requests from the government for advice on a policy issue or to review the effects of a past decision. It recently provided a report to the government on leverage and risk in the superannuation system, as requested in the government's response to the FSI. The report noted that leverage in superannuation funds has the potential to increase vulnerabilities in the financial system. But it found that the level of limited recourse borrowing by self-managed superannuation funds, while growing, remains relatively small.

Some of APRA's policy workstreams are of broader relevance to the stability of the financial system. Issues such as a bank loss-absorbing capacity framework and the countercyclical capital buffer (CCyB) have therefore been discussed by the CFR over the past year. APRA announced in January 2019 that it would maintain a CCyB setting of zero per cent. CFR agencies saw this as appropriate given moderate overall credit growth, ongoing improvement in the risk profile of new housing lending, and continued strengthening in ADIs' capital positions. Separately, APRA is considering implementing a non-zero CCyB default setting as part of its ongoing review of the ADI capital framework.

The CFR is supported by a number of working groups and committees, which pursue a variety of workstreams relevant to its remit. Of recent note:

- The CFR Financial Market Infrastructure (FMI) Steering Committee helps to coordinate monitoring and policy formulation in relation to FMIs and over-the-counter (OTC) derivatives markets regulation. Its recent work has included further consideration of the design of the proposed FMI resolution regime for Australia, including preparation for a further round of public consultation in the second half of 2019. The FMI Steering Committee has also been developing a proposal for legislative changes to support the CFR's policy framework for competition in the clearing and settlement of Australian cash equities, and the application of the CFR's *Regulatory Expectations for Conduct in Operating Cash Equity Clearing and Settlement Services in Australia* to ASX's CHESS replacement project.

- The CFR approved new terms of reference and a work plan for the Cyber Security Working Group. The working group helps to coordinate cyber related work programs among CFR agencies. CFR member agencies have been considering ways to increase the resilience of the financial sector to a material cyber incident through a range of initiatives, such as issuing new standards and guidance.

Members of other government agencies attend CFR meetings when discussions are relevant to their responsibilities. Representatives of the Australian Competition and Consumer Commission (ACCC) and the Australian Taxation Office attended the December 2018 meeting. CFR agencies also continued to work with their New Zealand counterparts via the Trans-Tasman Council on Banking Supervision to further strengthen the cross-border crisis management framework.

A range of other domestic developments are being pursued

In addition to the regulatory measures related to ADIs outlined in 'The Australian Financial System' chapter, in December 2018, APRA released new and enhanced prudential superannuation requirements. These reforms are substantial and are designed to strengthen the focus of registrable superannuation entity (RSE) licensees on the delivery of quality outcomes for their members. A central component of APRA's new framework relates to strategic and business planning requirements. An outcomes assessment will also be included as a key part of the process, as will requirements for the management and oversight of fund expenditure and reserves. The outcomes assessment will require RSE licensees to annually benchmark and evaluate their performance in delivering sound, value-for-money outcomes to all members. The new and enhanced requirements will cover both *MySuper* and choice products. The changes will be supported by continued work from APRA to identify and address underperformance within the industry. The aim is to lift standards across the industry for the long-term benefit of superannuation members. The changes also seek to ensure that RSE licensees meet their obligations to put their members' interests first. The new measures are due to take effect from 1 January 2020.

A bill recently passed by parliament strengthens APRA's powers in relation to superannuation in several ways. It enhances APRA's directions powers in respect of RSE licensees (including aligning its directions powers in relation to the superannuation industry with those in the banking and insurance industries). It also strengthens *MySuper* authorisation and cancellation provisions, and requires APRA approval for changes of ownership of RSE licensees.

In March 2019, APRA released a discussion paper proposing updates to its prudential standard on credit risk management requirements for ADIs. Credit risk is the risk of borrower default and is usually the single largest risk facing an ADI. APRA's changes seek to modernise the standard given the significant evolution in credit risk practices since it was last substantially revised in 2006. The proposals to an extent formalise changes APRA has made over recent years to enhance sound lending standards and credit risk management more broadly, rather than being a further tightening of lending standards.

Authorities have made progress in implementing an open banking regime, which will give consumers the right to share their banking data. Financial institutions and financial technology ('fintech') companies are exploring various uses of these data. Open banking has the potential to enhance competition in the banking sector by making it easier for consumers to switch banks, demonstrate their financial standing when seeking a loan, and find tailored financial products and services. Open banking in Australia will be the first application of the Consumer Data Right (CDR). This will allow consumers to direct businesses to transfer their data to an accredited third party. The government has introduced the *Treasury Laws Amendment (Consumer Data Right) Bill 2019* into parliament. In March, the ACCC issued draft rules for the CDR for public feedback. The draft rules should allow banking sector companies to begin planning for the start of the CDR in banking. A pilot of open banking is due to be launched in July 2019, with sharing of consumer data on credit and debit cards and deposit and transaction accounts, expected by February 2020.

Authorities are also reviewing arrangements that allow consumers to pay for a purchase over time but obtain goods and services immediately, known as 'buy now pay later' (BNPL) services. Of note, in November 2018, ASIC published a detailed report into BNPL arrangements, which found that the growth in these services has been rapid; the number of consumers using BNPL services increased five-fold in the two years to 2017/18 (to 2 million consumers). ASIC reports that there were 1.9 million BNPL transactions in the month of June 2018 (up from over 50,000 in April 2016) and that outstanding BNPL balances were $903 million as at the end of June 2018. The Senate also issued a report into the operation of BNPL services in February 2019.

Additionally, a number of legislative and regulatory changes are likely to follow on from the recommendations of the Royal Commission. This includes, for instance, the recommendation to extend the Banking Executive Accountability Regime from ADIs to all APRA-regulated entities such as insurers and RSE licensees.

Internationally, the focus remains on monitoring the implementation of reforms …

The Financial Stability Board (FSB) released several reports in late 2018 that together detail the progress made by jurisdictions in implementing several key post-crisis G20 reforms.[2] In summary:

- Efforts continue to enhance the ability to resolve systemically important financial institutions. This will help mitigate the 'too big to fail' problem. This refers to situations where the disorderly failure of a large, complex or interconnected financial institution would cause significant difficulties for the wider financial system and broader economy. In the past it had been assumed that governments would intervene to prevent a disorderly failure of these institutions. The FSB reported that implementation of the 'too big to fail' reforms is most advanced in the banking sector, where most home and key host jurisdictions of global systemically important banks (G-SIBs) have introduced resolution regimes

2 See FSB (2018), 'FSB 2018 Resolution Report: Keeping the pressure up', Seventh Report on the Implementation of Resolution Reforms, 15 November; FSB (2018), 'Reforming major interest rate benchmarks', Progress report, 14 November; FSB (2018), 'OTC Derivatives Market Reforms', Thirteenth Progress Report on Implementation, 19 November.

that are broadly aligned with the FSB's *Key Attributes of Effective Resolution Regimes for Financial Institutions* (*Key Attributes*). Progress in implementing the *Key Attributes* for insurers and for CCPs is less advanced.

- Progress continues in implementing reforms to major interest rate benchmarks. As discussed in the previous *Review*, existing benchmarks may not be sustainable over the medium term given insufficient market transactions upon which to base their calculation. The FSB reported that steps have been taken to strengthen key interbank offered rates and work is underway to support an orderly transition to new reference rates. It noted the significant progress in strengthening the Australian bank-bill swap rate, which is the key benchmark for Australian dollar financial products.
- In relation to OTC derivatives markets reforms, the FSB stated that good progress has been made in implementing comprehensive trade reporting requirements and comprehensive standards to determine when standardised OTC derivatives should be centrally cleared. While progress has also been made in implementing other related requirements, the FSB highlighted a need for additional efforts from regulators in some jurisdictions. This mainly related to implementing margin and higher capital requirements for non-centrally cleared derivatives, and the standardised approach to counterparty credit risk.

… and evaluating their effects

Many key reforms have already been implemented, such as key aspects of the Basel III and G-SIB reforms. As such, international bodies have been switching from working on policy design to focusing on evaluating the effects of the reforms. The aim is to assess whether the reforms are achieving their objectives and if they have had material unintended consequences that may need to be addressed. The FSB is the main body conducting and coordinating these assessments, using an evaluation framework it released in July 2017.

Over 2018, the FSB and relevant standard-setting bodies (SSBs) completed two evaluations of the effects of the G20 financial regulatory reforms – on central clearing and infrastructure finance. Preliminary findings from these evaluations were discussed in the previous *Review*. Further work continues in related areas.

- The first evaluation, on the incentives to centrally clear OTC derivatives, found that increased central clearing had mitigated systemic risk. But it also highlighted that the treatment of initial client margin in the Basel III leverage ratio calculation may be reducing the incentive to offer client clearing services (as discussed below).
- The second evaluation, on the provision of infrastructure finance, was the first part of a wider consideration of the effects of reforms on financial intermediation. Assessing trends in financial intermediation helps inform the analysis of the financing of real economic activity and hence the contribution of reforms to the broader G20 objective of strong, sustainable and balanced economic growth. The second part of this evaluation is currently assessing the effects of the reforms on the provision of financing for small and medium-sized enterprises. It is expected to be completed later this year.

The FSB recently launched an evaluation of the effects of the 'too big to fail' reforms in the banking sector. The evaluation is due to be completed in 2020. It will assess how effective these reforms have been in addressing the systemic and moral hazard risks posed by systemically important banks. It will also analyse broader effects on the financial system, such as with respect to overall resilience, the orderly functioning of markets, global financial integration, and the cost and availability of financing.

The Basel Committee on Banking Supervision (BCBS) is reviewing the leverage ratio

As noted above, the evaluation of central clearing by the FSB and relevant SSBs concluded that the treatment of initial client margin in the BCBS's leverage ratio calculation may result in concentration in, or even withdrawal of, client clearing services. The BCBS has since consulted on a targeted and limited revision to the leverage ratio exposure measure to address this issue. If there is sufficiently strong empirical evidence that the current treatment has reduced the availability of client clearing services, the BCBS is willing to consider whether the treatment of such derivatives in the leverage ratio calculation should be revised. One possibility would be to allow the initial margin received from the client to offset the potential future exposure of derivatives centrally cleared on the client's behalf for the purposes of calculating the leverage ratio. The BCBS will publish its conclusions after assessing feedback received.

The BCBS has also proposed revisions to leverage ratio disclosure requirements aimed at reducing 'window-dressing' behaviour. This refers to the tendency of some banks to reduce transaction volumes in key financial markets around regulatory reporting dates in order to temporarily reduce their leverage (and so report higher ratios) at those dates. The BCBS has previously made clear that window-dressing by banks is 'unacceptable'. It undermines the intended policy objectives of the leverage ratio requirement and potentially disrupts the operations of financial markets. To address this issue, the BCBS proposes to require banks to report quarter-average measures for some types of leverage ratio exposures, in addition to the existing quarter-end reporting.

Other reform measures are also being reviewed and/or revised

In addition to monitoring the implementation of reforms and evaluating their effects, SSBs continue to review existing policies and propose improvements where relevant. In January 2019, the BCBS announced revised minimum capital requirements for market risk following a quantitative analysis and consultation. The revised framework adds a simplified standardised approach for use by banks with small trading portfolios that are not complex. The existing standardised approach was also refined. For example, revisions were made to the standardised risk weights applicable to general interest rate risk, and certain exposures subject to credit spread risk. Revisions were also made to the assessment process for determining whether a bank's internal risk management models appropriately reflect the risks of individual trading desks. The revised standards will take effect on 1 January 2022.

In October 2018, the BCBS issued revised stress testing principles. The nine new principles replace the *2009 Principles for Sound Stress Testing Practices and Supervision*, and reflect the growth and evolution in stress testing practices over the past decade. Stress testing is now a core tool of risk management for both banks and banking supervisors. The revised principles provide high-level guidelines on the core elements of stress testing frameworks such as objectives, governance, methodology, resources and documentation.

In November, the International Organization of Securities Commissions (IOSCO) proposed a framework to help regulators measure the use of leverage by investment funds. This work is in response to recommendations made by the FSB in 2017 to address structural vulnerabilities arising from asset management activities (such as leverage and redemption run risk). The proposed framework would indicate how regulators could identify and analyse those investment funds that may pose stability risks for the financial system.

Work addressing risks outside the banking sector is ongoing

In November, the International Association of Insurance Supervisors (IAIS) proposed a new 'holistic' framework for the assessment and mitigation of systemic risk in the insurance sector. The proposed framework includes:

- addressing systemic risk based on the activities entities undertake;
- a global annual monitoring exercise;
- enhanced pre-emptive supervisory policy measures; and
- powers of intervention for supervisors where a potential systemic risk is detected.

This framework is based on the view that systemic risk may arise from the collective activities of the insurance sector as well as from the distress of individual insurers. It proposes a proportionate application of enhanced policy measures to the sector as a whole rather than just a small group of global systemically important insurers (G-SIIs). The proposed framework is expected to be finalised this year, for implementation in 2020.

Related to this:

- The FSB, in coordination with the IAIS, decided not to issue a new list of G-SIIs in 2018. As in 2017, this reflects the holistic framework approach instead of a focus on the risks posed by individual insurers. Nonetheless, the nine G-SIIs identified by the FSB in 2016 remain subject to higher loss-absorbency requirements, enhanced group-wide supervision and regular resolvability assessments.
- The FSB has several initiatives to assist the development of effective resolution regimes for insurers, including a 'resolvability monitoring' exercise. Also, the FSB will finalise the *Key Attributes* Assessment Methodology for the insurance sector by the end of 2019.

CCPs are an important component of the global financial architecture, particularly in light of the post-crisis reform commitment to increase the use of central clearing for standardised OTC derivatives. Reflecting this, the Committee on Payments and Market Infrastructures (CPMI) has been working on strengthening and harmonising the supervision and regulation of CCPs. In addition, in November 2018, the FSB, in consultation with IOSCO and the CPMI, outlined a process for evaluating whether existing financial resources and tools are adequate for resolving CCPs. The process involves authorities identifying loss scenarios that may lead to the resolution of a CCP in order to better evaluate likely resolution costs and available resources. Following feedback, further guidance on these issues will be developed by the end of 2020.

International bodies continue to assess and respond to the risks posed by crypto-assets. In November 2018, G20 countries signed a joint declaration committing to regulate crypto-assets for anti-money laundering and counter-terrorism financing purposes, in line with Financial Action Task Force standards. The BCBS is currently undertaking a quantitative impact study of banks' direct and indirect exposures to crypto-assets. Also, in March, the

BCBS published its expectations in relation to banks' exposures to crypto-assets and will, in due course, clarify the prudential treatment of such exposures to appropriately reflect the high degree of risk of crypto-assets. IOSCO has developed a Support Framework to assist with addressing domestic and cross-border issues arising from initial coin offerings (ICOs) that may affect investor protection, and a framework for identifying risks associated with the secondary trading of crypto-assets.[3] This is in addition to the Consultation Network established by IOSCO to share international experiences with ICOs, which was discussed in the previous *Review*.

In Australia, the Treasury released a paper in January seeking views on the potential benefits and risks of ICOs and the application of the domestic regulatory framework to ICOs. Relatedly, ASIC has continued its work to mitigate potential harm from crypto-assets to consumers and investors. In particular, ASIC intends to monitor ICOs closely to ensure compliant behaviour, and to introduce market infrastructure regulation for crypto-currency exchanges.

3 An ICO is a form of fundraising, used by a business or individual, to raise capital online. ICOs generally operate by allowing investors to use crypto-assets to purchase 'coins' that may offer some entitlement to future services. The ICOs are often global offerings that can be created anonymously and/or accepted anonymously.