Box E

The 2018 Financial Sector Assessment Program (FSAP) Review of Australia

In 2018 the International Monetary Fund (IMF) conducted its third FSAP review of Australia to assess the stability of the financial sector and the quality of domestic regulatory oversight arrangements. The main report from that review, Australia's *Financial System Stability Assessment* (FSSA), was released by the IMF in February 2019.[1] The report covered regulatory and supervisory oversight of banking and insurance, crisis management and financial safety net arrangements, financial market infrastructures (FMIs), the resilience of the banking sector and the management of various risks. The IMF's overall assessment was positive, indicating that the Australian financial system is fundamentally sound and has been further strengthened since the IMF's previous assessment in 2012. The IMF did, however, make several recommendations to improve current arrangements.

Council of Financial Regulators (CFR)[2] agencies worked closely with the IMF during the FSAP. The CFR agencies see this as an opportunity to enhance the efficiency and stability of the financial system and are now considering how best to address the IMF's recommendations.

This box outlines the FSAP process and the main findings and recommendations, highlighting several areas that are relevant to the RBA's responsibilities.

An FSAP review is a comprehensive assessment of the financial sector

An FSAP review is an in-depth assessment by the IMF of a country's financial sector and regulatory oversight arrangements. To undertake this assessment, the IMF reviews information provided by domestic agencies (for example, self-assessments and questionnaires) and meets with regulators, other public sector agencies, financial institutions, credit rating agencies and academics during a series of visits to the country.

During an FSAP review, the IMF analyses current risks, the resilience of the financial sector, the quality of the regulatory and supervisory framework, compliance with international standards, and the authorities' capacity to manage and resolve financial crises. A key benefit is that the IMF brings a global perspective to assessing domestic vulnerabilities and regulatory arrangements. By using a common approach (such as applying its own stress testing model), the IMF can compare local frameworks to global best practices. At the conclusion of the assessment, the IMF provides a series of recommendations to the local authorities on how current arrangements could be improved.

The FSAP is a key part of the IMF's member surveillance. As one of the 29 jurisdictions with financial sectors deemed by the IMF to be systemically important, an Australian FSAP is undertaken every five years or so (Australia's previous FSAPs were in 2005/06 and 2012).

1 The FSSA and other supporting FSAP reports for Australia can be found at <https://www.imf.org/external/np/fsap/fsap.aspx>.

2 The CFR is the primary mechanism for coordination between Australia's financial regulatory agencies. For more background on the CFR's membership, objectives and operations, see RBA (2018), 'Box E: The Council of Financial Regulators', *Financial Stability Review*, October, pp 69–73.

Overall, the IMF found a robust regulatory framework and enhanced systemic risk oversight

The FSAP assessment found that Australia has a robust regulatory framework, and that systemic risk oversight had been enhanced since the previous FSAP. It found that regulatory frameworks and practices were comparable with international best practices. Accordingly, the IMF did not recommend significant changes to Australia's regulatory institutional structure. The IMF noted several specific areas for improvement, to close apparent gaps and further strengthen oversight arrangements.

The IMF concluded that the Australian agencies had taken steps since the previous FSAP to further strengthen the financial system and enhance crisis management arrangements. Most notably, bank capital had been raised to levels that were more conservative than the international capital rules set by the Basel Committee on Banking Supervision (BCBS), with plans to raise them further. Banks' funding risks had been reduced and policy actions had successfully addressed rapid growth in riskier segments of the mortgage market. The IMF's stress testing indicated that the banking sector was relatively resilient and likely to withstand severe macroeconomic shocks. The IMF's stress test results were broadly similar to those obtained by the Australian Prudential Regulation Authority (APRA) in its 'bottom up' stress test conducted in 2017.

Nonetheless, the IMF observed that Australia faced several challenges, mainly related to the household sector. With its assessment largely finalised before the most recent housing price declines, the IMF argued that 'stretched' real estate valuations and high household leverage posed significant risks to the financial system and the economy. Other areas of focus for the IMF included Australia's concentrated banking system, banks' use of offshore wholesale funding, and progress on developing a resolution framework for FMIs.

The IMF highlighted positive aspects of current regulatory arrangements …

The IMF assessed the effectiveness of current regulatory arrangements in several areas.

- For the banking sector, the IMF conducted a full assessment against the *Core Principles for Effective Banking Supervision* issued by the BCBS. Australia achieved a high degree of compliance with international principles; at times going beyond agreed global minimum standards to provide additional resilience in the context of Australia's financial system.
- The IMF also conducted a limited assessment against the *Insurance Core Principles* issued by the International Association of Insurance Supervisors. The analysis concluded that APRA had undertaken a comprehensive reform of prudential regulation for insurance companies while improving the consistency of the framework between life and general insurers since the IMF's previous assessment.
- The IMF found that regulatory arrangements for the oversight of systemic risk had historically worked well. These arrangements are centred on the CFR and its members, with the CFR being relatively informal compared with similar bodies in some other jurisdictions. Member agencies had a strong track record of addressing financial stability issues in a productive and collaborative manner.
- The IMF noted the progress made on Australia's resolution framework and recovery planning since the 2012 FSAP. Recent legislation had expanded APRA's powers to resolve authorised deposit-taking institutions

(ADIs) and insurance companies in distress. It had also enhanced APRA's powers relating to conglomerate groups, foreign branches, transfers of business and resolution planning.

- FMIs in Australia were found to generally operate reliably, and the competitive landscape had seen new entrants and competitors emerge. The IMF noted that supervision and oversight of FMIs were well established, with supervisory expectations strengthened over the past few years.

A key element of an FSAP review is a stress test of the domestic banking system, using the IMF's 'top down' model.[3] The IMF recognised that the Australian banks were well capitalised, liquid, and had a long history of delivering high profits. Its stress test was nonetheless useful in identifying vulnerabilities in the banking system. The stress test assessed the resilience of Australian banks' capital and liquidity buffers to credit, liquidity, and contagion risks. The exercise covered the 10 largest banks, accounting for nearly 90 per cent of total banking system assets.[4] The IMF tested bank resilience over three years (2018–20) under both a 'Baseline' scenario and an 'Adverse' scenario. The latter combined three concurrent shocks: (i) a sharp decline in housing prices; (ii) slower global economic growth, particularly in China; and (iii) a sharper-than-expected tightening of global financial conditions.

The solvency (capital) component of the stress test found that the Common Equity Tier 1 (CET1) capital of the five largest banks would decline in the Adverse scenario, from 10.6 per cent to 7.2 per cent. This was still well above the minimum CET1 capital requirement of 4.5 per cent and above even the 7 per cent capital hurdle that also includes the capital conservation buffer of 2.5 per cent. The five mid-sized banks would see smaller falls in capital, with their average capital ratio falling from 9.7 per cent to 7.0 per cent. The falls in capital were broadly similar to those obtained by APRA in its 'bottom up' stress test conducted in 2017.

The liquidity component of the stress test led the IMF to raise some concern about the 'continued reliance' of Australia's banks on wholesale funding. This was in the context of the IMF's cash flow stress test, which used assumptions that were generally more severe than those underpinning the Basel III Liquidity Coverage Ratio (LCR) to model banks' cash flows 12 months into the future. The IMF found that a severe and sustained funding shock that persisted beyond the 30-day period covered by the LCR would see three banks experience cash shortfalls. This would be the case even after banks drew on their Committed Liquidity Facility (CLF) at the RBA.

… but nonetheless the IMF found scope for improvements

While the IMF noted the positive aspects of Australia's current regulatory and supervisory arrangements as discussed above, it also made several key recommendations for improvement (Table E1).

Regarding the banking sector, the IMF recommendations for improvement included: a more comprehensive assessment of banks' risk management and governance frameworks on a periodic basis; use of formal corrective actions where necessary; and for APRA to continuously develop its resources and skills to match the evolution in banking services and risks – particularly in specialised areas such as information technology (IT), cyber risk and 'fintech'. In terms of insurance, the

3 'Top down' stress testing involves one entity (e.g. the IMF) conducting its own analysis of how multiple institutions would fare in the event of stress. In contrast, 'bottom up' tests involve *each* entity assessing how a common stress would impact them, with a central agency then aggregating these results.

4 For more information on stress testing, see RBA (2017), 'Box D: Stress Testing at the Reserve Bank', *Financial Stability Review*, October, pp 46–49.

Table E1: Selected Key IMF Recommendations from the 2018 Australian FSAP

Banking and Insurance Supervision	Time[(a)]
Strengthen the independence of the Australian Prudential Regulation Authority (APRA) and the Australian Securities and Investments Commission (ASIC), by removing constraints on policymaking powers and providing greater budgetary and funding autonomy; strengthen ASIC's enforcement powers and expand their use to mitigate misconduct.	1–2 years
Enhance APRA's supervisory approach by carrying out periodic in-depth reviews of governance and risk management.	1–2 years
Strengthen the integration of systemic risk analysis and stress testing into supervisory processes.	1 year
Financial Stability Analysis (including stress testing)	
Commission and implement results of a comprehensive forward-looking review of potential data needs. Improve the quantity, quality, granularity and consistency of data available to the Council of Financial Regulators (CFR) agencies to support financial supervision, systemic risk oversight and policy formulation.	3–5 years
Enhance the agencies' monitoring, modelling and stress testing framework for assessing solvency, liquidity and contagion risk. Draw on the results to inform policy formulation and evaluation.	1–2 years
Encourage further maturity extension and lower use of overseas wholesale funding.	1 year
Systemic Risk Oversight and Macroprudential Policy	
Raise formalisation and transparency of the CFR and accountability of its member agencies through publishing meeting records as well as the publication and presentation of an Annual Report to parliament by CFR agency heads.	1 year
Undertake a CFR review of the readiness to apply an expanded set of policies to address systemic risks, including data and legal/regulatory requirements; and address impediments to their deployment.	1 year
Commission analysis by the CFR member agencies on relevant financial stability policy issues, including: policies affecting household leverage; as well as factors affecting international investment flows and their implications for real estate markets.	3–5 years
Financial Crisis Management and Safety Nets	
Complete the resolution policy framework and expedite development of resolution plans for large and mid-sized banks and financial conglomerates, and subject them to annual supervisory review.	1–2 years
Extend resolution funding options by expanding loss-absorption capacity for large and mid-sized banks and introduce statutory powers.	1–2 years
The Reserve Bank of Australia (RBA) to formalise its emergency liquidity assistance (ELA) framework with clearly defined preconditions for ELA and drawn-up terms and conditions.	1–2 years
Financial Market Infrastructures (FMIs)	
Strengthen the independence of the RBA and ASIC for supervisory oversight, enhance enforcement powers and promote compliance with regulatory requirements.	1 year
Finalise the resolution regime for FMIs in line with the Financial Stability Board's *Key Attributes of Effective Resolution Regimes for Financial Institutions*.	1–2 years

(a) IMF's stated implementation timetable
Source: IMF

IMF recommended further improvements to supervisory data systems to facilitate supervisory risk analysis of larger insurers, and further enhancing coordination between APRA and the Australian Securities and Investments Commission (ASIC) in assessing insurance companies.

A further important area of focus was systemic risk oversight and vulnerabilities. The IMF observed that Australia faced several challenges in these areas, mainly related to the household sector. It noted that recent policy measures had lowered risks from this sector and, accordingly, did not recommend further macroprudential policy measures at this time. Nonetheless, it suggested CFR agencies consider several steps to respond to remaining 'significant structural vulnerabilities'. These vulnerabilities included high household leverage and banks' concentrated exposures to the housing sector. It argued that 'stretched' housing valuations and high household leverage posed significant risks to the financial system and the economy. These informed its recommendations in this area, to improve systemic risk oversight, with a particular focus on the housing sector.

In particular, the IMF recommended that CFR agencies:

- expand their set of policy tools to enhance their flexibility to address systemic risk and vulnerabilities. It suggested that a 'readiness assessment' of potential policy options would help agencies identify associated data requirements, and address any legal/regulatory obstacles to their use. The IMF's proposed priorities for review included borrowers' debt-to-income and loan-to-valuation limits.
- invest further in data and analytical tools to strengthen financial supervision and systemic risk oversight. Relative to international experience, the IMF pointed to shortfalls in the granularity and consistency of data available for these purposes. It argued that the CFR agencies should therefore conduct a review of potential data needs and implement improvements.

The IMF further recommended that APRA draw up advance plans for the use of its new powers regarding lenders that are not ADIs. The IMF noted that the market share of non-ADI lenders was increasing. However, it acknowledged that their overall market share remains modest, and because this is a relatively untested area of regulation, careful consideration of costs and benefits would be required before any action. APRA's powers to collect data from non-ADI lenders have been strengthened in recent years, with steps currently underway for APRA to begin collecting these data soon from selected non-ADI lenders.

The IMF argued that there was limited transparency of the CFR's activities. It suggested that greater formalisation and transparency could further strengthen collaboration, boost confidence in the collective work of the regulatory agencies, and guard against possible delay in addressing emerging systemic risks. In light of this, the IMF recommended the CFR: present an annual report to parliament on critical financial stability issues; regularly publish a record of its meetings; and enhance the monitoring framework for systemic risk.

The CFR has taken steps to increase its transparency in recent years. The IMF acknowledged this, although some initiatives were implemented after the FSAP meetings took place. An expanded discussion of CFR activities has been published in the RBA's *Financial Stability Review* since late 2017. In December 2018, the CFR also started publishing a statement following each quarterly meeting, outlining the main issues discussed by the agencies. Further information

on the CFR's activities is also available on the CFR's website <www.cfr.gov.au>, which was re-launched in late 2018 to make it more informative and accessible.

In relation to crisis management arrangements, the IMF noted that the Australian banking sector continued to be dominated by four large banks. Their size implied that a failure would have a 'potentially enormous' impact on the financial system and the economy. Accordingly, the IMF recommended that the resolution policy framework for the largest banks be completed (for example, by expanding their loss absorbing capacity) and that resolution planning be further enhanced. These and similar recommendations fall mainly within APRA's remit and it is currently considering how best to address these issues.

The IMF recommended that the RBA formalise the framework for providing liquidity support to a distressed institution ('emergency liquidity assistance'). As was demonstrated during the global financial crisis, the RBA already has extensive procedures and mechanisms in place to provide liquidity support during stressed market conditions. These can be flexibly applied and adjusted according to the circumstances. The CLF, which was introduced by the RBA in 2015, had already formalised many elements of the arrangements for the RBA to provide liquidity to banks in a stressed situation. Nevertheless, the IMF argued that, as crises tend to escalate rapidly, the RBA would benefit from a more predefined liquidity assistance framework.

The results of its liquidity stress test of the banking system prompted the IMF to recommend that the agencies consider encouraging Australian banks to further reduce their use of overseas wholesale funding. The IMF also recommended that banks be encouraged to extend the duration of their liabilities to help lower structural funding risks.

For FMIs, the IMF recommended that enforcement powers for the supervision of central counterparties and securities settlement systems should be strengthened and independence from the relevant government minister should be increased. In particular, the IMF recommended that the RBA should have its own enforcement powers. While the IMF noted that Australian authorities had made progress in formulating a special resolution regime for FMIs, it recommended that this be finalised promptly. The IMF encouraged the CFR agencies to review lessons from the formulation and codification of the resolution regime for ADIs and insurers. The IMF also noted that the design of the FMI resolution regime would need to address issues specific to Australia's financial market structure – such as clearing and settlement facilities that are part of a vertically integrated exchange group, and the dominance of a few domestic financial institutions.

CFR agencies are considering the recommendations as part of the next steps

CFR agencies are currently considering, both individually and jointly, how best to address the IMF's recommendations. The adoption of some recommendations may require legislative change, while others require inter-agency collaboration and coordination. The CFR agencies value the recommendations and remain committed to the ongoing FSAP process as an opportunity for continuous improvement of domestic regulatory and supervisory arrangements. ✠