4. Domestic Regulatory Developments

The Council of Financial Regulators (CFR) coordinates the activities of Australia's key financial regulatory agencies: the Australian Prudential Regulation Authority (APRA); the Australian Securities and Investments Commission (ASIC); the Australian Treasury; and the Reserve Bank of Australia. The CFR is chaired by the Bank, which also provides the secretariat. CFR agency heads typically meet quarterly; ongoing inter-agency collaboration occurs through a number of working groups, as well as through frequent informal bilateral contact between individual agencies.

Over the past six months, the CFR has monitored the effects on the financial system of the COVID-19 pandemic and associated restrictions, and of Russia's invasion of Ukraine and resulting sanctions. Risks from housing lending have been an ongoing focus, in particular the increased share of lending at high debt-to-income ratios in recent times. The CFR has also sought to maintain a forward-looking agenda, including considering how the regulatory environment could respond to advances in technology, and addressing the financial risks of climate change. In addition, a substantial work program aimed at enhancing cybersecurity is underway.

The CFR has been closely monitoring the effects of the pandemic and sanctions on Russia and Belarus

In order to effectively coordinate their regulatory and policy activities, the CFR members share information on key developments that may affect the financial system. Over the last two years, this has included the effects of successive waves of COVID-19 infections and associated restrictions. In the six-month period since the last *Financial Stability Review*, the focus has been on the Omicron variant, which has had a less sustained impact on the economy than previous variants. In light of this and the support measures put in place earlier in the pandemic, household and business balance sheets remain strong and the financial system is well placed to maintain the necessary financing of economic activity.

A second key development has been Australia's imposition of sanctions on Russian and Belarusian entities – in line with the international community – in response to the invasion of Ukraine. Many of these sanctions are operating through the financial system, although Australian financial institutions have very little exposure to, or interactions with, Russian entities. The direct effects on the Australian financial system have therefore been modest so far. Nonetheless, developments in Ukraine and Russia have increased risks to the global economy as well as to financial systems in some countries, and the CFR agencies continue to monitor developments closely.

Risks in housing lending remain a key focus for the CFR

In response to growing financial stability risks from banks' residential mortgage lending, APRA decided in October 2021 to increase the serviceability buffer for home lending. CFR members supported this decision and have been monitoring ongoing developments closely. While difficult to isolate from broader trends, the increase in the serviceability buffer has reduced riskier lending at the margin. A particular focus of the CFR has been the share of lending at high debt-to-income ratios, which remains elevated. The CFR has discussed the actions being taken by banks to manage the risks within their portfolios and will continue to assess the need for further macroprudential measures. The CFR has continued to stress the importance of lending standards being maintained.

Given the increased focus over recent years on the use of macroprudential policy to promote the stability of the financial system, in November 2021 APRA published an information paper on the use of macroprudential policy tools. The framework covers the risk factors APRA uses to identify emerging threats to financial stability and the available policy tools. In conjunction with the information paper, APRA conducted a public consultation on an update of its credit risk management prudential standard. The update would require banks to ensure they could implement limits on higher risk residential mortgage and commercial property lending in a timely and effective manner. While the responsibility for determining and implementing macroprudential policies rests with APRA, the information paper stresses the importance of consulting with other members of the CFR as part of APRA's decision-making process. CFR meetings provide an important venue for these consultations, supported by working level discussion and analysis.

While much of the CFR's focus is on the banking sector, the CFR also monitors and assesses the role played by non-bank lenders. While this sector makes up a small share of the market, it is growing quickly (see 'Chapter 3: The Australian Financial System'). There is little evidence to date that it is contributing to increasing risks to financial stability.

The Australian Government, supported by the CFR, is considering how the regulatory framework should adapt to innovation

Both CFR members and the Australian Government recognise the need for regulatory frameworks to be sufficiently flexible and forward-looking to deal with innovations in financial services. The pace of innovation in the sector is currently high, with offerings such as mobile wallets, crypto-assets, stablecoins and decentralised finance providing the potential for financial services and products to be delivered in a very different way.

The Australian Government announced a series of reforms in December 2021 aimed at modernising elements of the regulatory framework to support this innovation and promote competition in payment and crypto technologies. The reforms include: developing a strategic plan for the payments system; developing a new, tiered payments licensing framework; consulting on the licensing of digital currency exchanges and a possible custody or depository regime for digital assets; and modernisation of the *Payment Systems (Regulation) Act 1998*. Much of this work is being undertaken by the Treasury, supported by the other CFR agencies. Existing CFR work in related areas has been brought together under a new working group examining the regulation of the crypto-ecosystem. The working group includes representatives from the CFR agencies, the Australian Competition and Consumer Commission (ACCC), the Australian Transaction Reports and Analysis Centre (AUSTRAC), the Australian Taxation Office and the Department of Home Affairs.

The Australian Government released a consultation paper in March 2022 outlining its proposed approach to licensing of service providers for crypto-assets. The paper proposes a licensing regime for 'crypto-asset secondary service providers', including exchanges, brokerage services, dealers and custody services. Obligations would be similar to those applied under the financial services licensing regime, aimed at ensuring minimum standards of conduct and operational resilience. They would include obligations to maintain adequate custody arrangements for the safeguard of 'private keys' for crypto-assets.

While not explicitly part of the Australian Government's reform package, the regulation of stablecoins – a type of crypto-asset that aims to maintain a stable value against one or more currencies or assets – will be an important element of a forward-looking regulatory regime. In March 2022, the CFR discussed possible regulatory approaches to payment stablecoins, which have characteristics that may make them attractive as a store of value and means of payment. While there has been limited issuance or adoption of these instruments in Australia to date, the potential for increased use has made them a focus for regulators globally. Given some similarities with stored-value facilities (SVFs), the CFR has agreed to work on options for incorporating payment stablecoins into the proposed regulatory framework for SVFs. The proposed SVF framework was released by the CFR in late 2020 and is being implemented as part of the government's reforms to the payments licensing framework announced in December 2021.

One constraint on some financial technology firms, and on some firms providing remittance services, has been an inability to access banking services. Banks declining to offer or withdrawing their services is commonly referred to as 'de-banking'. De-banking is often a consequence of banks' management of financial crime risks, but can have a significant impact on the affected firms and individuals relying on them for services. The issue highlights the challenge of balancing the objectives of controlling financial crime and promoting innovation and competition in financial services. The Treasurer has requested advice from the CFR by the end of June on key trends in de-banking, its underlying causes and possible policy responses. The ACCC, AUSTRAC and the Department of Home Affairs are joining the CFR agencies in this work.

CFR agencies have continued to work on enhancing cyber resilience

The CFR's Cyber Security Working Group is pursuing a program of work aimed at further improving the cyber resilience of the Australian financial system. The CFR agencies have developed a domestic cyber-attack protocol in order to better coordinate activities during cyber threats or incidents. A similar cyber-attack protocol is also being developed with New Zealand financial regulators, given the strong links between the Australian and New Zealand financial systems. CFR agencies recognise the important operational role the Australian Cyber Security Centre (ACSC) plays prior to and during such incidents, and engage closely with it, including through the Working Group. With Australia and other countries facing a heightened cybersecurity threat environment following Russia's invasion of Ukraine, the CFR agencies have coordinated on disseminating the ACSC's advice to regulated firms on their cybersecurity posture.

In March 2022, the CFR reviewed the outcomes of a pilot exercise under the Cyber Operational Resilience Intelligence-led Exercises (CORIE) framework, which was completed in October 2021. The pilot included several large financial institutions and financial market infrastructure providers. It involved mimicking the tactics, techniques and procedures of real-life adversaries to test and demonstrate institutions' cyber resilience levels. The pilot provided valuable information, both for the participating institutions and for the CFR agencies on the design of future exercises. The CFR has endorsed the adoption of an updated CORIE framework for a broader rollout of the testing program.

CFR agencies have also been working with the Department of Home Affairs on the development and implementation of new obligations to help protect 'critical infrastructure' against cybersecurity and other threats. New legislation: expands the critical infrastructure framework to cover the financial services and markets sector; enables the government to assist entities responsible for critical infrastructure during an extreme cyber incident; and introduces a requirement for entities to report significant cyber incidents to the ACSC. In addition, certain entities will be required to maintain a risk management program for identifying and mitigating threats, while a subset of entities responsible for 'systems of national significance' may be subject to enhanced cybersecurity obligations. CFR agencies are working to ensure the new regime is as aligned as possible with existing cybersecurity obligations placed on entities in the financial sector. The Reserve Bank has been assisting with the application of the reforms to the operators of payment systems specified as critical in Australia. These are the Mastercard debit and credit card systems, the Visa debit and credit card systems, the EFTPOS card system and the New Payments Platform.

Several work streams are aimed at addressing the financial risks from climate change

The CFR, supported by its Climate Working Group, remains focused on addressing the financial risks associated with climate change. In December 2021, it discussed developments related to the COP26 climate summit and in particular the establishment of the International Sustainability Standards Board (ISSB). The ISSB is developing high-quality global baseline climate and sustainability disclosure standards to meet the information needs of investors, and will work in close cooperation with the International Accounting Standards Board. This is a major step forward in setting global climate and sustainability reporting standards. ASIC is monitoring developments and consulting with stakeholders to understand the implications for Australian firms. In the meantime, ASIC is encouraging listed companies to use the Task Force on Climate-related Financial Disclosures recommendations as the primary framework for voluntary climate-related disclosures. The CFR supports this approach.

The CFR has also discussed the development of sustainable finance taxonomies. These taxonomies establish standards that allow investors to assess the sustainability credentials of specific projects and financial products. They have been developed in a number of other jurisdictions, including the European Union and China. The CFR welcomes work underway by the Australian Sustainable Finance Institute to develop an industry-led taxonomy – with involvement from regulators – that suits the structure and trajectory of the Australian economy and builds on international work on sustainable finance taxonomies.

APRA is leading a Climate Vulnerability Assessment (CVA) on behalf of the CFR (see 'Chapter 3: The Australian Financial System'), which will estimate the impact of two potential climate scenarios on Australia's five largest banks. The Reserve Bank has published analysis to assess the climate risk to the Australian banking system, which complements the CVA. APRA's prudential practice guide on climate change financial risks, released in November 2021, will assist banks, insurers and superannuation trustees to manage the financial risks of climate change.

Finally, ASIC has been seeking opportunities to improve consumer outcomes by changing industry practices to mitigate the risk of 'greenwashing'. ASIC is conducting targeted surveillance of financial products to identify misleading statements relating to environmental, social and governance claims, particularly across social media.

The CFR has considered a wide range of other issues affecting the financial sector

Other recent topics of discussion by the CFR have included:

- *The availability and affordability of insurance for businesses.* The business insurance market globally is seeing a rise in premiums and deductibles, more exclusions and reduced coverage.
- *Regulatory developments related to financial market infrastructures (FMIs).* Much of the cooperative work on FMIs is undertaken through the FMI Steering Committee, which reports to the CFR. Recent areas of focus have included progress with ASX's CHESS Replacement System, the licensing of international central securities depositories, and open access principles for clearing services. A regulatory reform package for FMIs, which includes the creation of an FMI resolution regime, has been agreed by the Australian Government, but is yet to be legislated.
- *The phasing-down of the Committed Liquidity Facility (CLF).* In light of the increased availability of government debt securities, APRA expects banks to purchase the high-quality liquid assets necessary to eliminate the need for the CLF and reduce their usage to zero by the end of 2022. CFR members discussed banks' anticipated progress towards meeting this expectation, with all affected banks expected to comply.
- *Forthcoming work on the use of derivatives by superannuation funds.* In November 2021, the Treasurer requested that the CFR report by June 2022 on the use of derivatives by superannuation funds. The report is expected to cover: the operational capability of funds to properly manage large volumes of derivative transactions; prudential implications for the operation of individual funds and the outcomes for members of those funds; and any broader implications in terms of financial system stability. The CFR discussed a proposed approach to this work in December 2021.

The CFR continues to engage with other regulators in Australia and New Zealand

The CFR agencies meet with their New Zealand counterparts through the Trans-Tasman Council on Banking Supervision (TTBC). The TTBC currently meets separately at the agency heads, deputies and working levels. The TTBC Heads met most recently in December 2021, with members providing updates on recent policy announcements, regulatory interventions and significant work to be undertaken.

The TTBC agreed its work plan for 2022, which includes continued information-sharing on key issues such as housing markets and climate-related risks to the financial system. The TTBC will continue to collaborate on responding to cyber risks and enhancing crisis preparedness. This work program will complement the ongoing bilateral engagements between TTBC member agencies.

The CFR invites other Australian Government agencies to its meetings when appropriate. Both the ACCC and AUSTRAC attended the CFR's March 2022 meeting.