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FINANCIAL REGULATION IN AUSTRALIA *since the GFC*[1]

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Post GFC standard-setting work has focused on financial stability and prudential supervision. In many respects, the impact of post-financial crisis global regulatory developments on Australia's framework of financial regulation has been evolutionary rather than revolutionary. Generally, we have not seen calls for the type of major changes that are being implemented in some other jurisdictions. While our existing framework is likely to undergo further refinement over time, we already have many of the key attributes identified by the Financial Stability Board. An earlier version of this paper was presented to the 2012 Australian Centre for Financial Studies' Melbourne Money and Finance Conference.

In the period since the global financial crisis (GFC) a massive wave of global standard setting has occurred in relation to financial sector oversight and regulation.[2] We have seen the emergence of Basel II.5 and Basel III as well as a range of new standards in areas like financial sector compensation and resolution regimes. This standard-setting work has some way to go, with substantial work still underway on the regulation of wholesale financial markets and shadow banking sectors as well as on the issue of whether domestic systemically important banks (D SIBs) should be subject to higher loss absorbency requirements along the lines that have already been agreed in relation to global systemically important banks (G SIBs).[3]

In addition, some of the jurisdictions that were at the epicentre of the financial crisis have been implementing their own regulatory changes. Examples include the United Kingdom (UK) Government's response to the recommendations of its Independent Commission on Banking and the United States' (US) Dodd-Frank legislation, the detailed rules for which are gradually being written by relevant regulatory agencies. Some of these changes depart from or go beyond internationally agreed standards. While this is not unusual, it can cause some issues for cross-border markets (such as in relation to over-the-counter (OTC) derivatives).

A new Financial Stability Board (FSB) has been established to coordinate the process of developing new regulatory standards. In some areas, the FSB has become a standard setter in its own right (e.g. compensation and resolution). It is playing a key role in monitoring national implementation of G20 commitments through its Coordination Framework for Implementation Monitoring (CFIM), a peer review council for G-SIB regulation and through its ongoing program of rolling thematic and country peer reviews. Some other standard setters are also playing a more active role in monitoring implementation (including the Basel Committee on Banking Supervision (BCBS) in relation to Basel III). Finally, G20 members are subject to more intensive peer review through the International Monetary Fund (IMF) and World Bank Financial Sector Assessment Program (FSAP) process as well as annual Article IV surveillance by the IMF.

Key themes

Standard-setting work since the financial crisis has been focused on four key objectives: enhancing oversight and supervision by national regulators; improving crisis management and resolution arrangements; strengthening the resilience of core prudentially regulated institutions; and increasing the transparency and resilience of major wholesale markets and the 'shadow banking' sector.

Enhancing oversight and supervision by national regulators

The aim of enhancing oversight and supervision reflects the view that absent or ineffective supervision was a key cause of the financial crisis. The FSB has produced recommendations to enhance supervisory intensity and effectiveness.[4] There is also a view that supervisors in major financial centres should have played a more active role in identifying and mitigating the build-up of systemic risk, both within the core banking system and also within wholesale markets and the shadow banking sector. The FSB has also played a role in promoting stronger cross-border cooperation between regulators that share responsibility for supervising G SIBs, including through the creation of individual supervisory colleges and crisis management groups.[5]

While it is not a requirement of new standards, some jurisdictions have responded to the crisis by restructuring domestic regulatory agencies and by introducing more formalised arrangements for oversighting systemic risk (e.g. the UK and US).

Improving crisis management and resolution arrangements

The focus on improving crisis management and resolution arrangements reflects the problems experienced by many national authorities in managing bank failures. In some cases, the lack of relevant powers made it difficult to resolve failing institutions and may have increased the cost of taxpayer support. Failures of large globally active banks also raised significant cross-border issues. In response to these developments, the BCBS produced recommendations on cross-border crisis resolution while the FSB has produced its *Key attributes of effective resolution regimes*.[6] G20 members have been asked to indicate their plans for implementing the key attributes, and national frameworks will be subject to a thematic peer review in the second half of 2012 (following on from the review undertaken by the BCBS in 2011)[7].

An important issue in this context has been the appropriateness of existing burden-sharing arrangements in the event of a major bank failure. In some jurisdictions, taxpayers have been required to provide substantial support to financial institutions. It has been difficult to recover these funds. This has substantially eroded the fiscal position of some governments. By contrast, shareholders, investors and depositors have received relatively favourable treatment. This has prompted considerable interest in how it might be possible to shift the burden of crisis management and resolution from taxpayers to the private sector. The issue was examined by the IMF in 2010.[8] It has also been considered by the BCBS and the FSB.

Different approaches are being adopted in this area, although there is not yet any consensus on how to proceed. To some extent this reflects the novelty of some of the proposals as well as the current environment of financial market volatility. One response has been the introduction of ex ante levies and crisis resolution funds. Some of these levies are also intended to discourage growth or encourage particular funding models. Another response has been to experiment with techniques to force private investors to participate in rescuing failed institutions (through bail-in rather than bail-out). Options that are being explored include requiring banks to issue a certain amount of 'bail-inable' debt in advance or giving regulators a general power to impose haircuts on liability holders in a crisis situation.

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Strengthening the resilience of core prudentially regulated institutions

The aim of strengthening the resilience of core financial institutions represents a response to concerns that some of them had inadequate capital and liquidity buffers in the lead-up to the crisis. There was also a more fundamental concern that the prudential framework exacerbated pro-cyclicality by allowing the build-up of excess leverage during booms then forcing excess deleveraging during subsequent downturns. Basel II.5 and Basel III will establish higher minimum capital and liquidity requirements for banks. In addition, G SIBs will be subject to higher loss absorption requirements in the form of capital surcharges. Higher regulatory capital requirements are being introduced alongside requirements for 'bail-inable' debt in some jurisdictions (e.g. Switzerland and the UK).

Some jurisdictions have gone further in seeking to boost the resilience of major financial institutions by limiting their activities. The US is pursuing this objective through the Volcker Rule while the UK has announced it will require certain retail functions of major banks to be 'ring fenced' from other operations.

Increasing the transparency and resilience of major wholesale markets and the 'shadow banking' sector

Increasing the transparency and resilience of wholesale markets and the shadow banking sector emerged more slowly as a key theme of international work than the other objectives. The initial focus of this work was on securitisation, credit rating agencies and credit default swap markets. However, it has expanded to cover all OTC derivatives, securities lending and repo markets, money market funds and hedge funds (including issues such as margining and re-hypothecation).[9] This reflects concerns on the part of some regulators that these markets are a potential source of wider financial vulnerabilities, including for core prudentially regulated institutions, as well as a concern that more intensive regulation of core prudentially regulated institutions may cause activity and risk to shift into the shadow banking sector. To date, the key output in this area has been the agreement to implement reporting and boost the use of central counterparty (CCP) clearing and trading platforms in relation to OTC derivatives.[10] There has also been agreement to collect more data on the operation of the shadow banking sector to better understand the risks involved. By the end of 2012 there is expected to be a decision on whether, and if so how, these areas should be subject to more intensive oversight.

Post GFC standard-setting work has focused very much on financial stability and prudential Post GFC standard-setting work has focused very much on financial stability and prudential supervision. Relatively little attention has been devoted globally to consumer protection issues, although the Organization for Economic Co-operation and Development (OECD) did produce some high-level principles on financial consumer protection.[11] However, this has been an issue in particular jurisdictions, such as the UK, which witnessed major problems with product miss-selling. In response to these developments, the UK has been considering how to make product issuers take more explicit responsibility for the design of retail products, rather than simply being required to disclose their key features. It has also shown an interest in the regulator having more powers to restrict the availability of products to retail consumers.

Australia's role in the process

As a member of the G20, Australia has been an active participant in the process of developing new global standards on financial regulation. The involvement of Australian officials in the work of international standard setters has increased markedly since the financial crisis, both in relation to standards development and reviews of implementation. Australia now has two seats in the restructured FSB (we only had one position in the former Financial Stability Forum). We have also become a full member of the BCBS for the first time, where we are represented by the Australian Prudential Regulation Authority (APRA) and the Reserve Bank of Australia (RBA).

The members of these bodies have approached standard-setting work from different perspectives. Regulators from Europe and the US have often been proponents of major change (although not always in the same direction). On the other hand, some emerging market economies have seen the financial crisis as a European and US problem that requires European and US solutions (especially as many of their own financial sectors were relatively unaffected by the financial crisis and did not require extraordinary public support).

The Australian Government took steps to secure the domestic financial system during the GFC through the introduction of the Financial Claims Scheme (FCS), the wholesale bank guarantees and Australian Office of Financial Management investment in the residential mortgage-backed securities (RMBS) market. However, taxpayers will earn a return for these measures. Our regulatory framework did not fail; although strains were exposed in a few areas (e.g. reliance on short-term funding). In these circumstances, the challenge for Australia has been to determine what lessons we should draw from the experience of Europe and the US, and the extent to which we should incorporate new approaches into the design and operation of our regulatory framework, especially where our financial system is materially different, or where potential recommendations may be at odds with existing domestic regulatory practice.

Implications for Australia's regulatory framework

In many respects, the impact of post-financial crisis global regulatory developments on Australia's framework of financial regulation has been evolutionary rather than revolutionary. Generally, we have not seen calls for the type of major changes that are being implemented in some other jurisdictions.

The financial crisis did not expose fundamental flaws in the basic supervisory architecture we introduced following the 1997 *Financial System Inquiry* or the way in which supervisors approach their responsibilities. Indeed, it reinforced the value of APRA's active supervisory oversight and close cooperation between members of the Council of Financial Regulators (CoFR). One of the key points we have sought to emphasise in the G20 context has been the importance of active supervisory oversight (rather than an excessive focus on detailed rules).

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One of the key points we have sought to emphasise in the G20 context has been the importance of active supervisory oversight (rather than an excessive focus on detailed rules). While some jurisdictions have adopted more elaborate and formalised approaches to macro-prudential regulation, there appears to be increasing recognition on the part of IMF staff that this can be carried out in different ways and that it is not necessary for all jurisdictions to adopt the approach that has recently been implemented in the UK or the US.

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In recent years, Australian authorities have devoted considerable attention to crisis management and resolution. This is an area where Australia benefited from the harsh lessons learned from the collapse of HIH Insurance. In the years since the HIH collapse, we progressively upgraded the powers of relevant regulators and coordination arrangements between regulatory agencies. This work has continued in the wake of the GFC, for example, through APRA's recent engagement with a selection of major banks on the development of resolution plans. The main development in this area involves extending crisis management arrangements to providers of systemically important financial market infrastructure.[13]

While our existing framework is likely to undergo further refinement over time, we already have many of the key attributes identified by the FSB. In relation to burden sharing, the government has not introduced new levies on the banking sector. As part of Basel III, APRA proposes that subordinated debt will be required to be 'bail-inable' at the point of non-viability.[14] However, Australia has not followed other jurisdictions like Switzerland and the UK in requiring banks to issue additional tranches of 'bail-inable' debt that could be used to replenish dwindling capital buffers. Given uncertainty about the effectiveness of these instruments in a crisis situation in light of their potential to trigger wider contagion, our approach to date has been to see how they perform overseas before making any recommendation to the government about their possible introduction.

As a member of the G20, Australia has agreed to implement Basel III to boost the resilience of our banking sector. APRA is currently consulting on how the new standards will apply in Australia. In contrast with some other jurisdictions, implementation of new capital standards will have relatively small impact on our banks because of the extent to which they have boosted capital since 2008 to meet the demands of investors and rating agencies (as well as APRA's conservative approach to implementation of Basel II).[15]

A key issue for Australia in the G20 context has been the need for additional capital surcharges over and above Basel III. Because we do not have any G SIBs, we have not been required to impose capital surcharges. However, the FSB and BCBS are considering whether and how to extend these requirements to D SIBs. This would be a significant departure from current practice if it was required to be introduced in Australia.

Australia's banks are expected to be subject to new liquidity standards from 2015.[16] Again, the immediate impact of these has been reduced by the efforts made since 2008 to strengthen bank funding positions, boost access to deposits and reduce their reliance on short-term funding. The immediate impact will also be limited by the ability of banks to meet a significant part of the new liquidity requirements through committed liquidity facilities (CLF) with the RBA (which are necessary because of our shortage of high-quality liquid assets). In the longer term, the impact of the Basel III liquidity rules will depend on decisions by APRA on the extent to which banks can access the CLF.

In common with most other G20 members, Australia has not elected to take additional structural steps to reduce the riskiness of banks, for example by banning certain activities or requiring 'ring fencing' of retail banking. In contrast with the UK and US, our major banks remain focused on traditional lending activities and do not have major investment banking arms. Moreover, experience overseas suggests 'traditional' banking is also a major source of risk (especially in relation to property lending).

The area where new global standards may have the greatest impact on Australia's regulatory regime in the longer term relates to wholesale financial markets and shadow banking. Up until now, these parts of our financial system have not generally been subject to direct regulation (although they have been indirectly affected to the extent that participants are prudentially regulated or are part of groups containing prudentially regulated entities). This reflects the position that there can be parts of the financial sector that are not regulated for on prudential or investor protection grounds.

In April 2012, the government set out how it will implement the G20 commitment on reforming OTC derivative markets.[17] This includes proposals for legislation that could be used to mandate trade reporting, use of central counterparty clearing and use of trading platforms. The FSB and other standard-setting bodies are currently examining the need for more intensive oversight and regulation of the shadow banking sector, including money markets and securities lending and repo markets. The outcome of these reviews is not expected until the end of 2012. However, they could potentially recommend a significant expansion of regulation. The issue for Australian authorities will be to determine whether this is justified given the relatively small size of Australia's shadow banking sector.[18]

Other issues

A key issue from the perspective of the Australian Government has been the impact of the financial crisis on competition in domestic banking (especially in lending markets). We have seen an increase in the market shares of the major banks as other lenders have struggled to access funding.

In response to these developments, the Government has sought to strengthen access to various types of funding (covered bonds, RMBS and deposits) as well as reduce obstacles to competition. This has included a new account switching package, new fact sheets and the banning of exit fees on new mortgages. The Government has also been examining options for promoting Australia's corporate bond market, both as a means to enhance bank access to domestic debt funding and as an alternative source of funding for larger corporations. These issues will become even more salient in the future if demand for credit rises. ■

Notes

1. The views presented in this paper are solely those of the author. They do not necessarily reflect the views of the Australian Government or the Department of the Treasury.
2. For details see Financial Stability Board progress reports to the G20 published on the FSB website (www.financialstabilityboard.org).
3. See FSB's interim report on *Securities lending and repos: market overview and financial stability issues* (27 April 2012); FSB's third progress report on implementation of *OTC derivative market reforms* (15 June 2012) and Basel Committee consultation document on *A framework for dealing with domestic systemically important banks* (1 August 2012).
4. See Basel Committee's *Good practice principles on supervisory colleges* (12 October 2010), the FSB report on the *Intensity and effectiveness of SIFI supervision* (2 November 2010) and FSB progress report on *Implementing the recommendations for enhanced supervision* (27 October 2011).
5. See FSF *Principles for cross-border cooperation on crisis management*, 2 April 2009.
6. See *Report and recommendations of the Basel Committee cross-border bank resolution group* (18 March 2010) and FSB *Key attributes of effective resolution regimes for financial institutions* (October 2011).
7. Basel Committee *Report on progress on resolution policies and frameworks*, 6 July 2011.
8. *Financial sector taxation: the IMF's report to the G20 and background material*, September 2010.
9. See FSB's *Overview of progress in the implementation of the G20 recommendations for strengthening financial stability, report of the Financial Stability Board to G20 Leaders*, 19 June 2012.
10. See FSB *Report on implementing OTC derivative market reforms*, 25 October 2010.
11. See G20 *High-level principles on financial consumer protection. The FSB has also completed a Thematic peer review of mortgage underwriting and origination practices*, 17 March 2011.
12. See for example, IMF Staff note on institutional models for macroprudential policy, 1 November 2011.
13. Treasurer's press release of 30 March 2012, 'Recommendations for financial market infrastructure reform'.
14. See APRA's Draft Prudential Standards on Basel III Capital Reforms in Australia (30 March 2011).
15. Speech by John Laker, 'Bank Regulation and the Future of Banking' (11 July 2012).
16. See APRA's Consultation package on implementation of Basel III liquidity reforms (16 November 2011).
17. Treasurer's press release of 18 April 2012, 'Implementing G20 commitment on OTC derivative reforms'.
18. See RBA *Financial Stability Review*, March 2012 (Box D).