Glenn Stevens: Financial regulation – Australia in the global landscape

Address by Mr Glenn Stevens, Governor of the Reserve Bank of Australia, to the Australian Securities and Investments Commission (ASIC) Annual Forum, Sydney, 26 March 2013.

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The title of this session is "Australia as a Global Citizen". Accordingly, I will seek to set financial and regulatory developments in Australia in a global setting. This is worth doing for its own sake, since local discussion is better informed if we can see how the various initiatives fit in to the broader setting. It is also important to remember that Australia, along with all other jurisdictions that sign up to international standards, will be evaluated by our peers. So it's worth spelling out our approach to some key issues.

In addition, from the end of this year Australia will have responsibility for chairing the G20 for a year, and financial reform and regulation have been prominent on the G20's agenda in recent years. So Australia's political leadership will have some responsibility for shaping, for a brief period, the oversight of the process. It is worth starting to think about how this might be done.

As a "global citizen", Australia has the responsibilities and rights of that "citizenship". The responsibilities are to uphold and play by the rules that are globally agreed, which include implementing global standards in regulation and oversight, and encouraging others to do so. The rights we have are the same as those of others: to have our say and to play our own part, however modest and small, in the development of those standards.

Something that is a bit new and, overall, refreshing is that Australia actually does have a place at more of the relevant tables than it used to. ASIC has long been a member of the International Organization of Securities Commissions (IOSCO) as were its predecessor organisations the ASC and the NCSC. It is quite a feather in the cap for ASIC that its chair has this month assumed the chair of the IOSCO Board. The expanded membership of the Basel Committee on Banking Supervision (BCBS) now allows Australia two members – APRA, naturally, and the Reserve Bank – where we had none before. The Financial Stability Board (FSB) likewise allows us two seats, compared with one previously, and membership of some of the key committees.

The international financial landscape

In the wake of the crisis that swept Europe and North America, the international regulatory environment for the financial system has changed significantly. An expanded Financial Stability Board, with the political backing of the G20 Leaders, has acted to coordinate this process, working with existing standard-setting bodies and also by developing its own processes.

There have been several main streams to the reforms.

The first is the Basel III prudential reforms, which aim to improve the resilience of financial institutions by strengthening capital and liquidity requirements. Compared with Basel II, minimum capital ratios are higher, capital has been defined more strictly to refer to genuinely loss-absorbing instruments, and use of counter-cyclical capital add-ons is contemplated, all supplemented by a simple constraint on overall leverage. More attention is focused on liquidity management by banks.

The second key stream of work has aimed to address the problem of "too big to fail". Global systemically important banks (G-SIBs) have been identified, and capital surcharges will be set to strengthen their resilience, beginning in 2016. Cross-border crisis-management groups have been established for nearly all of these institutions, and one of their key tasks is to review the recovery and resolution plans that are being developed for these firms. Intensity of

supervision is also being increased. For domestic systemically important banks, a principles-based regulatory framework has been developed.

While banks have been the major focus thus far, the overall policy framework for systemically important financial institutions (SIFIs) applies more broadly, and an identification methodology is close to being finalised for global systemically important insurers.

A third element is aimed at improving the functioning of markets for over-the-counter (OTC) derivatives, so as to reduce risk of contagion in the financial system. This is to be achieved by promoting or mandating central clearing of standardised OTC derivatives contracts, and adding to transparency through requiring trade reporting.

A fourth stream is aimed at addressing risks arising from shadow banking – that is, those entities and activities outside the regulated banking system that are associated with credit intermediation and maturity transformation. The FSB released key proposals last year for consultation and they are being refined on the basis of feedback received, for consideration at the G20 Leaders' Summit in September 2013.

What has Australia done?

Australia was not as badly affected by the crisis as some other countries. Our banking system overall, though hardly without blemish, stood up fairly well. This was testament to generally sound management in most institutions and a robust supervisory approach. But there were still lessons to be drawn for Australia and the regulators here have given careful thought to them and to the associated global reforms.

APRA finalised its prudential standards to implement the Basel III capital standards in late 2012. Australia, along with 10 other jurisdictions, adopted the capital elements of Basel III as from 1 January this year. Some major jurisdictions – the EU and the US in particular – are a little behind, though all the BCBS member jurisdictions had at least released draft regulations by mid-February.

Australia is considered an "early adopter" of the Basel III reforms. Given the relatively healthy capital positions of authorised deposit-taking institutions (ADIs), APRA is requiring ADIs to meet a number of the main capital measures two or three years earlier than the rather extended timetable required under Basel III and it is not using the discretion available under Basel III to provide a concessional treatment for certain items in calculating regulatory capital (e.g. deferred tax assets).[1]

APRA has also moved ahead on the liquidity standard, in conjunction with the Reserve Bank. We have established the Committed Liquidity Facility (CLF) – a mechanism by which the Basel III liquidity standard can be met, in a world in which government debt in Australia is relatively scarce compared with other jurisdictions.

Let me say a little about this facility. It is not a "bail-out" fund for banks. "Bail-outs" usually mean stumping up public funds to inject capital to an institution whose solvency is in question. The CLF does no such thing. It is a facility, for which the institutions concerned will pay a fee, which would provide cash against quality collateral pledged by institutions that the Bank and APRA judge to be solvent. The fee structure is designed to replicate the cost the institutions would incur if there were sufficient ordinary high quality collateral – i.e. government debt – for them to hold to meet the Basel liquidity requirements – which, of course, there is not. If we are to meet the global standards, we either have to have a facility like this, or have the government issue a few hundred billion dollars in extra gross debt so

[1] As part of international monitoring implementation of Basel III, Australia will undergo a so-called Level 2 assessment conducted by the BCBS later this year, which will assess the regulatory consistency of Australia's implementation of the Basel III minimum requirements.

the banks can hold it. The relevant ADIs will pay a fee of 15 basis points per annum for the facility whether they use it or not. If they do use it, any funding will be at an interest rate that is 25 basis points above the market rate. This has been developed openly, and under the scrutiny of the international regulatory community. It was approved by the Reserve Bank Board in November 2010.

With regard to the "SIFI" reforms, Australia's large banks cannot realistically be assessed as globally systemic. Hence there was no good reason for them to be classed as G-SIBs. But it cannot be denied that they are domestically systemic, which is why it is appropriate that the Basel Committee's domestic systemically important bank framework capture them. This will involve some additional minimum loss absorbency on the capital side but also an intensity of supervision that is greater than applied to the "average" ADI – an aspect that is already a key part of APRA's supervisory approach. In the area of resolution, a number of steps have been taken in recent years, including a strengthening in APRA's crisis management powers in 2008 and 2010.

So far as derivatives markets are concerned, legislation was passed in Australia in December 2012 to help meet emerging international standards. Given uncertainties around both the final shape of key regimes internationally, and the broader market and economic effects of regulation in this area, the final legislative framework contains considerable flexibility. In particular, the legislation does not directly introduce any trade reporting, central clearing or trade execution obligations for OTC derivatives transactions. What it does do is create a mechanism by which such obligations may be implemented by supporting regulations, which would be developed and administered by ASIC.

There is more focus generally on what are known as "Financial Market Infrastructures" (FMIs). In April last year, the Committee on Payment and Settlement Systems (CPSS) and IOSCO released new Principles for Financial Market Infrastructures, the culmination of two years of detailed standard-setting. The Reserve Bank has revised its own Financial Stability Standards for Central Counterparties and Securities Settlement Facilities, so as to align them with the Principles. It has also committed to assessing Australia's high-value payment system, RITS, against the Principles on an annual basis. ASIC similarly updated its Regulatory Guide for Clearing and Settlement Facility licensees to reflect the new Principles and aims to ensure consistency with the Principles in the regime it is designing for trade repositories.

With regard to shadow banks, the Reserve Bank presents an annual review of shadow banking developments to the Council of Financial Regulators. Our assessment is that the shadow banking system in Australia is relatively small compared with the formal ADI sector, which means that the recommendations being developed internationally are not as important an issue here as they may be for other jurisdictions, at least from a stability perspective. Separately, there is the dimension of investor protection. Here ASIC and APRA are working on strengthening the regulatory framework for retail debenture issuers. ASIC has proposed minimum capital and liquidity requirements, while APRA's proposals, which are forthcoming, will aim to make clearer that the products offered by these entities are not the same as the deposit products offered by banks.

Remaining challenges

From this very quick tour of the key regulatory themes, it should be obvious that much has been achieved, but that significant challenges remain. It is, I think, fair to say that as time has passed and implementation has come into focus, various difficulties and complications are coming to the fore. Some aspects of the Basel standards are being tweaked. It has been

necessary for standard-setting bodies to issue additional guidance, to provide further clarity regarding new reforms, and to ensure consistency in interpretation and implementation.[2]

To some extent this was to be expected. Reforms that seemed so simple and obvious, so bold and so sweeping in the immediate aftermath of the crisis of 2008, have turned out to be harder to implement than first expected. This is hardly surprising really, since so much is being attempted at the same time. It is not that attempting much is a mistake: there were serious problems to be addressed and a lot needed to be done. But in so doing, there was always a pretty good chance that the compounding effects of multiple reforms would contain some unexpected and unintended consequences.

To take one example, there is concern in some quarters about a potential shortage of high-quality collateral. This arises because regulatory reforms around bank liquidity and centralised clearing are likely to add to demand for high-quality liquid assets. This is spawning great interest by intermediaries to offer collateral transformation services – turning relative risky assets into ostensibly safe ones – that could present new risks.

OTC derivatives reforms have been a particularly thorny issue, not least because of the cross-jurisdictional reach of international regulation in this area. European OTC derivatives regulation and US regulation under the Dodd-Frank Act are clear examples of measures that potentially have a strong impact on other jurisdictions. A grouping of market regulators, including ASIC, has been convened to develop some common understandings around the cross-border application of rules. Particularly in a global market such as that for OTC derivatives, consistency with other jurisdictions' rules is an important consideration in the development of the domestic framework.

As OTC derivatives markets make this transition to central clearing, interest is emerging from overseas-based central counterparties in providing their services directly to Australian-based participants. Many international participants in the Australian interest rate swaps market already clear their trades through the UK-based global central counterparty, LCH.Clearnet Limited (LCH). LCH has announced that it will be seeking a licence to provide these services directly to Australian-based participants, alongside a competing offering being developed by the domestic derivatives central counterparty, ASX Clear (Futures).

To the extent that participants in smaller markets choose to clear via overseas-based central counterparties it is important that they can do so on appropriate terms, and also that the interests of regulators in these jurisdictions be given due weight. In July last year, ASIC and the Reserve Bank jointly published a document setting out the measures that would be taken to ensure appropriate regulatory influence where an overseas-based central counterparty was operating in Australia. These measures would be applied in the oversight of LCH or any other overseas-based central counterparty that might obtain a licence to provide such services.[3]

In a world of more central clearing, the question of how the official sector would deal with a situation of FMI distress assumes more importance. As a result of a review by the Council of Financial Regulators in 2011, work is in progress to develop legislative proposals that would

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[2] An example of this was recent guidance by the BCBS on the usability of high-quality liquid assets under the liquidity coverage ratio. Another is the technical guidance by the FSB to assist national authorities and cross-border crisis management groups in their recovery and resolution planning.

[3] In accordance with this approach, the Reserve Bank has already assumed a seat on a new cooperative oversight arrangement for LCH. This will provide a vehicle for representing Australian interests in the design and operation of this important piece of infrastructure.

give effect to a "step-in" power as part of a comprehensive resolution regime for FMIs. This is to be designed in accordance with international standards.[4]

These are just a few examples of how the world of regulation and financial oversight is growing more complex. Whether it is the additional demand for high-quality collateral arising from reforms on bank liquidity and centralised clearing, or the extra-territorial reach of US reforms under the Dodd-Frank Act, or the likely difficulties in maintaining systems of reference interest rates in a world where banks are now extremely wary of the legal risks involved in voicing an opinion about where market pricing might be, or the likelihood that some activities will migrate beyond the regulatory net, complications from regulatory activism are in evidence.

My guess is that we don't yet know what all the compounding effects of multiple reforms may be and it may be years before we do. A principle that the Reserve Bank, for its part, has sought to uphold in our own participation in the various reform streams is that we should proceed with all appropriate urgency where needed, but with deliberate care wherever possible, being conscious of the limits to our own knowledge as regulators and the likelihood of unintended consequences from steps we might take.

Further ahead

The financial reform agenda post 2008 has been very large and comprehensive. There has been a prodigious amount of work across a wide front. It is worth thinking about how this agenda might be managed in the future.

It is of course inappropriate to discuss in detail how Australia might approach its responsibilities in the G20 in 2014. The Russian G20 presidency is in full swing and will remain so until at least November. Our job until then is to assist in any way we can for a successful conclusion to that presidency. On financial regulation, the Russian chair has, to date, focused on the G20 working towards completion and implementation of previously announced reforms. This is a multi-year task and one we will inherit. One area the Russian presidency has identified for particular attention is the possible effects of regulatory reforms on the supply of long-term financing, given that one of their major themes is promoting long-term financing for investment. To date the FSB has found little evidence to suggest that global financial regulatory reforms have significantly contributed to current long-term financing concerns, but they have been asked to continue to monitor the possible effects.

Australia's approach will, of course, be a national one, adopted by government, not simply one established by the Reserve Bank.

Subject to all those constraints, I would simply observe that, in my opinion, by 2014 we will have reached a point in the financial regulatory sphere where the G20 should be looking for careful and sustained efforts at implementation of the regulatory reforms that have already been broadly agreed, but being wary of adding further reforms to the work program. Absent some major new development, which brings to light some major reform need not hitherto visible, to task the regulatory community and the financial industry with further wholesale changes from here would risk overload. Lest this be considered too weak a position, let us remember how much is being attempted. And since we are already seeing the need to "tweak" some earlier agreed proposals, it is surely clear that the details of implementation should increasingly be our focus over the next few years. The G20 will need to remain open to the possibility – the likelihood even – that as experience is gained with implementation and we grapple with the inevitable difficulties, and as we learn more about how the financial

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[4] The relevant standards are the FSB's Key Attributes of Effective Resolution Regimes for Financial Institutions. Work is also underway by CPSS-IOSCO to establish how best to apply the Key Attributes to financial market infrastructures.

system is likely to operate in a new world, we will want to make occasional adjustments to the rules.

None of that ought to be seen as a retreat from the high level objectives that have guided efforts to date: the desire for a more stable, more resilient and simpler financial system, that is better able and more inclined to play its "handmaiden of industry" role and better able to withstand failures of individual institutions. But in pursuing these goals, it is important that we:

- strike the right balance between more regulation and more effective enforcement of existing regulation. Inadequate enforcement and supervision was as big a problem as deficient rules
- recognise the cross-border aspects of the financial system, with the associated need for cooperation and, yes, compromise. Recognition of the legitimate interests of smaller markets is clearly of importance to Australia but many other jurisdictions as well. This often coincides with the role of pushing for a principles-based approach instead of a one-size-fits-all heavy-handed, rules-based approach. It may also involve working to develop a "regional voice" on some issues
- consider the combination of reforms in their entirety, and keep a lookout for unintended consequences. Given the breadth and speed at which reforms have been introduced in recent years, careful analysis of how the various initiatives will interact is becoming more important.

Keeping the regulatory structure fit for purpose across a broad range of jurisdictions around the world is in fact a task that will never be complete, since the financial system evolves – in response to technology and innovation, but also in response to regulation itself. It is important for Australia not only to keep abreast of the developments and implement the key elements of global regulation here, but also to continue to play our own part in helping to develop them, and refining them in light of experience.