

G20 Financial Regulatory Reforms and Australia

Carl Schwartz*

The global financial crisis prompted a comprehensive international regulatory response, directed through the Group of Twenty (G20). The Reserve Bank and other Council of Financial Regulators (CFR) agencies have been heavily involved in the reform process, including engaging with international bodies on policy development, and implementing agreed reforms domestically. While the reforms have achieved a great deal, the Bank and other CFR agencies are mindful that the pace and volume of change are challenging for the financial system and regulators, and raise the potential for unintended consequences. Five years after the peak of the crisis, and with substantial policy development completed, there is an opportunity to focus the financial regulatory agenda on implementing reforms already agreed, with a close eye on their effectiveness.

Introduction

The global financial crisis prompted a comprehensive international regulatory response, directed through the G20. The Australian financial system was not as badly affected by the crisis as many other countries, though the crisis did highlight room for improvement in aspects of Australian regulatory and supervisory arrangements addressed by international reforms. More broadly, as part of the global financial system it is in Australia's interests to play by the rules.

The Bank and other CFR agencies – the Australian Prudential Regulation Authority (APRA), the Australian Securities and Investments Commission (ASIC) and the Australian Treasury – have therefore been heavily involved in the global reform process, engaging with the relevant international bodies on policy development. Domestically, there has been substantial and ongoing work to implement the agreed reforms. Another important ongoing aspect of the reform process is demonstrating, through international review processes, that Australia has implemented agreed reforms appropriately.

While the reforms have achieved a great deal, the Bank and other CFR agencies are mindful that the pace and volume of change are challenging for the financial system and regulators, and raise the potential for unintended consequences. With substantial policy development completed, there is an opportunity to focus on implementation of reforms already agreed, and pay close attention to their effectiveness.

This article provides an update on the financial regulatory reforms initiated through the G20 following the global financial crisis, and Australia's involvement in the reform process.

Post-crisis International Financial Reforms

The financial crisis revealed a number of shortcomings in regulatory and supervisory policies and practices, particularly in north Atlantic countries. International policymakers responded forcefully. In November 2008, Leaders of G20 countries gathered for the first time – previously this forum had been restricted to Finance Ministers and Central Bank Governors. In addition to declaring a united front to stabilise

* The author is from Financial Stability Department.

the financial system, Leaders set out principles for financial reforms and established an ambitious 47-point action plan. Financial reforms were further developed at subsequent G20 meetings and have remained a significant item on the G20 agenda.

In seeking reforms at the 2008 meeting, the Leaders called on a variety of international bodies such as the Financial Stability Board (FSB) (then the Financial Stability Forum (FSF)), the Basel Committee on Banking Supervision (BCBS) and the International Monetary Fund (IMF) to oversee policy development and implementation. In doing so, the G20 agreed that the FSF would be reconstituted as the FSB with a stronger institutional basis, enhanced capacity and wider membership.

The Leaders agreed on four key areas for reform.

- The first is to address the riskiness of financial institutions by strengthening *prudential regulatory standards*, led by banking reforms known as Basel III. To strengthen banks' ability to withstand losses, minimum capital ratios have been raised, capital has been defined more strictly to refer to genuinely loss-absorbing instruments, countercyclical capital add-ons are being considered, and a simple constraint on overall leverage has been added. To strengthen banks' liquidity management, new requirements have been developed such as the Liquidity Coverage Ratio, whereby banks must hold sufficient liquid assets to withstand a hypothetical 30-day period of funding stress.
- The second is to address the problem of an institution being '*too big to fail*', where the threatened failure of a systemically important financial institution (SIFI) would leave authorities with no option but to bail it out using public funds. The focus to date has been on global systemically important banks (G-SIBs). Currently, 28 institutions have been identified as G-SIBs, for which supervisory intensity has increased and capital surcharges will be set. Cross-border crisis management groups have been established for these institutions, and one of their key tasks

is to enhance recovery and resolution plans for these firms. The overall policy framework for SIFIs also applies more broadly: a principles-based regulatory framework has been developed for domestic systemically important banks (D-SIBs), nine global systemically important insurers have been identified and identification methodologies are being developed for global SIFIs other than banks and insurers.

- The third is to limit the scope for contagion arising from interconnections between counterparties in the *over-the-counter (OTC) derivatives market*. This is to be achieved by encouraging or mandating central clearing of standardised OTC derivatives contracts, introducing higher capital charges and collateralisation where trades are not centrally cleared, and improving transparency by requiring that all contracts be reported to trade repositories and, where appropriate, moving trading onto electronic platforms.
- The fourth is to address risks arising from *shadow banking* – entities and activities outside the regular banking system that are associated with credit intermediation and maturity/liquidity transformation. At the September 2013 Summit, Leaders agreed on implementation of a number of policy proposals regarding shadow banking, including measures to reduce the risks posed by banks' interactions with shadow banking entities, and from securities lending and repurchase agreements.

Regulatory reform work has, however, extended well beyond these areas. Other areas of reform which have been agreed include regulators taking greater account of macroprudential risks across the financial system, taking steps towards more effective supervision, and addressing misaligned incentives across a range of areas such as securitisation, credit rating agencies and bankers' remuneration. The volume of work emanating from the reform process is considerable, with steps in each workstream typically involving the development of policies, implementation and subsequent monitoring and peer review of implementation.

Table 1 presents selected information from the FSB report on progress on financial regulatory reform presented at the G20 Leaders' Summit in early September, focusing on the four main areas previously identified; these account for only 20 of the 39 workstreams covered in the full report. Reflecting the considerable work on implementation, and the goal of minimising any disruption in moving to the

new regulatory environments, the reforms are often being phased in over a long period. As judged by the FSB, global policy development across the main areas is broadly on track with the planned timetable (green shading), though national implementation is lagging in some areas, particularly for crisis resolution preparation (red shading).

Table 1: Selected G20 Recommendations on Financial Regulatory Reform and Progress

Main Areas	Global policy development		National implementation	
	Bodies ^(a)	Status ^(b)	Deadline	Status ^(b)
1. Building Resilient Financial Institutions				
Development and implementation of the Basel III capital and liquidity framework.	BCBS	Green	Various, often phased in by 2019	Green
Adoption of Basel II and II.5 (enhancing securitisation and trading book exposure) frameworks.	–	–	2011	Green
Develop guidelines and strengthen supervision of banks' risk management practices.	BCBS	Green	Ongoing	Yellow
Implement FSB standards on sound compensation practices.	FSB	Green	Ongoing	Yellow
2. Ending 'Too Big To Fail'				
Develop measures for G-SIFIs including a resolution framework, higher loss absorbency and more intensive supervisory oversight.	FSB, BCBS, IAIS, CPSS, IOSCO	Green	Various: resolution plans 2013/14; loss absorbency 2016/19	Yellow
Extend G-SIFI framework to D-SIBs.	FSB, BCBS	Green	2016	–
Prepare methodologies to identify systemically important non-bank financial entities.	FSB, IOSCO	Green	–	–
Develop key attributes of effective resolution regimes. Countries to establish legal framework for crisis intervention and groups for major cross-border firms.	FSB	Green	Ongoing	Red
Supervisors to have strong mandates, independence, resources and powers to proactively address risks.	FSB	Green	Ongoing	Red
Establish supervisory colleges for significant cross-border firms.	–	–	June 2009	Yellow
Regular peer reviews on the effectiveness and consistency of national policy measures for G-SIFIs.	FSB	Yellow	Ongoing	Yellow

Table 1: Selected G20 Recommendations on Financial Regulatory Reform and Progress (continued)

Main Areas	Global policy development		National implementation	
	Bodies ^(a)	Status ^(b)	Deadline	Status ^(b)
3. OTC Derivatives Reforms				
Standardised OTC derivative contracts to be traded on exchanges or electronic trading platforms, where appropriate, and cleared through central counterparties. All derivatives trades to be reported to trade repositories. Non-centrally cleared contracts to be subject to higher capital requirements.	CPSS, IOSCO, BCBS		End 2012	
Standards to be developed on margining for non-centrally cleared derivatives.	BCBS, IOSCO, relevant authorities		–	–
Functioning and role of credit default swaps markets to be assessed.	IOSCO		–	–
Regulation, functioning and transparency of commodity derivative markets to be improved.	IOSCO, FSB, relevant authorities		Ongoing	
4. Shadow Banking – The Regulatory Perimeter				
Develop and implement recommendations to strengthen oversight of the shadow banking system.	FSB, SSBs		Ongoing	
Develop and implement recommendations to strengthen regulation of the shadow banking system.	FSB, SSBs		Various	–
Require hedge fund registration and ongoing disclosure of appropriate information.	IOSCO		Ongoing	
Develop mechanisms for cooperation between relevant authorities to ensure effective hedge fund oversight.	FSB, IOSCO		Ongoing	
Securitisation sponsors or originators to retain a part of the risk of the underlying assets.	IOSCO, BCBS, Joint Forum		Ongoing	

(a) BCBS – Basel Committee on Banking Supervision, FSB – Financial Stability Board, IAIS – International Association of Insurance Supervisors, CPSS – Committee on Payment and Settlement Systems, IOSCO – International Organization of Securities Commissions, SSBs – standard-setting bodies; Joint Forum – group comprising BCBS, IAIS and IOSCO

(b) Colouring reflects FSB judgements on status of global progress: green denotes complete or on track in a manner consistent with the plan; amber denotes facing some difficulties in meeting its objective and timelines in a significant number of member jurisdictions; and red denotes not making adequate progress across G20 jurisdictions; dashes signify not yet applicable or not relevant

Sources: FSB (2013); RBA

The global reform process has been dominated by the north Atlantic countries most affected by the crisis. In effect, these countries are promoting a marked strengthening in their domestic regulatory approaches from the earlier approaches. There has been considerable progress and many useful reforms have been undertaken. However, applying global reforms across a wide range of financial systems and regulatory approaches is not without challenges. Some of the international reforms are addressing problems emanating from more market-based financial systems than those in other countries. Some flexibility to adapt reforms to national circumstances is needed, particularly for countries where financial systems came through the crisis in relatively better shape and regulatory settings proved more appropriate – such as Australia and much of Asia. Another challenge for regulators and financial systems has been keeping up with the rapid pace of policy development and implementation.

Australia and the International Financial Reforms

As part of the global financial system, Australia has a strong incentive to play by the rules. Also, while the Australian financial system and regulatory arrangements fared better than many during the financial crisis, the experience highlighted room for improvement. Accordingly, Australian regulatory agencies have been actively engaged in all aspects of the international reform process: policy development, implementation and peer review. This has required active engagement by the Bank and other CFR agencies in the international arena, including representation on a wide range of international groups (Table 2).

Overall, Australia is generally meeting, or in some cases is ahead of, the international implementation timetable.

- On *strengthening prudential regulatory standards*, Australia is relatively well advanced in adopting the Basel III reforms. Of the 27 member

jurisdictions, Australia is one of 11 that have issued final Basel III capital rules that are legally in force. APRA is requiring authorised deposit-taking institutions (ADIs) to meet a number of the key capital measures two or three years earlier than the extended timetable required under Basel III and it is not using the discretion available under Basel III to provide concessional treatment for certain items in calculating regulatory capital (e.g. deferred tax assets). APRA, with input from the Bank, has also made good progress on developing the Basel III liquidity standards for Australia. While the Basel Committee has allowed delayed implementation, APRA has adopted the more ambitious original timetable and will implement the Liquidity Coverage Ratio requirement fully on 1 January 2015.

- Australian banks are not globally systemic and are therefore not subject to the stricter rules for G-SIBs addressing '*too big to fail*'. However, APRA is working on policies to reflect the Basel Committee's framework for domestic systemically important banks (D-SIBs), with the initial draft expected by early 2014. The framework will involve some additional minimum capital requirements to absorb losses and more intense supervision than is applied to the 'average' ADI – a feature that is already an important part of APRA's supervisory approach. In the area of resolution arrangements, a number of steps have been taken in recent years, including strengthening APRA's crisis management powers in 2008 and 2010, enhanced powers for information sharing for the Reserve Bank, ongoing engagement with New Zealand authorities around crisis management, and moves to refine the Financial Claims Scheme (FCS). This includes the CFR recommendation to government in March 2013 that the FCS should move to a prefunded arrangement. The FSB's peer review of resolution regimes found that Australia's resolution arrangements in respect of ADIs and insurers were generally consistent with international best practice and compared well to many other jurisdictions.

Table 2: Australian Representation on Selected International Groups^(a)

Body	Reserve Bank	Other CFR agencies
Group of Twenty (G20)		
Finance Ministers and Central Bank Governors	Governor	Treasurer
Other groups	5 representatives	5 representatives
Financial Stability Board (FSB)		
Plenary	Governor	Executive Director (Treasury), Chairman (ASIC) ^(b)
Steering Committee	Governor	Executive Director (Treasury), Chairman (ASIC) ^(b)
Standing Committee on Assessment of Vulnerabilities	Governor	
Regional Consultative Group for Asia	Governor	Executive Director (Treasury)
Official Sector Steering Group (on financial benchmarks)	Assistant Governor	Chairman (ASIC)
Other groups	11 representatives	13 representatives
Bank for International Settlements (BIS)		
Governors Meeting	Governor, Deputy Governor	
Asian Consultative Council	Governor, Deputy Governor	
Basel Committee on Banking Supervision	Assistant Governor	Chairman (APRA)
Group of Governors and Heads of Supervision	Governor	Chairman (APRA)
Committee on Payment and Settlement Systems	Department Head	
Other groups	14 representatives	15 representatives
International Association of Insurance Supervisors (IAIS)		
Working groups		3 representatives
International Organization of Securities Commissions (IOSCO)		
Board		Chair: Chairman (ASIC)
Asia-Pacific Regional Committee		Chairman (ASIC)
Task Force on Unregulated Financial Markets and Products		Chair: Chairman (ASIC), Senior Advisor (ASIC)/Senior Executive (ASIC)
Task Force on Financial Market Benchmarks		Chairman (ASIC), Senior Executive (ASIC)
Other groups		11 representatives

(a) Groups are generally separately named where a CFR agency head is a member, plus the CPSS given its importance to payment system reforms; other bodies not separately mentioned include the IMF, the OECD and several regional groupings

(b) The Chairman of ASIC is represented on these committees as Chairman of IOSCO

Source: RBA

- For *OTC derivatives markets*, in line with the G20 Leaders' commitments, amendments to the *Corporations Act 2001* were passed in Australia in December 2012 that give the government the power to impose mandatory central clearing, trade reporting or platform-based execution requirements. The legislative framework established in Australia is designed to be flexible, given the cross-border reach of some other jurisdictions' legislation in this area and uncertainties around the broader effects of regulation of these markets on market functioning. In particular, the Australian framework establishes a mechanism for the government to impose such requirements on the advice of the Bank, ASIC and APRA, rather than imposing them directly via legislation. To inform their advice, the regulators produce periodic assessment reports, which in October 2012 recommended the introduction of a broad-based mandatory trade reporting obligation for OTC derivatives, and in July 2013 recommended a central clearing mandate for US dollar-, euro-, British pound- and yen-denominated interest rate derivatives. In respect of Australian dollar-denominated interest rate derivatives, which the regulators consider to be the most systemically important derivatives product class in Australia, a decision on mandatory clearing has been deferred until the next report in early 2014.
- Australia has also adopted international reforms designed to improve the operational and financial robustness of financial market infrastructures (FMIs), such as central counterparties, given that OTC derivatives reforms will increase market participants' dependence on them. The Bank has revised its own Financial Stability Standards for central counterparties and securities settlement facilities to align them with the new international principles, and recently published its first assessments of the ASX clearing and settlement facilities against the new standards (RBA 2013). The Bank will assess Australia's high-value payments system, the Reserve Bank Information and Transfer System (RITS),

against the principles on an annual basis. ASIC has similarly reflected the requirements of the principles within its regime, where relevant. The CFR is also working to improve Australia's capacity to resolve distressed FMIs, which (as in many other jurisdictions) remains a gap in the resolution framework here.

- There has been relatively less domestic focus on implementation of *shadow banking* reform given that the bulk of global proposals have only recently been finalised. During the policy development phase, Australia has argued that regulators need sufficient flexibility to respond proportionately to risks, reflecting the fact that in Australia the shadow banking sector has a relatively small share of financing activity and the possibility that heavy regulation may impose costs in excess of potential benefits. In Australia, the CFR reviews potential risks arising from the shadow banking sector on an annual basis, ASIC has increased the scrutiny on hedge funds and APRA and ASIC have moved to strengthen regulation of finance companies that issue debentures to retail investors. Also, APRA will soon release further guidelines on securitisation.

In working on these and other areas of reform, Australia's motivation has been to ensure good policy outcomes, that flexibility in rules and implementation is retained where appropriate and that global rules remain sensible for Australia. At times, the Bank and other CFR agencies have sought to modify international proposals that were not well suited to the Australian financial system. For example:

- On Basel III liquidity, Australian banks would not be able to meet the proposed Liquidity Coverage Ratio requirement purely by holding existing liquid assets because government debt is relatively scarce in Australia compared with other jurisdictions. In response, the Bank and APRA successfully argued for a menu of alternative approaches to these requirements, and developed and gained global acceptance for the Committed Liquidity Facility through which the requirement can be met in Australia.

- A key issue in implementing the OTC derivatives reforms in smaller jurisdictions has been ensuring access to appropriate clearing arrangements. Regulators from some countries, including Canada and Australia, did not want to constrain market participants' choices by insisting that OTC derivatives be cleared locally, recognising that some market participants would rather clear via an overseas-based central counterparty (CCP). The FSB developed 'four safeguards' for access to, and oversight of, overseas-based CCPs to accommodate this. They are: a framework for international cooperative oversight; fair and open access criteria that promote competition; appropriate liquidity arrangements in all relevant currencies; and procedures for effective resolution.

The Way Forward for International Regulatory Reform

A familiar refrain regarding financial regulatory reform is that 'good progress has been made but much remains to be done'. As previously noted, even just across the four main areas of reform there remain a number of aspects of policy to finalise. Further rounds of policy implementation and peer review will follow. This will add to existing work that already extends well into the future. Even within major reforms like the Basel III framework, the timetable for full implementation of key capital and liquidity requirements stretches out at least to 2019.

Moreover, new workstreams and policy proposals keep arising. For example, following the flaws exposed by abuses of the London Interbank Offered Rate (LIBOR) and other financial benchmarks, a high-level working group on reform of financial benchmarks was established on which both the Bank and ASIC are represented. Following an international review, work has recently been initiated to improve the comparability across banks of the risk weights used under the Basel capital framework, and consider whether the framework achieves the right balance between simplicity, risk sensitivity and comparability across banks. Work has also recently

been commissioned to consider the global financial stability implications of national structural banking reform measures taken in part to address the 'too big to fail' issue – such as the Volcker Rule in the United States.

The pace and volume of change is placing large demands on regulators and financial institutions, and runs some risk of absorbing resources that could be used for more useful risk management purposes. There is also potential for the vast number of reforms to cut across each other and have unintended effects. One example of the tensions in financial regulation are reform efforts to reduce counterparty risk by increasing collateralisation of banks' exposures, including through CCPs. However, a recent Bank for International Settlements report suggests that the side-effects of doing so could run counter to achieving other high-level objectives, including reducing interconnectedness, reducing procyclicality and reducing uncertainty, given the way that financial institutions are likely to respond to managing collateral.¹

The G20 in 2014 could focus on implementation of agreed reforms, with refinement where necessary if they are ineffective or there are unintended consequences.² This approach should streamline the financial regulation agenda, which in the post-crisis period has grown dramatically.³ ❖

1 This example was highlighted recently in a speech by Lowe (2013).

2 The focus on implementation was suggested in a speech by Stevens (2013).

3 For a range of views on the G20 and financial regulation agenda, see Lowy Institute (2013).

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