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Peer Review of Australia: Review Report

Financial Stability Board (FSB)

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Peer Review of Australia

Review Report

21 September 2011

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Foreword

The peer review of Australia is the fourth country peer review under the FSB *Framework for Strengthening Adherence to International Standards*.¹ FSB member jurisdictions have committed to undergo periodic peer reviews focused on the implementation of financial sector standards and policies agreed within the FSB, as well as their effectiveness in achieving the desired outcomes. As part of this commitment, Australia volunteered to undertake a country peer review in 2011.

This report describes the findings and conclusions of the Australia peer review, including the key elements of the discussion in the FSB Standing Committee on Standards Implementation (SCSI) on 6 July 2011. The draft report for discussion was prepared by a team chaired by Mehmet Yörükoğlu (Central Bank of the Republic of Turkey) and comprising Li Wenhong (China Banking Regulatory Commission), Dora Balazs (French Securities Markets Authority), Akie Oba (Financial Services Agency of Japan), Roy Havemann (South Africa Treasury), and Mike Mitchell (Bank of England). Anil Misra and Costas Stephanou (FSB Secretariat) provided support to the team and contributed to the preparation of the peer review report.

The analysis and conclusions of the peer review are largely based on the Australian financial authorities' responses to a questionnaire designed to gather information about the initiatives undertaken in response to the relevant FSAP recommendations.² The review has benefited from dialogue with the Australian authorities as well as discussion in the FSB SCSI.

¹ A note describing the framework is at http://www.financialstabilityboard.org/publications/r_100109a.pdf.

² The FSAP report for Australia is available at <http://www.imf.org/external/pubs/ft/scr/2006/cr06372.pdf>.

Glossary

ADI	Authorised Deposit-taking Institution
ABS	Australian Bureau of Statistics
AFSL	Australian Financial Services Licence
AML/CTF	Anti-Money Laundering and Counter Terrorism Financing
APRA	Australian Prudential Regulation Authority
APS	ADI Prudential Standard
ASX	Australian Securities Exchange
ASIC	Australian Securities and Investments Commission
AUSTRAC	Australian Transaction Reports and Analysis Centre
BCBS	Basel Committee on Banking Supervision
BCP	Basel Core Principle
CCP	Central Counterparty
CUBS	Credit Unions and Building Societies
DOFI	Direct Offshore Foreign Insurer
DMF	Discretionary Mutual Fund
FCS	Financial Claims Scheme
FSAP	Financial Sector Assessment Program
FSB	Financial Stability Board
FSSSA	Financial System Stability Special Account
GDP	Gross Domestic Product
IAIS	International Association of Insurance Supervisors
ICP	Insurance Core Principle
IOSCO	International Organization of Securities Commissions
IRB	Internal Ratings-Based approach (Basel II)
IT	Information Technology
LCR	Liquidity Coverage Ratio
MoU	Memorandum of Understanding
NOHC	Non-Operating Holding Company
NPL	Non-Performing Loan
NSFR	Net Stable Funding Ratio
OBPR	Office of Best Practice Regulation
OTC	Over-the-Counter
PAIRS	Probability and Impact Rating System
RBA	Reserve Bank of Australia
RBNZ	Reserve Bank of New Zealand
RIS	Regulatory Impact Statement
RMBS	Residential Mortgage-Backed Securities
SCV	Single Customer View
SIFI	Systemically Important Financial Institution
SOARS	Supervisory Oversight and Response System
TTC	Trans-Tasman Council on Banking Supervision

FSB country peer reviews

The FSB has established a regular programme of country peer reviews of its member jurisdictions. The objective of the reviews is to examine the steps taken or planned by national authorities to address IMF-World Bank Financial Sector Assessment Program (FSAP) recommendations concerning financial regulation and supervision as well as institutional and market infrastructure. FSB member jurisdictions have committed to undergo an FSAP assessment every 5 years, and peer reviews taking place typically around 2-3 years following an FSAP will complement that cycle.

A country peer review evaluates the progress made by the jurisdiction in implementing FSAP recommendations against the background of subsequent developments that may have influenced the policy reform agenda. It provides an opportunity for FSB members to engage in dialogue with their peers and to share lessons and experiences. Unlike the FSAP, a peer review does not comprehensively analyse a jurisdiction's financial system structure or policies, nor does it provide an assessment of its conjunctural vulnerabilities or its compliance with international financial standards.

Executive summary

Australia underwent an FSAP in 2006, which concluded that “*Australia’s financial system is sound and healthy, having benefited from sustained favorable macroeconomic conditions over the past 15 years.*” At the same time, the FSAP highlighted some issues to be addressed in failure resolution and crisis management, banking supervision, securities regulation, and insurance regulation and supervision.

The Australian financial system weathered the global financial crisis well. The ADI sector remained profitable and no entities received any public capital support (section 1). The resilience of the system largely reflected the resilience of the economy at large. Structural reforms ensured that macroeconomic conditions at the time of the crisis were favourable, while a combination of automatic stabilisers and proactive policy measures buffered the domestic economy from the sharp deterioration in global economic conditions. In addition, the authorities took a number of steps to address specific financial system vulnerabilities. An important lesson from Australia’s experience is that strong economic fundamentals provide a crucial bulwark against the risks of a financial crisis, and that appropriate macroeconomic policies matter as much for the health of the financial system as does the strength of the supervisory framework.

Strong macroeconomic fundamentals were also supported by a sound regulatory and supervisory framework. Australia is an example of a jurisdiction that takes an implicit macro-prudential orientation to financial system oversight. The monitoring of risks has not required a separate macro-prudential regulator: both the prudential regulator and the central bank have financial stability mandates. While the institutional arrangements for macro-prudential oversight are relatively informal, the Council of Financial Regulators ensures a structured coordination process and the relevant agencies have a long history of achieving consensus on policy issues of system-wide importance - as illustrated by their actions during the crisis.

FSB members note that a macro-prudential orientation to financial system oversight requires substantial inter-agency coordination, but that the structure of effective institutional arrangements can differ substantially based on country-specific circumstances. Flexibility is also needed in the use of monitoring indicators and in the choice of tools. However, it is important to ensure that the responsibilities of each agency are clearly defined, particularly during a crisis, and that there is effective inter-agency cooperation. Ensuring consistency and coordination with other economic policies (e.g. fiscal policy) and credibility with market participants (e.g. via appropriate governance arrangements and communication policies) is also required.

The post-crisis period presents a number of policy challenges for Australia. First, the economy - and, by extension, the financial system - is going through a period of structural change in response to the strong demand for commodities from emerging Asian economies. As a result, Australia's terms of trade is at historic levels and the country is experiencing a commodity-inspired private investment surge. However, the economy's increased exposure to potentially volatile and cyclical commodity prices warrants particular focus. The use of prudential tools may be considered to manage sector-specific risks stemming from the structural changes in the economy.

Second, Australian banks have made good progress in reducing their dependence on wholesale (particularly external) funding, and they should continue to work towards managing this funding risk. Funding structures can vary significantly depending on country circumstances, and it is both unrealistic and undesirable to eliminate wholesale external debt as a funding source. However, it is important to closely monitor and stress test banks' overall liquidity positions; avoid over-reliance on any single (potentially volatile) source of funding; and ensure that funding is sufficiently 'sticky' and adequately matched to the maturity of assets.

Third, the presence of four domestic big banks presents important policy challenges for the authorities. Their size and nature of activities means that they could pose systemic and moral hazard risks in Australia. The authorities have a supervisory framework in place to address the risks posed by regulated entities (including SIFIs) through a graduated supervisory response. Any additional measures undertaken by the authorities in this area will depend on, and will need to be consistent with, the policy work on SIFIs that is underway at the international level by the FSB and BCBS. In addition, while a concentrated system by itself is not necessarily less competitive, it is important to proactively promote competition and contestability, as currently proposed in the various government reform initiatives. Consumer protection measures and policies to develop market-based sources of financing are useful in that context.

Significant and commendable progress has been made with regard to FSAP recommendations on failure resolution and crisis management (section 2). This includes the development of a crisis management framework, the establishment of a deposit guarantee scheme (Financial Claims Scheme, FCS), the strengthening of resolution powers, and the improvement in coordination with New Zealand on crisis management. Further development of resolution guidance for general and life insurers should be encouraged. Finalisation of a joint resolution package with New Zealand would also assist cross-border crisis management.

In terms of recommendations in this area, the current timetable for the implementation of a single customer view to support operation of the FCS is quite generous compared to that adopted in some other countries. Moreover, as a way of enhancing protection for taxpayers, the authorities could consider establishing an explicit provision in the *Banking Act* to enable the Government to recover the non-FCS related costs it may incur in resolving an ADI. Finally, bearing in mind the structure of the Australian banking industry, the acceleration of work on recovery and resolution plans for the larger banks would be useful, focusing on what the authorities regard as the banks' critical economic functions.

The Australian authorities have addressed to a large extent the FSAP recommendations on banking supervision (section 3). APRA has continued to promote effective risk management practices and strong capital reserves and to closely monitor the adequacy of ADIs' liquidity, and has improved stress test capabilities as well as enhanced coordination and information sharing with AUSTRAC. AUSTRAC has gradually built up its capacity for on-site verifications and has employed them as an important supervisory tool. APRA needs to remain vigilant regarding funding risks and continue to encourage ADIs to develop appropriate medium- and long-term funding plans. It should also continue to monitor risks arising from the property sector and further build up its own and ADIs' stress testing capabilities.

On the other hand, AUSTRAC will need to continue to develop the necessary skills and expertise to undertake on-site verification of ADIs' implementation of measures to guard against abuse by criminal elements. With regard to permissible activities and supervision over foreign banks, the authorities should go beyond reviewing use of the term 'merchant bank' and review the Section 11 exemptions of the *Banking Act* in order to establish an amended and clearer demarcation line between regulated and non-regulated entities. This would ensure that all institutions undertaking bank-like activities - even if this sector is relatively small and declining in size (as in Australia) - are subject to appropriate oversight, which can take different forms.

Recent regulatory reforms address some of the (relatively few and specific) gaps identified by the FSAP in securities regulation (section 4). In particular, the ambiguities in ASIC's use of evidence obtained from use of a search warrant have been removed; work is ongoing to improve the suite of tools for identifying and prioritising risk in ASIC's surveillance function; and a comprehensive Policy Statement is being developed to provide guidance on prospectus disclosure. In addition, the authorities monitor unit pricing errors and consider that the APRA-ASIC good practice guide in this area has brought the expected results.

There remains scope for progress in other FSAP recommendations. In particular, the legislation has not been amended to remove the Treasurer's power to provide direction to ASIC, so there remains the possibility for the Treasurer to influence ASIC's investigative activities. The authorities note that this power does not impinge in practice on the independence of ASIC's operations and has only been used once. In addition, although ASIC's budget has increased in recent years, its reliance on special purpose funding has not been reduced. This issue will be addressed in the current review of ASIC's funding and financial management. In addition, best execution obligations to fund managers should be further clarified, for example by issuing more concrete guidance (as recommended by the FSAP). Finally, ASIC should consider assessing the relevance and efficiency of capital requirements applicable to different types of market intermediaries, particularly "non-

exchange market intermediaries” dealing in wholesale OTC markets, so as to avoid any potential material regulatory gaps.

The regulatory and supervisory framework for general insurance has been considerably strengthened in recent years (section 5). Progress is evident in the enhancement of APRA’s legal authority to deal with troubled general insurers and the ability to take prompt and decisive legislative action in dealing with problem institutions without being constrained by regulatory burden requirements; the adoption of Stage II reforms that significantly enhanced the management and regulatory framework for general insurers; the implementation of the Potts Review recommendations; and the removal of the requirement for the Treasurer’s approval for APRA to refuse registration of a life insurer as well as of the requirement for the Treasurer’s agreement to certain actions by APRA under the pre-existing insurance legislation. The introduction of consolidated group supervision has also enhanced the ability of APRA to supervise the foreign subsidiaries of insurers domiciled in Australia.

1. Recent market developments and regulatory issues

Financial system structure

The Australian financial system is relatively large and has continued to grow in recent years. Between December 2005 and December 2010, financial system assets rose from AU\$3 trillion (approximately 300% of Gross Domestic Product or GDP) to AU\$4.6 trillion (approximately 340% of GDP), or a compound annual average growth rate of 9.2% (see Figure 1).

Authorised deposit-taking institutions (ADIs) are by far the most significant component of the system and currently represent nearly 60% of all financial system assets, compared to 51% in 2005 (see Table 1). In turn, four large domestic banks dominate the ADI sector³, accounting for roughly 75% of total ADI assets. The rest of the ADI sector comprises four mid-sized domestic banks, a few other small Australian-owned banks, several foreign-owned banks and a number of smaller credit institutions (with a mutual ownership structure). Life insurance, general insurance and superannuation funds account for about 25% of financial sector assets. Other institutions and non-bank financial intermediaries comprise a relatively smaller (around 15%) and declining share of the financial system.

There has been a marked increase recently in the concentration of the ADI sector. Contributing factors included the merger of two mid-sized Australian banks in 2007, the acquisition of smaller competitors by two of the large banks during 2008, and the reduction of lending by foreign-owned banks in the wake of the crisis. These developments saw the four largest banks increase their share of assets by approximately 10 percentage points between 2005 and 2010. These banks have grown substantially in size, ranking among the top 60 banks worldwide in terms of consolidated assets. Their focus, however, remains primarily on the domestic and New Zealand markets, which represent over three-quarters of their total assets. Although these banks operate as financial conglomerates, insurance and fund management typically account for only 5-15% of their group income, while their securities trading activities are very limited. Interest income from primarily mortgage and consumer lending accounts for roughly two-thirds of the major banks' total income, reflecting their focus on retail lending activities.

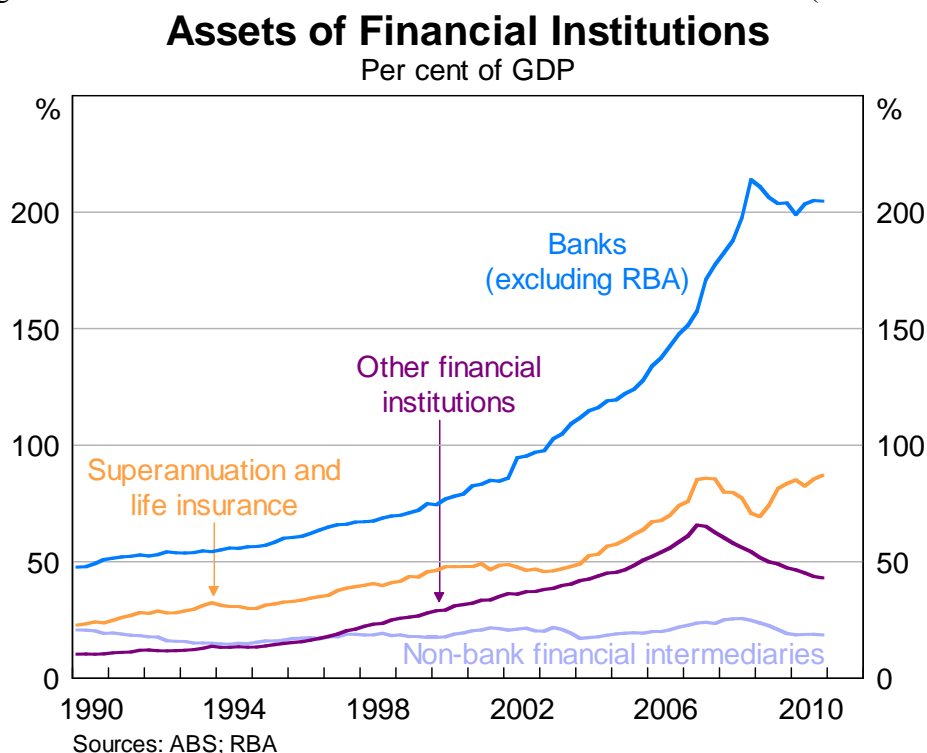
The Australian financial system is notable for its large pension fund ("superannuation") industry. Following negative growth during the recent financial crisis, asset levels have surpassed their earlier peak in 2007 and net contributions have been stable, reflecting the compulsory superannuation contributions made by employers.

Life insurance accounts for about 4% of total financial system assets.⁴ Life insurers have increasingly focused on wealth management rather than traditional life insurance business, with superannuation accounting for the large part of their assets.

³ These banks are Australia and New Zealand Banking Group, Commonwealth Bank of Australia, National Australia Bank, and Westpac Banking Corporation.

⁴ In Australia, life insurance companies can offer superannuation products through statutory funds. As of December 2010, these funds held assets for superannuation or retirement purposes of AU\$38.7 billion, or 3% of total superannuation assets. Many superannuation funds invest through investment vehicles offered by

Figure 1: Evolution of Assets of Australian Financial Institutions (1990-2010)



Source: Reserve Bank of Australia (RBA), Australian Bureau of Statistics (ABS).

Table 1: Breakdown of Financial System Assets (December 2005 and 2010)*

Sector	December 2005		December 2010	
	AU\$ billion	% of total	AU\$ billion	% of total
Authorised deposit-taking institutions (ADIs)	1,503	50.7	2740	60
<i>Four largest banks</i>	960	32	1,981	43
<i>Other domestic banks</i>	205	7	255	6
<i>Foreign banks</i>	286	10	427	9
<i>Credit unions and building societies</i>	52	2	76	2
Superannuation	688	23	1,111	24
<i>In life insurance**</i>	152	5	168	4
<i>Outside life insurance</i>	536	18	943	21
Life insurance (excluding superannuation)**	34	1	20	0
General insurance	104	3	133	3
Other***	638	22	593	13
Total	2,967	100	4,597	100
* Excludes Reserve Bank of Australia.				
** Based on estimates of the superannuation assets held in the statutory funds of life insurers.				
*** Includes registered financial corporations (finance companies and money market corporations), other managed funds and securitisation vehicles.				
Sources: ABS, Australian Prudential Regulation Authority (APRA), RBA.				

life insurance companies; these investments are not included in the figure for life insurance assets so that they are not double counted (they are recorded as assets held in the superannuation sector).

By the end of 2010, the Australian Securities Exchange (ASX) had recovered to 2006 levels in terms of both the number of listed companies (2,216) and combined market capitalisation (AU\$1.4 trillion); however, at 111% of GDP, its market capitalisation remains below the pre-crisis peak of 123% of GDP. Australia's non-financial corporate debt market is relatively underdeveloped compared with other financial markets. As of December 2010, total debt issued within Australia and offshore by domestic non-financial firms represented around 10% of GDP. However, a much larger proportion of debt (around 90% of GDP) has been issued within Australia and offshore by financial institutions, particularly banks.

Prior to the crisis there was rapid expansion in the securitisation market, enabling relatively high levels of competition in housing loans from non-bank mortgage originators whose predominant source of funding was securitisation. Securitisation markets contracted since mid-2007 due to the reputational damage suffered on account of the US subprime crisis and the subsequent global freezing of these markets. As a result, the share of housing loans funded through securitisation declined from a peak of almost 25% in mid-2007 to less than 10% in 2010. Partly as a result, the four major banks' share of new housing loan approvals increased from about 60% in 2007 to over 80% in 2008.

Regulatory framework

Australia has a 'twin peaks' model of regulation. The Australian Prudential Regulation Authority (APRA) is the prudential regulator of the financial services industry, while the Australian Securities and Investments Commission (ASIC) regulates companies and market conduct as well as disclosure in relation to financial products and services (including superannuation, insurance, deposit taking, and consumer credit). In addition, the Reserve Bank of Australia (RBA) plays a key role in analysing systemic risks and using relevant tools such as liquidity support or payments system powers.

The actions of Australia's main financial regulatory agencies are coordinated through the Council of Financial Regulators, which has a mandate to contribute to the efficiency and effectiveness of regulation and the stability of the financial system.⁵ Its membership comprises the RBA (which chairs the Council and supports the secretariat function), APRA, ASIC, and the Australian Treasury. The Council members have signed a Memorandum of Understanding on Financial Distress Management. The Council operates as an informal body in that it does not have any legal personality or powers separate from those of its member agencies. Members are able to share information and views, discuss regulatory reforms or issues where responsibilities overlap (including by setting up joint working groups with agreed terms of reference), and coordinate responses on potential threats to financial stability. The Council also advises the government on the adequacy of Australia's financial system architecture in light of on-going developments.

In addition to this informal arrangement, more formal coordinating structures are also in place such as overlapping board representation (one APRA member has representation on the Payments System Board of the Reserve Bank; and the Secretary to the Treasury has a seat on the Reserve Bank Board) and bilateral Memoranda of Understanding (MoU) between each of the Council members. The RBA and APRA have a Coordination Committee of senior staff which meets regularly.

⁵ For more details, see <http://www.rba.gov.au/fin-stability/reg-framework/cfr.html>.

Crisis response

The Australian financial system weathered the global financial crisis well. The ADI sector remained profitable and no entities received any public capital support during the crisis.⁶ The resilience of the system largely reflected the resilience of the economy at large – particularly the fact that the country experienced a relatively mild economic downturn. Moreover, a combination of sound macroeconomic and prudential policies, with proactive steps undertaken by the authorities during the crisis, ensured that potential risks were contained.

From a macroeconomic perspective, the economy had undergone substantial structural reforms in the late 1990s and early 2000s that strengthened its resilience to external shocks. Moreover, sustained high commodity prices boosted growth and public revenue, and supported a long period of fiscal surplus from 1997 to 2009; as a result, the Commonwealth government entered the crisis with negative net public debt. As the crisis unfolded, the automatic stabilisers were complemented by discretionary monetary (rate cuts) and fiscal (budgetary stimulus) measures whose effect was to significantly dampen the economic downturn. The Australian dollar also acted as a shock absorber, by depreciating sharply in the initial stage of the crisis on the back of falling commodity prices and rising risk aversion, followed by an appreciation in real effective terms by 35% between March 2009 and September 2010 as commodity prices recovered and interest rate differentials widened.⁷ Moreover, Australian households were in a relatively strong position compared to international peers – rapid house price increases had come to an end by late 2003, and households had already been through a period of balance-sheet adjustment.

Strong macroeconomic fundamentals were also supported by a sound regulatory and supervisory framework. APRA had in place a prudent framework requiring ADIs to manage their exchange rate risk, so the sudden and steep exchange rate fluctuations did not lead to significant currency mismatches and associated losses by ADIs. It closely monitored ADIs' credit quality and liquidity positions during the crisis; undertook a range of stress tests to check their resilience (see section 3); and it ensured that banks' capital adequacy remained strong, using both Pillar 2 measures and a stricter interpretation of Pillar 1 capital rules than the Basel II minimum requirements.

In the years leading up to the crisis, credit growth was quite strong, growing at a compound annual growth rate of 13.2% between 2000 and 2007.⁸ Poor quality lending was constrained by a long established consumer protection regime implemented from 1996 through the State and Territory based Uniform Consumer Credit Code (UCCC). The UCCC included a remedy where a contract was unjust, including where the unjustness arose because the debtor could

⁶ For a detailed analysis of the reasons for the Australian economy's resilience, see the RBA's *Financial Stability Review* (March 2009, at <http://www.rba.gov.au/publications/fsr/2009/mar/html/contents.html>).

⁷ For a detailed discussion, see the IMF's 2009 Article IV report (Country Report No. 09/248, available at <http://www.imf.org/external/pubs/ft/scr/2009/cr09248.pdf>).

⁸ In fact, Australia underwent a housing price boom in 2001-03, which ended fairly benignly in part due to the adoption of a variety of policy measures by the authorities (including interest rate hikes). For more information, see "Asset Prices, Credit Growth, Monetary and Other Policies: An Australian Case Study" by Bloxham, Kent and Robson (September 2010, RBA Research Discussion Paper 2010-06, available at <http://www.rba.gov.au/publications/rdp/2010/2010-06.html>).

only repay with substantial hardship.⁹ Non-conforming housing loans (the closest Australian equivalent to “sub-prime”) accounted for only around 1% of the mortgage market in mid-2007, compared to around 13% in the United States. In addition, Australian banks’ balance sheets are traditionally heavily weighted towards domestic loans, particularly to the historically low-risk household sector. They had limited direct exposure to U.S. collateralised debt obligations and subprime residential mortgage backed securities, which reduced contagion risks. Apart from New Zealand, there had been little incentive for Australian banks to invest offshore, in part because the domestic market is more profitable. As discussed below, while the banks’ non-performing loans (NPL) ratio rose during the crisis, it remained lower than in other countries, particularly for housing loans. This may be partly attributed to the prudential and consumer protection frameworks as well as to the fact that all Australian mortgages are ‘full recourse’, i.e. households are liable for the outstanding balance of the loan.

Notwithstanding these strengths, the crisis exposed some systemic vulnerabilities. In banking, these largely stemmed from the reliance of domestic banks on wholesale funding. Offshore funding rose in the 1990s, coinciding with financial market deregulation and the substantial expansion of the superannuation industry. The reliance of banks on offshore funding has also been indirectly related to Australia’s current account deficit (largely reflecting high levels of investment in the commodities sector), which implied that some funding for the economy needed to be intermediated from overseas. During this period, many households invested their savings in retirement funds rather than bank deposits, which were channelled to some extent into foreign equities. This shortfall in the pool of domestic savings relative to credit opportunities prompted banks to expand their share of offshore, non-deposit funding. Like many other banks overseas, wholesale funding for Australian banks, in the form of both short-term money market and longer-term debt and securitisation issuance, was negatively affected by the collapse of Lehman Brothers and its impact on global funding markets.

Partly to manage these risks, the Financial Claims Scheme (FCS) and the Guarantee Scheme for Large Deposits and Wholesale Funding were introduced in October 2008. The FCS is a post-funded deposit guarantee scheme administered by APRA, guaranteeing deposit balances up to AU\$1 million per depositor per ADI (see section 2).¹⁰ The Guarantee Scheme covered large deposits (balances above AU\$1 million) as well as eligible wholesale funding instruments on a fee-based, opt-in basis, until it was closed to new liabilities on 31 March 2010. This scheme played a critical role in assisting Australian ADIs to re-enter global credit markets by enabling them to raise around AU\$160 billion in guaranteed wholesale funds, and facilitated the lengthening of their debt maturity profiles. The introduction of government guarantees in markets where Australian ADIs raised significant funds – particularly the US

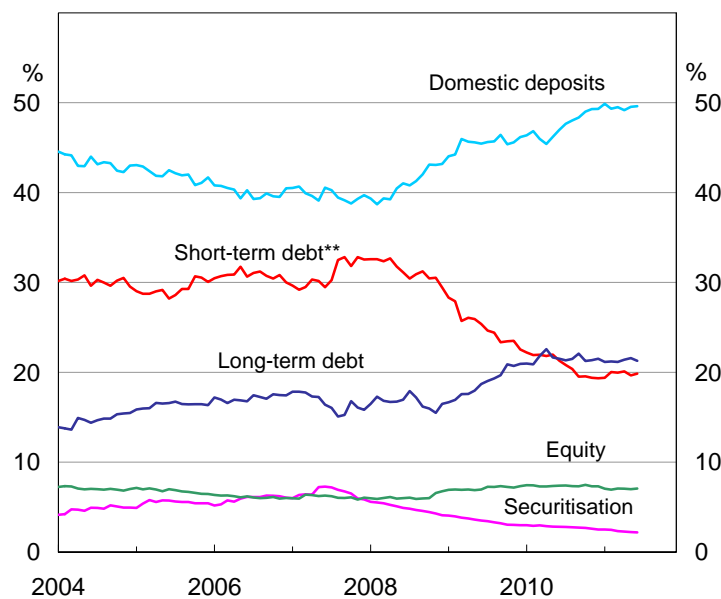
⁹ The *National Consumer Credit Protection Act 2009*, which largely translated the UCCC into Commonwealth legislation, refined this approach by including a specific requirement that lenders assess, before entering into a credit contract, that the contract was suitable for a consumer’s requirements and objectives, and that they had the capacity to repay the loan. This Act came into force for smaller lenders and brokers on 1 July 2010 and for ADIs on 1 January 2011. ASIC also issues guidance notes on responsible lending practices - see <http://www.asic.gov.au/credit>.

¹⁰ In December 2010, it was confirmed that the FCS was a permanent feature of the financial regulatory framework. Following a public consultation process, it was announced in September 2011 that the coverage threshold would be reduced to AU\$250,000 from 1 February 2012.

and Europe – increased the need for the Government to take similar measures and to ensure that Australian ADIs were not placed at a disadvantage relative to their competitors in accessing funds. The fee for access to the Guarantee Scheme was based on an ADI’s long-term credit rating and ranged from 70 to 150 basis points.

Good progress has been made since the crisis to reduce banks’ reliance on wholesale funding sources. As can be seen in Figure 2, the overall proportion of wholesale funding, particularly the part that is short term in nature (defined as debt with an original maturity of less than 12 months), has fallen since the crisis as a result of market and regulatory pressures. Short-term wholesale funding, as a share of bank funding liabilities, has fallen from 30% to 20% since December 2005. Over the same period, long-term funding has increased as a share of bank liabilities from 16% to 21%, while the share of funding from domestic deposits has also increased from 42% to almost 50%. Total non-resident liabilities of banks (including the amount due to their overseas operations) have been largely unchanged. In addition, the vast majority of banks’ foreign borrowing is either in Australian dollars or fully hedged back to Australian dollars.

Figure 2: Funding Composition of Australian Banks* (% of total funding, 2004-11)



* Adjusted for movements in foreign exchange rates.

** Includes deposits and intra-group funding from non-residents.

Sources: APRA, RBA, Standard & Poor’s.

Nevertheless, the economic downturn reduced banking sector profitability and increased NPL ratios, particularly for domestic business and personal loans. Banks strengthened their capital positions by raising equity and retaining earnings, resulting in the overall Tier 1 capital adequacy ratio increasing to almost 9.5% in 2010 from around 7.5% in 2007. Equity was raised through dividend reinvestment plans for existing shareholders and via new equity raisings (predominantly through private placements).

To assist smaller banks, credit unions and building societies (CUBS) and non-bank institutions' continued access to funding from the securitisation market, the Government established a purchase program of up to AU\$20 billion of residential mortgage-backed securities (RMBS) from these issuers. In addition, the RBA extended the list of securities used as collateral in repurchase operations to include certain RMBS securities, which assisted in the recovery of this market.

In September 2008, naked short selling of domestic equities was banned and a temporary ban, which has subsequently been lifted, was placed on covered short selling of financial and nonfinancial equities as a 'circuit breaker' to assist in maintaining and restoring market confidence. The *Corporations Amendment (Short Selling) Act 2008*, which was passed in December 2008, permanently banned naked short selling (subject to a number of exemptions granted by ASIC to facilitate and promote the efficient and orderly operation of markets); clarified ASIC's powers to regulate all aspects of short selling; and created a framework for a comprehensive short selling disclosure regime.

Moreover, during 2008 a significant amount of the growth in outstanding margin loans was unwound. This was due to volatile and generally falling share prices reducing the demand for new margin loans and causing a sharp repayment of existing margin debt. This caused the collapse of some financial advisory firms that had margin lending as a core element of their business models, resulting in significant losses for retail investors. In response, the Australian Government enacted legislation¹¹ to strengthen licensing and responsible lending requirements as well as to improve disclosure for investors.

While the Australian superannuation industry withstood the financial crisis relatively well, it did experience negative investment returns and declining liquidity. During the crisis, some trustees were forced to sell equities into a depressed market so that they could fulfil portability, switching, and capital drawdown requests. APRA granted a small number of trustees¹² a variation or suspension of the portability requirements when they could not meet them. Funds that sought relief from the portability requirements generally had substantial investments in a single underlying asset class. The subsequent government review of the superannuation industry notes that "some retirees experienced distress because their superannuation savings were concentrated in options such as mortgage trusts that had been previously thought to offer adequate liquidity", an assumption that proved faulty.¹³ Such instances were mostly identified in retail funds and members experienced the same liquidity problems as direct investors in these products. Although the short-term liquidity of some significant funds was challenged, most funds did not have liquidity problems and there was no large-scale flight toward what was perceived as the most liquid or safe fund or investment option, and no superannuation fund collapsed or was suspended by APRA during the global financial crisis. However, some members of retail funds did find their particular investment options frozen for a limited period of time.

¹¹ See <http://www.comlaw.gov.au/Details/C2009A00108>.

¹² See the superannuation industry overview in APRA's *Insight* publication (Issue 2, 2009, available at <http://www.apra.gov.au/Insight/Back-Issues-of-APRA-Insight.cfm>).

¹³ See chapter 6 of the Super System Review's Final Report (June 2010, available at http://www.supersystemreview.gov.au/content/content.aspx?doc=html/final_report.htm).

Major regulatory initiatives

Basel III: Australian banks are well placed to meet the Basel III capital standards. Their average Tier 1 capital ratio already exceeds the minimum Basel III requirement, while almost 75% of their capital is in the form of common equity. In a recent discussion paper on the implementation of the Basel III capital standards in Australia¹⁴, APRA proposes the adoption by ADIs of the minimum Basel III requirements for the definition and measurement of capital, except in certain areas where the approach will remain stricter; and the introduction of the new capital requirements in some areas under an accelerated timetable compared to the transitional arrangements provided by Basel III.

However, Australian banks will need to make some changes in order to meet the two liquidity ratios to be implemented under Basel III - the Net Stable Funding Ratio (NSFR) and (particularly) the Liquidity Coverage Ratio (LCR). The only domestic high-quality securities deemed sufficiently liquid by APRA (and therefore eligible for the liquidity ratios) are those issued by the national government and state authorities. The supply of these assets is well short of the amount that is necessary to meet the LCR requirements (banks already hold one-fifth of outstanding government securities). Australia has therefore had to adopt one of the menu of alternative approaches to meeting the LCR that are available to countries lacking a sufficiently large pool of high quality liquid assets. APRA and the RBA have announced the establishment of a secured credit line with the RBA to enable ADIs to cover any shortfall of assets for the LCR.¹⁵ The credit line will be available against the usual qualifying collateral for transactions with the RBA, but it will cost banks a market-based “commitment fee”. As in other jurisdictions, while banks would not be constrained from meeting the LCR, the cost of credit may increase and credit extension may be reduced as a result of these requirements. Lending rates have already increased on account of higher bank funding costs and the reassessment of risk.

As part of the reform package to promote competitive and sustainable banking (see below), the Government has proposed it would amend legislation to allow the issuance of covered bonds in Australia. The issuance of covered bonds is expected to enable banks to access cheaper, more stable and longer term funding. The proposed covered bond issuance is subject to a prudential limit so as not to unduly increase asset encumbrance in the banking system.

Increasing domestic banking sector competition: In December 2010, the Australian government announced a set of reforms (see Box 1) to enhance competition in the domestic banking system. The reform measures are targeted at three objectives: enhancing consumer protection, promoting competition by supporting small lenders, and improving the safety and sustainability of the financial system. The Senate’s Economics References Committee reiterated the concerns expressed by the government that increased concentration in the

¹⁴ The discussion paper (<http://www.apra.gov.au/adi/Documents/Revised%20-%202020-%20Basel%20III%20discussion%20paper%20-%206%20September%202011.pdf>) was issued on 6 September 2011 for public consultation. APRA plans to conduct a second phase of consultation in early 2012 on more detailed prudential standards to implement the capital reform package.

¹⁵ See Joint Media Release – APRA and RBA, No. 2010-31, “Australian implementation of global liquidity standards” (17 December 2010, available at http://www.apra.gov.au/MediaReleases/Pages/10_27.aspx). APRA will require relevant ADIs to demonstrate that they have taken all reasonable steps towards meeting their LCR requirement through their own balance sheet management, before relying on the RBA facility.

banking sector could have “undesirable impacts on competition”. The report makes a number of recommendations, particularly on increasing disclosures by financial sector participants and taking steps to lower barriers to entry and promote greater levels of competition.¹⁶

BOX 1: Proposed reforms for a ‘Competitive and Sustainable Banking System’¹⁷

In December 2010, the Australian Government announced details of its intention to continue with banking reforms, building on its actions during the crisis, and aimed at improving competition within the banking system, as well as improving banking sector safety and stability. The ‘Competitive and Sustainable Banking System’ initiative divides this reform initiative into three streams.

Stream 1: Empower consumers to get a better deal

Under this stream, the Government proposes initiatives to enhance consumer protection. These include transparency (for example, via the introduction of a mandatory key fact sheet for new home loan customers and increasing the transparency of ATM fees) and reducing the costs of switching (such as banning exit fees on new home loans and examining the feasibility of account portability).

In addition, the Australian Competition and Consumer Commission will be granted enhanced powers to prosecute anti-competitive price signalling, and the government will conduct extensive education and awareness campaigns.

Stream 2: Support smaller lenders to compete with the big banks

Proposals under this stream include educating customers about how CUBS are prudentially regulated and introducing a new ‘Government Protected Deposit’ symbol to clearly mark which deposits are protected by the Financial Claims Scheme; increasing the government’s investment to support the securitisation market by AU\$4 billion (thereby bringing the Government’s total investment to AU\$20 billion); and accelerating the recovery of the securitisation market to strengthen and diversify funding for smaller lenders.

Stream 3: Secure the long-term safety and sustainability of Australia’s financial system

In order to improve the safety and sustainability of the financial system, the Australian government is allowing banks and CUBS to issue covered bonds (in order to broaden access to cheaper, more stable, and longer-term funding); and developing a deep and liquid corporate bond market (by allowing the trading of Commonwealth Government securities on a retail securities exchange and reducing red tape associated with corporate bond issuance to retail investors).

¹⁶ See “Competition within the Australian banking sector” by the Senate Economics References Committee (May 2011, at http://www.aph.gov.au/Senate/committee/economics_ctte/banking_comp_2010/report/report.pdf).

¹⁷ See http://www.treasury.gov.au/banking/content/report/report_01.htm for more details.

Future of Financial Advice: Following the crisis, ASIC has developed regulatory guidance on timely issues such as short selling, credit rating agencies and hedge funds. More recently, the Government has launched the “Future of Financial Advice” reforms to improve the quality of financial advice and ensure better protection for retail investors.¹⁸ These reforms, expected to be introduced in mid-2012, are moving in the direction taken by some other jurisdictions such as in the European Union – for example, the introduction of a statutory duty to act in the best interest of clients, or the introduction of “product-neutral” charging regimes to align the interest of the clients with financial advisers. They also include a prospective ban on conflicted remuneration structures in relation to the distribution and advice of retail investment products. In addition, reforms are underway to bring competition between equity exchange markets in Australia while ensuring that market integrity is maintained.¹⁹ The RBA has also issued, on behalf of the Council of Financial Regulators, a discussion paper seeking feedback on whether to establish central clearing of over-the-counter (OTC) derivatives in Australia.²⁰

Lessons and issues going forward

The resilience of the Australian financial system in the face of the global financial crisis highlights the inter-linkages between economic and financial system performance. Structural reforms ensured that macroeconomic conditions at the time of the crisis were favourable, while a combination of automatic stabilisers and proactive policy measures buffered the domestic economy from the sharp deterioration in global economic conditions. A low public debt burden provided the authorities with fiscal space for a large and targeted fiscal stimulus, while the flexible exchange rate absorbed substantial external shocks (including from volatile commodities prices) and allowed the authorities to provide an appropriate monetary stimulus. This was supported by a strong regulatory and supervisory framework – the authorities took a number of steps to address specific financial system vulnerabilities.

Australia is an example of a jurisdiction that takes an implicit macro-prudential orientation to financial system oversight, where monitoring of macroeconomic and systemic risks is matched by the day-to-day supervision of individual financial institutions. This monitoring has not required a separate macro-prudential regulator: both the prudential regulator and the central bank have financial stability mandates. The ultimate responsibility for taking policy action lies with each agency based on its mandate and views. While the institutional arrangements for macro-prudential oversight are relatively informal, the Council of Financial Regulators ensures a structured coordination process and the relevant agencies have a long history of achieving consensus on policy issues of system-wide importance - as illustrated by their actions during the crisis. The historical relationship between APRA and the RBA, as well as the fact that both institutions have financial stability mandates, have contributed to effective inter-agency coordination.

¹⁸ See <http://futureofadvice.treasury.gov.au/> for more details.

¹⁹ See <http://www.asic.gov.au/asic/asic.nsf/byheadline/11-87MR+ASIC+publishes+final+competition+market+integrity+rules> for more details.

²⁰ See <http://www.rba.gov.au/publications/consultations/201106-otc-derivatives/pdf/201106-otc-derivatives.pdf> for more details.

In this context, there are lessons from the Australian experience for other countries:

- Strong economic fundamentals provide a crucial bulwark against the risks of a financial crisis, and appropriate macroeconomic policies matter as much for the health of the financial system as the strength of the supervisory framework;
- Authorities need to closely monitor identified systemic risks and, equally importantly, have the tools to take appropriate coordinated actions well before such risks manifest into problems; and
- A macro-prudential orientation to financial system oversight requires substantial inter-agency coordination, but the structure of effective institutional arrangements can differ substantially based on country-specific circumstances.

The post-crisis period presents a number of challenges for Australia, particularly in the context of domestic monetary policy tightening combined with relatively high household indebtedness against the backdrop of a fragile global economy. These challenges include:

- *Changing economic structure and reliance on commodities.* The economy - and, by extension, the financial system - is going through a period of structural change in response to the strong demand for commodities from emerging Asian economies; indeed, the IMF projects that, by 2015, as much as half of all Australian exports will go to China and India.²¹ As a result, Australia's terms of trade is at historic levels and the country is experiencing a commodity-inspired private investment surge. However, the economy's increased exposure to potentially volatile and cyclical commodity prices warrants particular focus. The use of prudential tools may be considered to manage sector-specific risks stemming from the structural changes in the economy.²²
- *Funding risks.* Australian banks have made good progress in reducing their dependence on wholesale (particularly external) funding, and they should continue to work towards managing this funding risk. Funding structures can vary significantly depending on country circumstances, and it is both unrealistic and undesirable to eliminate wholesale external debt as a funding source. However, it is important to closely monitor and stress test banks' overall liquidity positions; avoid over-reliance on any single (potentially volatile) source of funding; and ensure that funding is sufficiently 'sticky' and adequately matched to the maturity of assets. In addition, the Government's initiative to develop a domestic deep and liquid corporate bond market as part of reforms to enhance competition in the banking system is welcome.
- *Systemically important financial institutions (SIFIs).* The presence of four domestic big banks presents two important policy challenges for the authorities. First, their size and nature of activities means that they could pose systemic and moral hazard risks in Australia. The authorities have a supervisory framework in place to address the risks

²¹ See the IMF's 2010 Article IV report (Country Report No. 10/331, available at <http://www.imf.org/external/pubs/ft/scr/2010/cr10331.pdf>).

²² See for example, "Macroprudential instruments and frameworks: a stocktaking of issues and experiences" by the Committee on the Global Financial System (May 2010, available at <http://www.bis.org/publ/cgfs38.pdf>) and "Macroprudential policy tools and frameworks: Update to G20 Finance Ministers and Central Bank Governors" by the Financial Stability Board, Bank for International Settlements and International Monetary Fund (February 2011, available at http://www.financialstabilityboard.org/publications/r_1103.pdf).

posed by regulated entities (including SIFIs) through a graduated supervisory response.²³ Any additional measures undertaken by the authorities in this area will depend on, and will need to be consistent with, the policy work on SIFIs that is underway at the international level by the Financial Stability Board (FSB) and the Basel Committee on Banking Supervision (BCBS).²⁴ Second, while a concentrated system by itself is not necessarily less competitive, it is important to proactively promote competition and contestability, as currently proposed in the various government reform initiatives. Consumer protection measures and policies to develop market-based sources of financing are useful in that context.

2. Failure resolution and crisis management

In 2006, APRA already had a number of resolution tools (such as extensive direction powers, transfer of business to a third party or bridge bank, and the statutory manager tool²⁵ at the point of insolvency) available; however, there was a perceived gap in the ability of the authorities to resolve a distressed ADI in an orderly, low-cost manner. For instance, there was no deposit guarantee scheme to ensure an orderly payout in a liquidation, while low cost resolution options - such as the ability to impose resolution prior to insolvency and the ability to carry out partial transfers of business - were constrained to some degree by the limited powers available. At the time, the Australian authorities were in the process of reviewing their failure resolution and crisis management framework. The FSAP recommended that the framework should clearly establish the legal foundation and policy approach to achieve speedy, least-cost and minimally disruptive resolution of non-viable institutions.

The FSAP raised concerns that Australia's depositor preference system was by itself not sufficient to ensure timely payment to depositors in a liquidation. The report also noted that there was no equivalent priority for general insurance policy holders and that, following the failure of the HIH Insurance Group in 2001, the government compensated the policy holders. Prior to the FSAP, the Council of Financial Regulators had released a proposal to establish a scheme to provide retail depositors and general insurance policyholders with timely access to their funds in the event of closure of an ADI or general insurer. The FSAP supported the proposal, stating that it could be a useful element of an enhanced framework for failure resolution and crisis management.

²³ APRA uses two tools as the centerpiece of its risk-based approach to supervision: the Probability and Impact Rating System (PAIRS, http://www.apra.gov.au/CrossIndustry/Documents/PAIRS_Nov_2010.pdf), and the Supervisory Oversight and Response System (SOARS, <http://www.apra.gov.au/CrossIndustry/Documents/SOARS-Nov-2010.pdf>). In addition, consistent with Basel II's pillar 2 framework, APRA can impose higher minimum capital requirements on individual ADIs as needed to address risks that are not adequately captured by Pillar 1.

²⁴ See "Reducing the moral hazard posed by systemically important financial institutions" by the FSB (October 2010, available at http://www.financialstabilityboard.org/publications/r_101111a.pdf).

²⁵ A statutory manager assumes complete control of the entity, replacing the management and board. Under statutory management, a range of resolution options can be implemented, including the recapitalization of the entity or the transfer of some or all of the entity to another regulated entity. The statutory manager is appointed directly by APRA and is subject to binding directions from APRA.

The ability to impose resolution on a failing institution prior to insolvency is an essential part of crisis management. In 2006, the statutory manager tool could only be used either when the ADI had become insolvent or was about to suspend payment, limiting the possibility of early intervention. In addition, APRA didn't have a clear power to direct an ADI's board to recapitalise the institution. Any measures taken by an ADI's board to recapitalise the ADI would have had to comply with its constitution, Corporations Act requirements and ASX listing requirements, including shareholder consent. The FSAP recommended that the authorities should consider introduction of express provisions into the *Banking Act* to seize control of a failing institution while it is still solvent and to impose a resolution without shareholder and creditor consent.

The *Financial Sector (Business Transfer and Group Restructuring) Act 1999* enabled APRA to transfer all or part of a distressed ADI to another ADI or bridge bank. In a partial transfer, there may be a shortfall between the deposit liabilities and the assets that the acquiring ADI wishes to accept. In such a case, a "top-up" payment would have to be made. The FSAP recommended that the authorities should consider arrangements that would facilitate purchase and assumption of the transactions of failed institutions when these can result in lower-cost resolution outcomes. The framework for crisis management should aim at: (i) preserving financial and economic stability during a crisis; (ii) avoiding moral hazard and enhancing market discipline before a crisis; and (iii) reducing the fiscal cost of a crisis.

Finally, in 2005, reciprocal legislation was passed in Australia and New Zealand requiring supervisors in each country, when taking regulatory action, to seek to avoid disruption to the financial stability of the other country. The FSAP recommended that the authorities build on the progress made within the Trans-Tasman Council on Banking Supervision (TTC)²⁶ to improve coordination in crisis management, given the New Zealand exposure of Australian ADIs.

Steps taken and actions planned

Crisis management framework: In September 2008, the member agencies of the Council of Financial Regulators signed an MoU on financial distress management²⁷, which formalised what was already established in practice. The MoU sets out the objectives, principles and processes for responding to financial institution distress and the responsibilities of each of the agencies. It also establishes a coordination framework for each stage of responding to financial system distress. During the financial crisis, the Council of Financial Regulators acted as a mechanism to ensure close cooperation and coordination between the agencies, as was evidenced by the nature of the response actions taken at that time, such as the implementation in October 2008 of the FCS and the Guarantee Scheme for Large Deposits

²⁶ The New Zealand market represents the largest overseas exposure of the four major banks, amounting to 15% of their total assets and 85% of assets of the New Zealand market. The high interdependence of the two banking systems led to the formation of the TTC in February 2005 with the goal of enhancing information sharing, promoting a coordinated response to financial crises, and guiding policy advice to governments in relation to banking supervision. The TTC recommended legislative changes to lay the foundation for enhanced cooperation between APRA and the Reserve Bank of New Zealand (RBNZ).

²⁷ See <http://www.rba.gov.au/fin-stability/reg-framework/pdf/mou-cfr-fdm.pdf> for details.

and Wholesale Funding (see section 1). However, the crisis did highlight the need for further strengthening the crisis resolution frameworks within the Council.

In 2009, the Council of Financial Regulators developed a comprehensive guide for the resolution²⁸ of ADIs. It includes information on early warning indicators, diagnostics, systemic impact assessment, recapitalisation options, use of business transfer powers, implementation of an institution-specific government guarantee, liquidity support, and communications. This work has recently been refined, having regard to: (1) the October 2010 recommendations made by the FSB on reducing the moral hazard posed by SIFIs; (2) the lessons learnt from the ADI crisis simulation exercise that was held in December 2009; and (3) the results of an independent review by a law firm and informal peer review by selected foreign bank resolution authorities. In addition to testing the comprehensive guide, the ADI crisis simulation exercise was designed to test APRA's institutional problem diagnostic capability, RBA's systemic impact assessment, and the Council of Financial Regulators' ability to assess different response options. It also tested the capability to coordinate the provision of advice to the Treasurer and implement the agreed response option. A review undertaken by an independent consultant on the crisis simulation exercise highlighted possible refinements to communication arrangements between the agencies on the Council of Financial Regulators. ADI resolution options address both open and closed resolution issues.

In 2009, APRA established a Financial Crisis Management Plan that sets out internal arrangements for responding to the distress of any financial institution it supervises. The Financial Crisis Management Plan was tested in the ADI crisis simulation exercise in 2009 and is currently under review to align it more closely with the resolution framework established at Council level. It will be refined further in 2012.

APRA is currently considering the development of plans for resolving distress in insurance companies. As part of this process, a workshop for the agencies on the Council of Financial Regulators in November 2010 explored issues relating to resolving financial distress in a general insurer. APRA plans to further develop guidance over 2011/12 on the resolution of general insurance companies, which may include details on early intervention, transfers to a third party and funding options. APRA may consider holding a crisis simulation exercise in 2013 to test general insurance crisis resolution. Crisis management planning for life insurers is relatively less developed, although APRA may hold a workshop in the next 1-2 years to discuss resolution issues for life insurers, together with internal work on resolution options.

Financial Claims Scheme: The FSAP noted that in 2006 Australia had no explicit scheme to ensure timely payment to depositors or general insurance policy holders in the event of a failed institution. In October 2008, legislation was enacted that established the FCS for ADIs, which aims to protect depositors from loss and provide prompt access to their funds in the event that an ADI is insolvent and is about to be (or is being) wound up. The FCS currently protects depositors up to AU\$1 million in any one ADI and aims to pay out protected

²⁸ This includes both open resolution and resolution involving the Financial Claims Scheme. An "open resolution" is a resolution mechanism in which the ADI is enabled to meet its existing obligations and to continue business, whether through the existing ADI or in another entity. By contrast, a "closed resolution" is a resolution mechanism in which the ADI is closed to new business and is either made subject to the Financial Claims Scheme and wound up, or where its deposit liabilities are transferred to another ADI and the distressed ADI is then wound up.

deposits within seven days of the FCS being invoked. At the same time, the FCS Policyholder Compensation Facility for general insurers was also established, which would settle outstanding claims against an insolvent general insurer that has been placed into judicial management or is being wound up. All insurance claims below AU\$5,000 are covered by the FCS. Claims above this threshold are only covered for certain categories of policyholders, excluding medium-sized and large companies. There is currently no compensation scheme to cover policyholders of life insurance companies. The ‘Competitive and Sustainable Banking System’ reform package (see section 1) confirmed the FCS as a permanent part of Australia’s financial system.

The FCS is post-funded. Any payouts would be met by a standing appropriation, which is currently unlimited for ADIs but will be capped at AU\$20 billion per ADI from 12 October 2011. For general insurers, such an appropriation is currently capped at AU\$20 billion.²⁹ The amount paid out qualifies as a priority debt when the ADI or general insurer is wound up. If there is a shortfall in funds owed to the government after the ADI or general insurer is wound up, it can be recovered by imposing a levy on either the deposit-taking industry or the general insurance industry, as appropriate.³⁰

The limit of AU\$20 billion per ADI would not be sufficient to cover the protected deposits of any of the four major banks, even though their assets would ultimately be sold to fund any depositor reimbursements if the FCS was used in the resolution process. In any event, there could be circumstances in which these banks would be deemed too big to undergo payout and liquidation. The development of recovery and resolution plans for each of those banks (see below) would give greater clarity on the effectiveness of existing resolution tools, such as partial transfer powers to a private sector purchaser or bridge bank, in a fast-moving stress scenario. APRA and Treasury are considering further possible refinements to crisis management powers in order to ensure that they are appropriate.

The authorities have noted that, while taxpayer-funded support is generally a last resort, there are circumstances where such support is both necessary and cost-effective since the benefits to the stability of the system outweigh costs and risks. They have also noted that taxpayer-funded solutions can be structured to ensure that shareholders and subordinated creditors bear losses ahead of any risks taken by the taxpayer, and where taxpayer risks are compensated by appropriate risk management measures and access to upside benefits (for example, where the Government takes an equity stake). One of the challenges facing the authorities, as in several other jurisdictions, will be to develop appropriate plans - and, if necessary, additional tools - to allow them to resolve their four big banks without resorting to taxpayer support.

The Council of Financial Regulators has reviewed the current FCS cap of AU\$1 million per depositor per ADI and has proposed that the cap be lowered to between AU\$100,000 and AU\$250,000 in order to make it appropriate for the post-financial crisis environment. The Government released a consultation paper in May 2011 setting out this and other

²⁹ If an ADI and a general insurer in the same group fail after 12 October 2011, FCS payouts for the ADI would be capped at AU\$20 billion, while payouts for the general insurer would be separately capped at AU\$20 billion.

³⁰ A levy on the ADI industry is based on deposit liabilities, but cannot exceed 0.5% of an ADI’s deposit liabilities. A levy on the general insurance industry is based on gross premiums, but cannot exceed 5% of a general insurer’s gross premiums.

recommendations ahead of a decision on the cap, which is expected before October 2011.³¹ In September 2011, the Government announced that the cap would be lowered to \$250,000 from 1 February 2012, with transitional arrangements for term deposits in existence on the announcement date. The Government also announced several refinements to the FCS, aimed at targeting coverage more closely at Australian retail depositors and at increasing the efficiency of the scheme.

As administrator of the FCS, APRA is responsible for determining the amounts payable to each depositor and for arranging the payments to depositors. It is currently developing a framework for early payout, and it sees the ability of ADIs to establish a single customer view (SCV) as being essential to enable accurate payouts (limited to the FCS cap) within a short period of time. For many ADIs, their ability to produce a SCV is constrained by their current information technology (IT) systems. APRA plans to finalise the SCV reporting obligations for ADIs by the end of 2011. The requirement is likely to focus on ADIs having the ability to produce a SCV upon request and to generate payment instructions from it. ADIs will need to be able to produce SCV reports from around the beginning of 2014, taking into account a minimum two year transition period that commences from the time the SCV reporting standard is issued by APRA. There is scope for ADIs with particular IT challenges to apply to APRA for an extension of up to two years. On this basis, all ADIs would be able to produce SCV reports no later than the beginning of 2016.

The most likely options for payout are either via the failed ADI's payment channels or via RBA cheque. APRA could also open new accounts for depositors at another ADI and use the FCS to credit those accounts. However, a deposit book transfer to a third party ADI cannot be funded by the FCS. The Government has recently announced that it will proceed with the proposal to allow APRA to transfer a deposit book under the FCS of a failing ADI to another ADI, in accordance with the recommendations of the Council of Financial Regulators.

Resolution powers: In line with the FSAP recommendations, amendments were made in 2008 to the *Banking Act* to enable APRA to appoint a statutory manager prior to an ADI becoming insolvent. A statutory manager can assume complete control of the entity, replacing the management and board. He/she can issue, cancel or sell shares in the ADI, bypassing shareholder consent. In the case of general and life insurance, APRA has the ability to apply to a federal court for the appointment of a judicial manager to assume control of an insurance company in order to facilitate its resolution.

APRA has powers to give binding directions to regulated entities (including ADIs, general insurers and life insurers) and their authorized non-operating holding company (NOHC). The direction powers are wide-ranging and enable APRA to direct the entity to undertake (or cease) specified actions or activities, to remove and replace directors and senior management, and for ADIs and general insurers to take actions to recapitalise (bypassing normal shareholder consent requirements and other regulatory processes). These powers have been extended and enhanced through recent statutory amendments.

The other key changes that have been made to APRA's resolution powers since 2006 include enhancements to business transfer powers in October 2008 and, in June 2010, ability to transfer some or all of the business of a general insurer to another general insurer. APRA

³¹ See http://www.treasury.gov.au/documents/2025/PDF/CP_Financial_Claims_Scheme.pdf for details.

already had the power to transfer some or all of the business of an ADI to another ADI or bridge bank as well as the power to transfer some or all of the business of a life insurer to another life insurer. The enhancements in October 2008 enable a transfer of an ADI's assets and liabilities (other than deposit liabilities) to a non-ADI entity, such as an asset management company. Similar powers to transfer some or all of the business of a distressed general or life insurer to a non-insurer were obtained in June 2010. At the same time, APRA obtained the power to prevent an Australian branch of a distressed foreign ADI from moving assets out of, or liabilities in, the country.

Going forward, APRA and Australian Treasury are considering further possible refinements to the crisis management powers that will improve the ability to resolve groups, to resolve an Australian branch of a foreign ADI, and to resolve insurers. Any enhancements would be designed to enhance resolution options and to bring greater clarity to the resolution powers. The authorities have also engaged in discussions surrounding senior debt "bail-in" (i.e. the power to apply a haircut to creditor claims or convert a creditor claim into equity) in the context of the current international discussion on this topic under the auspices of the FSB.

Resolution funding: The FSAP recommended establishing arrangements for "top-up" payments to facilitate purchase-and-assumption transactions of failed institutions when these could result in lower-cost resolution. In 2008, the Financial System Stability Special Account (FSSSA) was established through an amendment in the *Banking Act*. The FSSSA, which is limited to a standing appropriation of AU\$20 billion at any one time, can be used to fund deposit transfers and the transfer of other business (e.g. to fund any shortfall in assets), a transfer of insurance business and non-deposit ADI business (e.g. transferring impaired assets at assessed market value to an asset management vehicle), as well as funding recovery structures in an open resolution as long as the FCS has not been declared. The Council of Financial Regulators plans to review this funding arrangement to determine whether any additional features are required.

Trans-Tasman Memorandum of Cooperation: The FSAP recommended building on the progress made within the TTC to improve coordination with New Zealand in crisis management. In September 2010, the TTC agencies signed a Memorandum of Cooperation on the management of trans-Tasman bank distress. The Memorandum of Cooperation sets out the objectives and principles of trans-Tasman bank resolution, identifies the responsibilities of each agency, and prescribes high-level guidance on the crisis resolution process. It addresses the burden sharing issue by stating that the Australian participants will have responsibility for the design and implementation of capital support for the parent bank and the New Zealand participants will have responsibility for the design and implementation of capital support for the New Zealand subsidiary. The TTC agencies have also developed comprehensive guidance on the management of trans-Tasman bank distress.

Lessons and issues going forward

Significant and commendable progress has been made on failure resolution and crisis management - in particular, the development of a crisis management framework, the establishment of a deposit guarantee scheme (Financial Claims Scheme), the strengthening of resolution powers, and the improvement in coordination with New Zealand on crisis management. Further development of resolution guidance for general and life insurers should

be encouraged. Finalisation of a joint resolution package with New Zealand would also assist cross-border crisis management.

APRA has stated an aspiration of implementing a FCS payout within seven calendar days. In order to pay out depositors accurately and within the FCS limit, it is particularly useful for ADIs to have a single customer view that enables the ADIs, overseen by APRA, to identify deposits covered by the FCS. The implementation of a SCV is currently proposed to take effect by the beginning of 2014, although an extension of up to two years may be granted. The authorities believe that a faster SCV timetable would not be achievable without imposing an excessive compliance burden on ADIs. The current timetable is quite generous compared to that adopted in some other countries - for instance, all banks in the UK were only given 18 months to implement a SCV.

Resolution financing may be required when using partial business transfer powers. The FSSSA appears able to provide the liquidity required, up to AU\$20 billion at any one time, to fund deposit transfers when there is a shortfall in assets. The authorities are aware that this amount is insufficient to cover the deposits of the largest banks in Australia in a situation where a private sector purchaser is unwilling to accept the assets of the failed ADI. Although there is no explicit provision in the *Banking Act* for the Government to make a claim on the rump ADI, for funds expended under the FSSSA on partial business transfers, the Treasury could use contractual arrangements with the distressed ADI to recover costs. However, these mechanisms may not be sufficient to recoup all taxpayer-funded expenditure and there is no provision to impose a levy on the financial industry in order to meet the funding costs. Therefore, as a way of enhancing protection for taxpayers, the Australian authorities could consider establishing an explicit provision in the *Banking Act* for the Government to recover the costs of funding a resolution by establishing a priority claim on the rump ADI for funds released by the FSSSA and to impose a levy on the financial industry as a means of making up any shortfall in recoveries. An alternative approach would be to allow the FCS to be used to fund open resolution measures, such as transfers of business, which is the approach used in the UK.³²

Work has begun on developing institution-specific recovery plans for Australia's six largest banks, with preliminary consideration being given to whether some form of recovery plan requirement might apply to smaller ADIs and to insurers. APRA expects that engagement on recovery plans with the ADIs will be carried out at either board or senior management level. Recovery planning will be undertaken in 2011 and 2012 for at least the six largest banks, with resolution planning being subsequently considered. Bearing in mind the structure of the Australian banking industry, the acceleration of work on recovery and resolution plans for the larger banks would be useful, focusing on what the authorities regard as the banks' critical economic functions.

³² In the UK, the contribution made by the Financial Services Compensation Scheme to resolution costs is limited to the amount that would have been paid out had the firm gone into insolvency less any recoveries that would have been made.

3. Banking supervision

The FSAP assessed compliance with the Basel Core Principles for Effective Banking Supervision (BCPs) to be of high level in Australia, with overall good quality of banking supervision and systems in place that provided a foundation for a leading-edge, modern banking supervision. At the same time, it made several recommendations on how to further enhance its effectiveness³³:

- APRA should emphasise strong risk management practices and maintenance of strong capital reserves in ADIs;
- APRA should continue to closely monitor the adequacy of banks' liquidity in light of the declining retail deposit base at the large banks and with increasing reliance on wholesale funding;
- APRA and the RBA should build on the experience with the FSAP stress tests to continue the dialogue with banks and consider requesting the banks to conduct and report stress test results on a regular basis;
- Removing the legal obstacles to the Australian Transaction Reports and Analysis Centre (AUSTRAC)³⁴ sharing information with APRA, implementing effective coordination in exchange of relevant information between AUSTRAC and APRA, and establishing an effective supervisory verification program to ensure that APRA is able to obtain all necessary information regarding prudential issues, including those that extend beyond AUSTRAC's narrow mandate; and
- Revising the criteria for exempting institutions from regulation so that the demarcation line between regulated and non-regulated entities becomes clearer and all foreign bank subsidiaries undertaking bank-like business in Australia are subject to APRA oversight.

Steps taken and actions planned

Risk management practices and capital adequacy: During the recent crisis, APRA's focus on ADIs' credit quality was on business lending, in particular commercial property lending. This has been a key theme of APRA's prudential reviews, with the objective of strengthening ADI risk management in this area. APRA's frontline supervisors have been assessing the risk appetite and business strategy of each ADI active in this line of business; underwriting standards and quality of the origination process; portfolio limits on such lending and rationale for any recent changes to limits; quality of internal management reports on the performance of the portfolio; and rigour of stress testing applied to the portfolio, particularly by geographic area. A 'severe but plausible' commercial property stress was included in the macroeconomic stress test of the ADI industry (see below).

³³ The assessment of Australia was undertaken before the BCPs were last revised, so the principles mentioned in this report do not correspond to the ones that are in use since 2006.

³⁴ AUSTRAC is the agency assigned the anti-money laundering and combating the financing of terrorism role in Australia's financial system, in line with the functional approach to regulation that has been adopted.

APRA also intensified monitoring of lending to corporate as well as small and medium-sized enterprises that performed less well than housing lending during the financial crisis. The focus here involved close monitoring of ADI ‘watchlists’, large exposures and industry concentrations, as well as assessments of the effectiveness of credit risk management processes and rigour of stress testing. Over the past year, APRA’s attention has once again turned to housing lending due to factors including competitive pressures, signs of an easing in lending standards as maximum loan-to-valuation ratios have risen, and increases in mortgage rates. For ADIs seeking overseas expansion, teams of frontline and specialist staff have been established to evaluate specific proposals.

APRA adopted the Basel II framework on 1 January 2008. Prudential Standard (APS) 110 requires an ADI to have in place an internal capital adequacy assessment process. It also allows APRA to require an ADI at so-called Level 1 (licensed entity) and Level 2 (consolidated group) to hold a risk-based capital adequacy ratio greater than the regulatory minimum, and to set higher minimum requirements on the components of capital. Australian banks have maintained strong capital positions before and after the crisis, and APRA intends to implement Basel III at least in line with the BCBS timelines (see section 1). The IMF assessment in 2009 shows that Australia has a robust and high-quality Basel II implementation that has built upon and substantially strengthened the risk-management capabilities of the major banks.³⁵ In addition, APRA released a Discussion Paper in March 2010 outlining its proposals to extend the current supervisory framework to Level 3 entities (conglomerate groups)³⁶, and it intends to finalise these reforms in 2013.

Adequacy of liquidity: In early August 2007, when global market turbulence first emerged, APRA intensified its oversight of ADI liquidity management and established a dedicated team to maintain daily contact with ADIs. APRA also began to collect information on liquidity from a range of institutions and developed standard metrics for liquidity stress. APRA has continued to focus in this area by monitoring and assessing the liability structure, liquidity management and forecast funding requirements of ADIs. Since the onset of the crisis, Australian banks have increased deposit-gathering activities, reduced reliance on short-term wholesale funding, and increased their holdings of liquid assets (see section 1).

APRA’s prudential requirements for liquidity have been under review since 2008-9. The proposed changes recognise the revised principles and complementary liquidity reforms set out by the BCBS.³⁷ APRA plans to implement the 2008 BCBS liquidity principles during 2011-12 and other elements of the Basel III liquidity requirements (LCR and NSFR) in accordance with the BCBS timetable. In November 2010, APRA requested that locally incorporated ADIs currently subject to scenario analysis requirements undertake a self-assessment against the 2008 BCBS liquidity principles and submit their results, including any remedial plans, to APRA in February 2011.

³⁵ See <http://www.imf.org/external/pubs/ft/scr/2010/cr10107.pdf> for details.

³⁶ See <http://www.apra.gov.au/Policy/upload/Discussion-paper-Supervision-of-conglomerate-groups-March-2010.pdf>.

³⁷ See “Principles for Sound Liquidity Risk Management and Supervision” (September 2008, <http://www.bis.org/publ/bcbs144.pdf>) and “Basel III: International framework for liquidity risk measurement, standards and monitoring” (December 2010, <http://www.bis.org/publ/bcbs188.pdf>).

Stress testing: APRA uses stress testing as part of its regular supervisory activities to understand the vulnerabilities facing individual institutions and industries, as well as the potential for systemic threats. There are prudential requirements for regulated institutions to undertake stress tests covering various types of risk.³⁸ When the global financial crisis began in the second half of 2007, APRA conducted a range of top-down stress tests on individual ADIs to determine their resilience in the face of a sharp decline in offshore wholesale funding and a prolonged shutdown of securitisation markets.

APRA also conducts its own internal stress testing activities. Its main development in stress testing practices since 2006 has been to undertake industry-wide or macroeconomic stress scenarios to identify problems with both individual ADIs and with the banking system as a whole. The crisis highlighted liquidity risk as a particularly relevant factor. Both APRA and ADIs have responded with more robust stress testing practices. More recently, APRA has undertaken a comprehensive stress test of the larger ADIs based on a 'severe but plausible' macroeconomic scenario built around a continued deterioration of global economic conditions. The main results of the stress test for the 20 largest locally incorporated ADIs by asset size, which were published on an aggregated basis by APRA, suggest that none of the ADIs would have failed under the downturn macroeconomic scenario, and that none of the ADIs would have breached the 4% minimum Tier 1 capital requirement of the Basel II Framework.

Going forward, APRA plans to incorporate reputation effects (including from subsidiaries and related entities) and liquidity impacts within the stress testing models. APRA also intends to focus on improving the regulated sector's approach to using appropriate company-wide stress testing. It is currently developing a prudential practice guide on stress testing which it expects to release for industry consultation in 2012. It will also improve its internal infrastructure to better monitor industry practices and undertake industry-wide stress tests.

BCP 1(6) (Information sharing) and 15 (Use of banks by criminal elements): The *Anti-Money Laundering and Counter Terrorism Financing (AML/CTF) Act 2006* permits APRA to access AUSTRAC information with authorisation by the AUSTRAC Chief Executive Officer. At an institutional level, both formal and informal frameworks have been established for APRA and AUSTRAC to share information that might be relevant to APRA's prudential oversight role. First, an MoU between AUSTRAC and APRA was signed in February 2007, which sets out a framework to collaborate in areas of interest in which cooperation is essential if their functions are to be performed effectively and efficiently. Second, additional guidelines between AUSTRAC and APRA for the provision of non-public information were established in July 2007. The eligible information defined in these guidelines includes *Financial Transaction Reports Act 1988* information. Third, a joint committee comprising representatives of the two agencies was established in July 2007 to facilitate cooperation and coordination arrangements for information sharing, referral of matters between the agencies, and provision of mutual assistance.

With regard to the issue of having an effective regime of on-site verification that was identified by the FSAP, AUSTRAC has employed on-site assessments and desk reviews to

³⁸ The prudential requirements for stress testing market and liquidity risks have been in place since September 2000, while those for credit risk were formalised as part of Basel II implementation in January 2008.

monitor the industry's compliance with AML/CTF obligations. The scope of assessment covers sampling of customer due diligence processes, reviews of threshold transaction reports and international funds transfer instruction reporting processes and controls, and reviews of other systems and governance to manage money laundering and terrorism financing risks. AUSTRAC conducted an increasing number of on-site assessments since 2007 of banks and other lenders.

BCP 2 (Permissible activities) and 25 (Supervision over foreign banks' establishments): Under Australia's *Banking Act 1959*, 'banking business' means both taking deposits and making advances, and all entities wishing to carry on 'banking business' are required to obtain authorization by APRA. Other institutions can, however, issue deposit-type instruments to retail customers, such as "at call debentures", without banking authority. These entities may have a financial services license and are subject to regulation by ASIC as issuers of debt instruments or market intermediaries, and risk-based capital requirements for some of them are currently under review (see section 4).

The *Banking Act* empowers APRA to grant very specific conditional exemptions from the Act's provisions. APRA is currently reviewing the exemptions that are currently granted to 39 financial entities (often owned by foreign banks) which allow them to call themselves 'merchant banks' without being subject to prudential regulation.³⁹ Many of these entities are no longer involved solely in short-term money market operations, but have expanded into various investment banking activities (e.g. underwriting, market making, trading etc.). However, the majority of them have assets of less than AU\$50 million and are therefore not significant in size. Moreover, to the extent that they are owned by local ADIs, then APRA's consolidated approach to supervising ADIs would include these subsidiaries.

In addition, in accordance with long-standing government policy, APRA has exempted specified religious development funds from *Banking Act* restrictions against carrying on banking business. The exemption, which is subject to restrictions on the types of products that these entities can offer, was recently extended for an interim period of two years, pending a more complete review by the Government in conjunction with APRA.

Lessons and issues going forward

The Australian authorities have addressed to a large extent the FSAP recommendations on banking supervision. APRA has continued to promote effective risk management practices and strong capital reserves and to closely monitor the adequacy of ADIs' liquidity, and has improved stress test capabilities as well as enhanced coordination and information sharing with AUSTRAC. AUSTRAC has gradually built up its capacity for on-site verifications and employed such assessments as an important supervisory tool. APRA has taken a more conservative stance in certain areas than is required by the BCBS standards, such as requiring banks to maintain higher quality capital (in terms of deductions and the common equity component of Tier 1 capital), adopting higher risk weights on certain loan types (e.g. low documentation loans), and setting a relatively high floor of 20% for loss given default on residential mortgages. Thanks to good macroeconomic fundamentals and a sound regulatory

³⁹ These entities were established at a time when foreign banks were unable to carry on banking business in Australia, and domestic banks were prohibited from direct involvement in the short-term money market.

and supervisory framework, ADIs were generally resilient to the global financial crisis (see section 1).

The reliance by major Australian ADIs on wholesale funding, particularly from abroad, remains a potential vulnerability. While its use has declined in recent years (see section 1), APRA should continue to remain vigilant regarding funding risks and to encourage ADIs to develop appropriate medium- and long-term funding plans. Given the relatively good performance of these institutions during the financial crisis, the authorities should also continue to monitor the possibility that ADIs may be emboldened to take on riskier strategies to offset the higher funding cost. While scenarios such as a global economic downturn, a rise in the unemployment rate and a fall in house prices have been used in recent stress tests, more severe scenarios related to funding risk could also be explicitly included in future tests.

Exposures to the household sector and to commercial real estate (including developers of residential property) represent a large share of Australian ADI assets and a potential source of risk. With more than half of ADI lending directed to these two sectors, APRA should continue to closely monitor related risks, especially given high household debt and the inherent cyclicity of property development businesses. APRA's regular stress testing has provided a strong base for assessing the vulnerabilities of ADIs. APRA should continue its efforts to build up its own as well as ADIs' stress testing capabilities and to closely monitor their risk assessments.

At the same time, there exists scope for more progress in a few areas mentioned in the FSAP recommendations. AUSTRAC currently manages the threat of serious crime by requiring ADIs to notify it of all suspicious matters, including on matters that go beyond money laundering and terrorist financing, such as possible bribery, drugs and fraud offenses. Going forward, AUSTRAC will need to continue to develop the necessary skills and expertise to undertake on-site verification of ADIs' implementation of measures to guard against abuse by criminal elements. Such verification will need to be based not only on the *AML/CTF Act* and Rules, but also on BCP 18 (abuse of financial services) guidance and the requirements mentioned in the FSAP recommendation. In particular, achieving compliance with BCP 18 requires on-site verification that ADIs have implemented effective measures to address a range of issues that go beyond anti-money laundering and countering terrorism financing - including smuggling, embezzlement, bribery and fraud.

With regard to permissible activities and supervision over foreign banks, the Australian authorities have been reviewing the exemption granted to some types of financial entities. The RBA has undertaken to conduct an annual assessment of the risks to financial stability posed by institutions engaged in bank-like activities and to report to the Council of Financial Regulators. However, the recommended revision to the relevant criteria for exempting institutions from regulation has not yet been made in the legislation, i.e. in Section 11 of the *Banking Act*. Building on international efforts in this area⁴⁰ and in line with recent steps to better monitor and oversee the (relatively small) 'shadow banking' system in Australia⁴¹, the

⁴⁰ See "Shadow Banking: Scoping the Issues" by the FSB (April 2011, available at http://www.financialstabilityboard.org/publications/r_110412a.pdf).

⁴¹ See "The Shadow Banking System in Australia" in the RBA's Financial Stability Review (September 2010, available at <http://www.rba.gov.au/publications/fsr/2010/sep/html/box-b.html>).

authorities should go beyond reviewing use of the term ‘merchant bank’ and review the Section 11 exemptions in order to establish an amended and clearer demarcation line between regulated and non-regulated entities. This would ensure that all institutions undertaking bank-like activities - even if this sector is relatively small and declining in size (as is the case in Australia) - are subject to appropriate oversight. Depending on the business model, risk characteristics and contribution to systemic risk, the appropriate oversight of such institutions can take different forms.

4. Securities regulation

Supervision of financial markets in Australia is primarily a principles-based system that sets out the regulatory objectives in terms of desired outcomes. The FSAP observed that Australia had a high overall level of compliance with the Objectives and Principles of Securities Regulation issued by the International Organization of Securities Commissions (IOSCO), and concluded that the vast majority of these standards had been fully implemented. At the same time, the FSAP highlighted certain areas where compliance with the IOSCO standards could be further improved and recommended the following actions:

- While recognising the high level of operational independence of ASIC in practice, the authorities should consider removing the power of the Treasurer to give directions and to instruct ASIC to carry out an investigation. The possibility of funding a proportion of ASIC’s work directly from a levy on the financial services industry, and to reverse the growing dependence of ASIC (at the time of the FSAP) on special purpose funding, should also be considered.⁴²
- In relation to enforcement and surveillance powers, the removal of ambiguities in ASIC’s use of evidence obtained from use of a search warrant was recommended to be considered.⁴³ In addition, ASIC was asked to satisfy itself that it has adopted a comprehensive suite of tools for identifying and prioritising risks in the surveillance function. Finally, the FSAP noted that the October 2005 FATF Mutual Evaluation Report on Australia identified significant limitations in the legislation governing AML/CTF efforts and its enforcement. In particular, the FSAP underlined relevant AML/CTF gaps in the field of securities regulation such as in customer due diligence, ASIC’s powers to revoke a license, or its use of sanctioning powers.
- While recognising the benefits of a principles-based regulatory approach, the FSAP recommended that ASIC should be more specific about its expectations to market

⁴² In cases where ASIC is considered to perform functions in addition to its traditional role as corporate, financial services and markets regulator, it receives “special purpose funding” from the Government to supplement its general appropriation.

⁴³ At the time of the FSAP, ASIC could use a search warrant issued by a magistrate under the *Australian Securities and Investments Commission Act 2001* (Cth) (“ASIC Act”), available for both civil and criminal proceedings, only if it suspected that its notice to produce documents had not been complied with. At the same time, a search warrant was available only for criminal proceedings in cases where there were reasonable grounds to suspect that evidence of criminal offences might be located on the premises to be searched. This meant that ASIC could apply to a magistrate for a search warrant for civil proceedings only if the documents it had previously requested had not been produced.

participants in certain areas - such as the rules to be followed by fund managers in relation to best execution, appropriate trading and timely allocation of trades, the prevention of churning, and underwriting agreements - by issuing a Policy Statement. Similar considerations led to a recommendation to ASIC to provide more guidance on prospectus disclosure.

- A series of high profile and large cases of unit pricing errors had been registered in the years preceding the FSAP. The assessment underlined the necessity for the authorities to evaluate at a later stage whether the measures put in place at the time of the FSAP, such as the guide to good practice in unit trust pricing, would bring the expected outcomes.
- With respect to the regulation of market intermediaries, it was recommended to consider making reciprocal the constraints on ASIC when seeking to suspend or cancel the license of an APRA supervised entity. Furthermore, in relation to expectations set by ASIC to market intermediaries not falling under the supervision of APRA, the FSAP recommended that risk-based capital requirements should be enhanced to meet international norms and to take proper account of the systemic risk of large exposures in OTC markets.

Steps taken and actions planned

Regulatory independence (IOSCO Principle 2): The legislation governing the power of the Treasurer to direct ASIC to investigate a particular matter has not been modified in response to the FSAP recommendation. The Australian authorities believe that ASIC's independence is already ensured in performing and exercising its functions. The power of the Treasurer to give certain directions to the securities regulator is perceived to be well circumscribed and not to result in political interference. The authorities confirm that the power only relates to asking ASIC to investigate a particular matter where it is in the public interest to do so. The Minister also has a power to give ASIC a written direction about policies it should pursue or priorities it should follow. This is the only power that has been used, and it was only used back in 1992 when the Government gave a direction to ASIC regarding its relationship with the Commonwealth Director of Public Prosecutions, and this decision was made public.

The funding sources allocated to ASIC have significantly increased in recent years - from AU\$130 million in 2000-01 to AU\$339 million in 2010-11 - and continue to be based on an appropriation from the federal Government. At this stage, the Government does not envisage moving towards an industry levy on the financial services industry as a dedicated source of funding for ASIC. However, ASIC's new functions for front-line market surveillance have been partially financed from fees imposed by regulation on financial markets since August 2010, and the Government will be consulting shortly on proposals to recoup ASIC's additional market supervision costs flowing from introduction of competition in exchange market services. The Treasury expects to issue a proposal for consultation in mid-2011, while the new system is expected to be in place from January 2012.

In order to assess ASIC's overall funding and financial management arrangements in light of the new activities or functions that have been entrusted to it, the Government is undertaking a review in 2011. Although the authorities cannot provide relevant figures at this stage due to

the pending review⁴⁴, they note that special purpose funding continues to be used to support ASIC in taking on new responsibilities (e.g. regulation of consumer credit and market supervision reforms), facing the challenges of the post-crisis regulatory environment, and financing the modernisation of ASIC's IT system.

Enforcement and surveillance issues (IOSCO Principles 8-10): Through an amendment in 2010 of the *ASIC Act*, the regulator can now, for the purposes of any investigation (criminal or civil), either issue a notice in order to produce documents or apply to a magistrate for a search warrant under the *ASIC Act*, without needing to first issue a notice for the production of the documents.

With regard to risk-based surveillance, ASIC notes that it has a well functioning system in place for identifying and prioritising risks. ASIC is undertaking an IT project (Project STAR) to consolidate into a single view its significant data on individual entities and their relationship. A strategic and operational risk assessment is conducted each year focusing on any risks that could affect ASIC's ability to perform its functions. Currently, an internal audit is being undertaken on ASIC's risk-based approach to surveillance activity.

In the AML/CTF area, new legislation was adopted in 2006 (see section 3). This legislation brought more comprehensive obligations to reporting entities in relation to customer due diligence, which was one of the points raised by the FSAP. However, an evaluation of this legislation is beyond the scope of this peer review and needs to be undertaken in the broader context of AML/CTF via an FATF update on the 2005 Mutual Evaluation Report.

Prospectus disclosure (IOSCO Principle 14): Further to the FSAP recommendation, ASIC is currently preparing more concrete guidance on prospectus disclosure. The public consultation process closed in June 2011, and it is proposed that new guidance will be announced by end-2011. The proposed guidance in the consultation document provides more comprehensive and detailed information about why issuers should include certain elements into their prospectuses and what these elements should be - such as investment overview, presentation of the issuer's business model, relevant risks, financial information about operating history, information in relation to directors and key managers, related party transactions, and other relevant information. ASIC has also issued prospectus guidance in recent years for specific entities and situations - for example, improving disclosures on debentures and unsecured notes for retail investors, or setting out guidelines for offers of "plain vanilla" bond.

Expectations of behaviour for fund managers (IOSCO Principle 17): The *Corporations Act 2001* sets out the basic requirements for the dealing activities of fund managers in terms of high-level principles, such as the obligation to act honestly and in the best interests of members, to exercise care and diligence, to treat members who hold interests in the same class equally, and to act without the misuse of information. The FSAP suggested issuing more concrete guidance through a Policy Statement mainly to ensure that fund managers have a better understanding of ASIC's expectations in these areas.

⁴⁴ It should be noted that ASIC's funding is not classified into special purpose funding and core funding, which complicates the estimation of relevant figures in a consistent manner over time. New budgetary measures may contain components that affect both of these categories, but these are not listed separately in the budget documents. The ready availability of such figures is also affected because of changes in past few years to the way the Government funds all of its portfolio bodies for items such as IT and other capital expenditures.

In response, ASIC amended the relevant Class Order in 2007 to permit the underwriting of rights issues and placements by associates of the responsible entity for a listed managed investment scheme, subject to conditions that also address the risks of potential conflicts of interests. With regard to best execution, ASIC is currently undertaking a market integrity reform for competition in exchange markets that involves setting out best execution obligations for certain entities, such as market operators and market intermediaries executing orders. The public consultation on this reform showed general support for extending the scope of persons subject to best execution rules, including fund managers. The extension of this obligation would require the issuance of a new regulation by the Treasury.

Other than publishing additional guidance on underwriting agreements and considering the extension of best execution obligations, ASIC has issued no further guidance on fund managers' obligations in the form of a Policy Statement as recommended by the FSAP. At the same time, the authorities stress that fund managers are required by law to submit a compliance plan to ASIC, in which they present their actions to comply with the provisions of the *Corporations Act* and the constitution of the fund, and to identify the related risks. ASIC has issued a Regulatory Guide which sets out guidance on what such a plan might contain in order to comply with the higher-level obligations in the *Corporations Act* and the fund's constitution.

Unit pricing errors in the funds industry (IOSCO Principle 20): In response to the problem of unit pricing errors in the fund management industry, ASIC and APRA issued a Regulatory Guide to good practice in unit pricing at the time of the FSAP. ASIC considers that the Guide has brought the expected results, but it continues to monitor relevant market developments - for example, through a general assessment survey carried out in 2009 about issues of non-compliance of fund managers. The survey indicated that unit pricing errors are mentioned among detected breaches, and that they are self-reported and remedied appropriately. Superannuation funds regulated by APRA continue to experience some problems in this area, but APRA considers that the situation has generally improved since the Guide was issued.

Reciprocal constraints on ASIC and APRA for consultation on licensing (IOSCO Principle 21): There have been no legislative steps to impose a strict legal obligation on APRA to consult with or to notify ASIC before it suspends or cancels a license for a market intermediary. APRA and ASIC consult each other in accordance with agreed and established protocols as well as on an ad hoc basis, in particular in cases where the revocation of an entity's license by APRA results in changes in the entity's *Australian Financial Services Licence* ("AFSL") status. The authorities note that this form of cooperation works well and do not consider a legislative change necessary.

Enhancing ASIC's risk-based capital requirements (IOSCO Principles 22 and 29): The FSAP recommended enhancing ASIC's risk-based capital requirements for those market intermediaries that do not require a banking licence and are therefore not under the supervision of APRA. Particular attention was given to "non-exchange market intermediaries" that might take positions in OTC markets, without having sufficient capital to meet requirements reflecting IOSCO guidance in this area.⁴⁵ By contrast, intermediaries that

⁴⁵ See pages 114-117 of the "Methodology for Assessing Implementation of the IOSCO Objectives and Principles of Securities Regulation" (<http://www.iosco.org/library/pubdocs/pdf/IOSCOPD155.pdf>).

are exchange market participants (i.e. members of the ASX) have to follow comprehensive requirements set by the stock exchange.

Following the FSAP, ASIC's efforts in this area have concentrated on intermediaries that offer OTC derivatives to retail clients (other than those regulated by APRA or those operating under stock exchange rules) given the securities regulator's primary mission of retail investor protection. The financial resource requirements for these intermediaries were reviewed in the second half of 2010. Furthermore, a consultation is currently underway on proposals to simplify financial resource requirements and increase the capital of smaller intermediaries as well as the liquid financial resources available to them. Subject to the responses that it receives and any resulting need for further consultation, ASIC aims to issue a Regulatory Guide by October 2011.

While these actions do not fully address the relevant FSAP recommendation, ASIC considers that the scope of entities that are not covered by the regulatory framework (i.e. not regulated by APRA, not subject to stock exchange rules, and not included in ASIC's reforms for retail OTC intermediaries), as well as the risks that they pose, is relatively small.⁴⁶ In addition, the Australian authorities jointly undertook an assessment in 2009 of OTC derivatives markets.⁴⁷ The assessment concluded that, compared to other jurisdictions, there were no severe OTC market-related problems in Australia at the beginning of the financial crisis, that the concentration of OTC activity occurs within prudentially regulated banks, and that only a very small proportion of the OTC market is not subject to APRA's capital requirements.

Lessons and issues going forward

The recent regulatory reforms address some of the gaps that have been identified by the FSAP. In particular, the ambiguities in ASIC's use of evidence obtained from use of a search warrant have been removed; work is ongoing to improve the suite of tools for identifying and prioritising risk in ASIC's surveillance function; and a comprehensive Policy Statement is being developed to provide guidance on prospectus disclosure. In addition, the authorities monitor unit pricing errors and consider that the APRA-ASIC good practice guide in this area has brought the expected results.

At the same time, however, there remains scope for progress in other FSAP recommendations. The legislation has not been amended to remove the Treasurer's power to provide direction to ASIC, so there remains the possibility for the Treasurer to influence ASIC's investigative activities. The authorities note that this power has only been used once (back in 1992) and has not impinged in practice on the independence of ASIC's operations.

In terms of funding, while ASIC's budget has increased in recent years, its reliance on special purpose funding has not been reduced. This type of funding may help to provide rapid support to urgent and unforeseen additional regulatory tasks. However, use of such funding should be avoided for any purposes (such as the modernisation of ASIC's IT system) that are

⁴⁶ Those entities that are not regulated by APRA, not subject to stock exchange rules, and not included in ASIC's reforms for retail OTC intermediaries, represent approximately 18% and 3% of the revenue and assets respectively of all AFSL holders.

⁴⁷ See "Survey of the OTC Derivatives Market in Australia" May 2009 (APRA/ASIC/RBA, available at <http://www.rba.gov.au/payments-system/clearing-settlement/survey-otc-deriv-mkts/sotcdma-052009.pdf>).

necessary for ASIC to fulfil its basic mission. This issue will be addressed in the current review of ASIC's funding and financial management.

With respect to fund management, best execution obligations should be further clarified, for example by issuing more concrete guidance (as recommended by the FSAP). Many jurisdictions already apply such detailed standards, in line with IOSCO's recommendations in the area.⁴⁸

Finally, ASIC should consider assessing the relevance and efficiency of capital requirements applicable to the different types of market intermediaries, particularly for "non-exchange market intermediaries" dealing in wholesale OTC markets, so to avoid any potential material regulatory gaps. The detailed review that the authorities are planning to undertake in the near future of the ASX risk-based capital requirements as they relate to non-clearing participants⁴⁹ could be a good opportunity to assess these requirements more broadly.

5. Insurance regulation and supervision

The FSAP noted that the regulatory and supervisory framework for the insurance sector demonstrated a high level of observance with the Insurance Core Principles (ICPs) issued by the International Association of Insurance Supervisors (IAIS), and that substantial reforms had been undertaken to reflect international best practices. It made a number of recommendations to further strengthen compliance, particularly in areas of partial implementation of the ICPs:

- Adopting Stage II reforms in the insurance sector⁵⁰ and enhancing APRA's legal authority to deal with a troubled general insurer;
- Ensuring that supervisors are not constrained, by their bid to reduce regulatory burden, in taking prompt and decisive action in dealing with problem institutions;
- Supervisory authority: (i) an effective coordination scheme to ensure that ASIC's inputs are addressed in an appropriate and timely manner; (ii) providing more clarity on the circumstances under which the Treasurer may give directions to APRA; and (iii) public disclosure of the reasons for the removal of APRA members should be considered.
- Supervisory cooperation and information sharing: Consideration should be given for APRA to consult with or notify ASIC in taking any action on an insurer's license.
- Licensing: (i) implementing the recommendations of the Potts Review for Direct Offshore Foreign Insurers (DOFIs) and Discretionary Mutual Funds (DMFs) as

⁴⁸ See "Principles for the Supervision of Operators of Collective Investment Schemes" by the IOSCO Technical Committee (September 1997, <http://www.iosco.org/library/pubdocs/pdf/IOSCOPD69.pdf>).

⁴⁹ ASIC's review of the ASX capital rules, for which it will be responsible as from August 2011, will not cover clearing participants because these will remain the responsibility of ASX.

⁵⁰ These reforms aim to strengthen the prudential regulation of the general insurance industry in areas such as corporate governance, capital requirements, risk management and reinsurance. They build upon the Stage 1 reforms implemented in 2002 that followed the collapse of HIH Insurance, one of the major general insurance companies in Australia in 2001, as well as regulatory gaps identified by APRA when compared to international standards and practices.

appropriate; (ii) reviewing the requirement that APRA can refuse registration to a life insurer only with the approval of the Treasurer; and (iii) giving explicit powers for cross-border supervision of insurance activities to APRA.

- Enforcement or sanctions: (i) empowering APRA to deal with troubled institutions in a timely and cost-effective manner; and (ii) expediting the ongoing review on harmonising the powers of APRA across different financial sectors.

Steps taken and actions planned

Stage II reforms: Following consultations on each topic, these reforms were implemented in October 2006 by revising the relevant prudential standards. In addition, the prudential framework for general insurers has been modified by the introduction of consolidated group supervision (see below).

Enhancing APRA's legal authority to deal with a troubled general insurer: Under the *Insurance Act 1973*, the judicial management of general insurers was not allowed. General insurers were only administered under the *Corporations Act 2001* in the interests of creditors or members, not in the interests of policyholders and financial system stability. However, the *Financial System Legislation Amendment (Financial Claims Scheme and Other Measures) Act 2008* amended the *Insurance Act 1973*, which enhanced APRA's power to deal with troubled general insurers. In the interest of policyholders and financial system stability, insurers can now be judicially managed under the amended *Insurance Act 1973* (section 2).

Supervisory ability to take prompt and decisive action for problem institutions: Amendments were made to the insurance legislation in 2010 that ensure APRA is able to take prompt and decisive action with respect to an insurer, for example by strengthening APRA's powers to give binding directions and its powers over life insurance NOHCs. Consultation with interested parties on administrative actions (i.e. the exercise of APRA's powers) varies depending on the type of action being taken and the urgency of the situation. In addition, while most of APRA's administrative actions are subject to a post-decision merits review⁵¹, some of its crisis resolution powers are exempted because of the need for urgent action and certainty of outcome.

ICP 3 (Supervisory authority): No steps have been taken since the FSAP to adopt more formal mechanisms to ensure that ASIC's policy inputs are addressed appropriately and in a timely manner. The government's view is that the current informal consultation scheme works effectively and that there is no need for formal arrangements as long as ASIC can declare its opinion and develop the guidelines to reflect its opinion.

At the time of the FSAP, under the *Australian Prudential Regulation Authority Act 1998 (APRA Act)*, the Treasurer could provide APRA direction for policies or priorities that it should follow, although not on insurer-specific issues. However, the Treasurer's agreement was still required for certain actions that APRA could take under the pre-existing insurance legislation. In response to the FSAP recommendation, this legislation was amended to

⁵¹ Under a merits review, an independent tribunal can review and potentially overturn an administrative action taken by a government agency, including APRA. This ensures that all persons affected by a decision receive fair treatment.

conform to the *APRA Act* by removing the requirement to have the Treasurer's agreement to those actions. More specifically, the *Financial Sector Legislation Amendment (Review of Prudential Decisions) Act 2008* removed several provisions for Ministerial agreement related to the *Insurance Act 1973* and the *Life Insurance Act 1995*.

No additional steps have been taken to publicly disclose the reasons for the removal of APRA members. The *Australian Prudential Regulation Authority Act 1998* specifies the cases where an APRA member may be removed (a situation that has not materialised to date), but does not require public disclosure. The Government considers that the necessary safeguards are provided as a result of Cabinet scrutiny attached to the removal of an APRA member and regards such disclosure as inappropriate since it raises privacy concerns and the information may be too sensitive to be publicly disclosed. The authorities also believe that the issue of public disclosure is already adequately addressed because the reasons that an APRA member could be removed are limited to those prescribed in section 25 of the Act and if the APRA member wished to challenge his/her dismissal, he/she would be able to apply to have this decision reviewed by the judicial system. Where a decision is reviewed, the court proceedings and its decision are made public, thereby ensuring adequate transparency.

ICP 5 (Supervisory cooperation and information sharing): No additional legislative steps have been taken since the FSAP and there are no plans to develop a framework for APRA to consult with or notify ASIC about insurance licenses. At the time of the FSAP, ASIC and APRA had already entered into a MoU that enables them to share information and consult with or notify each other in areas of common interest where cooperation is essential for the effective and efficient performance of their respective regulatory functions. In addition, their representatives have operational and enforcement liaison meetings on a regular basis. Insurance issues, including those related to licences, are on the agenda of these regular meetings where necessary. APRA and ASIC also regularly liaise on an informal basis regarding insurance issues and entities. Therefore, the authorities believe that the current processes work well and that they do not need to form an official framework for consultation or notification between APRA and ASIC.

ICP 6 (Licensing): The *Insurance Act 1973* was amended to extend the definition of 'carrying on insurance', which provides for DOFIs to be subject to prudential regulation (effective as of 2008). Under this amendment, DOFIs must receive authorization from APRA in order to carry out business in Australia, unless specific exemption provisions are met. In addition, APRA revised its supervisory framework to categorize insurers based on their risk profiles. In terms of DMFs, the *Discretionary Mutual Funds Act 2007* subjects them to rigorous and compulsory data collection to enable APRA to better understand their use and operation.

In accordance with the relevant FSAP recommendation, the *Financial Sector Legislation Amendment Act 2008* removed the requirement that the Treasurer's approval is necessary for refusing the registration of a life insurer.

APRA had previously supervised individual entities on a stand-alone basis (Level 1). Under single industry supervision (Level 2) that became effective at the end of March 2009, supervision is applied to consolidated groups that incorporate APRA regulated entities in that group, including both domestic and international ones. As a result, the foreign subsidiaries of insurers domiciled in Australia are included in the consolidated capital calculation for the insurance group and are covered by the scope of overall Level 2 group supervision. More

recently, APRA has proposed to revise its current supervisory framework to introduce conglomerate group supervision as well (see section 3).

ICP 15 (Enforcement or sanctions): The *Financial System Legislation Amendment (Financial Claims Scheme and Other Measures) Act 2008* and *Financial Sector Legislation Amendment Act 2010* amended the relevant regulation, including the *Insurance Act 1973* and *Life Insurance Act 1995*, in order to enhance Australia's crisis management and prudential framework (see section 2). In particular, the amended Act includes the following provisions:

- APRA has the power to require a general insurer to transfer its business;
- APRA can issue a recapitalisation order to a general/life insurer in certain cases; and
- APRA has the right to apply to the federal court for the appointment of a judicial manager of general and life insurers.

Lessons and issues going forward

Significant progress has been achieved in the regulatory and supervisory framework for general insurance in recent years following the FSAP recommendations. In particular, progress is evident in the enhancement of APRA's legal authority to deal with troubled general insurers and the ability to take prompt and decisive legislative action in dealing with problem institutions without being constrained by regulatory burden requirements; the adoption of Stage II reforms that significantly enhanced the management and regulatory framework for general insurers; the implementation of the Potts Review recommendations; and the removal of the requirement for the Treasurer's approval for APRA to refuse registration of a life insurer as well as of the requirement for the Treasurer's agreement to certain actions by APRA under the pre-existing insurance legislation. The introduction of consolidated group supervision has enhanced the ability of APRA to supervise the foreign subsidiaries of insurers domiciled in Australia. Finally, APRA's intention of introducing a conglomerate group supervisory framework is a welcome development since it would further strengthen the scope of supervision in Australia, including for insurance.

Annex: Australia peer review – Selected FSAP recommendations

a. *Failure resolution and crisis management*

Relevant FSAP Recommendations	<ul style="list-style-type: none"> • The failure and crisis management framework should clearly establish the legal foundation and policy approach to achieve speedy, least-cost and minimally disruptive resolution of non-viable institutions. The questions of deposit insurance and policyholder protection should also be an element of a comprehensive framework for resolution of failed institutions and crisis management. • The authorities should consider introduction of express provisions into the Banking Act to seize control of a failing institution while it is still “solvent” and to impose a resolution without shareholder and creditor consent. • The authorities should consider arrangements that would facilitate purchase and assumption transactions of failed institutions when these can result in lower cost resolution outcomes. The framework for crisis management should aim at: (i) preserving financial and economic stability during a crisis; (ii) avoiding moral hazard and enhancing market discipline before a crisis; and (iii) reducing the fiscal cost of a crisis. • Build on the progress made within the Trans-Tasman Council to improve coordination in crisis management, given the New Zealand exposure of the Authorised Deposit-taking Institutions (ADIs).
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b. *Banking supervision*

Relevant FSAP Recommendations	<ul style="list-style-type: none"> • APRA should emphasise strong risk-management practices and maintenance of strong capital reserves as ADIs shift their focus away from residential real estate lending and into businesses such as SME lending and wealth management, and expansion overseas. • APRA should continue to closely monitor the adequacy of banks’ liquidity in light of the declining retail deposit base at the large banks and with increasing reliance on wholesale funding. • APRA and RBA should build on the experience with the FSAP stress tests to continue the dialogue with banks and consider requesting the banks to conduct and report stress test results on a regular basis. • <u>BCP 1(6) : Information sharing</u>: The legal obstacles should be removed in regard to the Australian Transaction Reports and Analysis Centre
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	<p>(AUSTRAC) sharing information with the APRA and implementing effective coordination with respect to the information gathered by AUSTRAC that is relevant to APRA’s prudential oversight of the adequacy and implementation of banks’ internal policies;</p> <ul style="list-style-type: none"> • <u>BCP 2 : Permissible activities</u>: The criteria for exempting institutions from regulation should be revised so that the demarcation line between regulated and non-regulated entities becomes clearer; • <u>BCP 15 : Use of banks by criminal elements</u>: An effective supervisory verification program should be established, ensuring that APRA is able to obtain all necessary information regarding prudential issues, including those that extend beyond AUSTRAC’s narrow mandate; • <u>BCP 25 : Supervision over foreign banks’ establishments</u>: The criteria for exempting institutions from regulation should be revised so that all foreign bank subsidiaries undertaking bank-like business in Australia are subject to APRA oversight.
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c. Insurance regulation and supervision

<p>Relevant ICP Assessment Recommendations</p>	<ul style="list-style-type: none"> • Measures should be taken for pushing ahead with the Stage II reforms (e.g., capital management, reinsurance documentation, formalised corporate governance standards and fit-and-proper framework, and enhanced disclosure requirements) in the insurance sector and enhancing APRA’s legal authority to deal with a troubled general insurer; • It should be ensured that the supervisors are not constrained, by their bid to reduce regulatory burden, in taking prompt and decisive action in dealing with problem institutions; <p><u>Supervisory Authority (ICP3)</u></p> <ul style="list-style-type: none"> • In the absence of policymaking powers for ASIC, effective mechanisms should be in place to ensure that their policy inputs are addressed appropriately and in a timely manner. • The circumstances under which the Treasurer may give directions to APRA should be clearly spelt out. • Considerations should be given for public disclosure of the reasons for the removal of APRA Members. <p><u>Supervisory cooperation and information sharing (ICP 5)</u></p> <ul style="list-style-type: none"> • Considerations should be given for APRA to consult or notify ASIC in taking any action on an insurer’s license, where appropriate. <p><u>Licensing (ICP 6)</u></p> <ul style="list-style-type: none"> • The recommendations of the Potts Review on the regulatory status and
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	<p>scope for Direct Offshore Foreign Insurers (DOFIs) and Discretionary Mutual Funds (DMFs), should be implemented, as appropriate.</p> <ul style="list-style-type: none"> • Consideration should be given to reviewing the requirement that the APRA can refuse registration of a life insurer only with the approval of the Treasurer. • The APRA should be given explicit powers for cross-border supervision of insurance activities carried out by subsidiaries of insurers domiciled in Australia. <p><i>Enforcement or sanctions (ICP 15)</i></p> <ul style="list-style-type: none"> • The APRA should be empowered to deal with troubled institutions in a timely and cost-effective manner. In this regard, considerations should be given to expedite the on-going review on harmonising the powers of the APRA across the banking, life insurance and general insurance industries.
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d. Securities regulation

<p>Relevant IOSCO Assessment Recommendations</p>	<p><i>Principles Relating to the Regulator (IOSCO Principle 2)</i></p> <ul style="list-style-type: none"> • Amending the ASIC Act should be considered to remove the power of the Treasurer to give directions and to instruct ASIC to carry out an investigation. • The reversal of the growing dependence of ASIC on special purpose funding should be considered. The possibility of funding a proportion of ASIC’s work directly from a levy on the financial services industry should be considered. <p><i>Principles for the Enforcement of Securities Regulation (P 8)</i></p> <ul style="list-style-type: none"> • The removal of the ambiguities in ASIC’s use of evidence obtained from use of a search warrant should be considered. • ASIC should satisfy itself that it has adopted a comprehensive suite of tools for identifying and prioritising risk in the surveillance function. <p><i>Principles for Issuers (P 14)</i></p> <ul style="list-style-type: none"> • ASIC should issue, as planned, a comprehensive Policy Statement on guidance on prospectus disclosure. <p><i>Principles for Collective Investment Schemes (P 17)</i></p> <ul style="list-style-type: none"> • ASIC should issue a Policy Statement setting out its expectations of behaviour by the responsible entity for a managed investment scheme in the areas of best execution, appropriate trading and timely allocation of trades, the prevention of churning, and underwriting agreements. <p><i>Principles for Market Intermediaries (P 22)</i></p>
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	<ul style="list-style-type: none">• Making the constraints on the ASIC reciprocal when seeking to suspend or cancel the licence of an APRA-supervised entity should be considered.• The ASIC should take steps to ensure that Australia’s risk-based capital requirements meet international norms. <p><i><u>Principles for the Secondary Market (P 29)</u></i></p> <ul style="list-style-type: none">• ASIC should take steps to ensure that Australia’s risk based capital requirements take proper account of the systemic risks of large exposures in OTC markets.
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