Financial Stability Review – March 2008

Developments in the Financial System Infrastructure

Crisis Management Arrangements

Over recent years, the Council of Financial Regulators has been reviewing aspects of Australia's arrangements for the management of a financial crisis. Recently, as part of this work, the Council has examined possible lessons from the run on the UK bank Northern Rock, the first bank run in the United Kingdom for around 130 years.

One aspect of the UK arrangements that has featured prominently in the post-crisis evaluations is the design of the deposit insurance scheme. Prior to the run, depositors were guaranteed to receive repayment of the first £2,000 of any deposit in a failed bank, and 90 per cent of the next £33,000. There were, however, no arrangements in place to make these repayments to depositors in a timely fashion. The combination of the 10 per cent 'haircut' on repayments above £2,000 and likely delays in repayment are widely thought to have contributed to the scale of the run.

This experience is consistent with the Council's previous analysis that arrangements in Australia would be enhanced by the establishment of a scheme to repay depositors in a failed authorised deposit-taking institution (ADI) in a timely fashion. Under the existing legislation, depositors rank ahead of other creditors in a failed ADI, although they are likely to have to wait some time before they could be repaid. Given this, the Council is working on an Early Access Facility, which would provide early repayment of up to $20,000 per depositor in a failed institution; it is estimated that this cap is sufficient to cover the entire deposits of around 80 per cent of depositors. Such a facility was recommended to the previous Government, and is before the current Government, while Council members have continued to

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investigate a number of technical issues relating to making early repayments to depositors in a closed institution.

A second element in dealing with a potential crisis is the provision of liquidity to the inter-bank market by the central bank. In this regard, arrangements in Australia are quite flexible. The Reserve Bank deals in the cash market every day, and adjusts the supply of settlement balances in line with changes in the demand for those balances. It is also prepared to deal with a wide range of counterparties and in a wide range of assets, and undertakes repurchase agreements with relatively long maturities on a regular basis. In addition, there is a safety valve through which institutions experiencing temporary technical settlement problems can obtain overnight funding at 25 basis points above the cash rate target. This additional flexibility has helped the system adjust to the recent periodic large increases in the demand for liquidity and the repricing of risks in inter-bank markets.

The UK experience has also focused attention on the difficulties that can arise when liquidity support outside of the central bank's normal operations becomes public knowledge. An important catalyst for the run on Northern Rock was rumours that the Bank of England was prepared to provide 'emergency' liquidity to the bank, with the run only being contained when the Government announced a guarantee of deposits. Further, resolution of the difficulties at Northern Rock has been complicated by the difficulties that any new owner would have had in refinancing in the market the funding provided by the Bank of England. These difficulties contributed to the recent decision by the UK Government to take Northern Rock into public ownership.

The Council is currently examining the implications of this experience for crisis management arrangements in Australia. It is also reviewing APRA's powers for dealing with a distressed financial institution. While these powers are more extensive than those available to the Financial Services Authority in the United Kingdom, the Council has recommended legislative changes that would give a statutory manager appointed by APRA additional powers, and provide APRA with greater flexibility in arranging a takeover by, or a transfer of assets and liabilities to, another ADI in a timely fashion.

A final issue is the co-ordination arrangements among the authorities, which have been criticised in the United Kingdom. While the Council of Financial Regulators has no formal role in crisis management, all the relevant agencies are represented on the Council and would be in close contact during a crisis. Council members also recognise that in most situations it is the Government that is likely to play a leading role, particularly if taxpayers' funds are being put at risk. To date, communication arrangements have worked well, with

Council members sharing liaison on a regular basis and discussing market developments frequently.

Basel II Capital Framework

APRA's revised prudential standards for ADIs based on the Basel II Capital Framework came into effect on 1 January 2008. As discussed in previous *Reviews*, in calculating capital requirements under Pillar 1 of Basel II, an ADI must have regard to at least three business risks – credit risk, market risk and operational risk. The measurement of market risk – the risk of trading losses – is largely unchanged from the previous Capital Accord (Basel I). In contrast, the explicit measurement of operational risk – the risk of losses resulting from events such as fraud and technology failure – was absent from Basel I, while the measurement of credit risk – the risk of losses arising from default by customers or counterparties, and by far the largest risk for most ADIs – has been substantially reworked.

Basel II provides ADIs with three options for measuring credit risk. The ‘ standardised approach’ is similar to Basel I, except that there is a wider range of risk weights, based on external credit rating agencies' assessment of differing borrower types. For ADIs with more sophisticated risk management systems, there are two ‘internal ratings-based’ (IRB) options. Under the Foundation IRB approach, ADIs use their own estimate of the probability of default for each borrower, but must apply the supervisor's estimate of the loss given default to determine the capital requirement. Under the Advanced IRB approach, ADIs can use their own estimates of both the probability of default and the loss given default to determine the capital requirement. There are also different approaches to managing operational risk.

The majority of Australian ADIs have adopted the Basel II standardised approaches for credit and operational risk and, in this regard, were not subject to an approval process. APRA's prior approval, however, was required before an ADI could adopt either of the IRB approaches for credit risk or the advanced measurement approaches (AMA) for operational risk. To date, three banks have been approved to use the Advanced IRB approach, while one has been approved to use the Foundation IRB approach. In addition, three banks have applied to move to an IRB approach during 2008 but to remain under Basel I in the meantime. All four banks that are using the IRB approaches, as well as two other banks, have been approved to use the AMA approach for operational risk.

While the ADIs that were given approval to adopt the IRB and AMA approaches have met all the pre-requisites, APRA is continuing to discuss a number of risk estimates and categorisations with each of the ADIs concerned. Until these discussions are completed, it is difficult to determine the exact impact of changes to regulatory capital requirements; a clearer picture should be evident a little later this year with the introduction of a suite of new Basel II reporting forms. In any event, ADIs using the advanced approaches are subject to a cap of 10 per cent in 2008 on any reduction in capital requirements from the Basel II changes. (This cap will be retained during 2009 pending a review of the experience with the Basel II advanced approaches.) Any reductions in regulatory capital may also be offset by the end of transitional arrangements on 31 December 2007 for the introduction of International Financial Reporting Standards. Taking these various changes into account, and any further Pillar 2 adjustments which APRA is still to discuss with the ADIs concerned, changes to regulatory capital requirements for ADIs using the advanced approaches are likely to be modest.

APRA Review of ADIs' Liquidity Management Policies

Recent events have greatly increased the attention that both financial institutions and regulators pay to liquidity management. The strains in financial markets over the past six months have seen some financial institutions provide significant funding under committed lines of credit, and simultaneously investors have required large premiums for committing funds for other than very short terms. These developments have led to some institutions running larger maturity mismatches than previously, and have focused attention on the management of those mismatches.

APRA's current prudential framework for liquidity risk requires each ADI to have a liquidity management strategy that is appropriate for the operations of that ADI, that is, a strategy that ensures that the ADI has sufficient liquidity to meet its obligations as they fall due. The strategy should set out how the ADI measures, manages and assesses its liquidity position and how it is able to respond to a liquidity crisis. As part of its liquidity management, an ADI would typically: set limits on maturity mismatches; set minimum benchmarks for holdings of high-quality liquid assets; and have strategies for a diversified liability base and for the sale of assets.

In addition, each of the larger ADIs must implement a liquidity scenario analysis framework to assess and measure its liquidity position under different operating circumstances. The two sets of scenarios specified in APRA's prudential standards, which an ADI is required to consider at a minimum, are a business-as-usual or 'going concern' scenario and a 'name crisis' scenario. The purpose of the first scenario is to assess the ADI's ability to meet its obligations under normal operating conditions. The second scenario is one in which the ADI confronts adverse circumstances specific to it and, as a consequence, has significant difficulty in rolling over or replacing its existing liabilities. For this scenario, the ADI must be able to demonstrate that it is capable of operating for at least five days in a crisis. In other words, the ADI's net cash flow position over the five-day period must be positive, taking into account any expected cash receipts from realising liquid assets and other funding sources that would be available to the ADI in that situation.

In assessing their ability to meet a name crisis, the four largest banks are able to take into account the Interbank Deposit Agreement which can be drawn upon under adverse conditions. Under this agreement, if one of these banks is experiencing liquidity problems, the others can be required to deposit equal amounts of up to $2 billion each for a month with that bank. At the end of the month, the recipient of the funds may choose to repay the deposits either in cash or by the assignment of mortgages. While this arrangement may be useful in dealing with a liquidity problem specific to just one bank, it is obviously of less use in a situation in which all banks are simultaneously experiencing liquidity difficulties.

In 2006, APRA began a comprehensive review of ADIs' liquidity risk management policies as well as its own supervisory regime in this area. The review has included an assessment of the current liquidity risk management practices of ADIs, in particular ADIs' approaches to liquidity scenario analysis and their participation in wholesale funding markets, including securitisation and offshore markets. APRA has also been reviewing the liquidity monitoring and supervision techniques of overseas regulators, and participates in a Basel Committee on Banking Supervision working group on liquidity that is reviewing existing international standards in this area. APRA plans to publish a discussion paper on liquidity management for industry consultation later in 2008, reflecting the work done in updating APRA's existing framework, issues highlighted by the recent global financial market turmoil, and the international policy direction.

In response to the recent turmoil in financial markets, APRA has significantly increased the intensity of its day-to-day monitoring of ADIs' liquidity and funding positions. Further, in late 2007, APRA requested that ADIs provide their most recent funding plans for calendar year 2008, updated to reflect current market conditions. APRA has recently been reviewing these plans and discussing them with institutions. This process will most likely be ongoing.

Recent Changes to Insolvency Laws

There have recently been a number of changes to the insolvency laws arising from the *Corporations Amendment (Insolvency) Act 2007* that have strengthened the rights of creditors of a company placed in administration. One aspect of the insolvency laws is that they allow companies to use voluntary administration to act quickly, without the involvement of the courts, to resolve a business failure. The setting of tight time frames and milestones for completion of the various tasks in an administration is an important feature of this voluntary administration procedure. The recent changes increase creditors' opportunities to participate in statutory meetings, and allow administrators more time to conduct an examination of the company's financial circumstances and consider the best options for its future.[3] The changes also provide creditors with extra time to communicate with each other and determine whether they are satisfied with the company's/administrator's actions, and if not, creditors can resolve to replace the administrator appointed by the directors of the company with one of their choosing.

Other main changes include:

- ASIC and the Companies Auditors and Liquidators Disciplinary Board have been given greater powers to regulate insolvency practitioners and deal with misconduct;
- liquidators will have to report to ASIC annually, rather than once every three years. ASIC will also have the power to review an administrator's remuneration; and
- administrators will be required to declare any 'relevant relationships' and declare any indemnities that have been provided.

In a related development, the Insolvency Practitioners Association of Australia, in consultation with ASIC and the Insolvency and Trustee Service Australia, has issued a new *Code of Professional Practice for Insolvency Professionals*. The code has been effective since 31 December 2007 and is intended to support compliance with the new law.

Issuance of Debentures to Retail Investors

Following the collapse of several property development companies in recent years, ASIC has taken a number of steps to improve disclosure requirements applying to unlisted and unrated debentures. This follows concerns that retail investors in these debentures did not always fully understand the risks that they were taking. In mid 2007, it is estimated that unlisted and unrated debentures accounted for approximately $8 billion of the $34 billion in debentures held by retail investors and self-managed superannuation funds.

ASIC's proposed changes were released for industry consultation in August 2007. This was followed in October 2007 by the release of the new requirements in *Regulatory Guide 69 – Debentures – Improving Disclosure for Retail Investors*. Under the new arrangements, disclosure benchmarks have been set for, among other things, equity capital, liquidity, related-party transactions and credit ratings. If issuers do not meet these benchmarks, they are required to explain why this is so. ASIC is now reviewing fundraising documents against this 'if not, why not' approach, with a view to issuing a public report in June 2008.

Another element of ASIC's response relates to the advertising of debentures. In December 2007, ASIC released *Regulatory Guide 156 – Debentures Advertising* which details several principles-based standards in relation to the advertising of debentures. The standards, which apply only if the debentures are offered to retail investors, require that advertisements:

- include a prominent statement to the effect that investors risk losing some or all of their principal investment;
- only quote an interest rate if it is accompanied by prominent disclosure of either the current credit rating for the debenture and what that means, or where to find this information, or, where the debenture does not have a rating, explain the implications of the debenture not having a rating;
- state that the debenture is not a bank deposit and avoid the use of terms such as 'secure', 'secured', and 'guaranteed', as these statements may convey a misleading impression as to the risk profile of the debenture;
- not state, or imply, that the investment is suitable for a particular class of investor; and
- be consistent with the corresponding disclosures in the prospectus.

In addition, any statements made in response to inquiries are subject to the same regulation regarding misleading and deceptive conduct as the advertisements.

The guide also makes clear that ASIC expects publishers to have systems and controls to detect and refuse advertisements for debentures that do not comply with these advertising standards. While the primary responsibility for advertising material rests with the organisation placing the advertisement, the publisher or other media conduit may also have some responsibility for its content. Accordingly, ASIC has included guidance on the role of publishers and the media in promoting debenture products.

Compliance with the new standards for advertising has been in effect since February 2008.

Regulation of Mortgage Brokers

As discussed in previous *Reviews*, the regulation of mortgage brokers in Australia has been under consideration for some time. In part, this reflects concerns that a small number of brokers may have been associated with predatory lending practices and that their remuneration structures – predominantly high upfront and low trailing commissions – might have adverse consequences for both borrowers and lenders. Another concern is that there is no national licensing or regulation of mortgage brokers.

In November 2007, the NSW Office of Fair Trading released a draft Bill intended to form the basis for all states and territories to regulate their finance and broking industries. The draft Bill was prepared for the Ministerial Council on Consumer Affairs by the Finance Broking Working Group (chaired by NSW and comprising the Commonwealth Treasury, ASIC and all state and territory governments) and takes account of input from regulators, the broking industry and consumer representatives.

Under the proposed arrangements, all broking services would be regulated, with the only exceptions being a broking service provided to a business with more than 20 employees (100 employees if a manufacturer), or to a business seeking credit in excess of $2 million.

In addition, strict licensing requirements would be established to ensure only reputable brokers join the industry, with, for example, licensees being required to meet certain qualification and ongoing training requirements. Licensees would also need to be members of an ASIC-approved external dispute resolution scheme, with decisions binding on the broker. Probity and police checks would also be undertaken to prevent applicants with a history of unfair practices from obtaining a licence.

Other features of the draft Bill include:

- a requirement that the broker provide specified disclosures about costs and services before negotiating a broking agreement with the client;
- a requirement that brokers make sufficient enquiries about the consumer's financial status to ensure that they can afford the product recommended;
- the establishment of a national register of authorised brokers;
- a requirement that brokers have professional indemnity insurance so that any claim on a broker can be met;
- provision for a stay of home repossession where damages are being claimed from the broker that could allow the consumer to get their repayments back on track;

- a prohibition on charging upfront fees until the credit has been formally offered and on lodging caveats over property to secure fees; and
- a requirement that brokers recommending a reverse mortgage provide analysis that shows why this is the right product for the consumer's circumstances and a requirement that the broker give examples to the consumer to illustrate the reduction in their equity in the home over a period of time.

Submissions on the draft Bill closed on 15 February 2008.

Competing Market Venues for the Trading of ASX-listed Securities

Under the *Corporations Act 2001*, an operator of a 'financial market', such as a trading platform for equities, must have an Australian Market Licence that is granted by an Australian Government minister; at present this responsibility sits with the Minister for Superannuation and Corporate Law. A prospective provider must submit an application through ASIC, which then provides this application to the Minister along with advice as to whether the operator will be able to comply with obligations set out in the Act and related Corporations Regulations. Once a licence is granted, the chief obligation on the licensee is that it ensures its market is fair, orderly and transparent. ASIC undertakes regular assessments to monitor the licensee's compliance with this obligation.

In 2007, ASIC received formal market licence applications from AXE ECN Pty Ltd and Liquidnet Australia Pty Ltd. Both of these applicants propose to provide services for the trading of equities listed on the Australian Securities Exchange (ASX), thereby competing with the trading services offered by the ASX.

While competition of this nature has existed for some time in other countries, this is the first time the Australian regulatory authorities have received such applications. While such competition is to be welcomed, the prospect of the same listed securities being traded simultaneously in multiple trading venues raises important issues around the transparency, integrity, supervisory ability and efficiency of both individual market operators and the market for ASX-listed securities as a whole.

Because of these broader considerations, ASIC has undertaken a lengthy period of consultation. It released a consultation paper in July 2007, *Competition for market services – trading in listed securities and related data*, and, after considering submissions to this paper, released a second paper in November 2007, with the response period having closed on 29 January 2008. ASIC has recently provided its advice to the Minister on these matters.

So as to provide transparency to the process by which prospective market operators might access its clearing and settlement facilities, the ASX launched a public consultation in March 2008, setting out a timetable for the release and implementation of an access regime for these facilities.

Footnote

[3] The time for holding the first creditors meeting has been extended from five to eight business days after the commencement of the administration. The administrator's notice of the first creditors' meeting has been extended from two to five business days prior to the meeting. The period for holding the second meeting of creditors has been extended to 25 business days with a new convening period of 20 business days. In addition, the time allowed for a creditor to enforce a charge, where it is a majority chargeholder, has been extended from 10 to 13 business days, thereby giving creditors more time to make an informed decision.

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