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### Australian Response to International Recommendations on Financial Market Turbulence

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2 June 2008

## Australian response to international recommendations on financial market turbulence

Today I outline Australia's response to the recommendations of the Financial Stability Forum (Forum) Report on enhancing the resilience of financial markets and financial institutions.

While Australia's financial and regulatory systems remain robust, the Prime Minister and I have both recently emphasised the need for a coordinated global response to the current turbulence on financial markets.

In recent discussions, including with my foreign counterparts and leading economic policy makers at the Spring Meetings of the International Monetary Fund in Washington, I have found this view to be widely shared internationally.

Against this backdrop, the Forum has developed a series of recommendations to address current financial market turbulence and improve long term market functioning.

The Australian Government has been actively involved in designing these recommendations and we will continue our involvement as further detailed work is undertaken.

The recommendations cover a range of measures which Australia's financial markets and regulatory system are well placed to accommodate.

Today I am releasing a table which highlights action that Australian financial authorities, namely the Australian Prudential Regulation Authority, the Australian Securities and Investment Commission, the Reserve Bank of Australia and the Treasury, are undertaking to address each of five areas identified by the Forum.

These areas are:

- Strengthened prudential oversight of capital, liquidity and risk management.
- Enhancing transparency and valuation.
- Changes in the role and uses of credit ratings.
- Strengthening the authorities' responsiveness to risks.
- Robust arrangements for dealing with stress in the financial system.

I have asked the financial regulators and my department to work closely together on the recommendations and to keep me regularly informed on developments.

I will be using my meetings in Europe and Asia to work toward the global implementation of these recommendations.

The Government intends to establish a Financial Claims Scheme which would provide depositors in authorised deposit-taking institutions and policyholders in APRA regulated general insurers with access to funds in a timely manner in the unlikely event that such a financial institution should fail. The Government will also ensure that Australia's regulators have the tools available to effectively manage a failing institution.

This follows a proposal by the Council of Financial Regulators, now supported by recommendations from the Forum, for dealing with banks experiencing difficulties.

The Forum, of which the Governor of the Reserve Bank of Australia is a member, was convened in April 1999 to promote international financial stability through information exchange and international co-operation in financial supervision and surveillance.

Australia's financial markets and regulatory system have responded well to global market turbulence compared to other countries around the world. However, our regulation needs to keep pace with rapid market innovations and address issues which current events on global markets have highlighted.

The Council of Financial Regulators consists of the heads of the Reserve Bank of Australia, the Australian Prudential Regulation Authority, the Australian Securities and Investments Commission and the Treasury. The Australian Office of Financial Management is the agency charged with managing the debt and cash management needs of the Australian Government.

# Actions being undertaken by Australia to address FSF Recommendations<sup>1</sup>

Issue & FSF Recommendation	Australian Action	Australian Agency	Timing
<b>STRENGTHENED PRUDENTIAL OVERSIGHT OF CAPITAL, LIQUIDITY AND RISK MANAGEMENT</b>			
<b>Capital requirements</b>			
<i>The Basel II capital framework needs timely implementation. Supervisors will assess the impact of the implementation.</i>	The Basel II framework was implemented in Australia from 1/1/2008.  APRA will be assessing the impact of Basel II in Australia on an on-going basis and, where shortcomings in capital requirements are obvious, moving to impose necessary additional requirements via Pillar 2.	APRA	Implemented
<i>Supervisors will strengthen the Basel II capital treatment of structured credit and securitisation activities.</i>	The Government supports this principle recommendation.  APRA will continue its involvement with the BCBS and consider the capital requirements for such instruments: as necessary, APRA will modify prudential standards and capital requirements.  Additionally, ASIC will examine the current requirements for securities firms and take note of IOSCO recommendations.	APRA / ASIC	2008
<i>Supervisors will continue to update the risk parameters and other provisions of the Basel II framework as needed.</i>	The Government supports this principle recommendation.  APRA will continue its involvement with the BCBS and consider the capital requirements for such instruments: as necessary, APRA modify prudential standards and capital requirements.	APRA	2008-
<i>Authorities should ensure that the capital buffers for monoline insurers and financial guarantors are commensurate with their role in the financial system.</i>	The Government supports this principle recommendation.  APRA has significantly increased the capital requirements for lenders mortgage insurers in recent years and continues to assess the appropriateness of capital requirements.	APRA	2008-
<b>Liquidity management</b>			
<i>Supervisors will issue for</i>	APRA is currently participating in the	Treasury /	2008-

<p><i>consultation sound practice guidance on the management and supervision of liquidity by July 2008.</i></p>	<p>development of the BCBS consultation document. APRA will be strengthening its ADI liquidity requirements and will determine if any additional changes are necessary following the outcomes of the BCBS consultation process.</p> <p>APRA and RBA are involved in BCBS and FSF work on the further development of guidance on liquidity for cross-border banks.</p>	RBA / APRA	
<p><b>Supervisory oversight of risk management, including of off-balance sheet entities</b></p>			
<p><i>Supervisors will use Pillar 2 to strengthen banks' risk management practices, to sharpen banks' control of tail risks and mitigate the build-up of excessive exposures and risk concentrations.</i></p>	<p>The Government supports this principle recommendation.</p> <p>APRA is already moving to implement Pillar 2 requirements based on risk profiles of individual ADIs. APRA will continue to share experiences with the BCBS.</p>	APRA	2008-09
<p><i>Relevant regulators should strengthen the requirements for institutional investors' processes for investment in structured products.</i></p>	<p>The Government is requesting APRA and ASIC to examine this recommendation and report to it on whether a combination of Australian regulation and industry standards already provide for sound regulation and industry practice in this area.</p>	APRA – Prudentially regulated entities incl Super funds ASIC - MIS	
<p><i>The financial industry should align compensation models with long-term, firm-wide profitability. Regulators and supervisors should work with market participants to mitigate the risks arising from inappropriate incentive structures.</i></p>	<p>Market participants are subject to risk and conflict management obligations at law. This requires consideration of staff remuneration and incentive arrangements so they don't encourage disproportionate risk-taking and insufficient regard to longer-term risks.</p> <p>Australia also has legislative disclosure requirements for listed companies and other reporting companies about the remuneration arrangements of senior management personnel. These requirements are complemented by corporate governance executive remuneration and risk management principles issued by the</p>	ASIC	2008-

	Australian Securities Exchange Corporate Governance Council.		
<b>Operational infrastructure for OTC derivatives</b>			
<i>Market participants should act promptly to ensure that the settlement, legal and operational infrastructure underlying OTC derivatives markets is sound.</i>	<p>The combination of Australian regulation and industry standards currently provide for a robust framework for the reliable operation of OTC markets. The Government supports the financial industry working to increase the reliability of these markets.</p> <p>Australia supports market participants to working to improve standard credit derivative trade documentation.</p> <p>Australia supports market participants working to automate and set rigorous OTC derivative trade related standards.</p>	Industry under ASIC supervision	2008
<b>ENHANCING TRANSPARENCY AND VALUATION</b>			
<b>Risk disclosures by market participants</b>			
<i>Financial institutions should strengthen their risk disclosures and supervisors should improve risk disclosure requirements under Pillar 3 of Basel II.</i>	<p>Australia supports the financial industry adopting the FSF's risk disclosure recommendation.</p> <p>Australia supports work by market participants and auditors to provide relevant market related risk disclosures.</p> <p>Disclosure rules under Pillar 3 of the Basel II framework were introduced from 1 January 2008. APRA will review the current requirements as part of its assessment of Basel II in Australia.</p> <p>The RBA Governor has written to internationally active Australian Authorised Deposit-taking Institutions encouraging them to strengthen their risk disclosure to the market, in accordance with the relevant FSF template, where they need to do so.</p>	Industry AUASB / FRC APRA	2008  2008- 2009
<i>Accounting and disclosure standards for off-balance sheet entities</i>	Australia notes that the IASB is aware of the importance of speedily responding to these issues.	AASB / FRC	2008-09

	Australia, through its representation on the International Accounting Standards Committee Foundation, will continue to support the IASB's work in this area.		
<b>Valuation</b>			
<i>International standard setters should enhance accounting, disclosure and audit guidance for valuations. Firms' valuation processes and related supervisory guidance should be enhanced.</i>	<p>Australia supports this principle recommendation.</p> <p>Australia notes that the IASB is currently working on this issue. Australia, through its representation on the International Accounting Standards Committee Foundation, will continue to support the IASB's work in this area.</p> <p>Australia also notes that the IAASB has established a task force on fair value auditing guidance to address some of the valuation difficulties highlighted by the recent volatility on global financial markets. Australia, through the Australian Auditing and Assurance Standards Board will actively engage in the work being progressed by the IAASB.</p> <p>APRA is engaged in work with the BCBS regarding the supervisory assessment of banks' valuation processes. APRA will consider the guidance issued by the BCBS and, as necessary, modify prudential standards and capital requirements.</p>	Industry in consultation with APRA and ASIC AASB / FRC	2008-09
<b>Transparency in securitisation processes and markets</b>			
<i>Securities market regulators should work with market participants to expand information on securitised products and their underlying assets.</i>	<p>Australia supports transparency to investors (whether wholesale or retail) about the quality of the underlying assets of securitised products. The Corporations Act requires prospectuses to contain full risk disclosure and that the relevant disclosures in wholesale offer documents not be misleading or deceptive.</p> <p>Australian law through the Corporations Act requires a high level of information about</p>	Industry / Treasury / ASIC / ASX	2008-

	<p>risk characteristics when a regulated person offers to issue a financial product to a retail client. Public issuers are also subject to continuous disclosure regime obligations.</p> <p>Australia supports wholesale market participants providing a high level of information on risk characteristics to each other. The Corporations Act prohibits such disclosures from being misleading or deceptive.</p> <p>The Government supports industry looking at ways to improve the post-trade transparency of credit instruments.</p>		
<b>CHANGES IN THE ROLE AND USES OF CREDIT RATINGS</b>			
<b>Quality of the rating process</b>			
<i>CRAs should improve the quality of the rating process and manage conflicts of interest in rating structured products.</i>	Treasury and ASIC are examining and will report on the role and regulation of credit rating agencies with reference to the FSF's CRA recommendations.	CRAs Treasury / ASIC	2008
<b>Differentiated ratings and expanded information on structured products</b>			
<i>CRAs should differentiate ratings on structured finance from those on bonds, and expand the initial and ongoing information provided on the risk characteristics of structured products.</i>	Treasury and ASIC are examining and will report on the role and regulation of credit rating agencies with reference to the FSF's CRA recommendations.	CRAs Treasury / ASIC	2008
<b>CRA assessment of underlying data quality</b>			
<i>CRAs should enhance their review of the quality of the data input and of the due diligence performed on underlying assets by originators, arrangers and issuers involved in structured products.</i>	Treasury and ASIC are examining and will report on the role and regulation of credit rating agencies with reference to the FSF's CRA recommendations.	CRAs Treasury / ASIC	2008
<b>Uses of ratings by</b>			



<b>investors and regulators</b>			
<p><i>Investors should address their over-reliance on ratings. Investor associations should consider developing standards of due diligence and credit analysis for investing in structured products.</i></p> <p><i>Authorities will review their use of ratings in the regulatory and supervisory framework.</i></p>	<p>Treasury and ASIC are examining and will report on the role and regulation of credit rating agencies with reference to the FSF's CRA recommendations.</p>	<p>Industry Treasury / ASIC</p>	<p>2008</p>
<p><b>STRENGTHENING THE AUTHORITIES' RESPONSIVENESS TO RISKS</b></p>			
<p><b>Translating risk analysis into action</b></p>			
<p><i>Supervisors, regulators and central banks – individually and collectively – will take additional steps to more effectively translate their risk analysis into actions that mitigate those risks.</i></p>	<p>The Government will continue to ensure that regulators have appropriate resources to maintain and, as necessary, strengthen their supervisory capabilities.</p> <p>Additionally, Australia supports efforts to improve the role and action played by the FSF and IMF in international financial supervision.</p>	<p>APRA / ASIC / RBA Treasury</p>	<p>2008</p>
<p><b>Improving information exchange and cooperation among authorities</b></p>			
<p><i>Authorities' exchange of information and cooperation in the development of good practices will be improved at national and international levels.</i></p>	<p>Australia supports these actions. APRA, ASIC and the RBA already actively cooperate with their foreign regulatory peers.</p> <p>The Government is requesting that Australia's regulators relevantly participate in any colleges established relating to large global financial institutions.</p> <p>APRA has Memoranda of Understanding with a number of overseas regulators and as part of these processes has already participated in supervisory colleges. APRA</p>	<p>APRA / ASIC / RBA</p>	<p>2008-</p>

	<p>will look to further its participation in such arrangements where opportunities present themselves.</p> <p>At Australian level, the Council of Financial Regulators and bilateral regulatory cooperation arrangements already provide mechanisms for quick supervisory responsiveness.</p> <p>Australia supports improvements at the international level to improve supervisory responsiveness and will work with other countries on this issue.</p>		
<b>Enhancing international bodies' policy work</b>			
<i>International bodies will enhance the speed, prioritisation and coordination of their policy development work.</i>	<p>Australian regulators already participate actively in international committees and Australia's adherence to international standards has recently been tested by the FSAP process.</p> <p>Australia also considers that finance ministry policy officials should also participate more actively in efforts to improve policy coordination.</p> <p>Australia supports enhanced cooperation between the IMF and FSF with an increased focus on identifying and reporting on threats to the global financial system and the global economy – an early warning system for global financial risks.</p>	Council of Financial Regulators / Treasury	2008
<b>ROBUST ARRANGEMENTS FOR DEALING WITH STRESS IN THE FINANCIAL SYSTEM</b>			
<b>Central bank operations</b>			
<i>Central bank operational frameworks should be sufficiently flexible in terms of potential frequency and maturity of operations, available instruments, and the range of counterparties and collateral, to deal with extraordinary situations.</i>	<p>The operational framework for monetary policy in Australia already accommodates such flexibility. The RBA has a flexible framework which has allowed it to inject a significant amount of funds into the market in response to increased demand in recent times.</p> <p>Consideration will be given to whether further mechanisms are required.</p>	RBA / Treasury	2008-

<b>Arrangements for dealing with weak banks</b>			
<i>Authorities will clarify and strengthen national and cross-border arrangements for dealing with weak banks.</i>	<p>Legislation will be introduced to improve statutory management powers, facilitate the transfer of assets and liabilities between institutions, facilitate recapitalisation, and harmonise court injunctions powers across the prudential Acts.</p> <p>A Memorandum of Understanding between regulators and protocols to guide the management of a failing institution is being developed to ensure clarity in the division of responsibilities between national authorities.</p>	Treasury / Council of Financial Regulators	2008
<i>Authorities will review and, where necessary, strengthen deposit insurance arrangements.</i>	<p>To ensure appropriate measures are in place to deal with any financial system failure, legislation will be introduced to establish a Financial Claims Scheme (FCS) to provide timely access to funds for depositors and general insurance policyholders in the event a financial institution fails.</p> <p>Funding for the FCS will be provided by Government in the first instance, with funding recovered through the subsequent liquidation of the failed institution and, if necessary, a levy on surviving institutions.</p> <p>The FCS will be administered by the Australian Prudential Regulation Authority (APRA) and would be activated by the Treasurer.</p> <p>These arrangements will put in place an explicit depositor protection scheme. Australia's arrangements will be considered against agreed international principles when those principles have been settled.</p>	Treasury / Council of Financial Regulators	2008-
<i>Authorities will strengthen cross-border cooperation in crisis management.</i>	Australia supports participation in international sharing of experiences and efforts to strengthen cross-border cooperation.	Treasury / Council of Financial Regulators	

Australia's largest and most direct cross-border involvement is with New Zealand. The Trans-Tasman Council on Banking Supervision was established in February 2005 to, inter alia, promote and review trans-Tasman crisis response preparedness.		
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## Abbreviations:

**AASB**

Australian Accounting Standards Board

**ADI**

Authorised Deposit-Taking Institution

**APRA**

Australian Prudential Regulation Authority

**ASIC**

Australian Securities and Investments Commission

**AUASB**

Auditing and Assurance Standards Board

**BCBS**

Basel Committee on Banking Supervision

**CRA**

Credit Rating Agencies

**FCS**

Financial Claims Scheme

**FRC**

Financial Reporting Council

**FSAP**

Financial Sector Assessment Program

**FSF**

Financial Stability Forum

**IAASB**

International Auditing and Assurance Standards Board

**IASB**

International Accounting Standards Board

**IOSCO**

International Organisation of Securities Commissions

**MIS**

Managed Investment Scheme

**OTC**

Over-the Counter

**RBA**

Reserve Bank of Australia

<sup>1</sup> In the third column, the timeline for those recommendations for which work is expected to be continued over time is represented by adding a dash (-) after the date when the implementation is expected to start.

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