

Executive Roundtable and Professional Placements

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Session 4, Part 1

International Responses to Current Financial Turbulence: Basel II / Role of Financial Stability Forum

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- In response to the financial market turmoil, the G7 asked the Financial Stability Forum (FSF) to report to it on the underlying causes and weaknesses that have contributed to the turmoil. In April 2008, the FSF released its *Report on Enhancing Market and Institutional Resilience* identifying the main areas where action needs to be considered. These include:
 - Strengthening prudential oversight of capital and liquidity and, in particular, improving the regulatory arrangements that apply to off-balance sheet exposures, securitisation activities and other contingency liquidity risks;
 - Enhancing transparency and re-examining how fair value approaches to valuation should be applied when markets are illiquid and/or the only transactions taking place are by distressed sellers;
 - Re-examining the role and uses of credit ratings by both financial institutions and regulators, as well as addressing the conflicts of interest that can arise within these agencies;
 - Improving co-operation among authorities, such as the establishment of international colleges of supervisors for large global financial institutions, and better co-ordination between the IMF and FSF; and
 - Enhancing crisis management arrangements, both for domestic and internationally operating financial institutions.
- Initiatives are underway, both at a domestic and international level, to implement the recommendations. The Australian Treasurer issued a detailed press release in early June describing the actions being taken by Australian authorities to address the recommendations. The main actions are:
 - *Prudential oversight of capital, liquidity and risk management:* APRA is strengthening its deposit-taking institutions' liquidity requirements. (Unlike

many countries working towards implementation of Basel II, Australia implemented Basel II in January 2008.)

- *Transparency and valuation:* In May 2008, the Governor wrote to six internationally active banks in Australia encouraging them to strengthen their risk disclosure to the market. To date, only the Commonwealth Bank has released its regular six monthly financial statement, which provided some of the information suggested in the FSF template. The other institutions are due to report in the coming months.
- *Role and uses of credit ratings:* ASIC and Australian Treasury are currently reviewing the Australian regulation of credit rating agencies. The review is considering the extent to which investors rely on ratings agencies and whether the level of diligence and discussion undertaken by the agencies warrants this reliance. It is also examining how the agencies deal with conflicts of interest. Current regulation requires ratings agencies to disclose how their own code of conduct implements IOSCO's Code of Conduct and where it deviates, to explain why it has deviated.
- Some of the recommendations, such as those on credit rating agencies, are very difficult for a small country like Australia to act on unilaterally. For example, the major credit ratings agencies are global corporations, and apart from licensing requirements, it is challenging for Australian authorities to have much influence on them. In part, Australia relies on other regulators, such as in the US, Europe and UK to oversee the ratings agencies and ensure the recommendations are followed.
- *Authorities responsiveness to risks:* The Australian and New Zealand authorities are continuing to work together to strengthen cross-border co-operation. APRA and the Reserve Bank of New Zealand already maintain intensive formal and informal consultation relationships on the banking groups operating in both countries.
- The cross-border crisis management recommendations remain a particularly difficult area to implement, although the authorities in Australia and New Zealand are continuing to make progress on this important matter. The challenges arise from both the inherent complexity of banking crises and the politics involved. In particular, crisis management arrangements may require governments across two or more countries to pre commit to actions that may well be taken by future governments in at least one, if not all, countries involved.
- *Dealing with stress in the financial system:* The Australian government has announced its intention to implement a scheme to provide depositors with timely access to their funds in the event of a failure. The legislation to give effect to the Financial Claims Scheme will also improve powers to deal with distressed institutions, including powers to facilitate the recapitalisation of failing entities. This legislation is currently being drafted, with the expectation that it will be introduced later this year.

- Regarding *domestic market operations*, the Reserve Bank of Australia's arrangements are already very flexible, permitting it to deal daily with a wide range of counterparties across a wide range of maturities, and allowing it to respond rapidly to any tensions in the domestic money market. The pool of collateral that the Bank is willing to accept in its operations was further broadened in late 2007, in part to address dislocations in the domestic credit market.
- Internationally, some concrete examples of actions to implement the recommendations include:
 - The new Basel II capital regime has introduced capital requirements on 364-day renewable liquidity facilities; previously these facilities, which underpinned many of the structured finance transactions, had no capital requirements.
 - The Basel Committee on Banking Supervision has published proposals to increase capital requirements on exposures in the trading book to structured finance products.
 - Regulators are examining ways to reduce risks in the operational infrastructure for OTC derivatives. In the US, the Federal Reserve, together with the private sector, have agreed to an agenda to improve the infrastructure for OTC derivatives, which includes setting up a central counterparty for CDS trades.
 - The International Organisation of Securities Commissions has revised its Code of Conduct for rating agencies, recommending that they use differentiated ratings scales for structured credit products and conventional securities. However, Moody's has publicly stated that it has decided against such a change, citing poor industry feedback. The US Securities and Exchange Commission is reforming its regulation of ratings agencies by broadly following the revisions to the Code of Conduct. In addition, various SEC official rules and requirements will be amended to have fewer references to credit ratings.
- The FSF and IMF have agreed to co-sponsor an informal discussion of issues relating to the financial market turmoil at the annual IMF-World Bank meeting in Washington DC in October 2008. To ensure broad representation, G-20 Deputy Governors, Deputy Finance Ministers, and heads of supervision, as well as delegates from a number of emerging market countries have been invited. This meeting does not yet appear to have been publicly announced.
- The FSF's next meeting is on 29-30 September 2008 and the FSF members, including the Bank, will review progress across all recommendations. A final report on the implementation will be delivered to the G7 at its meeting in October 2008.