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Post-Crisis Regulatory Change in Australia and New Zealand

Christine Brown, Kevin Davis and David Mayes

Australia-NZ Shadow Financial Regulatory Committee*

Abstract

Australia and New Zealand escaped the worst of the financial crisis which emerged in 2007-8, but suffered some financial disruption (some part of which was home grown). Governments and regulatory authorities took significant actions to limit the impact of the crisis on the Antipodean financial markets. These have been important in determining the course of subsequent regulatory change. Also important has been the task of dealing with the international regulatory agenda which has been focused on resolving structural and behavioural problems experienced in European and US financial sectors, but which were less apparent in the local markets.

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* Christine Brown, Department of Accounting and Finance, Monash University (christine.brown@monash.edu.au);
Kevin Davis, Department of Finance, University of Melbourne, and Australian Centre for Financial Studies (kevin.davis@unimelb.edu.au);
David Mayes, Department of Finance, and Europe Institute and NZ Governance Centre, University of Auckland, d.mayes@auckland.ac.nz).

For ease of reference, various regulatory and legislative documents have been hyperlinked in the text

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1. Experience and Lessons from the Crisis

> "Australia and New Zealand escaped the worst of the financial crisis, but not without extraordinary policy actions of our own at various times, and not without a certain legacy of issues to deal with in our own neighbourhood" (Bollard and Ng, 2012, p57).

Australia and NZ escaped the worst of the financial crisis which began in 2007. But that was not without significant government actions to prevent spillovers from the international disruption affecting local financial markets and economies. Nor was it without some significant, largely home-grown, failures and disruption in the non-prudentially-regulated parts of the financial sectors. These reflected failures of market discipline and regulatory structures which allowed complex, opaque business structures and financial products to evolve over the preceding years and to be marketed to poorly informed investors and consumers. Those problems were more varied and widespread in the more developed Australian financial sector, but NZ experienced a virtual wiping out of its finance company sector which commenced in the middle of the 2000s. Notably, Australia ranks 70th out of 185 countries on the World Bank's Index of Investor Protection whereas NZ ranks first.[1] Both countries score particularly poorly on the Morningstar (2013) Index of Protection of mutual fund investors.

Reasons for the relatively favourable Antipodean experience are well known and include: favourable economic conditions; limited involvement of the banking sector in complex products and trading activities; high levels of bank profitability; strong supervision of banks; rapid government fiscal, monetary, and regulatory responses to the crisis. (Brown, Davis, Lewis and Mayes (2011) provide an overview). Since that time, the financial sectors of both countries, tied together by the dominant role of the four major Australian banks in both, have experienced relatively limited growth along with relatively little disruption.[2] Credit growth has been subdued, equity returns have been modest, and interest rates have declined – albeit not to the liquidity trap levels of the northern hemisphere (see Figure 1).

[1] http://www.doingbusiness.org/data/exploretopics/protecting-investors
[2] Davis (2013) and Maddock and Monckton (2013) provide an overview of post crisis developments in the Australian financial system and economy.

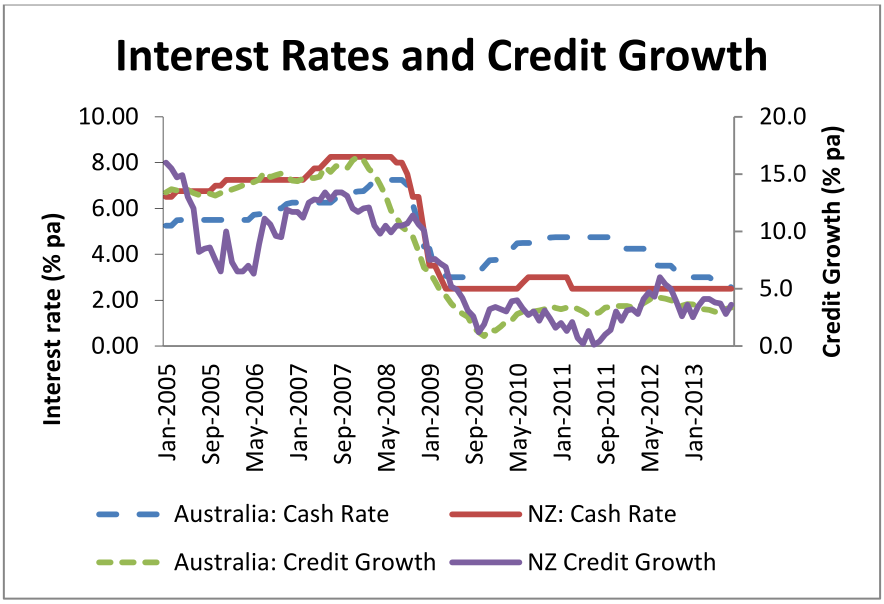

Figure 1

Source: RBA Table F1 and D01, RBNZ Table hb2 and hc2

Concerns about government debt and fiscal deficits (see Figure 2) perceived by some to be unsustainable (following surpluses prior to the crisis), and aggravated in the case of NZ by the fiscal consequences of massive earthquakes in February 2011 have inhibited stimulus measures to boost economic growth – even though both countries still have quite low debt/GDP ratios by current international standards (29 per cent for Australia and 37 per cent for NZ)[3].

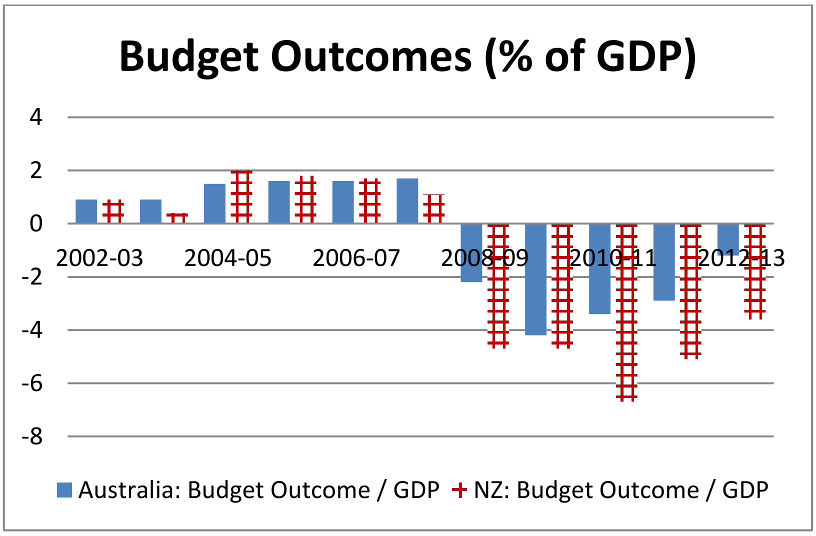

Figure 2

Source: Australian Treasury, NZ Treasury

[3] This is Gross Debt / GDP. Sourced from IMF World Economic Outlook database, October 2013.

In both countries, however, GDP growth has returned to moderate levels following the slowdowns induced by the financial crisis (figure 3).

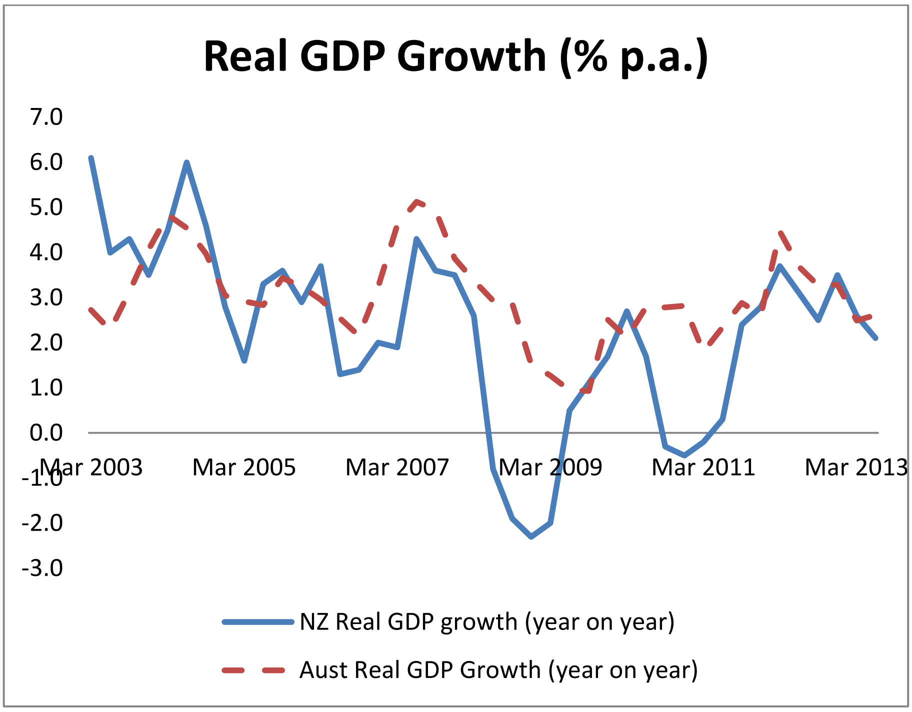

Figure 3

Source: ABS 562006; RBNZ table hm5

Arguably, most activity in the financial sectors has been in dealing with the plethora of new and changed regulation emanating both from international standard setters and from local responses to the problems in the non-prudentially-regulated sector made apparent at the time of the crisis. In Australia there have been 11 parliamentary committee inquiries into aspects of the financial sector since 2007 (Mulino, 2013), a broad-ranging review of the financial sector promised by the new government elected in September 2013, and a raft of changes impacting upon the large and growing superannuation sector. In NZ, supervisory arrangements have changed with the replacement of the Securities Commission with the Financial Markets Authority, and the RBNZ taking on enhanced prudential regulation and supervision responsibilities for banks, and also prudential regulation, but not supervision, of previously unregulated non-bank deposit takers such as finance companies and of insurance.

One consequence of the extent of actual and proposed regulatory changes in both countries is the problem for individual regulatory agencies, market participants and analysts of assimilating and understanding the likely interaction between and consequences of those changes (Debelle, 2013). While governments and agencies have increased the amount of information provision through creation of dedicated websites for particular areas of policies (such as a dedicated website for the Australian Council of Financial Regulators), assessing overall impact is a complex task.

Despite the relatively good performance of the Antipodean economies and financial sectors, there remain concerns (often expressed by international agencies) about the risk profile and systemic stability of the financial sectors of the two countries. Both have high housing prices by international standards, with bank assets heavily weighted towards mortgage debt. With bank loan/deposit ratios in excess of unity (although declining), bank funding (which dominates the provision of debt finance in the absence of deep corporate bond markets) remains significantly dependent on international wholesale debt markets, although less so since the crisis, with funding of persistent current account deficits increasingly occurring through other channels. Both currencies have been favourites for speculative carry trade strategies, with the relatively large foreign exchange exposure of external debt (held largely by foreigners) making exchange rates susceptible to changes in market sentiment (whether rationally based in views about the resources boom outlook or otherwise). The high concentration of the banking sectors and similar risk profiles and exposures of the four major banks also attract attention, but (unlike in some other countries) there has been little interest in any regulatory initiatives to change the structure or limit activities of the banking sector.

Nevertheless, a range of stress tests conducted by the Australian and NZ regulators, and in conjunction with international authorities such as the IMF, have indicated capacity to deal with significant economic and financial shocks. Underpinning that resilience appear to be relatively conservative lending practices, and strong bank capital and profitability positions.

In its December 2012 Financial System Stability Assessment of Australia the IMF in a generally favourable review noted:

> "However, a number of risks will need to be closely managed, including risks from a combination of high household debt and elevated house prices, reliance on offshore funding, and a highly concentrated and interconnected banking system. A higher minimum capital requirement for systemically important institutions may be desirable".

Other recommendations included: consideration of ex-ante funding of the Financial Claims Scheme (deposit insurance) and application of risk based capital and exposure rules to (non-prudentially regulated) AFSL holders[4]

In both countries, regulators have proceeded to implement the Basel Accord changes at a faster pace and with more stringent requirements than set down by the Basel Committee (see Table 1). And while there is strong regulatory support for the G20 and Basel processes in both countries, in other regards, including the domestically driven regulatory agendas, they have displayed differing approaches. This is most apparent in the area of depositor protection, with NZ eschewing deposit insurance, in favour of a "haircut" approach, while Australia belatedly (but with little logical foundation given priority of APRA's claims on assets of a failed bank, see section 7) bowed to international norms with plans announced in August 2013 to introduce a fee for the value of insurance provided to depositors by its Financial Claims Scheme. Neither country however has yet adequately tackled the problem of implicit guarantees over banks and particularly D-SIBs, although the NZ regulators would no doubt argue that their strong focus on market discipline of banks and director liabilities goes some way in this regard.

Attitudes towards the merits of reliance upon disclosure and financial advice arrangements have also arguably changed. In Australia, reliance upon disclosure as a mechanism for retail borrowers to assess suitability of a credit product has been supplemented by a responsibility for credit providers to ensure suitability for the customer. "If not why not" disclosure requirements used by ASIC for a range of entities raising or managing funds have been recently supplemented by introduction of, or proposals for, explicit capital, liquidity and cash flow forecasting requirements. Financial advice and financial product sale regulations have been strengthened to improve protection of retail purchasers of financial products. Nevertheless, this is an increasingly problematic area with the substantial growth of self managed super funds (SMSFs), which are now around one third of the large and growing pool of superannuation savings, and provide a ready target for purveyors of unsuitable financial products.

In the following sections we examine regulatory developments in recent years in the two economies under a specific set of topic headings, before providing an overall assessment in the concluding section.

[4] Providers of financial services and products are required to hold an Australian Financial Services License (AFSL) appropriate for those activities.

Table 1: Introduction of Basel Regulations in the Antipodes

Regulation	Australia	New Zealand	Basel
Basel 2.5	1 January 2012	1 January 2012	
Basel 3 Minimum 4.5% Common Equity Capital Ratio	1 January 2013	1 January 2013	2019
Basel 3 Capital Conservation Buffer	1 January 2016	1 January 2014	2019
Basel 3 Liquidity Coverage Ratio	1 January 2015	1 April 2010	60% in 2015, full by 2019
Net Stable Funding Ratio	2018	1 April 2010	2018

2. Supervisory Arrangements and Powers

With the banking sectors of both countries surviving the crisis well, it could be expected that there would be little change in the supervisory arrangements applying to banks. That has been the case in Australia, although APRA's powers have been strengthened by legislation in 2008 and 2010, and there is current consultation on further potential changes to APRA's crisis management powers. These include powers to appoint statutory managers to non operating holding companies (NOHC) and other relevant institutions, greater resolution and transfer powers over branches of foreign financial institutions, enhanced directions powers. However, there has been little discussion about the implications of such increased powers for accountability requirements for APRA.

But the adequacy of funding for APRA's activities is a potential issue (see Table 2) – particularly given the continuing growth of institutional superannuation (pension) funds which it also supervises (along with insurance companies). Seeking to rein in budget expenditures, the Federal government has introduced several "efficiency dividends" requiring cuts in public sector department and agency expenditures – including applying this to APRA and ASIC, despite their funding coming primarily from Financial Institution Supervision levies on prudentially regulated industries. One consequence has been the closure of APRA's (previously small) research department, and another being less chance of the comprehensive banking and other data collected by APRA being made publicly available for research and analysis.

Notably, despite the regulatory and supervisory activity generated by the financial crisis and subsequent response, APRA's funding has increased by only around 20 per cent from pre-crisis levels. Substantial future increases in FIS Levies reflect the costs associated with "Superstream" reforms aimed at improving operating efficiency within the superannuation system. (Also shown in Table 2 are the Financial Assistance Levy amounts levied on superannuation funds to recoup government compensation of super fund members who have incurred losses due to fraud and operational events).

Table 2: APRA Funding and Expenses ($ mill)

Year ending June	Expenses	Revenue	FIS Levies	Superstream component of FIS Levies	Financial Assistance Levy
2004	74	76	59		8
2005	82	86	97		33
2006	92	95	98		3
2007	91	108	113		-
2008	101	88	104		-
2009	103	105	108		-
2010	116	122	125		-
2011	118	102	116		55
2012	121	114	132		-
2013	118	116	270	122	17
2014f	125	112	259	100	
2015f	111	119	232	75	

***Source:* APRA Annual Reports; Treasury, Proposed Financial Industry Levies For 2013-14**

Bank regulation and supervision in NZ needs to be seen in the context of a local banking sector which is dominated by subsidiaries of the four major Australian banks (with a deposit market share of around 80% in 2013 (APRA 2013)). Arguably this enables the RBNZ to pursue a somewhat more market-oriented approach to bank regulation and supervision than the Australian supervisor (APRA) of the parent banks. This is reflected in the RBNZ variant of a three pillars approach based around market discipline, regulatory discipline, and self-discipline – contrasting with the Basel pillars of capital requirements, supervisory processes, and market discipline. "[P]rudential supervision…in New Zealand is comparatively light-handed. It is not about completely eliminating risk, but rather aims to ensure that risk is well understood by market participants, including depositors and policyholders". (Fiennes and O'Connor-Close, 2012).

The main changes in responsibilities and powers of the RBNZ have involved assuming prudential regulation responsibilities for non-bank deposit takers (NBDTs) between 2008 and 2010 (following a Government Review of Financial Products and Providers in 2006), and prudential and supervisory responsibility for insurance companies in 2010. Prudential standards for both sectors have been introduced, but the responsibility for supervision of NBDTs remains in the hands of independent trustees. Whether enhanced regulation is sufficient to overcome the earlier weaknesses of the trustee supervision model exposed by the collapse of this sector, remains to be seen – although the number of surviving institutions is now relatively small (with some having converted to bank status).

Arguably, in both countries, the main weaknesses in the financial sector exposed by the financial crisis were in the areas of market conduct, unregulated financial institutions, and protection of investors and consumers of financial products and services. In Australia, these areas are the responsibility of ASIC. While there has been no substantive changes to the legislative powers of ASIC, it has taken over responsibility of supervision of trading in financial markets from the Australian Securities Exchange (ASX) in 2010 – a change made inevitable by the decision to allow the introduction of a new trading platform (Chi X) in competition with the ASX. New ASIC Market Integrity rules were introduced in April 2011. ASIC will also have regulatory responsibility for any Financial Market Infrastructures (FMIs) established for the trading and settlement of OTC derivatives under legislation passed in December 2012. There is currently a Senate Inquiry into ASIC's oversight of the financial advice industry, following ongoing concerns with this area.

There have been substantive changes in the structure of agencies (other than the RBNZ) responsible for financial sector regulation in NZ. The Financial Markets Authority (FMA) was created in 2011, replacing the Securities Commission and taking over some previous responsibilities of the Ministry of Economic Development, and the roles of Government Actuary and Registrar of Companies. It is responsible for conduct and disclosure regulation. Responsibility for protection of consumers of financial services and products is divided between the FMA and the Ministry of Consumer Affairs and the Commerce Commission. The fact that the first chief executive, although a New Zealander, has come from ASIC is suggestive of greater convergence in approach among the two countries.

The New Zealand Council of Financial Regulators (NZCFR) was established in 2011 comprising the RBNZ, FMA, Treasury and Ministry of Business, Industry and Employment. Australia's Council of Financial Regulators (comprising Treasury, RBA, APRA, ASIC), a non statutory body with no regulatory functions, has been in operation since 1998, and is a successor to the Council of Financial Supervisors which was established in 1992. The Trans-Tasman Council on Banking Supervision has existed since 2005, and in 2010 a memorandum of cooperation for dealing with crisis situations and financial distress in a trans-Tasman banking group was signed.

The new Australian Government which took office in September 2013 has promised the creation of a Financial System Inquiry to review the financial sector – the last such general inquiry was the Wallis Inquiry which reported in 1997. At the time of writing the terms of the proposed Inquiry were still to be announced.

3. Financial Institution Governance, Remuneration and Organization

After the financial crisis APRA embarked on a program of industry consultation, with a view to consolidation of prudential standards. In January 2013, APRA Prudential Standard CPS 510 *Governance* was introduced, applying to all prudentially regulated institutions, other than superannuation funds, and replacing earlier sector specific standards. The main features include requirements for board size and composition, independent chairman, regular board performance assessment and renewal plans, alignment of remuneration policy and risk taking, and a requirement for remuneration committee and audit committee. Australia was one of only two countries surveyed in FSB Thematic Review[5] not to require (but expected by the supervisor) independence of the CRO.

The Prudential Standard CPS 520 *Fit and Proper*, designed to ensure persons who are responsible for the management and oversight of prudentially regulated institutions have the required skills experience and knowledge and act with integrity and honesty. However, there is no prior vetting of appointments by APRA.

Compensation practices at large financial institutions were viewed to be a key contributing factor in the Global Financial Crisis. In the Financial Stability Board's (FSB) 2011 thematic review of remuneration, Australia complied either through regulation or supervisory practices with all of the principles and standards except for S10,[6] effective alignment with risk taking – which is said to be not applicable due to no bail-outs having occurred. With little disruption to the banking sector in Australia, there has been no incentive to impose bonus caps, unlike in Europe where the investment banking bonus cap is likely to be passed by the European Parliament, but opposed by the UK Treasury.[7] In June 2013 APRA released the final Prudential Standard APS 330 *Public Disclosure* relating to Pillar 3 disclosures on the composition of capital and on remuneration by authorised deposit-taking institutions (ADIs)

[5] http://www.financialstabilityboard.org/publications/r_130212.pdf
[6] http://www.financialstabilityboard.org/publications/r_111011a.pdf Annex A
[7] http://www.bbc.co.uk/news/business-24273838

in Australia. While Australian ADIs are required under the Standard to disclose qualitative and quantitative information about their remuneration practices and aggregate remuneration data for senior managers and material risk-takers, there are no formal caps on remuneration. Under the *Public Disclosure* Standard ADIs are required to provide additional information on their capital adequacy, full details of the terms and conditions of each regulatory capital instrument and reconciliation between their regulatory capital and financial statements. In May 2013 APRA released for consultation proposed risk management and capital adequacy requirements for the supervision of conglomerate groups.

With over $1.5 trillion under management (and growing in relative size due to compulsory contributions and tax concessions), Australian superannuation fund assets are now around half the size of the banking sector which has assets of just over $3 trillion as at June 2013.[8] Governance in superannuation funds is not covered under CPS 510, but is of obvious importance given the size of the funds under management. Since the GFC there has been an examination of the prudential standards governing the licensees of responsible superannuation entities (RSEs). Some changes were made to Prudential Standard SPS510 on Governance in November 2012, aligning it with CPS510 described above. The standard requires a process for board renewal and assessment of board performance. Boards must have a board remuneration committee and a remuneration policy that aligns remuneration and risk management; as well a board audit committee with a dedicated internal audit function is mandated. The board must also ensure that directors and senior management collectively have the full range of skills needed for effective and prudent operation of the business. Prudential Standard SPS 530, Investment Governance was released in July 2013 for responsible superannuation entities (RSEs) managing superannuation funds. This standard provides explicit requirements on the RSE licensee to formulate specific and measurable investment objectives for each investment option, including return and risk objectives; to develop and implement an effective due diligence process for the selection of investments; to determine appropriate measures to monitor the performance of investments on an ongoing basis; to review the investment objectives and investment strategies on a periodic basis; and to formulate a liquidity management plan.

The superannuation sector in New Zealand is much smaller but growing rapidly following the introduction of a voluntary scheme, called Kiwisaver, that has been taken up by a large majority of those of working age. At present the extent of its regulation, by the FMA, is more

8 http://www.rba.gov.au/statistics/by-subject.html

limited than that of its Australian counterpart but its rising importance is likely to lead to a corresponding increase in regulatory attention.

All systemically important banks have to be locally incorporated in New Zealand as 'the RBNZ wishes to ensure that the New Zealand board of any systemically-important registered bank, or a New Zealand statutory manager, has unambiguous legal authority and practical ability to control all the functions, systems and management capacity necessary to operate a bank on a stand-alone basis if and when necessary'.[9] This policy was introduced in 2000 and its full implications have been steadily introduced, culminating in the requirements for preparedness for Open Bank Resolution in 2013, discussed in Section 8. Local incorporation entails a fiduciary duty to safeguard the interests of New Zealand-based depositors, rather than simply to the parent company. Director liability for disclosure statements is particularly strong, involving the possibility of imprisonment for up to three years and civil liability for misleading statements. The existence of strict liability means that the range of defences that can be offered is restricted.

4. Information, Risk Management and Disclosure

The turmoil in financial markets that was caused by the Global Financial Crisis exposed weaknesses in the structure of markets and the laws governing their operation, regulatory oversight, corporate governance, director and executive conduct, and very importantly the risk management practices of companies and market participants. Good corporate governance and risk management practices can appear to be of second order importance in a booming market, but the collapse of the equity markets worldwide exposed prudentially regulated institutions and corporations alike to flaws in structures and practices.

With regulators' heightened expectations on risk management of entities under their jurisdiction, including good governance and timely information disclosure, in March 2013 ASIC released a consultation paper on risk management practices for Responsible Entities (managers of mutual funds etc). The general approach is to require responsible entities to disclose against certain benchmarks on an 'if not why not basis'. In addition a number of investor guides have been developed to help investors better identify and assess the risks of investing (including the MoneySmart web-site) for the managed funds sector, the hedge

[9] http://www.rbnz.govt.nz/regulation_and_supervision/banks/relationships/0163826.html.

funds sector, unlisted mortgage schemes[10], exchange traded funds (ETFs), agribusiness schemes and infrastructure entities, among others.

With respect to prudentially regulated institutions in May 2013 APRA released for consultation its proposal for harmonised risk management requirements for ADIs, general insurers, single industry groups and conglomerate groups[11]. Proposals are expected to take effect from January 2014. There is a move internationally to introduce the Legal Entity Identifier (LEI) which is designed to create and apply a single, universal standard identifier to any organization or firm involved in a financial transaction internationally, allowing regulators to conduct more accurate analysis of globally systemically important financial institutions, and risk managers to aggregate exposures to multiple entities more accurately. The Australian authorities have no plans for compulsory introduction of LEIs but would support a private sector establishment of a Local Operating Unit (LOU) to manage introduction and have incorporated optional LEI provisions into some regulations.

In June 2013 APRA released Prudential Standard APS 330 requiring additional disclosure by ADIs including additional capital adequacy information; full details of capital instruments; reconciliation of regulatory capital and financial statements; information about remuneration practices and amounts. In addition APRA has revoked the use of the term ‘merchant bank’, stating the need for a clear demarcation between the regulated banking sector and the non-regulated shadow banking sector.

The Credit Rating Agencies came under scrutiny for the wrong calls they made in the lead-up to and during the GFC. Domestic licensing (holding an Australian Financial Services Licence (AFSL)) of CRAs has been required since January 2010, with conditions involving compliance with the IOSCO code of conduct and annual compliance reporting. Regulatory arrangements were recognised on October 5, 2012 by the European Commission as equivalent to their requirements, enabling endorsement by European CRAs of Australian issued ratings. But credit ratings are only able to be made to retail investors if an external dispute resolution scheme has been instituted under conditions of an AFSL. Major ratings agencies have eschewed this, so that such ratings are not available on Australian websites to retail investors.

[10] ASIC’s response to consultation on unlisted property schemes can be found at http://www.asic.gov.au/asic/asic.nsf/byheadline/12-57MR+ASIC+releases+exchange+traded+funds+report?openDocument

[11] There is no

In NZ, most deposit taking institutions are required to have a credit rating and the RBNZ currently approves only S&P, Moody's and Fitch. In Australia, APRA has implemented Basel requirements for the standardised approach with regard to credit ratings.

During the GFC the Australian Securities Exchange (ASX) suffered severe disruption and trading halts as a result of margin lending, securities lending and short selling. Issuers and advisers of margin lending facilities must now comply with the licensing, conduct and disclosure requirements set down in the Corporations Legislation Amendment (Financial Modernisation) Act 2009. ASIC has issued clear guidelines on applying for AFS Licences that are necessary for both standard margin lending (both issuance and advice) and non-standard (where interest in marketable securities are transferred). Since the transfer of market surveillance to ASIC in 2010, ASIC is also responsible for the reporting framework for disclosure of short-selling activities. This is discussed further in terms of consumer protection in Section 10.

5. Basel Capital Reforms

> "Our systems are already focused on utility banking, rather than on the riskier types of investment banking." Bollard and Ng, 2012, p64
> "In contrast with the UK and US, our major banks remain focused on traditional lending activities and do not have major investment banking arms" (Beckett, 2012, p23)

Regulators in both Australia and New Zealand have proceeded apace with the introduction of new Basel capital requirements (see Table 1), and adopted more stringent definitions of allowable capital and risk weights than contained in the Basel recommendations and implemented in many other countries.[12] For example in a review of NZ, the IMF (2013) estimated that the conservative approach means capital ratios are 100-200 basis points below the figures which would be obtained if using the approach of other some other major countries. Among the factors giving rise to this outcome are minimum allowable housing risk weights of 25 to 35, and no allowance of innovative hybrid capital. Similar comments have been made about the Australian approach. The RBNZ is currently considering applying a higher correlation factor (and thus a higher risk weight) to high LVR housing loans. (RBNZ, 2013).

[12] APRA's and RBNZ Basel 3 prudential standards can be found respectively at: http://www.apra.gov.au/adi/PrudentialFramework/Pages/Basel-III-CCR-Final-November-2012.aspx, and http://www.rbnz.govt.nz/regulation_and_supervision/banks/banking_supervision_handbook/

Regulators in both countries have downplayed the value of a leverage requirement: "we have not adopted the Basel III leverage ratio as we consider it is a poor measure of risk for New Zealand banks" (RBNZ, 2013, p8).

While the Australian banks (whose subsidiaries also dominate the NZ market) have complained about the consequences of higher capital requirements for their funding costs, that effect can be expected to be of lower consequence than it is for banks in most other countries. The reason is that both Australia and NZ operate dividend imputation tax systems which means that dividends paid to shareholders have attached tax credits reflecting the company tax paid on the original company income. Consequently there is no (or less of an) interest tax shield arising from leverage – with such a shield only arising from foreign shareholders not being able to use such franking credits, or from payment of interest in foreign locations reducing foreign (and thus) total tax paid. While the significantly reduced relevance of an interest tax shield for the Australian operations is relatively clear cut, this is not so for the major NZ banks owned by Australian bank parents. One consequence of the inability of Australian bank parents to effectively use NZ tax credits received with dividends from their subsidiaries was their issuance of stapled securities as a form of regulatory capital. Interest on the loan note issued by the NZ subsidiary (which was stapled to a preference share instrument issued by the Australian parent) reduced NZ tax paid.

Notably, APRA has yet to review its prudential guidelines for securitisation which do not require "skin in the game" (retention of some exposure), but instead provide maximum capital relief for clean sales. "APS 120 is presently out of step with the United States and the European Union. In particular, it does not have a mandated "skin in the game" requirement, a major component of the reform initiatives in those jurisdictions. In addition, the rules dealing with disclosure to investors are not as stringent and the rules regarding issuer self-assessment and review of assets are far less prescriptive." (Brown and Newman, 2011)[13]

A significant number of banks have issued substantial amounts of hybrid securities with contingent capital features which are required by APRA if they are to be included as regulatory capital.[14] Those securities have been primarily targeted at retail investors (including self managed super funds), with little wholesale investor interest. This has led to

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[13] The RBA is currently implementing a requirement for disclosure of loan-level data in RMBS to be publicly available if those securities are to be eligible for repos at the RBA, and a new prudential standard for securitisation which is expected to require "skin in the game" is expected in 2014.

[14] One consequence of the contingency requirements was that it would cause the affected securities to be treated as equity for tax purposes rather than debt (with interest deductible for tax purposes at the company level) necessitating legislation to prevent this tax consequence.

concerns being expressed by ASIC, the securities regulator, as to whether retail investors understand the risk associated with such securities and consequent pricing.

APRA is currently examining whether particular banks should be classified as D-SIBs and subject to additional capital (higher loss absorbency) requirements. It has also released standards for supervision of conglomerate groups (level 3 supervision) to take effect at the start of 2014.

6. Basel 3 - Liquidity

Both the Australian and New Zealand authorities have proceeded rapidly with the introduction of new liquidity requirements, with the RBNZ acting well ahead of the Basel timetable, having foreshadowed in November 2008 the intention to introduce locally designed liquidity requirements.

NZ introduced a liquid assets requirement in April 2010 in the form of required holdings to meet both one-week and one-month mismatch requirements. In doing so, the RBNZ adopted similar tiering of HQLA instruments to the Basel LCR, allowing various forms of private sector securities to be eligible subject to specified haircuts. Since its introduction, NZ banks have had an average mismatch ratio (HQLA minus net stress outflow projections as a ratio to total funding) in the order of five to seven per cent. The Core Funding Requirement, requiring 65 per cent (and 70 per cent by July 2011 and 75 per cent by January 2013) of funding to be customer deposits and greater than one year wholesale deposits was introduced in April 2010.

Australia has committed to fully implementing the Basel Liquidity Coverage Ratio (LCR) by January 2015. In doing so, it has rejected the Basel option of allowing certain private sector and multilateral agency securities to count as HQLA 2A and 2B for purposes of partially meeting the requirement. Consequently, eligible HQLA consists only of government debt (and cash and deposits at the RBA – with actual bank holdings of the latter being minimal due to interest rate and system liquidity management arrangements).

This position appears to confuse the potential implications of a general system-wide and bank specific liquidity crisis. In the event of the latter, holdings of high ranking private sector securities should be marketable to acquire needed liquidity. In the event of a system-wide liquidity crisis, the RBA will need to provide liquidity through repurchase transactions against good private sector collateral. Hence the rationale for excluding such securities from eligibility to meet some part of the LCR is unclear.

One consequence of this decision is that there is a shortage of available eligible securities, with relatively little government debt on issue and much of it held by foreign investors. The result has been that the Australian authorities have opted for one of the Alternative Liquidity Approaches (ALA) permitted by the Basel Committee, specifically the Committed Liquidity Facility (CLF) option to apply from the start of 2015. Under this approach, banks can use amounts accessible through a fee-based CLF with the RBA to meet the LCR requirement. The RBA has announced a fee of 15 basis points for the facility, with borrowings under the facility to be priced at the official cash rate plus 25 basis points (the same as currently exists for overnight borrowings). The size of the CLF available to each bank is to be determined by an official assessment of an appropriate share of the estimated total CLF needed given some forward looking longer term estimate of aggregate required HQLA less reasonably available HQLA.

Use of the CLF, should it be needed, involves the provision by the bank of collateral acceptable to the RBA for repurchase agreements, and this broadly includes the types of private sector securities (other than equities) included in the definition of HQLA 2A and 2B. While there is no requirement to hold such assets prior to use of the CLF, it would seem likely that bank liquidity management practices would lead to some level of precautionary holdings to enable access to the CLF should it be needed.

Thus some induced level of bank demand for such private sector securities can be expected from the CLF arrangements, although not as much as might be expected if they were eligible for use as HQLA. It can be asked whether use of one of the other ALA approaches (such as allowing greater use of HQLA 2A or 2B with larger haircuts) might not be simpler and more consistent with other goals of policy such as encouraging further development of the domestic corporate bond market. While Basel capital requirements are separately likely to induce further development of this market, endowing such securities with enhanced liquidity characteristics through eligibility as HQLA would also work in that direction.

Perhaps the one clear benefit from the CLF approach is the fact that banks will be charged some fee for the “liquidity put” which they have available anyway. Whether that fee (of 15 basis points) is appropriate is another matter. There is, arguably, no unique optimal fee (since the effect of different fee levels is to change the demand for government debt and thus its relative return), but the maximum fee is constrained by practice of the RBA paying the cash rate minus 25 basis points on bank exchange settlement accounts held with it.

One consequence of the proposed introduction of the new liquidity requirements is that banks have already adjusted relative pricing of deposits. Carr (2013) illustrates the substantial wedge that has been driven between rates paid by banks for the "more stable" term deposits from retail customers and those from other financial institutions. With deposits from self managed super funds being treated by APRA as retail deposits, this has the indirect effect of further inducement for individuals to shift from institutional super funds to SMSFs.

There is clear evidence (Shi and Tripe, 2012) that the banks in New Zealand have not merely responded to the new liquidity rules but have anticipated them and taken the increasing of the maturity of their liabilities rather further than is required both in domestic and foreign funding.

7. Deposit insurance

Prior to October 2008, Australia and NZ were the only OECD countries without explicit deposit insurance. The Australian position was motivated by reliance on depositor preference as a perceived mechanism for ensuring safety of deposits, while the NZ position reflected a strong commitment to the desirability of market discipline.[15]

The market disruption following by the Lehman collapse led both governments to introduce deposit guarantees and make fee-based guarantees available for new issues of wholesale debt by banks. The debt guarantee facility was terminated on 1 March 2010 in Australia and 30 April 2010 in NZ. The banks (particularly the four majors) made substantial initial use of the schemes[16] but by 2010, as credit spreads returned to more normal levels, were exercising an unpriced implicit option to buyback guaranteed debt from investors, cancel the guarantee, and issue new, unguaranteed, debt. Those options meant that the initial pricing of the guarantees was even more favourable to the banks (less so in NZ) than appeared at face value.

The two countries have followed different paths with regard to deposit insurance. The New Zealanders initially introduced the Crown Retail Deposit Guarantee available to banks (and other deposit takers) on an opt-in basis for a fee with a cap of $1 mill. (after an initial temporary period with no cap). The scheme was terminated in October 2010 (for banks, but extended until end 2011 for other deposit takers on less favourable terms) with the authorities

[15] This is reflected in the announcement by the NZ Finance Minister in 2011 regarding the termination of the Deposit Guarantee. "The Government does not favour compulsory deposit insurance. This is difficult to price and blunts incentives for both financial institutions and depositors to monitor and manage risks properly." English (2011)

[16] The amount guaranteed reached a maximum of $170 bill in Australia and $10.3 bill in NZ.

reverting to their preferred position of no explicit insurance and promotion of a "haircut" scheme referred to as Open Bank Resolution (OBR). (Hoskin and Javier, 2013)

In contrast, the Australian Government has stated that its Financial Claims Scheme (FCS) is a permanent feature of the financial landscape. Initially, after a short period of a blanket deposit guarantee, deposit insurance for amounts up to $1 mill per depositor was provided for no charge. The size of the insurance cap was reduced in February 2012 to the current level of $250,000.

Prior to the announcement of a planned fee (of 5 -10 basis points p.a. per dollar of insured deposits) in early August 2013,[17] the absence of a fee, which is relatively uncommon in an international context, had been seen by international agencies as a weakness of the Australian scheme. The scheme involved a non-risked based *ex post* funding model whereby, should an ADI fail and APRA be unable to recoup amounts paid out to insured depositors from remaining assets of the ADI, the Treasurer may impose a levy on other ADIs to cover any shortfall.

In fact, the argument for a fee, on the grounds of an insurance premium is hard to sustain, given the structure of Australian bank balance sheets and priority arrangements. For example, insured deposits constitute around 25-30 per cent of total funding of the major banks. The possibility that APRA, which would rank above all other depositors and creditors in liquidation, would not recoup the amount it had paid out to insured depositors from the assets of a failed bank, is extremely small. Balance sheets of regional banks, credit unions and building societies and foreign bank subsidiaries (also covered by the scheme) are slightly less favourable to this outcome (given greater reliance on retail deposits), but it is unlikely (judging by past experience) that the authorities would not arrange exit via takeover rather than liquidation.

The explicit protection (essentially by subordination of claims of other deposits and creditors) of retail deposits from the FCS is less of an issue in terms of potential competitive distortions than the perceptions of implicit government guarantees for all creditors – particularly in the case of the four major banks. Such perceptions, to the extent they exist, reduce the

[17] "The Government will progress a recommendation from the Council of Financial Regulators, which includes the Reserve Bank of Australia and the Australian Prudential Regulation Authority, to establish a dedicated Financial Stability Fund to help meet any future cost of the Financial Claims Scheme (FCS), as well as the cost of other resolution activities that protect depositors. The dedicated Fund will build gradually over time to a target size of 0.5 per cent of total deposits protected by the FCS. Establishing the Fund is expected to have a net positive impact on the budget of $733 million over the forward estimates, from 1 January 2016." http://www.budget.gov.au/2013-14/content/economic_statement/download/2013_EconomicStatement.pdf

disciplining effect of such subordinated creditors (who are effectively providing the insurance to retail depositors) and generates the competitive advantage of ADIs arising from the FCS. A fee for the FCS may then be justified, not on pure cost of insurance grounds, but rather on competitive distortions arising, or on the potential costs to APRA of subsidising open resolution arrangements or benefits to depositors of having rapid access in event of a failure.

The FCS also applies to general insurance policy holders, but this area has attracted little attention. Members of institutional superannuation funds regulated by APRA also receive protection from losses due to fraud. In 2011-12, $55 million was provided by the government as compensation for investment losses due to the failure of Trio Capital (to be ultimately financed by a levy on other prudentially regulated super funds). This created considerable controversy, because members of Self Managed Super Funds who had investments with Trio were not eligible for compensation.

New Zealand's opposition to deposit insurance was heavily reinforced by their experience with the hastily put together temporary scheme as it involved a major payout to the creditors of one large finance company, South Canterbury Finance, and considerable moral hazard as the company increased risky lending substantial once it could raise guaranteed deposits.[18]

8. Resolution arrangements and contingent capital

APRA has sole responsibility for resolution of banks and insurers. There is no special resolution regime for securities/ investment firms or financial market infrastructure (FMI) providers who would be dealt with under standard insolvency arrangements (although proposals relating to the latter based on recommendations of the CFR are under consultation).

APRA has authority to override shareholder rights, temporarily operate a bank, sell or transfer assets and liabilities, create a bridge bank or an asset management company.[19] It does not have bail-in powers – except where they are specified in the prospectus for the liabilities involved. (A number of banks have included bail-in clauses in recent issues of hybrid securities marketed primarily to retail investors, enabling those securities to qualify as regulatory capital). APRA's resolution powers were strengthened in 2008 and 2010 legislation and a discussion paper was released in September 2012 covering further extension of crisis management powers. One feature of that paper, however, was no discussion of possible changes to accountability arrangements commensurate with the increased power.

[18] This experience was the subject of a critical review by the Auditor-General http://www.oag.govt.nz/2011/treasury/docs/crown-retail-deposit-guarantee-scheme.pdf.
[19] http://www.financialstabilityboard.org/publications/r_130411a.pdf (Table 2)

There is some requirement for APRA to take into account implications of resolution for NZ financial stability (reflecting the dominant role of the four major banks in each country).

APRA has implemented trial work with large banks on formulation of recovery, but not as yet resolution plans.

New Zealand has introduced a strikingly different framework for resolving the four large banks (and others that choose to opt into the scheme) which has been labelled Open Bank Resolution.[20] Rather than seeking a joint solution with Australia or pursuing the ideas advocated by the US and the UK for resolving the parent, New Zealand has decided to make sure that all banks are resolvable irrespective of what other authorities decide they want to do.

This regime has three main characteristics: first the systemic banks have to be locally incorporated and separately capitalised and these subsidiaries must be capable of operating on their own without support from their parent overnight. This effectively means that the banking group must be fragmented on national lines. Second, the main method to be used for resolution is to be a bail in of the creditors in order of priority as in an insolvency, i.e. starting with the shareholders, then moving on to the subordinated debt holders and then on up in seniority until writing down a class of creditors restores solvency on a conservative valuation of the extent of the losses. Third, the bank is to be kept operating during the process, in the sense that the resolution will be performed between the close of business on one day and the reopening on the next. Doing this requires a *lex specialis* under which a statutory manager (a form of receiver) can be appointed, who freezes the operations at the close of business, performs the conservative valuation, writes down the claims, dividing them into frozen and unfrozen parts and restarts the operations, all without triggering any close out clauses or other interruptions to normal business.

Since there is no deposit insurance and depositors are junior unsecured creditors, as unlike Australia there is no depositor preference, this means that depositors are highly likely to be written down unless the degree of failure is small. This imposes a major prepositioning requirement on the banks as they have to be capable of dividing all accounts overnight into their frozen and unfrozen parts, where customers can access the unfrozen part normally the following morning.

[20] See Hoskin and Woolford (2011) for an overview.

The statutory manager will continue to run the bank until such time as recapitalisation by the private sector can be organised. Thus in many ways this will operate like a bridge bank and will probably require a government guarantee against further loss. The RBNZ had originally considered a debt for equity swap instead of a simple write down of claims but had rejected this because it would not necessarily produce suitable new owners.

These changes had been under consideration for some time and the first steps were introduced before the global financial crisis. The Reserve Bank's main argument in favour of this scheme is that the very existence of a credible regime for resolution under which top management lose their jobs and shareholders are wiped out will encourage much more prudent risk management of banks in their own self-interest and will encourage more efficient resolutions, particularly through the private sector, which the emphasis on an industry solution, followed by bailing in and with bailing out a distant last (RBNZ, 2012).

9. Regulation of the non-bank sector and shadow banking

"Shadow banking" is a relatively small part of the financial sectors of Australia and NZ. In Australia, insurers and institutional superannuation funds are prudentially regulated by APRA. Securitisation had been increasing in relative importance prior to the financial crisis, as had managed funds, but both sectors have subsequently decreased in size (see table 3). Money market funds (cash management trusts) have declined in size due to competition from insured bank deposits, and are typically floating Net Asset Value funds. Hedge funds remain relatively small (see appendix 1). Other financiers (RFCs) have also declined in size, and been a source of financial institution failures, and APRA is currently considering proposals to limit such non-prudentially regulated registered financial corporations and charitable institutions from using the terms "deposit" and "at-call" in raising funds, in order to better distinguish them from ADIs. What is particularly noticeable, and understated due to the exclusion of self managed super funds (SMSF) from table 3 is the growth in superannuation funds. (SMSF had around $400 billion in assets in June 2012). The ongoing growth of this sector due to compulsory contributions and substantial tax concessions ha significant implications for the future evolution and shape of the Australian financial system (Davis, 2013).

Table 3: Australian Financial System Assets

	ADIs	RFCs	Life Insurance and Superannuation	Managed Funds	General Insurance	Securitisation Vehicles
Jun-2006	1635	176	787	301	114	216
Jun-2007	1936	223	1025	378	144	274
Jun-2008	2389	251	997	353	135	239
Jun-2009	2658	216	936	314	134	193
Jun-2010	2686	169	1051	313	133	146
Jun-2011	2815	171	1172	288	150	136
Jun-2012	3033	154	1234	272	159	127
Jun-2013	3170	155	1421	278	na	128

Notes: ADIs comprise banks, building societies and credit unions, RFCs are registered financial corporations, including money market corporations, finance companies and general financiers.
Source: RBA Bulletin, Table B1

In NZ, the funds management sector is relatively small, while non bank lenders have declined in size, and are under prudential regulation (but not supervision) by the RBNZ. (See Table 4). The managed funds sector includes the government supported KiwiSaver superannuation scheme which has grown significantly since inception, although employer contribution rates (of 3 per cent of wages) are well below those mandated in Australia (9 per cent and planned to increase to 12 per cent).

Table 4 New Zealand Financial System Liabilities

At December	2000	2005	2007	2008	2009	2010	2011	2012
Banks	178	253	332	403	380	382	395	407
Non-bank lending institutions	10	26	31	27	24	21	17	14
Funds under management	61	63	72	62	68	72	74	83
Total financial system liabilities	249	342	435	492	472	474	486	504

Source: RBNZ Financial Stability Review, May 2013

Both Australia and New Zealand experienced substantial failures of non-bank, non-prudentially-regulated financial institutions before, during, and after the financial crisis. Many of these failures were home grown, although the prior growth reflected the pre-crisis conditions of excessive risk taking, high leverage, emergence of complex structures, and little regulatory protection of investors outside the prudentially regulated sector. There was little in the way of systemic effects, although some stock market disruption was experienced in Australia through failures of firms involved in securities lending activities. In both countries the "shadow banking" sector has been, and remains, relatively small. "Repo" funding is not used substantially as a means of funding by non-banks, although repos are the principal instrument of system liquidity management used by the Reserve Banks.

The responses to these failures have differed significantly between the two countries. In New Zealand, the problem was the failure of a large part of the finance company sector (non bank deposit takers - NBDTs) where private trustees had been assigned the task of supervision, and where regulatory oversight was minimal. In September 2008 NBDTs were placed under the prudential regulation of the RBNZ and the introduction of the Crown retail deposit guarantee scheme in October 2008 applied to them as well as to banks (and removed in 2011). NBDTs are required to have a credit rating if issuing NZD deposits or debt securities, a minimum capital ratio of 8 per cent is required, and related party exposures required to be no more than 15 per cent of tier one capital. Reflecting the priority given to non-official oversight, independent trustees are still regarded as the appropriate supervisors.[21]

The contrast with Australia could not be more stark. In Australia, such non-bank institutions have been kept outside of the prudential net and no formal regulatory requirements (such as minimum capital requirements, related party exposures) were imposed upon them – until proposals for minimum capital and liquidity requirements for some entities were released in February 2013 by ASIC.

Following several failures of non prudentially regulated financial firms in the mid 2000s, ASIC introduced in October 2007 proposals for new disclosure requirements for issuers of unlisted and unrated debentures based upon an "if not why not" approach. Since extended to a range of other investment vehicles, the "if not why not" approach involves requiring entities raising funds to disclose in prospectuses and product disclosure statements whether their business models and financial structures accord with ASIC provided benchmarks and, if not, why not. Responsible entities for mortgage schemes, unlisted property schemes, infrastructure schemes, agribusiness managed investment schemes, and hedge funds and providers of OTC contracts for difference, were subsequently subjected to the "if not why not" approach – with the benchmarks provided differing across the different types of entities.

Perhaps indicating recognition that such an approach was not working, and reflecting a number of recent high profile failures of finance companies (such as Banksia in 2012), in February 2013 ASIC released proposals, albeit not implemented to date, to impose minimum capital (8 per cent of risk weighted assets) and liquidity requirements (9 per cent of liabilities

[21] The RBNZ (2013) reviewed the effectiveness of the NBDT regime.

in HQLA) on debenture issuers. Prudential supervision of such entities was eschewed with improved powers and responsibilities for trustees and auditors required, and a requirement for provision of a prospectus to investors holding maturing securities prior to the investments being rolled over.[22]

A similar change in approach, away from reliance on disclosure and towards explicit regulations for responsible entities (managers of collective investments) was announced in June 2013 by ASIC. These changes impose specific requirements on all AFSL holders including Market and Clearing Participants (on ASX or Chi-X), Responsible Entities (RE's) – the managers of retail hedge funds (and other MIS), Investor –directed portfolio services, custodial or depository services, trustee companies, issuers of margin lending facilities, FX dealers, retail OTC derivative issuers. They include minimum net tangible assets (capital) requirements and a liquidity requirement. For Responsible Entities of managed investment schemes, for example, the net tangible assets requirement is 0.5% of the value of scheme assets (or a specified cash amount or 10% of average revenue if higher) and cash assets must exceed some proportion (minimum of 50% or $150,000) of the RE's net tangible assets).

10. Consumer / Investor Protection

The financial crisis and its aftermath exposed considerable problems in the structure of investor and borrower protection arrangements in both Australia and New Zealand, and these have given rise to a significant domestically driven agenda of regulatory change in Australia. (Grady, 2012, provides an overview). Some part of those changes has involved a lessened faith in free market outcomes where reliance on education, advice, and disclosure were previously perceived to be a suitable basis for achieving acceptable outcomes. But notably, both Australia and New Zealand remained near the bottom of the Morningstar (2013) international league table for protection of investors in mutual funds in 2013. Morningstar (2013, p23) comments that "Australia has major problems with Disclosure" while New Zealand, despite planned changes still rated a "D".

A key issue in the discussion has been the culpability of financial advisers and providers of finance, even though Australia has since 2001 had a licensing regime requiring providers of financial products and services (which includes advice) to hold an Australian Financial Services Licence and comply with the training and other obligations involved. One

[22] On 19 April 2013 APRA published recommendations on how finance companies and debenture issuers might be better distinguished from banks, including proposals to restrict use of the words "deposit" and "at-call" and to impose a minimum maturity of 31 days on debentures.

consequence has been, in Australia, a shift in emphasis away from reliance on disclosure, education and advice as the basis for achieving good outcomes towards direct intervention in financial market contract conditions and imposing greater responsibility upon financial product and service providers for assessing suitability of their offerings for potential customers.

In Australia, failures of several margin lenders (Opes Prime, Tricom) brought to light the use of securities lending structures, in which ownership of the underlying securities was transferred, as the basis for margin loans, with subsequent on-lending of those securities to banks for the provision of finance. When these entities failed, borrowers were unable to recover their securities and suffered losses – although public relations concerns ultimately led to the banks involved providing compensation to those borrowers. As a result, legislation was introduced to include margin lending under the definition of a financial product and thus subject to regulation by ASIC which proposed that non-standard margin loan arrangements involving transfer of title from the borrower to the lender would require additional disclosure.

Margin lending was also a component of predatory lending practices arising from the high (and double) leverage strategy which financial planning firm Storm Financial inflicted upon clients for whom it was unsuited. Those clients, many retirees, were induced to re-mortgage their homes to free up cash which could then be used as equity for margin loans financing a share portfolio. The scale of losses involved and political fallout led to a Senate Inquiry (Ripoll Inquiry) which led to the introduction of a range of new legislative requirements for the financial planning/advising industry, locally referred to as the Future of Financial Advice (FoFA) reforms. These had three main components (voluntary from July 2012 and compulsory from July 2013):

- Arrangements involving financial advisers receiving commissions from financial product providers were prohibited
- Asset based fees could only be charged on the net assets under management – not on the amount financed by borrowings
- Financial advisers were required to have a fiduciary duty to their clients.

A review of the case for a statutory, government or industry funded, compensation scheme for investors facing losses due to financial adviser or service provider fraud, did not support such an approach, but did lead to the government announcing in 2013 plans for strengthening advisor professional indemnity insurance requirements.

As it transpires (and reflecting in part compliance costs), the financial advising sector is increasingly becoming structured as groups which are subsidiaries of the major banks and other financial product providers, creating the potential for other forms of indirect payments from the product providers (the parent entities) to financial advisers recommending their products. Notably, the industry was able to successfully oppose provisions in the bill that would have required clients to explicitly opt in to renewal of contracts with advisers every year. The current situation is that the requirement would apply every two years, but there have been press reports that the new government may further weaken that provision. How these changes, implying more reliance on up-front fees (and less "hidden" remuneration) impact upon the access to, and use of, financial advice remains to be seen.

In June 2010, the Government announced the regulations under the National Consumer Credit Protection Act (NCCP) which has replaced the State-based Uniform Consumer Credit Code. Under Phase 1, changes include:

- Responsible lending conduct (making it an offence for credit providers to enter into an "unsuitable credit product" and transferring responsibility for determining suitability from the borrower to the lender, indirectly having the potential effect of reversing a growing trend of "no-doc" or "low-doc" loans.
- Extended hardship criteria for relief
- Predatory lending and exploitative practice prohibitions.

Prohibition of mortgage loan exit fees (other than for fixed rate mortgages) was introduced in 2011 as part of the Competitive and Sustainable Banking Sector reforms while prohibition of fees (in excess of explicit costs incurred by the bank) for overdrawing of accounts, and other measures relating to protection of credit card users have also been implemented. Reflecting government concerns about financial exclusion and credit costs for users of payday lenders and other informal credit providers, a maximum annual credit charge of 48 per cent p.a. for small consumer credit contracts was legislated in September 2012. Increased disclosure for, and protection, of reverse mortgage borrowers was also contained in that legislation.

The rebalancing of power in consumer credit arrangements also includes financial difficulty / hardship provisions. Financial Service Providers must stop enforcement action when a borrower in hardship lodges a notice of dispute with the Financial Ombudsman Service (FOS). Given time lags in FOS dealing with applications, this reduces the ability of banks to deal speedily with loans in arrears/ default. Bankruptcy laws have also been changed in recent years reducing the costs to individuals from entering bankruptcy, a debt agreement or a personal insolvency agreement.

Comprehensive credit reporting (collection of positive information by credit bureaus) has been legislated in Australia (December 2012) to come into effect from March 2014. While this will facilitate lending decisions, it remains to be seen whether the large banks will migrate to full participation (provision and use of positive information) or remain as limited participants only providing and using negative data. It also remains to be seen how the additional information available will assist given the new responsibilities of lenders to ensure suitability of credit products for retail borrowers.

Also relevant are the "Stronger Super" reforms which included permitting superannuation funds to provide simple financial advice and requirements that a default (MySuper) option be provided.

Notably Anderson et al (2012a, 2012b) find that there is little change in levels of shareholder and creditor protection in Australia between 2006 and 2010, but that the levels rank high in an international context. In contrast, in the World Bank investor protection index, Australia ranks poorly, with a low score on liability of directors being particularly noticeable. In this regard, it is worth noting that COAG (the Council of Australian Governments) decided in December 2012 on a set of principles and guidelines for the imposition of personal criminal liability on directors as a consequence of corporate offences, which involve a reduction in the severity of liability.

Erskine and Marlin (2012) note that Australia and NZ are in bottom 3 of 22 OECD countries in terms of disclosure by managed funds. The Australian low ranking is partly due to lack of mandated disclosure of portfolio holdings. Subsequent legislation, The Superannuation Legislation Amendment (Service Providers and Other Governance Measures) Act 2013, came into effect June 2013, requiring 6 monthly disclosure of holdings on a look through basis (ie both direct and indirect holdings via fund managers), but introduction deferred until June 2014. Australian super funds opposed the legislation and lobbied for deferral of introduction due to concerns that hedge funds will object to implied disclosure of their holdings.

11. Capital Market Regulation

One feature of Australian and NZ capital markets is the relatively small size of domestic bond issuance by non-financial corporates, although Kangaroo and Kauri issues have been relatively large. Issues by financial institution, particularly of hybrid securities, and (prior to the crisis) RMBS issues have also been significant. Government issues have been growing recently in the light of higher government deficits –with most government debt issued domestically (and in local currency), but with significant foreign holdings.

The Australian authorities have been keen to promote the development of a domestic corporate bond market, including issues to retail investors, and have liberalized issuance arrangements, commencing in 2010 when "vanilla" bonds could be issued with a short-form prospectus or "two- part" (shelf registration) process. In March 2013, this arrangement was extended to issues to retail investors, and potential legal liabilities for directors arising from such issues reduced. In late 2012, legislation enabling trading by retail investors of depository interests in government bonds on the ASX was passed.

Table 5 Timeline of recent government initiatives aimed at promoting corporate bonds

Regulatory Change	Date implemented
Listed companies allowed to issue "vanilla" bonds under either a short-form prospectus or a two-part prospectus model.	May 2010
Australian banks allowed to issue covered bonds	October 2011
Two-part prospectus model extended to "vanilla" bonds issued to retail investors and length of base prospectus eligibility raised from 2 to 3 years.	March 2013
Listing of beneficial interests in Australian Government Bonds	May 2013

Significant changes in securitisation arrangements have occurred, in particular the allowance of covered bond issuance in both countries from late 2011,[23] up to a maximum proportion of 8 (Australia) or 10% (NZ) of assets. The four major banks, which had not been major users of traditional securitisation techniques, have used this option substantially. The traditional securitisation market, which was decimated by the financial crisis has been slow to recover, with new issues not covering maturing amounts such that total outstandings have fallen from $274 billion in June 2007 (of which $100 billion was overseas) to a low of $125 billion ($15 billion overseas) in December 2012 before stabilising in 2013. In the initial years after the

[23] ANZ bank issued covered bonds in NZ before the introduction of the enabling legislation (Vucetich and Watson, 2013)

financial crisis, the support of new issues by smaller entities provided by the Australian government's key investor support (operated through the AOFM) limited the demise of the market. This support program was officially terminated in April 2013. The program had been allocated additional funds in April 2011, and significant investments continued to be made until August 2012, although allocations to the AOFM in the last four supported issues of 2012 were zero.

The Australian equity market is relatively large by international standards, on a population adjusted basis, and that of NZ less significant. While competition in provision of trading platforms has occurred (via entry of Chi X), clearing and settlement of cash equity trading remains a monopoly of the ASX. It is planned that this situation will be reviewed at the end of 2014 in the light of the progress made by the ASX on developing a code of practice to ensure an efficient market.

Despite much public debate, the issue of high frequency trading and dark pools has not created particular concern to Australian regulators. A study by ASIC suggested that HFT was not as prevalent in Australia as in some overseas markets, and while dark trading had remained around 25-30 per cent of turnover, this was occurring via an increasing number of systems. Proposed changes include minimum size requirements for dark orders, rules to improve transparency and fairness for crossing system operators, minimum resting periods for orders by HFTs. Comerton-Forde (2012) notes that while Australia is HFT-friendly, an absence of "trade-through protection" and lack of rebates on trading fees are likely to reduce the growth of HFT relative to other markets.

The financial crisis exposed shortcomings in Australian regulation of short selling, with substantial use of naked short sales. During the crisis, short selling was banned for some stocks for some period, and subsequent regulations have tightened provisions. Requirements for better disclosure of securities lending were also introduced in 2011

Australia passed legislation in December 2012 giving the government authority to apply mandatory clearing and trading arrangements, as well as trade reporting, to OTC derivatives.[24] In a July 2013 joint report, the RBA, APRA and ASIC recommended that the Australian government should consider a central clearing mandate for major foreign currency interest rate derivatives, but not, at this stage for credit derivatives, nor AUD interest rate derivatives (although two CCPs, ASX Clear (Futures) and LCH.Clearnet Limited have

[24] Information at http://financialmarkets.tspace.gov.au/

received regulatory approval to offer central clearing). In July 2013, ASIC finalised rules about trade reporting and licensed trade repositories, to be phased in over the next few years.

12. Financial Market Infrastructure and Competition Policy

An ongoing concern in both Australia and NZ financial sectors has been the issue of whether adequate competition exists in the banking sector – and in other financial markets where the four major banks also have significant involvement. The temporary demise of securitisation following the crisis was a major concern in this regard, since it removed the main source of prior competition which had been seen as reducing housing loan interest rate margins quite substantially over the preceding decade. While the major Australian banks took a modest hit to profit rates following the crisis (in both Australia and NZ), they quickly bounced back to return on equity figures generally in the upper teens.

Notably, the reorientation of bank funding preferences away from international wholesale markets and towards domestic (and particularly) retail deposits, has led to increased competition in those latter markets, with a consequent increase in interest rates paid (and only modest increase in total deposits). In both countries, retail term deposit rates have, since around 2009 exceeded equivalent maturity wholesale or government rates, and in both cases, resulting higher funding costs from both higher wholesale and retail funding markets was passed onto borrowers via increases in variable rate mortgage interest rates (Wong, 2012, Robertson and Rush, 2013). The resulting increase in mortgage rates relative to the official indicator, headline, overnight cash rates have increased public disquiet about lack of competition by banks reporting high profit levels.

Specific proposals introduced in the Competitive and Sustainable Banking System reforms announced in December 2010 included: introduction of bans on variable rate mortgage loan exit fees (from July 2011); requirement to provide Key Loan fact sheets on customer request from January 2012; allowing larger mutual building societies and credit unions to be rebadged as mutual banks (which some have since done); and requirements for banks to reduce impediments to account transfer by facilitating reassignment of direct credits and debits (from July 2012).

In NZ, several NBDTs have converted to bank status in recent years, and two Indian banks, with a focus on remittance business, have also entered. There are currently 22 banks registered, but the four major Australian banks dominate the market, with the fifth largest bank being less than 25 per cent of the size of the fourth largest. However, this bank, KiwiBank, was deliberately created by the government as a domestic competitor for the four main Australian banks. It is a subsidiary of NZ Post, which is a state-owned enterprise. It has focused on household and SME business and has a rapidly growing market share.

"[A]mendments to the Corporations Act 2001 were passed in Australia in December 2012 that give the government the power to impose mandatory central clearing, trade reporting or platform-based execution requirements" (Schwartz, 2013) to be implemented via recommendations of the regulatory agencies. In October 2012 mandatory trade reporting for OTC derivatives was recommended and mandated central clearing for major foreign currency interest rate derivatives recommended in July 2013 by the Australian regulators.

The RBA has introduced Financial Stability Standards for CCPs and Securities settlement facilities which are in line with CPSS-IOSCO principles and which took effect from 29 March 2013. The CFR has recommended "step-in" powers (appointment of a statutory manager) for ASIC and the RBA over a troubled FMI, although this remains to be implemented.

Reflecting concerns regarding safety of client investments in managed investment schemes arising from experience in the financial crisis, AISC has produced recommendations for improved practices for custodial and depository organisations.

Competition Market Integrity Rules were implemented in October 2011 to facilitate cash equity market competition. These relate to volatility controls, automated trading, dark liquidity etc., aimed at preventing entry of anomalous orders and reduced transparency due to dark pools. Chi-X commenced operations as an alternative trading platform in August 2011 and had achieved around 15 per cent of market trading share by mid 2013. However, the CFR in its review of the cash equity market determined that at this stage there was no case for allowing new entry of a CCP, but to be reviewed in 2015 based on implementation of a code of practice by the ASX.

The RBNZ is systematically looking at all areas of its responsibilities and checking its powers and preparedness against the principles being produced by the standard setters in the FSB-BIS framework and the IMF advice. It is currently looking at payment systems and concluded that its powers of direction are in adequate compared with the international practice.[25] While there are currently no central counter parties in derivatives markets they have decided that they need greater powers to be able to regulate and encourage them. As a

[25]Reserve Bank of New Zealand (2013) .

new organisation, the FMA is still reviewing the areas of its responsibilities and has been exercising its powers of enforcement, which were a substantial weakness in the previous regime, where the Securities Commission's scope for action was decidedly limited.

13. Macroprudential regulation and Systemic Stability

While none of the local banks have been designated as G-SIBs (and none of the local insurers as G-SIIs) it is generally expected that at least the four major banks will eventually be designated as D-SIBs. APRA is expected to produce draft policies in early 2014 (Schwartz, 2013). While there is increased attention being paid to the network structure of the financial sector and implications for systemic stability, there has been no explicit interest expressed by governments or regulators for initiatives (such as forms of structural separation of banks) which might affect system stability. In NZ, some such initiatives were introduced some years ago via requirements for separately capitalised subsidiaries of international banks operating domestically, and for outsourcing and IT arrangements with the Australian parent banks to be structured such that local operations could continue to operate independently in the event of the parent encountering trouble. In Australia, the ability for banks (and other prudentially regulated institutions) to operate within a Non-Operating Holding Company (NOHC) framework has existed for some years. While several groups have adopted such a structure (Macquarie, Suncorp), none of the four majors has proceeded down that path. Whether the structural separation of activities achieved under such a framework would reduce risk spillovers between the various activities of the group is an open question.

The Australian regulators are proceeding cautiously with regard to the introduction of CCP requirements, recognising the potential for benefits of such multilateral clearing for some derivatives to be reduced by a reduction in bilateral clearing economies across a wide range of derivatives.

The NZ authorities have proceeded down the road of introducing new instruments for system stability reasons. From October 1, 2013, banks are to be restricted to having no more than 10 per cent of new housing loans with loan to valuation ratios (LVRs) of over 80 per cent. Other macro-prudential tools noted in a May 2013 memorandum of understanding between the RBNZ and the Minister of Finance (requiring the RBNZ to consult, but being able to make independent decisions) include changes to the core funding ratio, countercyclical capital buffers, and adjustments to sectoral capital requirements. The countercyclical capital buffer is expected to be available as a macro-prudential tool by January 1, 2014 (RBNZ Financial Stability Review, May 2013).

14. Supervisory Practices - International Cooperation, Regulatory structures, Supervisory incentives

Given the dominant role of the four major banks, one of the main aspects of international cooperation relevant to the two countries is the Trans-Tasman Council on Banking Supervision which was established in 2005 and upgraded in 2010 with the signing of a memorandum of understanding regarding dealing with responses to distress of a trans-Tasman banking group. The memorandum does not lay down any specific practices but rather a set of principles including ensuring cooperation and consideration of impacts on financial stability in each country.

In both countries, the regulators appear to be committed to compliance with international core standards and principles.

There is activity in terms of cross border cooperation, particularly with the Asian region. At the recent (October, 2013) APEC meeting, progress on an Asian Funds Passport (similar to the UCITS model) was announced involving Australia, South Korea, New Zealand and Singapore. Mutual recognition arrangements for securities issues have also been in existence between Australia and New Zealand since 2008.

Mutual Assistance in Business Regulation Regulations 1992 (MABRA) amended in December 2012 to enable ASIC to better assist foreign regulators on supervisory matters, and further amendments in progress to enable assistance with multi-jurisdictional regulators.

15. Conclusion

The Australasian financial systems were not as heavily challenged by the financial crisis as those of the northern hemisphere, and stress tests conducted subsequently suggest that they remain able to cope with shocks of the type underpinning the financial crisis. And the regulators in both countries, with notable exceptions in some areas, have been quick in complying with the global regulatory agenda aimed at mitigating the impact of similar shocks in the future. Both countries, for example, have moved in advance of the requirements of Basel III to improve capital and liquidity buffers, although the regulators appear wedded to reliance on the opaque risk-weighted measures, rather than giving more emphasis to a leverage ratio limit. But escaping the last crisis should be no cause for complacency as to whether there are other potential weaknesses in the financial structures which have not yet been exposed. There are two main areas of relevance in this regard.

First, while the authorities in both countries have sought to extend regulatory coverage across the whole of the financial system in the light of international recommendations and recognition of existing weaknesses, the regimes still rely on disclosure and market discipline to a greater extent than in many OECD countries. The tendency for light touch regulation is particularly strong in New Zealand, and both countries score poorly on international league tables for protection of investors in managed funds. This may not have systemic stability implications, given the currently small size of unregulated shadow banking in both countries, but determining appropriate levels and mechanisms of protection for individuals in their dealings with the financial sector is an ongoing agenda issue. The significant growth of self managed super funds in Australia raises particular problems in this regard.

Second, while there has been concern, on competition grounds, about having financial systems dominated by a small number of banking groups operating across virtually all parts of the system, there has been relatively limited attention paid to the implications for financial stability. And there has been even less discussion of whether there is merit in interventions to "ring fence", circumscribe activities of, or structurally separate, banks on financial stability grounds. Whether attempting to "reshape" the financial system, rather than simply accepting and regulating the existing (and evolving) structure is a debate yet to be had.

More generally, the massive ongoing growth in superannuation in Australia (and to a lesser extent in NZ) is reshaping the structure of the financial system towards a larger role for managed funds and capital markets relative to traditional intermediation. With similar forces arising from the global regulatory agenda, there are new risks likely to emerge and yet to be identified from the changed interdependencies within the financial system.

While Australia has joined the deposit insurance "club" (although its depositor and deposit insurer priority structure involves significant design differences not always appreciated), New Zealand is becoming more isolated on the topic of deposit insurance. The combination of this with Open Bank Resolution and no depositor preference has the potential for considerable financial instability in the event of any serious threat to the main four banks. Following Australia and the rest of the OECD in providing explicit insurance would be a low cost means of extending public confidence and would help offset the rise in the cost of capital that RBNZ expects OBR to cause.

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APPENDIX 1: HEDGE FUNDS and ETFs in Australia

The ASIC (2013) report on Hedge Funds identified 603 hedge funds (including fund of funds) and noted that their share of managed funds was only 3.1 per cent of the total in 2013, half managing less that $50 million and only 8 managing more than $500 million. Hedge funds in Australia come under the disclosure requirements of the Corporations Act, and also the Managed Investments Scheme regulation if offering to retail investors. This requires a product disclosure statement (PDS) and ASIC has outlined characteristics of managed funds which would lead to them being regarded as hedge funds. For such entities, short-form PDFs are not permitted, and an "if not why not" disclosure approach applies ASIC (2013, RG240). Much of the disclosure regime is focused upon offerings to retail investors – and most do not, with around10% of hedge fund investments coming from retail investors.

In March 2012, ASIC released a report on regulation of exchange traded funds (ETFs), a product which has grown substantially and is popular with retail investors. The ASX introduced new rules (referred to as the AQUA rules) in 2008 enabling ETFs and other products to be issued by other than a listed entity, provided the price of the product was effectively market determined and the value of underlying assets is not under the control of the issuer. (However, the main ETFs introduced before that date are listed under the Listing Rules and are CHESS depository instruments).