

G20 Toronto Summit and the  
Regulatory Reform Agenda  
June 2010

# How is your business navigating the G20 change agenda?



What would you like to change?

PRICEWATERHOUSECOOPERS 

## Overview

A key message from the leaders at the G20 Summit in Toronto was that much has been achieved but there is still plenty to do.

At the June 2010 G20 Summit in Toronto the world's leaders evaluated progress in the regulatory reform agenda. With much still to be done they pledged to continue to act together to achieve the reform agenda within the agreed or accelerated timeframes. The next six months will be crucial in shaping the post GFC regulatory landscape with consistency and timely implementation continuing to represent major challenges.

The BCBS December 2009 proposals had indicated that full implementation of the enhanced capital and liquidity standards should be achieved by the end of 2012. On the face of it this timeframe remains intact, although some flexibility has been introduced at Toronto. Leaders acknowledged that transitional provisions informed by macroeconomic impact assessment and differing national starting points and circumstances may be necessary to protect the ongoing economic recovery. This does raise the prospect of inconsistent application of the new standards between countries in the early years.

## The Australian perspective

Given the reform agenda remains firmly on track, the challenges facing Australia and our banks remain largely unchanged.

Implementation is entering a critical stage. A large number of international standards and requirements will be finalised during the second half of 2010, even if economic circumstances and other implementation challenges result in phased implementation. Two key messages emerge:

1. Hopes of a lengthy and significant transition phase have not been encouraged by the summit outcomes, especially given our relative economic strength and our sophisticated regulatory framework.

Australian banks will want to ensure that if Australia remains at the vanguard of implementation, this does not place them at a disadvantage to their global peers.

2. It may be tempting to wait for all the answers but as the timetable included in this article quite clearly demonstrates, the impact of the changes will be pervasive, touching the fundamental economics of many activities as well as key systems and business and risk management processes.

Successful implementation for both banks and the financial system as a whole will depend on a thorough understanding of the requirements and the effect on the bank's business model, and on quality change management.

## The Reform Agenda

The Toronto Summit Declaration appraised progress in the reform agenda for each of the four reform pillars.

### Pillar 1 Strong Regulatory Framework

Global Regime for Bank Capital and Liquidity - Final framework to be agreed at Seoul Summit in November 2010

- Outcome of Quantitative Impact assessment in July will determine both the final framework and the transition horizon for implementation.
- Confirmed support for a leverage ratio which achieves international comparability after adjusting for accounting differences.

### Financial Markets Infrastructure

- Committed to reducing the reliance on external ratings in rules and regulations.
- Re-emphasised importance of achieving a single set of high quality global accounting standards.

### Pillar 2 Effective Supervision

- FSB to make recommendations to next Summit on the operational mandate, capacity and resourcing of supervisors and specific powers to be adopted to proactively identify and address risks including early intervention.

### Pillar 3 Systemically Important Financial Institutions (SIFIs)

#### Resolution of SIFIs in Crises

- Agreed to develop concrete policy recommendations to address problems associated with systemically important financial institutions.
- Committed to implement domestic resolution powers and tools in a manner that preserves financial stability.
- Committed to the 10 key recommendations on cross-border bank resolution issued by BCBS in March 2010.

#### Addressing SIFIs

- Continue developing robust institute specific recovery and rapid resolution plans for major cross border institutions by the end of 2010.
- Agreed financial sector should shoulder the burden of intervention, with a financial levy being but one policy option.

### Pillar 4 Transparent International Assessment and Peer Review

- Pledged continuing support for robust and transparent peer reviews which are fundamental in making the financial sector safe for all.

# Financial Sector Reform

Legend ■ Issued  Pending  Anticipated  Deadline

- G20

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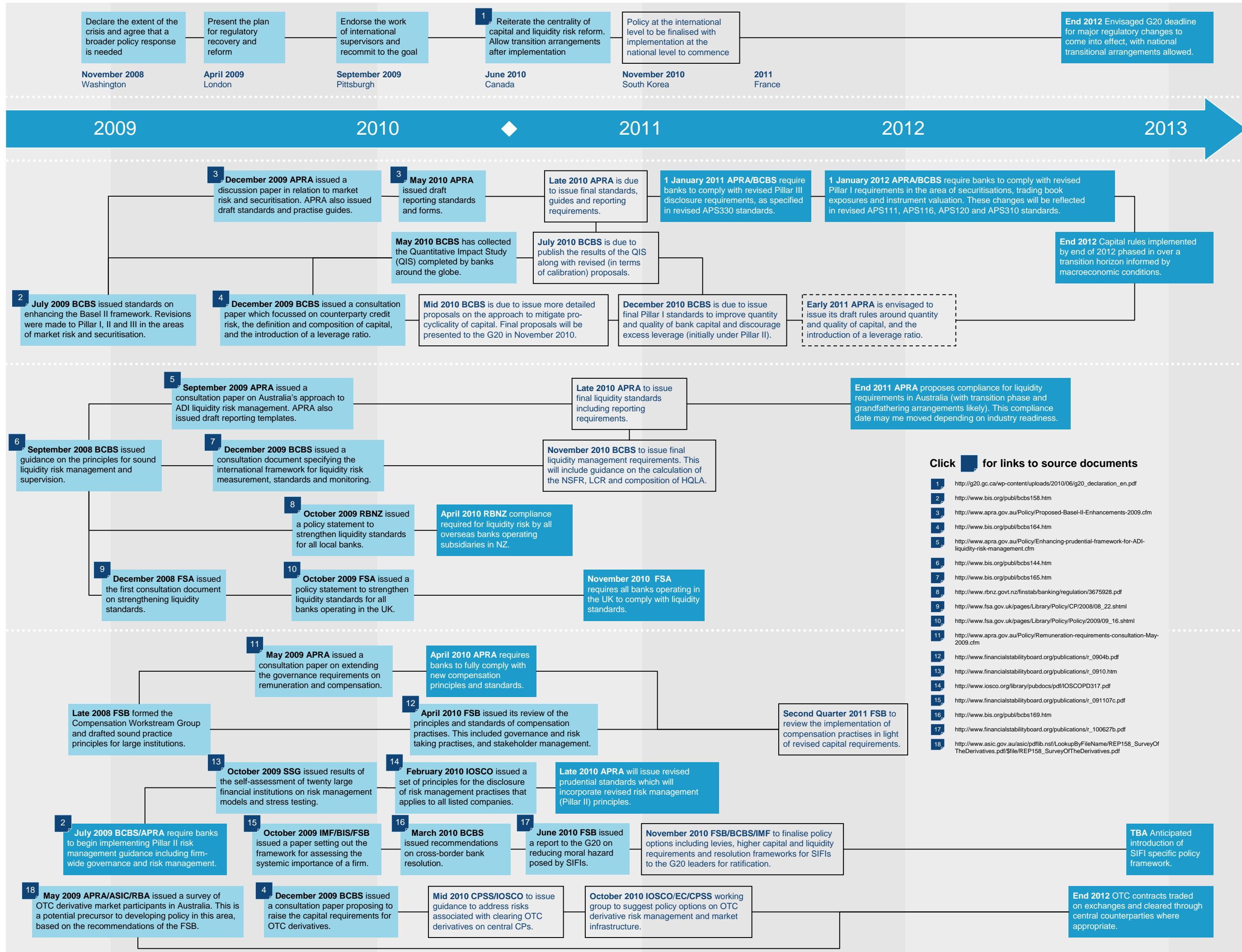
- Capital  
Pillars I and III  
Leverage ratio

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- Liquidity  
Going concern (NSFR)  
Market Disruption  
Name crisis (LCR)

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- Financial system resilience  
SIFIs  
Remuneration  
Risk management/Pillar 2  
OTC Infrastructure



Click ■ for links to source documents

1. [http://g20.gc.ca/wp-content/uploads/2010/06/g20\\_declaration\\_en.pdf](http://g20.gc.ca/wp-content/uploads/2010/06/g20_declaration_en.pdf)
2. <http://www.bis.org/pub/bcbs158.htm>
3. <http://www.apra.gov.au/Policy/Proposed-Basel-II-Enhancements-2009.cfm>
4. <http://www.bis.org/pub/bcbs164.htm>
5. <http://www.apra.gov.au/Policy/Enhancing-prudential-framework-for-ADI-liquidity-risk-management.cfm>
6. <http://www.bis.org/pub/bcbs144.htm>
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12. [http://www.financialstabilityboard.org/publications/r\\_0904b.pdf](http://www.financialstabilityboard.org/publications/r_0904b.pdf)
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## Overview and timelines

In December 2009 the BCBS proposed changes aimed at strengthening global capital requirements which, together with the market risk capital package issued in July 2009, formed their response to lessons learnt from the GFC. So far APRA has published two discussion papers in response to the July 2009 BCBS market risk capital package, with final standards and reporting forms expected later this year. Implementation is expected by the end of 2011 in line with BCBS' timetable. Implementation of the global capital requirements is still set for the end of 2012, with the transition horizon being informed by the macroeconomic impact assessments being completed by the FSB and BCBS. Phase-in arrangements will reflect differing national starting points and circumstances.

## Proposed changes

### Market Risk Capital

- Increased level of "risk weighted assets" (RWA) relating to trading activities by up to 150%, with structured credit and credit derivative operations being hardest hit as a result of:
  - additional stressed VaR to take account of severe market disruption
  - an incremental capital charge to cover the risks of credit migration and a loss of liquidity in trading positions for banks modelling specific risk
  - increasing the capital charges for any exposure to securitisation / re-securitisation vehicles.
- Risk management to more closely monitor risk, particularly banking / trading book classifications.
- Expand Pillar 3 disclosures around the risks associated with trading and securitisation activities.

### Capital

- Raise the quality, consistency and transparency of the capital base:
  - stricter rules on eligibility of instruments included in (fundamental) Tier 1 capital. APRA has already begun phasing out non-eligible innovative Tier 1 instruments
  - internationally consistent capital deductions
  - harmonisation of regulatory definitions and adjustments to common equity. APRA already adopts a relatively conservative approach in this area.
- Increased public disclosures of the regulatory capital base, reconciled to financial statements.
- Strengthening counterparty credit risk requirements arising from derivatives, repos and securities financing. Additionally, encouraging participants to move OTC contracts to central counterparties and exchanges.
- Introduce forward-looking provisioning, increase use of capital buffers and 'downturn Probability of Default' (PD) in calculating credit risk, to reduce pro-cyclicality and ensure sufficient capital for periods of severe disruption and economic downturns.
- Introduce a non-risk based, internationally comparable Leverage Ratio (asset : equity multiple) to supplement risk-based capital requirements. Whilst not yet quantified by BCBS, other jurisdictions such as Canada and Switzerland already have ratios in the range of 3% - 5%.

## Impact on Australian banks

These changes are expected to touch all areas of the bank and for some businesses the impacts have the potential to be significant:

- Financial markets operations will require more capital as a result of the **increased capital charges** arising from **market risk** stressed VaR and securitization exposures.
- Corporate/institutional banking businesses will require **more capital** as result of increased **counterparty credit risk** for derivatives, repos and securities financing.
- All lending will require **more capital** as a result of using **downturn PDs**.

The introduction of a non-risk based **leverage ratio** could further **increase the amount of capital** required across all operations.

Banks may also need to hold **more capital to absorb increased deductions** for intangibles, minority interests and adjustments to provisioning. Apart from provisioning, the tightened rules around deductions are not expected to cause major issues for Australian banks due to APRA's current conservative approach.

A further challenge for banks already grappling with blow outs in funding costs resulting from expanded credit spreads on debt instruments and a shortage of deposits in the system is the **trend towards common equity** as eligibility criteria for Tier 1 instruments are strengthened, **increasing the average cost of capital**.

The combined effects of more capital and increased average cost of capital may translate into **price rises for customers** and see banks **reassessing business strategies**

**Investment in systems and processes** to provide the data and information will be necessary to meet the increasingly onerous governance and disclosure requirements.

Whilst many of the changes are significant and the challenges can not be under estimated, the Australian banks are still better placed than many of their global banking counterparts which have highly leveraged capital structures and large exposures to trading and structured securities markets.

## Overview and timelines

In December 2009 the Basel Committee (BCBS) proposed changes to strengthen the liquidity risk management framework, and introduce quantitative standards for funding liquidity. Many commentators (and banks) support the principles behind the reforms – strengthening bank resilience to liquidity and funding stresses. It is the calibration of the reforms which is key. Too light, and nothing will be achieved. Too much, and the reforms can damage banks' ability to lend, and potentially affect the timing and strength of the global economic recovery.

## Proposed changes

- Extension of the 5 day “name crisis” stress test to 30 days: Both APRA and the BCBS have proposed a liquidity coverage test, designed to ensure banks can survive a significant level of stress for one month. The stress assumptions set by APRA are expected to broadly converge with those used overseas.
- Introduction of a 3-month stress test: This is an APRA-only proposal, and designed to test bank resilience to the withdrawal of offshore wholesale funding from the Australian market.
- Introduction of a 1 year structural Net Stable Funding Ratio (“NSFR”): Proposed by Basel, and expected to be adopted by APRA, this measure is designed to promote greater use of stable and long term funding.
- Extending the APRA ‘going concern’ cash flow projection requirement from 1 to 12 month. It will now be applied to all ADIs, regardless of the size and nature of their operations.
- There will be significant restrictions to the eligibility of liquids assets banks may count towards these more onerous stress tests.
  - “Liquids” may only comprise sovereign and semi-sovereign bonds; however the eligibility may be expanded to include other instruments from other issuers for a limited portion of the portfolio.
- APRA’s has also adopted measures consistent with the BCBS Principles for Liquidity Risk. These include requirements for detailed Board-approved liquidity risk appetite statements, and the inclusion of liquidity costs in product pricing. APRA proposals also include the introduction of a standardised reporting framework covering both regular liquidity data and crisis reporting.
- A common theme in APRA and overseas liquidity regulation is that of “self sufficiency” for foreign subsidiaries and branches. They will not be able to rely on undrawn facilities from parent entities, even if contractually enforceable.
- The Minimum Liquidity Holdings (MLH) regime will be retained, but restricted to small retail-based ADIs.

## Impact on Australian banks and financial system

The proposals point to the strong intent of regulators to use liquidity requirements to push banks away from business models that are perceived as generating a cost to society and the public purse.

Much attention to date has been on the impact of holding **larger buffers** of lower yielding “liquids”, driving up bank liquidity costs, with borrowers bearing the immediate costs, and savers reaping the rewards.

This impact on banks (and customers) will be amplified by the **scarcity of liquids** - increased demand for government bonds (in excess of the supply) together with reduced investor appetite for bank paper will distort financial markets.

As a result traditional **government bond investors may be priced out of the market** and forced to increase their risk appetite to maintain yields. The government bond market is also an important reference rate and any distortions reduce capital markets transparency.

Attention is now turning to the effects of the NSFR. The implications go far beyond the financial sector, and banks and corporates alike will be competing for a limited pool of increasingly expensive term funding.

There may come a point where **banks have to restrict lending volumes**, or reduce asset maturities, to balance the NSFR. This will have a knock on effect on economic growth.

Banks will be **constrained from playing their traditional “maturity transformation” role**. The result may simply be the transfer of funding and liquidity risk to the corporate sector - rather than the elimination of the risk.

In order to achieve compliance with new prudential and reporting requirements for liquidity most banks can expect **significant technology spend** given the extensive additional data requirements.

# Systemically Important Financial Institutions

## Overview and timelines

One critical objective of the global reform initiatives is to mitigate the risk of shocks being transmitted across the financial system through “systemically important financial institutions” (SIFIs) without tax payers bearing the burden. The FSB has been tasked with developing final policy recommendations by November 2010.

## Proposed changes

- Reduce the probability of a SIFI failing. Options being discussed include capital and/or liquidity surcharges, requirements to use contingent capital and potential limits to size, complexity and/or riskiness of institutions.
- Develop effective resolution plans “living wills”. Policy is expected to include strengthening national resolution powers, cross border execution and firm-specific contingency planning.

## Impact on Australian banks

Assuming Australian banks are not considered systemically important on a global level, they could benefit in the event that capital and liquidity surcharges are imposed on global SIFIs.

# OTC Derivatives

## Overview and timelines

G20 leaders reaffirmed their objectives that OTC derivative contracts should - where possible - become standardised, centrally cleared and traded on exchanges or electronic platforms and reported to trade repositories by December 2012. Consistent global implementation of underlying policy changes remains a crucial challenge in order to prevent regulatory arbitrage.

## Proposed changes

- Guidance for central counterparties and trade repositories in OTC markets was published in May 2010.
- A working group has been established to set out policy options promoting the use of standardised OTC products. Recommendations will be made to the FSB in October 2010.
- BCBS has proposed capital penalties for trading in OTC derivative contracts, creating strong incentives to move such contracts to central counterparties.

## Impact on Australian banks

The scale of activity and magnitude of outstanding exposures in the Australian OTC derivatives market are relatively low by international standards. As a result of increased international regulatory scrutiny we expect the following emerging themes:

- a continued shift to ‘vanilla’ business and improved execution of standard documentation
- a continuing trend towards collateralisation of exposure (CVA) and other measures to limit counterparty risk
- a shift towards straight-through processing and centralised third-party platforms.

# Risk Management (Pillar II)

## Overview and timelines

The final BCBS enhancements from June 2009 included guidelines in regard to the Pillar 2 framework. Before and during the financial crisis regulators observed a gap between regulatory expectation around Pillar 2 interpretation and actual bank practice. APRA made clear that it expects ADIs to have regard to the supplemental Pillar 2 guidance immediately while indicating that some of those aspects may get incorporated into prudential standards at a later stage.

## Key points

- Accountability of the board and senior management for setting and monitoring a comprehensive risk tolerance and implementing a fully embedded “risk culture”.
- Need for risk management to consider how individually immaterial risks may combine to create material losses (eg credit concentration risks).

## Impact for Australian banks

- Further enhancement of stress testing framework and tools to become more dynamic and integrated across risks.
- Gearing up risk control units and increase CRO status.
- Find ways to assess the strength of risk culture and if necessary demonstrate progress over time.

# Addressing the impact of the regulatory reform agenda

What do you need to consider now in order to ensure that your organisation is well positioned to withstand the tidal wave of regulatory reforms? A successful response requires a clear understanding of the proposed changes in the context of the whole organisation – strategy, governance, risk, financial management and core operations and activities.

	Key questions	Key success factors
Core Business Strategy	What is the impact of revised regulatory capital and liquidity requirements on our businesses profitability?	Review overall business strategy in light of changing risk appetite, including funding and capital costs.
	Where are our areas of relative advantage and disadvantage compared with competitors?	Assess impact of changes on your bank's activities, relative to competitors.
	How will customers respond to price increases as a result of our increased capital and liquidity costs?	Segment potential customer response and resilience to availability and cost of credit.
Business Impact	How should our key business processes be re-engineered to ensure capital and funding utilisation is efficient?	Review future capital and funding plans with the appropriate business stakeholders.
	How should pricing respond to changing and more granular liquidity and capital requirements?	Review impact on risk-adjusted performance measures and transfer pricing.
	Are our risk management information systems robust and flexible enough?	Assess capability to meet onerous management reporting and public disclosure requirements
	What is the impact on the bank's IT strategy?	Integrate planning with existing IT projects such as replacement of core banking systems
Risk Appetite and Framework	What are the implications on the risk management framework and business operating models?	Re-assess the risk framework to ensure they clearly articulate risk appetite with strong measurement and monitoring processes across all businesses.
	Are our systems and controls around risk measuring, monitoring, management and reporting sufficient to meet requirement?	Review your models capability to reflect increased / more sensitive funding and capital costs in your product pricing.
	Does our existing governance framework and approach to risk management meet evolving expectations of supervisors?	Assess your needs for stress-testing, in particular more integrated cross-balance sheet stress testing.
Change Management	How do we address the speed, global reach and depth of change, impacting all parts of the bank?	Take a group-wide perspective to define, design and implement solutions.
	How do we manage the associated risks, with the very high cost of failure, eg. loss of license?	Ensure appropriate senior management sponsorship and oversight.
	Who are the critical internal stakeholders?	Objectives must focus on driving appropriate risk taking behaviours within the business.
	Which current infrastructure projects provide potential cross-dependencies and synergies?	Align the response with other strategic projects in the organisation.
	Are we familiar with ALL regulatory proposals in relevant jurisdictions we operate in?	Take a holistic view of regulatory change and formulate coordinated project streams.

At PwC we help our clients to [understand the potential impact for them](#).

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