THE FSI AWAKENS

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Legal Briefings – By **Steven Rice**

In order to provide certainty, banks and their advisers will need to pay particular attention to the loss absorbency and recapitalisation measures which were supported by the Federal Government in its recent response to the Financial System Inquiry. These measures were part of a number designed to increase the 'resilience' of the financial system.

The Federal Government also stated it supports APRA's increase in the average internal ratings-based (**IRB**) risk weights to 25% by July 2016. While this change to the IRB-based risk weights measure was communicated as a means of ensuring the financial system is more resilient, the only policy justification for this change given by the government in its Response is that the increase in the IRB risk weights will 'aid competition in the banking sector'. Given that an IRB-based approach is only available to banks with sufficiently robust risk management frameworks—with banks that do not have such frameworks being limited to the 'standardised' approach—it is curious that in terms of financial system resilience the government has supported an increase in capital requirements for IRB-based banks rather than considering whether risk management frameworks elsewhere could be enhanced.

The devil will be in the detail with regards to the government's endorsement of APRA's implementation of loss absorbency and recapitalisation measures. These will be undertaken to address the so-called 'too big to fail' problem and will undoubtedly include eligibility criteria for instruments which will be included for loss absorbing and recapitalisation capacity purposes. Setting of such eligibility criteria will be important to give banks ongoing certainty, and will be a matter that banks and their advisers will need to pay particular attention to as part of the consultation process. In respect of these measures, it is pleasing that the Response has endorsed APRA's implementation of this recommendation 'in line with emerging international practice'. Hopefully this will mean that Australian banks are not put at a comparative disadvantage to their international peers.

The government has endorsed a leverage ratio 'backstop', on the basis that such a ratio will address potential shortcomings in the existing prudential capital requirements. This ratio will need to be carefully addressed in order to ensure that its implementation does not have the effect of increasing financial system risk by advantaging other, less regulated, sectors.

The government’s commitment to ‘[c]onsult on measures to ensure financial regulators have the tools they need to manage any future financial crisis’ by mid-2016 is curious, given the existing consultation which has already occurred in this area. Treasury released an extensive consultation paper in December 2012 on this topic, and while the Financial System Inquiry noted that the existing consultation process on this topic has been paused due to the government’s deregulatory agenda, it is not readily apparent why any further consultation is needed.

KEY CONTACTS

If you have any questions, or would like to know how this might affect your business, phone, or email these key contacts.

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