

Philip Lowe: The Reserve Bank of Australia's regulatory responsibilities

Remarks by Mr Philip Lowe, Deputy Governor of the Reserve Bank of Australia, at FINSIA Regulators Panel, Sydney, 5 November 2015.

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I would like to thank FINSIA for the invitation to speak today. It is a pleasure to be part of this year's Regulators Panel.

The Reserve Bank's regulatory responsibilities lie in three general areas. First, along with APRA, we have a broad responsibility for stability of the financial system. Second, we have specific responsibilities for competition and efficiency in Australia's payments system. And, third, we have responsibility for prudential supervision of Australia's clearing and settlement facilities. This afternoon, I would like to say a few words about each of these three areas and some of the issues that lie ahead.

Financial stability – the importance of good quality data

First, the financial stability responsibility. Over recent times, much has been said about the risks in the Australian housing market, with the Reserve Bank publishing its latest analysis just a few weeks ago in the six-monthly *Financial Stability Review*. Rather than go over this ground again, I want to highlight just one issue: that is, the importance of high-quality data.

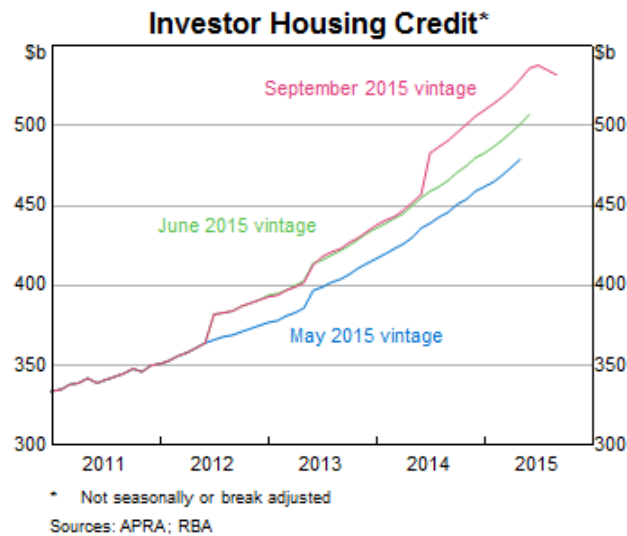
Now this might seem a rather obscure issue to highlight. But the basis of good analysis is good data. Improvements over time in the quality and comprehensiveness of the data on housing prices have, for example, helped improve the general understanding of housing market developments. In contrast, unfortunately, recent problems with the data relating to banks' owner-occupier and investor housing loans have worked in the other direction, complicating our understanding of what is going on in the housing market.

These data problems have emerged as lenders have taken a closer look at their housing loans following increased supervisory scrutiny. As lenders have looked more closely, what they have found has surprised and, to some extent, concerned us.

There are two issues that are worth drawing your attention to.

The first is that over the past six months there have been very large upward revisions to the value of investor loans outstanding, with offsetting downward revisions to owner-occupier loans. Material revisions have been made by more than 10 institutions, including two of the largest lenders. The scale of these revisions can be seen in Graph 1, which shows the stock of investor credit outstanding as reported in each of May, June and September this year. The cumulative effect of the upward revisions has been to increase the stock of investor credit outstanding by around \$50 billion, or 10 per cent. According to these new data, investor loans now account for 40 per cent of total housing loans outstanding, not the 35 per cent reported earlier in the year.

Graph 1



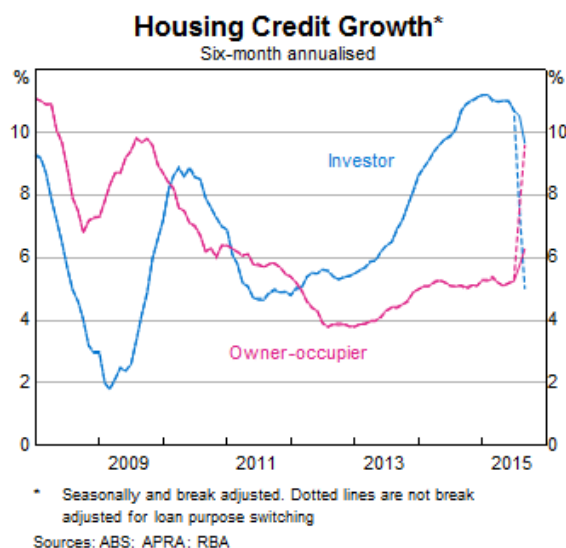
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While the reasons for some of these earlier errors have been identified, in other cases the reasons are unclear and lenders have not been able to provide comprehensive back data. As a result, when calculating growth rates for investor and owner-occupier credit, the RBA has had to make adjustments for what are effectively breaks in the series.

The second data issue has emerged over the past couple of months and has worked in the other direction, with lenders reporting that some loans that were previously recorded as investor loans were really loans to owner-occupiers. This is partly because, when faced with the higher interest rate on investor loans, some borrowers have indicated to their bank that they are not an investor, but rather an owner-occupier, and so should not have to pay the higher rate. Our liaison with lenders suggests that further reclassifications of this nature could be expected over coming months.

The effect of these recent reclassifications on measured growth rates can be seen in Graph 2. Taken at face value, the data suggest a very sharp slowing in growth in investor credit and a sharp pick-up in owner-occupier credit (shown as the dotted lines). However, if we make adjustments for these reclassifications then the changes in growth rates are much less pronounced (the solid lines).

Graph 2



[Click to view larger](#)

These various data problems have reinforced our view that the supervisory focus on investor lending has been entirely appropriate. And it is disappointing that some lenders' internal systems have not been up to the task of reporting accurate data on the split between investor and owner-occupied housing loans.

This issue was discussed at the most recent meeting of the Council of Financial Regulators, with Council members considering what steps could be taken to improve the quality of data. Among other things, it has been decided that APRA, the RBA and the Australian Bureau of Statistics will, next year, undertake a thorough review of the data collected from authorised deposit-taking institutions regarding their domestic books.

Payments system issues

The second area that I would like to touch on is the RBA's payments system work. Here, there are two issues of particular focus over the year ahead.

The first is the industry efforts to develop a new 21st century payments system for Australia. These efforts are, to a significant degree, in response to the RBA's strategic review of innovation in the payments system that was concluded in 2012.

While some aspects of Australia's payments system rank relatively well by global standards, the underlying architecture for some of our systems has aged and is limiting innovation. One example of this that many of you may be familiar with is that when you send a payment from your online bank account to another person or business you are limited to just 18 characters in describing the payment. The reason for this restriction is that the entire payment instruction – including the BSB, the amount, the banks involved etc. – is limited to just 120 characters. And the origin of this limit is the capacity of the magnetic tapes that were used to exchange information between banks and, before that, the capacity of computer punch cards with their 80 columns. In effect, our payments system in 2015 is still being constrained by the technology of earlier generations. So it is difficult to argue that this renewal of our payments system is before time!

The new system will allow Australians to transfer money to one another almost instantly, no matter where they bank. It will also remove the need to know somebody's BSB to make a payment; just a phone number or email address will be needed. And we will no longer be limited to just 18 characters in describing the payment; instead we will be able to send a wealth of information.

The industry is working hard on building this new system. It is a very significant piece of work, involving many hundreds of millions of dollars, and the timeline is relatively tight. But when finished, it is likely to form the backbone of many of our payment systems over the next few decades.

The RBA is closely involved in all of this work. It has played a major role in establishing the broad direction of the industry's efforts. It is building a core piece of infrastructure that will allow payments to be settled in real time. And it is also building the capability for our own customers – primarily the Australian Government – to use this new payment system.

The second area of focus over the next year is the ongoing review of the regulation of the card payments system. Earlier in 2015, the RBA released an issues paper inviting submissions on a broad range of topics in this area. A number of these were also discussed in the Financial System Inquiry (FSI).

The topic that has attracted most attention is the concerns about excess surcharging on credit cards. In its response to the FSI, the government indicated that it will ban excessive surcharging and give the ACCC enforcement powers. An important element here is to define what exactly constitutes 'excessive surcharging'. This is an issue the RBA will be working on over the months ahead. We will also be working closely with Treasury and with the ACCC as the necessary legislation is developed.

Another relevant topic is the appropriate level of the interchange benchmarks in the card systems and the compliance arrangements around those benchmarks.

We are continuing to consult on whether it is in the public interest for these benchmarks to be lowered. In terms of compliance, perhaps not surprisingly, the schemes have become increasingly adroit at maximising interchange fees while still complying with the benchmarks. We have seen interchange pricing become increasingly complex, with significant price discrimination between merchants. We have also seen the schemes introduce and promote new high-interchange, high-reward cards, with merchants typically having little, or no, visibility over the interchange fees that apply when a specific card is presented. How best to deal with these developments – including whether the compliance arrangements can be simplified and whether transparency of the system can be further improved – is an important ongoing element of our work.

Clearing and settlement facilities

The third area of our regulatory responsibilities that I want to touch on is the one area where the RBA still effectively acts as a prudential supervisor; that is for central counterparties and securities settlement facilities – two types of so-called financial market infrastructures (FMIs).

Since the financial crisis, the prudential regulation of these entities has taken on added focus, both in Australia and elsewhere. This reflects the critical role that these entities play in the smooth functioning of the financial system, with this role increasing following the agreement by the G20 nations to clear all standardised OTC derivative through central counterparties.

While, globally, the transition to central counterparties has been slower than was originally agreed, significant progress has been made. In Australia, the majority of new trades in standardised interest-rate derivatives is now centrally cleared. This shift has been supported by recently introduced regulations that provide for mandated central clearing of interest-rate derivatives denominated in Australian dollars and other major currencies for internationally active dealers.¹

Over the next year or so, the RBA's priorities for work in this area will include two key elements.

The first is the development of more robust crisis management arrangements for FMIs. The RBA currently sets standards that the FMIs it supervises are required to meet. These standards provide a high degree of assurance regarding the stability of these entities, but they don't rule out the possibility that they could experience severe financial difficulties, prejudicing the stability of the overall financial system. Given this, it is important that there are appropriate arrangements in place to deal with such an eventuality, should it ever arise.

The current arrangements in this area were considered by the FSI and have been under review by the Council of Financial Regulators for some time. In its response to the Inquiry, the Government endorsed the implementation of a framework to provide regulators with clear powers in the event that an FMI was heading towards failure. This is consistent with an existing proposal consulted on by the Government to make the RBA the resolution authority for central counterparties and securities settlement facilities based in Australia. Under the proposed arrangements, the RBA would be able to give formal directions and to intervene if severe financial stress of an FMI risked causing wide disruption to the financial system. One way that the RBA might do this is to appoint a statutory manager to operate the critical functions of the FMI for a period of time. This is similar to the framework that is already in place for banks and that is the responsibility of APRA.

¹ For a more detailed update on the progress of reforms, see Edey (2015), available at <http://www.rba.gov.au/speeches/2015/sp-ag-2015-10-22.html>.

Developing these arrangements for FMIs is a significant task. Changes in legislation are required and the RBA is developing detailed strategies and operational arrangements. These efforts are drawing on international work on resolution strategies led by the Financial Stability Board, as well as similar work that has been undertaken for banks.

The second, and related, priority relates to the growing threat to FMIs from cyber attacks. By their very nature, these entities are heavily dependent on technology and connections to external parties, and this dependency has increased over recent years. At the same time, the nature of cyber threats has rapidly evolved, with increasingly sophisticated methods being used by those attempting to cause disruptions.

The RBA is working closely with the FMIs it supervises to better understand their approach to cyber resilience. As part of this work, the RBA and ASIC asked the ASX to conduct a self-assessment of its cyber-security practices for the FMIs that it operates. This assessment concluded that the ASX's practices were generally aligned with the upper tiers of maturity levels under internationally used cyber security standards.² But this is an area that needs to be continually watched, and there is considerable work going at the international level, with the RBA closely involved in this work.

As a financial institution itself, the RBA also sees the increasing prevalence and sophistication of cyber attacks and has made its own very significant investments to address the risks. In the area of payment infrastructure, we are undertaking work to strengthen further the resilience of the Reserve Bank Information and Transfer System, commonly known as RITS. This system is owned and operated by the RBA and lies at the heart of Australia's wholesale payment system.

With those introductory remarks I look forward to participating in the panel discussion.

Thank you.

² ASX's high-level self-assessment was carried out against the United States National Institute of Standards and Technology Cybersecurity Framework.