Speech to Australian Prudential Regulation Authority leadership team

A speech by Greg Medcraft, Chairman,
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Australian Prudential Regulation Authority (APRA) leadership team meeting

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Introduction

Good morning everyone. Thank you for inviting me here today.

I want to use this opportunity to set out three things that I think would be of interest to you.

1. ASIC's strategy for the future and the approach we will take going forward;
2. The overlap of responsibilities between ASIC and APRA and how we manage them; and
3. The future shape of the securitisation market.

Strategy for the future

Having joined ASIC as a Commissioner in February 2009, I have seen how ASIC developed and changed under the direction of Tony D'Aloisio. Under my chairmanship, ASIC will continue with its current business priorities.

Consistent with our business priorities, we will focus on **three key outcomes**.

The first key outcome is to promote confident and informed investors and financial consumers. We want investors to be confident and informed when participating in our financial markets. Three areas of particular focus on this are:

1. **Education**: Investors taking responsibility for their investment decisions remains core to our system. But we need to arm investors with the necessary skills and knowledge so they can make informed investment decisions. The concept of diversification and the function of risk versus reward are paramount.

   ASIC's launch of the new website 'MoneySmart' will play an important role in financial consumer education. The internet is a powerful tool and in addition to websites, we will use new media, such as YouTube, to communicate our message to the public. We are also implementing the Helping Our Kids Understand Finance initiative. This involves embedding financial literacy in the national school curriculum from Kindergarten to Year 12 in over 6,000 schools. Combined, these measures will promote confident and informed investors and financial consumers.

2. The other side to promoting confident and informed investors is to focus on **gatekeepers** and I use gatekeepers in the widest sense of the term. This includes accountants, directors, advisors, custodians, product manufacturers, market operators and participants.

We need to hold them to account. I think that the recent Federal Court decision in our case against the Directors and former executives of Centro Properties Group is a clear example of the way ASIC can achieve this. Self-regulation also has an important role to play and ASIC can support this. We can encourage the development of industry standards to complement existing regulations. Industry standards can go beyond the legal minimums, particularly in areas such as ethics.

3. The final leg supporting confident and informed consumers is to focus on **consumer behaviour**: This involves recognising how investors and consumers make decisions. Communication with financial consumers is not restricted to product disclosure statements. Advertising plays a critical role and the use of communication channels other than the PDS needs to be considered.

   For instance, new media has given industry more interactive channels through which product distributers can contact consumers. Care must be taken when advertising to ensure the product is appropriate and suitable for the target audience.

The **second key outcome** that ASIC will focus on, is promoting fair and efficient financial markets. We will continue to do this through market supervision and surveillance.

And our **third key outcome** is the efficient registration and licensing of our stakeholders. In this, we will have a particular focus on small business.

The main factors guiding our approach towards the three key outcomes will be:

1. **Our legislative responsibilities** – These are what ASIC is required to do under the Corporations Act such as licensing, company registration, market surveillance, etc.
2. **Systemic or regulatory risk** – We are looking to promote resilience in our capital markets and, as Benjamin Franklin once said, ‘an ounce of prevention is worth a pound of cure’.
3. **The expectations gap** between what stakeholders expect and what ASIC is doing. The wider the gap, the greater the need for ASIC to take action; and fourthly
4. **Government policy objectives** – ASIC will implement Government policy and will take direction from the Minister.

ASIC will use **key drivers** to achieve our objectives. These drivers include:

- **Engagement with industry and stakeholders** – ASIC has stakeholder teams that are aligned to the various sectors of the financial economy, an approach similar to APRA’s with its front line teams. These teams are close to their stakeholders and have regular contact. ASIC also uses soft, or targeted, consultations in conjunction with formal public consultations, depending on the scope and timing of the issue.

- **Surveillance** – ASIC conducts reactive surveillances when an issue arises. But we are also highly focused on risk-based, proactive surveillance to check compliance and mitigate possible issues.
- **Guidance** – ASIC issues guidance in the form of ASIC Regulatory Guides, Information Sheets and Reports. We also support industry associations to provide guidance on how to comply with the law.
- **Education** – As I mentioned earlier, ASIC has a strong focus on investor and financial consumer education. But we also educate market participants and companies on how to comply with their legal obligations.
- **Deterrence** – We deter through enforcement actions. And we will continue to have the capacity and resolve to take on the big cases and pursue wrong-doers.
- **Policy advice** – Where there's a gap in the law or it needs strengthening, ASIC will provide policy advice to Government.

This focus on key outcomes and the drivers behind them will guide ASIC's activities in the years ahead.

Overlap with APRA

Under our **twin peaks regulatory system**, with APRA focusing on prudential supervision and ASIC focusing on conduct and disclosure, there is some overlap in our regulated populations.

For example, many ADIs are also Australian Financial Services Licence holders and may even be Australian Credit Licence holders. There is also overlap for superannuation, general insurance, and life insurance and friendly societies.

We sometimes have conflicting objectives. For instance, for ADIs, APRA's mandate is to protect depositors by working with the entity until it is back to full health. It would work 'behind the scenes' and not make a public disclosure. However, ASIC's mandate is to protect investors by disclosing any wrongdoing to the market and through disclosure generally. This could create tension in the regulation of products such as covered bonds, particularly in relation to the cover pool assets.

In order to ensure we have efficient regulation in the areas of overlap, it's **critical that our organisations communicate** with each other. And since the advent of the global financial crisis, I think we have become closer at all levels. For example, the Commissioners catch up from time to time over lunch.

We have **designated contacts** to facilitate communication:

- ASIC – Hillary Ray, Senior Lawyer in the Deposit Takers Credit and Insurers
- APRA – Louis Serret, General Manager, Enforcement.

We have a **memorandum of understanding** which covers issues such as:

- regulatory and policy developments;
- mutual assistance and coordination;
- information-sharing;
- unsolicited assistance; and
- international representation.

The MoU was updated in May last year to reflect ASIC's new structure and areas of responsibility regarding market surveillance and credit. The MoU sits with the Joint Protocol which was signed in June last year.

The **Joint Protocol** sets out an overview of the ASIC–APRA liaison structure, including the seniority of attendees and frequency of the meetings. Both agencies meet every 8 weeks for operational liaison meetings and enforcement liaison meetings.

These liaison meetings discuss:

- current projects;
- matters relating to dual-regulated entities; and
- requests for information to be shared.

Outside these formal procedures, I know that staff communicate face-to-face or by telephone on a regular basis. Both agencies are committed to a strong working relationship based on trust and ease of communication. Dialogue between the agencies might be initiated by a breach report received by one or both of the agencies, a customer complaint, or as part of an industry-wide project looking at a particular issue or product.

There are many examples of our organisations coordinating and working with each other and they include:

- **The Stronger Super proposal with Treasury**. The agencies have been involved with the working group consultation process run by Treasury and they regularly liaise in relation to these areas of potential reform including in relation to trustee governance and the proposed MySuper reforms.

- Ongoing discussions about the **dual regulation of superannuation trustees** who are RSE licensees and also responsible entities of registered managed investment schemes. We are working to identify any regulatory gaps in our dual regulation of these entities. We are exchanging information to understand the practical implications of the legislative exclusions as well any implications arising from regulatory change for superannuation trustees.

- Ongoing discussions about **consistency of capital requirements** for our regulated communities, including responsible entities, superannuation trustees, insurance companies and conglomerates. ASIC has recently consulted on the financial resource requirements for responsible entities. APRA is currently contemplating the capital requirements for superannuation trustees, insurance companies and conglomerates. This presents us, as regulators, with a unique opportunity to achieve as much consistency as is practicably possible in relation to the capital requirements for the majority of our regulated communities.

ASIC is conscious of the need to communicate with APRA in relation to particular dual regulated entities where appropriate, and appreciates APRA's willingness in the same way.

For example, for **ASIC's risk-based surveillance of the investment banks** who are AFSL holders and also ADIs, the relevant teams within each organisation have been working very well together. Before ASIC conducts its review, APRA shares background information about the entity, particularly any cross-over issues or risks. As the review is conducted, general themes arising from the reviews are shared at the operational liaison meetings. And finally, when the review is complete, ASIC shares its specific findings with APRA.

Another area of cooperation between the organisations is the use of **secondments**. There have been three secondments between ASIC and APRA in the last four years. These secondments have been useful in:

- raising the level of understanding of the other's activities and operational processes; and

- providing an increasing pool of staff in each regulator that have close contacts with their former colleagues in the secondee organisation.

I believe there is now a habit and practice of:

- engaging with the other regulator before regulatory actions are taken;

- notifying, discussing and jointly planning supervisory activities;

- discussing which regulator is the most appropriate to investigate certain matters or take particular action
- if necessary, modifying original timetables to accommodate the other regulator; and
- coordinating day-to-day operations, especially in special circumstances.

I think the GFC has increased the level of cooperation between ASIC and APRA and I will be encouraging the co-operation to continue.

Future shape of securitisation

I will now share with you my thoughts on the future shape of the securitisation market.

Regulators around the world are trying to **restore confidence and promote a sustainable and resilient securitisation market**. This is because securitisation is seen as critical in supporting the provision of credit to consumers and businesses. The IMF has said ‘it is important to recognise the many benefits associated with sound securitisation. Given the pivotal role of securitisation as an alternative and flexible funding channel, failure to restart securitisation would come at the cost of prolonging funding pressures on banks and a diminution of credit.’

ASIC is co-chair of the **IOSCO Task Force on Unregulated Financial Markets and Products** which has made recommendations designed to improve confidence in the securitisation markets.

The recommendations cover:

- enhancing disclosure;
- implementing ‘skin in the game’; and
- encouraging international cooperation toward convergence of national regulations.

These recommendations have been supported at the FSB and G20 levels.

I want to clarify a point on **skin in the game** which is often misunderstood. Skin in the game is not intended to be a capital buffer to protect investors from losses. Rather, it is intended that originators and sponsors should share in the losses suffered by investors, if any occur. This is an incentive for originators to implement appropriate underwriting and servicing standards. It addresses the misalignment of incentives issue inherent in the originate-to-distribute model by aligning the originator and sponsor's interests, with those of investors.

ASIC has been designing the skin in the game requirement so that it does not interfere with APRA's prudential supervision. It should not preclude capital relief under APS 120. We are aiming for regulatory alignment with other jurisdictions while taking into account the characteristics of our market.

While regulators have been pushing the market in a certain direction with these proposed reforms, investors have been pulling the market in the same direction. The collapse of the securitisation markets globally has shifted the balance of power so that securitisation markets are now investor-driven.

This means that the **market is already reshaping**, even before regulatory intervention has taken effect. Investors are demanding better disclosure, or transparency of collateral, and many deals already have skin in the game.

However, there are some **structural issues** which are preventing the securitisation market from becoming a sustainable market. We have lost half the investor base in the Australian market with the disappearance of conduits and SIVs. In order to resolve this structural issue, new investors are needed.

Bullet maturity bonds in the mortgage sector could widen the investor base as they attract a different class of fixed income investors. These investors want more certainty in the timing of the repayment of principal and are often restricted to investing in bond indices such as the UBS Australian Composite Bond Index.

Bullet RMBS was mentioned in the Government's Banking Package last December to promote access to funding by smaller lenders. And ASIC will assist Treasury where appropriate.

We have seen a number of recent deals which have bullet tranches and this will need to continue if we are to develop this market. In the interim, the investor confidence is being addressed through disclosure and skin in the game.

The US mortgage securitisation market will also reshape. It will survive because there are market pressures for it to exist. There's not enough capital in the banking sector alone to support the mortgage market.

However, the mortgage market won't recover until the housing market bottoms out. They need structural change in order for the market to recover, and this is through the withdrawal of government support of Fannie and Freddie.

I also see US MBS moving to the classic corporate bond model of bullet maturity and inclusion in an index.

As part of the reshaping of the market, I think the **incentive to securitise will shift from capital arbitrage to funding diversity**. It will become an alternative to covered bonds, which don't achieve off balance sheet treatment or capital relief either.

Going forward, I think securitisation structures will reduce the credit dependence on the servicer. And as the credit ratings of banks fall, securitisation becomes more attractive over covered bonds, since cover pools will need greater over-collateralisation to achieve a AAA rating.

Conclusion

I hope I have given you an overview of ASIC's strategy for the future, how our organisations deal with overlaps in regulation and the future shape of the securitisation market.

ASIC will continue with its current priorities and focus on three key outcomes:

1. Confident and informed investors and consumers;
2. Fair and efficient markets; and
3. Efficient registration and licensing.

ASIC and APRA should continue our close relationship. Where our activities overlap, our actions should be complementary. We must maintain regular dialogue and communications.

And finally, regulators are focused on restoring confidence in the securitisation market and promoting a market that is sustainable and resilient. Investors are driving the market, but structural issues still remain. The bullet bond market will need to grow in order to broaden the investor base.

Thank you for your time.