3

Financial System Stability

Year 2000 problem (Y2K)

3.1 The Reserve Bank's most recent annual report defines the Y2K problem as:

> A pressing operational risk for banks … which arises because some computer hardware and software will be unable to deal correctly with dates beyond 31 December 1999. Left unchecked, the problem would threaten dislocation within banks and in their dealings with customers and counterparties, with potentially serious disruption to the financial system...[1]

3.2 The Bank began work on the Year 2000 problem in 1996, and in 1997 a Year 2000 Project was formalised and a set of milestones was agreed.[2] In 1997 an Interbank Working Group (IWG), including the four major banks and the Reserve Bank, was established to address Y2K issues affecting the banking community.[3] This working group, together with the Australian Payments Clearing Association (APCA), has been coordinating a program of testing of each of the major payment streams since October 1998. [4]

3.3 The IWG works closely with a Y2K coordination group set up by the Council of Financial Regulators ,which includes the Reserve Bank, the Australian Securities and Investments Commission, the Australian Prudential Regulation Authority (APRA) and the Australian Financial

---

1 *Reserve Bank of Australia 1998 Report and Financial Statements.* Sydney, RBA, p 9.

2 RBA and APRA, *Year 2000 Preparations in the Australian Banking and Financial System July 1998,* p 21. The milestones are elaborated in the RBA annual report on page 58.

3 Ibid., p 15.

4 *Reserve Bank of Australia 1998 Report and Financial Statements.* Sydney, RBA, p 59.

Institutions Commission. The Y2K coordination group met for the first time in August 1998.[5]

3.4 In July 1998 the RBA and APRA released a booklet entitled *Year 2000 preparations in the Australian banking and financial system* and in January 1999 the Council of Financial Regulators published an updated version of the booklet, which outlines the activities of all Council members and the Y2K preparations being undertaken by regulated institutions.[6]

3.5 According to the latest booklet, the RBA Year 2000 Project has progressed largely to schedule: the inventory, assessment and renovation phases are now complete, and testing and implementation phases are 95 per cent complete and signed off.[7] Testing in the payments system is subject to compliance with external testing dates set by the APCA.[8] The RBA has begun a review of likely Y2K risks and cost effective solutions to augment its existing control framework, and the end of September 1999 is the deadline for the establishment of contingency plans for all critical systems and processes.[9]

3.6 The RBA is supplementing its normally significant buffer stocks of notes to meet any additional demand for currency notes in the lead-up to the Year 2000.[10] As the Governor explained to the Committee in December 1998, the Bank is both printing more notes, and not destroying old notes to build up a stockpile for possible use.[11]

3.7 At the December 1998 hearing, the Governor said it was possible that in the lead up to the year 2000 there could be concern about disappearing bank balances,[12] and that it was important to have an educational campaign to counter irrational community fears about Y2K.[13] At an informal meeting with the Committee in April this year, APRA executives confirmed that there was more to fear from communal panic about the integrity of the banking system than there was to fear from computer system malfunctions.

3.8 At the June 1999 hearing, the Governor said that the Australian financial system was extremely well prepared for Y2K. Over $1 billion had been

5 *Council of Financial Regulators Annual Report 1998*. Sydney, RBA, p 13.

6 Council of Financial Regulators, *Year 2000 Preparations in the Australian Banking and Financial System April 1999*. Sydney, RBA, 47p.

7 Ibid., pp *42-43.*

8 Ibid., p 43.

9 Ibid., p 43.

10 Ibid., p 43.

11 Evidence, p 36.

12 Evidence, p 36.

13 Evidence, p 37.

spent on checking and updating computer systems. Problems had been fixed. Pensions would be paid on time. Elaborating the point , he said that:

> …the Australian financial system rightly enjoys a world-class reputation for its high level of Y2K preparedness. [14]

3.9 Consequently, the biggest Y2K issue for the banks is not longer technical, but rather 'an issue of public reaction'. [15] To reassure the community, the Bank has been talking with other banks, building societies and credit unions to make sure they are communicating with their customers to reassure them their deposits are safe '…because the simple fact is that their deposits are safe and their records are not at risk from Y2K related problems'...[16] The Governor encouraged the community to regard the first few days of the new year as just another long weekend:

> … So, in my view, you really only need to take out enough money to cover you over a long weekend. That is what I will be doing. Those who want a little extra reassurance in the form of extra cash can be confident that it will be readily available.[17]

3.10 The Governor did not say whether any specific educational campaigns were being planned, but reiterated that it is important to make sure that people don't overreact.

> The main public education is to make sure that people do not fall victim to the doomwatchers on that score. I think that one will be won.[18]

3.11 Following the hearing, the Reserve Bank issued a media release announcing that, as part of Y2K planning, the Bank was putting into place certain arrangements to ensure that financial intermediaries have adequate liquidity flows around the Year 2000.[19] The media release also announced that the Bank will undertake market operations 'as necessary' to ensure that market conditions remain consistent with monetary policy.

3.12 Over the next couple of months the Committee will monitor the education programs for Y2K of the financial institutions and discuss this issue with the RBA at the November hearing.

---

14 Evidence, p 47.

15 Evidence, p 47.

16 Evidence, p 48.

17 Evidence, p 48.

18 Evidence, p 81.

19 Reserve Bank of Australia, 'Year 2000 and RBA Domestic Dealing Arrangements'. Media Release, 21 June, 1999.

The regulatory framework

3.13 On 1 July 1998 new structural financial system arrangements came into place with the establishment of APRA. Supervision of banks was transferred to APRA leaving the RBA to focus more broadly on potential risks to system stability and on how such risks might be reduced without unduly discouraging financial efficiency and innovation. In the second half of 1998 Memoranda of Understanding were developed between the Reserve Bank and APRA on their respective responsibilities for promoting the stability of the Australian financial system, and between the Bank and the Australian Competition and Consumer Council on respective responsibilities for payments system access and competition.

3.14 At the December 1998 hearing the Bank reported that arrangements under the new regulatory framework were working extremely well.[20] At that stage it was anticipated that the second stage of the reforms, involving the transfer of regulatory responsibility for building societies, credit unions and friendly societies from the States and Territories to the Commonwealth, would be implemented by July 1999. Federal legislation[21] which will enable APRA to supervise non-banks (building societies, credit unions and friendly societies) passed through the Senate on 17 June 1999, but complementary State government legislation is required to complete the transfer process.

3.15 In April 1999, the Committee conducted a program of informal briefing visits to a number of financial institutions in Sydney and Melbourne. At several of these, concerns were raised about how the new regulatory regime is funded. There were suggestions that the levy system contained some iniquities and that a fresh look at the levy system was perhaps warranted.

3.16 APRA is funded by charges levied on the banks it regulates. The amount of levy payable by an 'authorised deposit-taking institution' (ADI) is determined according to a legal formula, and minimum and maximum amounts apply. Levy percentages and minimum and maximum levy amounts are to be determined by the Treasurer, but a maximum levy of $1 million has been specified in legislation. The current levy percentage of 0.013% means that the maximum levy of $1 million is reached when an ADI's asset value is $7.7 billion. However, an ADI with an asset value of $10 billion paying the maximum of $1 million would be paying an effective levy rate of 0.01%, and many ADIs have asset values which far

20 Evidence, p 32.

21 The Financial Sector Reform (Amendments and Transitional Provisions) Act 1999.

exceed these amounts; National Australia Bank's total assets, for example, are valued at around $250 billion.[22]

3.17 The question of the funding of the new regulatory framework was raised with the Bank at the June hearing. The Committee told the Bank it had heard a number of concerns about the levies to be charged by APRA[23], and asked the Bank whether it also had concerns about the levy system. The Governor said he thought there were some problems which would need to be redressed by legislative changes, and that these were currently being examined.[24]

3.18 On 3 August 1999 the Minister for Financial Services and Regulation, Mr Joe Hockey, announced there would be a review of financial sector levies to determine whether existing levy arrangements are providing an effective funding mechanism for the supervision of prudentially regulated institutions.[25] Review recommendations are to be provided to the Minister by early October 1999, and the Committee will be interested to discuss proposed changes with APRA and the Bank later this year.

The payments system

3.19 The 'payments system' refers to the ways in which consumers, businesses and other organisations make transactions with one another. It encompasses the differing forms of payment instruments – such as cash, cheques and electronic funds transfers – and the technical processes involved in transferring value from one party to another.

3.20 Under the new regulatory framework, the Reserve Bank was given greatly enhanced regulatory powers in the payments system, which are exercised by the new Payments System Board within the RBA.[26] The Bank now has independent responsibility for assessing payment system performance in terms of access, efficiency, and safety. Where the Bank is not satisfied with performance on these scores, it is able to 'designate' a payment system as being subject to direct regulation. It can then impose access rules or determine operating standards for participants of that system. [27]

22 Research on APRA funding done by C. Field in the Law and Bills Digest Group of the Information and Research Services of the Department of the Parliamentary Library.

23 Evidence, p 83.

24 Evidence, p 84.

25 The Hon Joe Hockey, MP, Minister for Financial Services & Regulation. *Media Release: Review of Financial Sector Levies.* 3 August 1999, 1p.

26 *Council of Financial Regulators Annual Report 1998.* Sydney, RBA, p 10.

27 *Reserve Bank of Australia 1998 Report and Financial Statements.* Sydney, RBA, p 14.

3.21 In late April 1999, the Bank's Payments System Board welcomed a decision by commercial banks to shorten cheque clearance times to a three-day clearing cycle, which would have taken Australia close to world 'best practice'. [28] However, in an article in the July edition of the *Bulletin,* the Reserve Bank criticised banks for failing to expedite implementation of the promised three-day cheque turnaround policy. The Chairman of the Payment Services Board has written to bank chief executives seeking details of banks' plans for moving forward on this matter.[29] The Committee will follow up on this issue when it meets with the Bank again in November.

Transparency

3.22 In a communique of 30 October 1998, G7 Finance Ministers and Central Bank Governors called upon all countries participating in global capital markets to commit to complying with a set of internationally agreed codes and standards. Following this, the Australian Prime Minister commissioned a task force to advise on how Australia could contribute to international financial reform. The Task Force, chaired by the Treasurer, endorsed the G22 recommendation that the International Monetary Fund (IMF) prepare transparency reports and recommended that, in addition, Australia take the lead in preparing a self-assessment transparency report, providing a format and methodology that other countries could choose to follow.[30]

3.23 Australia has since undertaken a comparison of its monetary and financial policy framework against a working draft of the proposed IMF *Code of Good Practices on Transparency in Monetary and Financial Policies – Declaration of Principles.* As reported in the Treasury's recent report, *Making Transparency Transparent: An Australian Assessment*, Australia's monetary policy arrangements are generally consistent with the principles underlying the IMF draft Code, although all of Australia's 'modalities of accountability' are not defined in legislation, as is recommended in the draft Code.[31] An example of an 'accountability modality' which is based on convention rather than legislation is the bi-annual appearance of the

28 Manager, Information Office, Reserve Bank of Australia. *Media Release : Cheque Clearing Times.* 28 April 1999.

29 Dr Laker, Assistant Governor (Financial System), RBA, 'The Role of the Payments System Board', *Reserve Bank of Australia Bulletin July 1999.* Sydney, RBA, p 13.

30 The Treasury. Mar 1999. *Making Transparency Transparent: An Australian Assessment*, Canberra, AGPS, p vi.

31 Ibid., p 11.

Bank Governor before the House of Representatives' Economics Finance and Public Administration Committee.

3.24 An article in the *Financial Review* following the release of the Treasury report noted the broadly positive assessment of the transparency of Australia's monetary policy, but suggested that the Reserve Bank should not be content merely to satisfy IMF draft transparency standards, but should strive to meet even higher 'world best practice' standards embraced by many in the corporate world.[32]

3.25 At the December 1998 hearing with the Committee, the Governor indicated he was satisfied with the levels of transparency offered by the Bank with regard to the formulation of monetary policy, though he acknowledged 'there will no doubt always be people asking for more'.[33]

3.26 At the June 1999 hearing, the Committee asked the Bank whether it would countenance issuing monetary bias statements, as the US Federal Reserve has recently begun to do, and/or the delayed release of the minutes of Bank board meetings. The Governor's responses indicate there are no immediate prospects of the RBA adopting either additional transparency measure. The Governor questioned the value of releasing monetary bias statements by saying:

> I am not sure what value there is in that, particularly if you put on a bias and then you take it off again. ..I am not sure what value people got out of the fact that they had this statement saying, 'We have a bias to tighten', because it certainly did not give them any indication of the future development of US monetary policy. I myself think it is just another complication.[34]

3.27 As for the (delayed) release of Bank board meeting minutes, the Governor reiterated previous comments that:

> People think this release of minutes is a great idea, but my suggestion is that you go back and read some of the minutes and see whether you think it is a great idea after you have read them.[35]

3.28 The Committee is generally satisfied with these responses, particularly given the Governor's efforts to communicate the Bank's views through Committee hearings and other public statements.

32 Transparency and the RBA. *The Australian Financial Review*, 9 April, 1999.
33 Evidence, p 23.
34 Evidence, p 84.
35 Evidence, p 84.