

## **Regulation by Objective – The Australian Approach to Regulation**

Statement to the US Senate Committee on State Homeland Security and Governmental Affairs

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In 1996, the Australian Government commissioned a committee to review the Australian experience with financial deregulation, to assess the forces for change in the financial system over the coming decade or so, and to recommend a regulatory architecture that would best cope with these changes.

The Financial System Inquiry Committee (known informally as the Wallis Committee) reported in March 1997 with 115 recommendations ranging from the competitive structure of the financial system to detailed legislative changes. The Australian Government implemented all but a few of these recommendations. At the core of these recommendations was a proposal to realign the then-existing hybrid structure of multiple, institutionally-based prudential regulators and product-based conduct and competition regulators into a consolidated group of regulators based on regulatory objectives.

The primary motivation behind the proposal was to make regulation more effective. In particular, there was a desire to better regulate financial conglomerates and to minimize regulatory arbitrage (to ensure that institutions selling the same financial products are subjected to the same regulatory requirements).

The Committee was conscious of the reality that a sound regulatory architecture is a necessary but not a sufficient condition for effective regulation. Effective regulation requires strong powers, best-practice rules and standards, appropriate skills, a flexible risk-focused approach to supervision, and acceptance by regulators, government, and the community generally of the need to take enforcement action against institutions and individuals who do not comply with the law. Without a supportive regulatory architecture, implementing these first-line strengths can be undermined to the point of ineffectiveness. By the same token, a sound architecture without the necessary tools, skills and commitment is also doomed to failure.

The particular shape of the architecture recommended by the Committee was unique in the world at the time and reflected a balancing of many considerations.

The underlying philosophy adopted by the Committee was that regulatory intervention can only be justified if it addresses market failure. In general, markets function most efficiently without regulatory interference. The reality, however, is that markets can fail for a variety of reasons. The decision to intervene to alter the natural functioning of a market through regulation should be justified on the grounds that the cost of the market failure is greater than the costs imposed by regulation (either direct resource costs or losses of efficiency).

In broad terms, the Committee agreed that financial markets fail to produce efficient, competitive outcomes for one or more of four main reasons.

First, individuals or companies may engage in anti-competitive behaviour, such as collusion or market dominance. The role of competition regulation is to ensure that market forces operate effectively and are not circumvented by market participants.

Second, as much as we wish it were not so, there are individuals and firms that are prepared to cheat, defraud, misrepresent products, and manipulate markets to their own advantage. While this may occur in any market, this type of misconduct is especially egregious in financial markets where products are complex, the stakes are often high (possibly involving an individual's entire lifetime savings), and the evidence of misconduct is often easily hidden for long periods. For financial markets to operate efficiently and effectively, participants must act with integrity and there must be adequate information on which to make informed judgements. For these reasons, conduct regulation focuses on setting and enforcing standards of disclosure and conduct in dealing with clients and investors.

The third source of market failure, information asymmetry, arises where products or services are sufficiently complex that disclosure by itself is insufficient to enable consumers to make informed choices. This form of market failure should be distinguished from market misconduct associated with inadequate disclosure. Information asymmetry arises where disclosure by itself is insufficient to resolve the market failure. Information asymmetry arises in situations where buyers and sellers of particular products or services will never be equally-well informed - regardless of how much information is disclosed. Regulation to deal with information asymmetry is usually referred to as "prudential regulation".

At issue in prudential regulation is the complexity of both the product and the institution offering it. This problem is common in areas such as drugs and aviation and is particularly relevant in the area of financial services. The regulatory response in these cases is to interpose a regulatory body between the supplier of the service and the consumer. The role of the regulator is to establish and enforce a set of behavioural rules for the supplier that are designed to ensure that the promises being made by the supplier have an acceptably high probability of being met. Since no regulator can guarantee that all promises will be met under all circumstances (to do so would require extreme, self-defeating regulation) it is common for governments to add an additional level of government support, such as deposit insurance, in those cases where these particular promises are not met.

The range of financial institutions and activities that should be covered by prudential regulation is a matter of judgement. Typically, deposit taking and insurance are subjected to prudential regulation. In some countries, the prudential net is extended to include private pension schemes, securities dealers, and other financial institutions. The crisis of 2008 has caused some to question whether the range of institutions subject to prudential regulation has been too narrow.

Prudential regulation overcomes the asymmetric information market failure in part by substituting the judgement of a regulator for that of the regulated financial institutions and their customers. To the extent that the regulator absorbs risks which would otherwise be born by financial institutions and their customers it introduces a 'moral hazard' problem - whereby the perceived shifting of risk from the regulated financial institutions to the regulator may induce the institutions to take greater risks than they would otherwise take. Moral hazard is accentuated when explicit government guarantees are involved.

The incentive problems associated with moral hazard explain the particular approaches that prudential regulators normally adopt to the various aspects of prudential regulation. It also means that the potential cost of prudential regulation in terms of economic efficiency can be very high if the conflicting incentives are not handled very carefully. Consequently, there is an onus on governments both to limit the spread of the prudential umbrella to those parts of the financial system that genuinely warrant this form of regulation and to ensure that the regulator adopts regulatory measures that correct the market failure at minimal cost.

The primary distinction between the methods used by prudential regulators and those used by competition and conduct regulators is that the former are largely preventative (i.e., they primarily seek to avoid promises being broken), while the latter are largely responsive (that is, they primarily involve prosecution of those who break their promises or who disobey the rules). Prudential, or preventative, regulation involves the imposition of prescriptive rules or standards governing the prudential behaviour of financial institutions making certain types of promises. These rules may be directed at specific areas of concern, or directed more generally towards ensuring that these institutions have the financial strength and soundness to honour the promises that they have made.

The fourth main source of financial market failure is systemic instability. It is a fundamental characteristic of parts of the financial system that they operate efficiently only to the extent that market participants have confidence in their ability to perform the roles for which they were designed. Systemic instability arises where failure of one institution to honour its promises leads to a general panic as individuals and corporations fear that similar promises made by other institutions may also be dishonoured. A crisis occurs when contagion of this type leads to the distress or failure of otherwise sound institutions. The liquidity crisis of September 2008, following the failure of Lehman Brothers is one of the most vivid examples of this type of systemic instability.

The more sophisticated the economy, the greater its dependence on financial promises and the greater its vulnerability to failure of the financial system to deliver against its promises. The importance of finance and the potential for financial failure to lead to economic instability introduces an ‘overarching externality’ that warrants regulatory attention.

The primary defence against systemic instability is the maintenance of a sustainable macroeconomic environment, with reasonable price stability in both product and asset markets. This responsibility falls directly to government in its formulation of monetary and fiscal policy. Systemic stability is also supported by having a prudentially sound system of financial institutions. Thus, policies designed to combat market failure arising from asymmetric information automatically support policies designed to combat market failure arising from systemic instability. As highlighted by the crisis of 2008, policies designed to reduce the opacity of financial markets and to provide regulators with adequate information on systemic inter-linkages and aggregate systemic exposures can be just as critical.

Beyond these general macroeconomic and prudential measures, the additional regulatory tools most appropriate for resolving this type of market failure are the lender of last resort facility and direct regulation of the payments system.

The Committee recommended a regulatory structure comprising four separate agencies, each of which would be assigned the objective of addressing one the four main sources of market failure. In July 1998, based on the Committee’s recommendations, the Government instituted what has come to be known as an “objectives-based” regulatory architecture based on the following four agencies:

- the Australian Competition and Consumer Commission (ACCC), which is responsible for competition regulation and consumer protection throughout the whole economy;
- the Australia Securities and Investments Commission (ASIC), which is responsible for conduct regulation across the financial system, including all financial institutions, markets, and market participants;

- the Australian Prudential Regulation Authority (APRA), which has responsibility for the prudential soundness of all deposit taking, general and life insurance, and private pension schemes; and
- the Reserve Bank of Australia (RBA), which is responsible for systemic stability, through monetary policy, provision of system liquidity, and regulation of the payments system.

This architecture has also been referred to as a “twin peaks” architecture, a term coined by Michael Taylor to describe a structure in which conduct and prudential regulation are each carried out by a separate regulator. In this terminology, the Australian model is more accurately described as a “four peaks” model. While unique at the time, this model, or a variant of it, has since been implemented by the Netherlands.

The Committee considered a wide range of issues in arriving at its recommendations. Among the more difficult of these were: whether or not to separate banking regulation from monetary policy; where to draw the boundaries around those institutions warranting prudential regulation; and how best to ensure inter-agency cooperation.

The Committee recognised that there were significant synergies between banking regulation and monetary policy. Coupled with the credibility enjoyed by the RBA as a successful banking regulator, there was a strong case to retain banking regulation within the RBA. There was, however, an equally powerful argument that the growth of financial conglomerates required a more coherent approach to prudential regulation than could be provided by different agencies. While the Committee considered adding regulation of insurance and other deposit-takers to the responsibilities of the RBA, there would have been a danger that pursuing two very different and potentially conflicting objectives might distract the RBA from its primary responsibilities of monetary policy and system stability. Ultimately the Committee decided that a new agency dedicated to all forms of prudential regulation and a streamlined central bank responsible for systemic stability through its control of monetary policy and the payments system offered a more focused and flexible structure.

Drawing the boundaries around prudential regulation was also difficult. Ultimately, the Committee decided that the boundaries should be determined by the nature of the particular financial promises being made by particular types of financial institutions.

Not all financial promises are equally intense. Financial promises can be distinguished according to three primary characteristics:

- the inherent difficulty of honouring the promise;
- the difficulty faced by the consumer in assessing the capacity of the promisor to deliver on the promise; and
- the extent of adversity that would be caused by promissory breach.

Each of these characteristics involves risk. The more difficult the promise is to keep, the greater the risk to the consumer and the greater the impact of information asymmetry. Some financial promises, such as common equity claims, are relatively easy to honour in that they contain very general and flexible obligations. Other financial promises, such as demand deposits (a promise to pay a fixed nominal amount at the total discretion of the promisee) are very onerous.

The more complex the institution making the promise, the more difficult it is for the promisee to assess its capacity to deliver on its promises, and therefore the greater the risk for the promisee. Some structures, such as simple trusts, are relatively transparent, while others, such as banks and insurance companies (especially when they are part of financial conglomerates) can be extremely complex and opaque.

Finally, the greater the consequences of promissory failure, the greater the risk, not only to the individual, but also to the community. The consequences of the failure of a major insurance company to honour its insurance claims, for example, would be likely to generate much greater adversity within the community than the failure of a non-finance company to meet its equity obligations.

Since prudential regulation is costly and interventionist by nature, the Committee believed that it was important that it be limited to institutions making financial promises that were judged to have a sufficiently high intensity in all three characteristics outlined above. Only in these cases would the potential cost of the market failure dominate the potential efficiency costs of prudential regulation.

While the case for including all deposit-taking institutions and all forms of insurance within the prudential net was very strong, the case for pensions was less so. The situation was complicated by the way in which the Australian pension system had evolved since the mid 1980s. To reduce the burden on a growing unfunded public pension scheme, successive Australian Governments had encouraged private pension provision through tax concessions and a series of compulsory pension contributions imposed on employers as an offset to wage claims. The vast majority of the funds that emerged in response to this policy were defined contribution schemes in which the investment risks are borne ultimately by the pension beneficiary. Thus, these funds ranked low on the first promissory characteristic, although higher on the second, and very high on the third. While this made a case to treat pensions like any other forms of investment, there was still a significant defined benefit pension industry, pension contributions were mandatory, and the choice of fund was restricted. In combination, these meant that the Government retained at least an implicit responsibility associated with the risk of fraud and poor management. For these reasons the Committee recommended including private pensions within the prudential responsibility of APRA.

Finally, to encourage inter-agency cooperation, the Committee recommended establishing the new prudential agency, APRA, with a Board that would include ex-officio representatives from ASIC and the RBA. When APRA was restructured in 2003 as a Commission, and the inter-agency representation was lost, responsibility for coordination passed to the Council of Financial Regulators, which includes representatives of the RBA, APRA, ASIC, and the Commonwealth Treasury.

The assumed strengths of the objectives-based architecture are many. In general these have been born out by the Australian experience.

First, by assigning each regulatory agency to a single objective, there is maximum regulatory focus. This model avoids the conflict of objectives faced by regulators under virtually every other architecture. Where an agency faces multiple objectives there is a danger is that one will, for whatever reason, dominate the other in terms of visibility with senior management and/or allocation of resources (as appears to have been the case with Northern Rock in the UK).

Second, there are significant potential synergies in bringing together all regulators of a particular market failure. APRA, for example, was able to bring together best practices from banking and insurance regulation to create a stronger framework for both. APRA was also one of the first agencies to apply a broad risk-based supervisory approach to all prudentially-regulated sectors of the financial system. Similarly, by bringing all markets under ASIC's purview Australia was one of the first countries in the world to introduce a single licensing regime for market participants.

Third, bringing all prudentially-regulated entities under the one roof is conducive to eliminating regulatory arbitrage. Prior to the creation of APRA there were at least three different types of institution able to issue demand deposits in Australia. These were regulated by nine different agencies. Following its creation, APRA introduced a fully-harmonized regime for all deposit-taking institutions. These are now regulated as "Authorized Deposit-taking Institutions" (ADIs) under a single licensing regime. This coherence over deposit taking was important in preventing a shadow banking sector from emerging in Australia.

Fourth, bringing all prudentially-regulated institutions under the one roof should facilitate a more consistent and effective approach to regulating financial conglomerates. APRA has been at the forefront of international efforts to develop a framework for consolidated supervision of conglomerates.

Fifth, allocating a single objective to each regulator minimizes the overlap between agencies and the inevitable turf wars that accompany such overlaps. There are always grey areas in practice, however neat the principles might appear in theory. The greatest potential overlaps are between prudential regulation and systemic stability regulation on the one hand (to the extent that prudential soundness provides one of the key foundation stones for systemic stability), and between prudential and conduct regulation on the other (to the extent that they each involve regulation of different aspects of the same institutions). Notwithstanding the potential for overlap, these have tended to diminish rather than amplify with time and experience. In part this is a consequence of the clear lines of responsibility in each situation. And, in part, it is a consequence of the determination by the key parties to cooperate in the interests of the system as a whole.

Sixth, the allocation of a single objective to each agency should minimize cultural clashes. As a general rule, conduct agencies are dominated by lawyers. Prudential agencies, in contrast, are typically dominated by accountants, economists, and finance experts. When these two groups are combined in the same agency there can be a clash of cultures as one seeks to dominate the other.

Finally, in line with the expectations of the Wallis Committee, streamlining the old (partly State-based) regulatory structure reduced the cost of regulation and facilitated strong financial sector development and new entrants to the field, without reducing safety or soundness.

Notwithstanding the resilience of the Australian financial system over the past 18 months, we have learned much about our architecture and our overall approach to financial regulation from the international crisis. Regulators worldwide have much about which to be modest, and Australian regulators are no exception.

On the positive side, the objectives-based architecture withstood its first major test without collapsing. Indeed, the Australian financial system has weathered the financial storm better than most, although we have certainly not been immune from the economic consequences that have followed. The resilience of the Australian system was helped by exceptionally tough prudential standards. Whereas some countries exploited "discretions" in the Basel framework to lower the capital requirements for their local banks, APRA went the opposite direction to impose arguably

the toughest regime in the world. As a consequence, our major banks are among the few AA rated banks left standing. Our resilience was also helped by some good fortune. As pointed out by our recently retired RBA Governor, Ian Macfarlane, the reliance of Australian banks on global wholesale markets for funding left the system with a liquidity risk, but helped it avoid some of the credit risks taken by banks in other countries that had surplus deposits and a shortage of suitable local lending opportunities.

In terms of crisis management the coordination arrangements worked as expected, with excellent cooperation between agencies on information flows and rapid responses to the exigencies of the times. The singularity of focus provided by the objectives-based architecture was seen by the Australian agencies as a major positive factor in this respect.

On the less positive side, we have learned that both the regulators and industry know less about measuring and managing risk than we thought we did. The regulatory focus on value-at-risk has proved to be misplaced. Risk measures based on historical data that focus on the centre of the distribution of outcomes are poorly placed to deal with tail-risk events. In its defence, APRA has been among the few international regulators to conduct extensive stress (or scenario) tests of the industry over the past decade, although the sophistication and regularity of these will undoubtedly increase in coming years. We have seen at first-hand the dramatic pro-cyclical impact of market-value based accounting and regulatory rules. We have had to rethink the way in which liquidity risk is measured and regulated.

Most importantly, we have learned that financial stability regulation is a much more complex exercise than simply overseeing the payments system and keeping the monetary policy dials on autopilot. The need for much greater information about inter-linkages and exposures throughout the financial system is obvious. Less obvious is how to collect and ensure the security of that information, given the commercial sensitivity of much of what will be involved.

It is difficult to predict the exact shape of financial regulation in five years. What is reasonably certain is that the standards, methods, and approaches applied will look quite different to those that have been that were applied over the past five years. If not, we will be destined to experience the same problems.

But these are challenges more for regulatory implementation rather than regulatory architecture.

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