The framework for financial supervision: macro and micro issues

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Introduction

It is a great pleasure to have been invited to participate in this conference. As some of you may already know, the Australian Government commissioned a review of its framework for financial regulation just over two years ago. I was a member of the review team and had the honour of being appointed the inaugural Chairman of the restructured prudential regulation agency that emerged from the Government's review.[1]

Against that background, I believe that the most useful contribution I can make to this conference is to share with you the key issues that arose in the review of our framework. I will also share with you some of our experience following implementation of the new framework, just over six months ago.

My paper is structured around what I regard as the key ingredients of an effective framework for supervision:

- a coherent regulatory philosophy;
- the government's commitment to the regulator;
- the commitment and competence of the regulator's staff; and
- education of the public as to the role and limitations of regulation.

Philosophy

Background to the Financial System Inquiry

Let me begin with philosophy. Since those involved in our Australian review spent much of their energy discussing regulatory philosophy, I should start with a brief background to the review and why we focused so heavily on philosophy.

[1] Throughout this paper I will use the terms regulation and supervision interchangeably.

The Financial System Inquiry, or Wallis Inquiry, as it came to be known, was the first full-scale review of the Australian financial system since the Campbell Inquiry in the late 1970s.

Unlike the situation facing the Campbell Inquiry, we were not faced with an overwhelming mandate for change at the time of our deliberations. Nor were we faced with a financial crisis, as has been the case preceding many financial reforms elsewhere in the world. Our banking system was functioning well; it was profitable and well capitalised. Our insurance industry was healthy and our financial markets in general were considered among the best in the world for disclosure and market conduct. Not only was our financial system functioning well, large sections of both the finance industry and the regulatory community were quite vocal in expressing their resistance to any form of change.

So why did we have an inquiry? Primarily because the Government wanted to be forward looking. The Government was aware of pressures that were arising from technology and globalisation and that these pressures might lead to changes in the industry over time, which could in turn put pressure on the regulatory structure. It was their intention that we should review these long-range issues without the distraction of a crisis. The particular focus of our Inquiry was underscored by the Treasurer's terms of reference, which emphasised the need to analyse the forces shaping the future and to design a regulatory framework to best ensure an efficient, flexible and competitive financial system.

In this way we had the luxury of being able to give adequate consideration to the underlying issues of reform – that is, to the philosophy of regulation.

The rationale for regulation

In constructing a framework for supervision, the Wallis Committee began with the fundamental question of why we regulate.

The Committee agreed that the primary rationale for regulation is market failure.

Western economies are built on the principle that free markets produce efficient outcomes. It is widely recognised, however, that even the best of markets can fail to produce efficient outcomes in certain circumstances and that they can fail in this way for a variety of reasons. Private enterprise only works efficiently where regulation corrects market failure.

The main sources of market failure identified by the Committee were:

- anti-competitive behaviour;
- market misconduct;
- systemic instability; and
- information asymmetry.

All markets face potential problems associated with the conduct of market participants.

Anti-competitive behaviour in the form of collusion or exercise of monopoly power has long been recognised as a source of inefficiency in free market outcomes. Competition regulation establishes laws to prevent these forms of anti-competitive behaviour from generating overpricing of products and underprovision of services essential to economic growth and welfare.

Similarly, market integrity regulation typically seeks to minimise market misconduct in the form of market manipulation and consumer exploitation. Market integrity regulation aims to promote confidence in the efficiency and fairness of markets by ensuring that markets are sound, orderly and transparent. For these reasons, regulators around the world impose and enforce disclosure requirements (such as prospectus rules) and conduct rules (such as prohibitions on insider trading and market manipulation).

These two forms of market failure are common to all markets, financial and non-financial. They are as relevant in retailing and agriculture as they are in banking. In many markets, these are the only forms of market failure and economy-wide regulation aimed at resolving the associated problems is considered adequate.

The third form of market failure, systemic instability, is almost unique to the financial markets. 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. Third party, or systemic, risks occur where failure of one institution to honour its commitments leads to a general panic as individuals fear that commitments made by similar institutions may also be dishonoured. Bank runs are the most common example of this type of contagion. However, equally disruptive consequences can also flow from other types of market disturbances such as stock price collapses and even the failure of a single large institution – where that institution is involved in a complex network of transactions including forward commitments.

The fourth form of market failure identified by the Wallis Committee – 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 is not unique to financial services and occurs in non-financial areas such as air safety, drugs, and medical services.

Financial contracts contain promises to make payments at specified times, in specified amounts and in specified circumstances. However, not all financial promises are equally onerous. Financial promises can be distinguished according to the following characteristics:

- the inherent difficulty of honouring the promise;
- the difficulty faced by the consumer in assessing the creditworthiness of the promisor; and
- the adversity caused by promissory breach.

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.

Similarly, the creditworthiness of some financial promises, such as unit trusts, is relatively transparent to consumers, while that of others, such as insurance contracts and bank deposits, can be extremely difficult to assess.

The consequences of promissory breach can also vary widely. The consequences of a failure of the payments system, for example, would be much more dramatic than the failure of a company to meet its equity obligations.

Drawing the institutional boundaries

The question of where to draw the boundary for regulating this particular form of market failure was not easy. The Wallis Committee was conscious of the reality that regulation imposes certain obligations on government, both implicit and explicit. For financial markets to operate efficiently, it is critical that the government's regulatory imprimatur (or worse, its implicit guarantee) is not extended any further than is needed.

The Wallis Committee took as its guiding principle that institutions making financial promises warrant regulation only where their promises are judged to have a high intensity in all three of the characteristics outlined above. This is the same principle applied to regulation in other areas where asymmetric information is involved. Thus we regulate the sale of complex drugs but not of complex electronic equipment.

As with these other areas of the economy, there is still judgement required about when a promise reaches sufficient promissory intensity to justify regulation. The form of regulation in these cases involves interposing the regulator's judgement between the purchaser and the provider to ensure a high degree of promissory confidence. In financial markets, this form of regulation is usually referred to as "prudential regulation".

The Wallis Committee noted that the regulatory structure existing in Australia at the time was based along institutional lines (institutions were allocated among the then existing regulators largely according to their institutional groupings). The philosophical framework outlined above suggested that a better structure would be based on functional lines, with one regulator for each of the types of market failure. Indeed, that is what we recommended and that is what the Government implemented during the course of 1998.

We now have four regulatory bodies, each charged with managing one of the four areas of market failure:

- the Australian Competition and Consumer Commission (ACCC) – with responsibility for administering laws to prevent anti-competitive behaviour;
- the Australian Securities and Investment Commission (ASIC) – with responsibility for regulating disclosure, market integrity and consumer protection, with the objective of promoting confidence in the efficiency and fairness of markets by ensuring that markets are sound, orderly and transparent;
- the Reserve Bank of Australia (RBA) – with responsibility for overseeing systemic stability through its influence over monetary conditions and through its oversight of the payments system; and
- the Australian Prudential Regulation Authority (APRA) – with responsibility for regulating asymmetric information problems in the finance industry, by setting and enforcing standards of prudential behaviour for all institutions making promises in the areas of deposit-taking, insurance and superannuation.

I should emphasise that the recommendation to move to this new structure was not an indictment of the regulatory structure as it existed at the time. On the contrary, the current strength of our economy and financial system is ample evidence that the old system was meeting the demands made on it. Rather, the new system was born out of the need to be forward looking and to design a system that would be capable of withstanding change.

Limitations on structural reform

In making its recommendations to the Australian Government, the Wallis Committee acknowledged that there was no unique best regulatory structure for all situations. The Committee believed that the recommended structure was the best for Australia, given its stage of financial development and size. A different decision may have been made ten years ago. A different decision may be made in ten years' time – indeed, the Committee recommended that reviews be undertaken at regular intervals and that the effectiveness of the regulatory bodies be monitored very closely.

Despite the emphasis in the Committee's Report on regulatory structure, it is my view, and I believe that it would be shared by the Committee, that while structure is important, it is only a necessary, rather than a sufficient, condition for sound regulation. Overall regulatory success depends at least as heavily on three other factors:

- the government's commitment to the regulator;
- the commitment and competence of the regulator's staff; and
- education of the public as to the role and limitations of regulation.

The government's commitment to the regulator

Legislative backing

The most fundamental support that the government can give to a regulator is to ensure that the regulator has the legal powers needed to carry out its functions effectively. Not only does this give the regulator the power to function, it gives the regulator the ability to protect the government's own exposure.

One means of limiting the government's exposure is to ensure that the regulator has the necessary powers to minimise the probability that public funds will be required to cope with a financial disaster. This does

not mean that it is the responsibility of regulators to prevent financial institutions from taking risks, or from exiting the industry if their risk management decisions turn out to be poor. On the contrary, it is the business of financial institutions to trade in risk, and some turnover in the industry is healthy. The role of the regulator is to manage these exits in a way that minimises potential loss to depositors (or policyholders in the case of insurance regulation) and avoids any loss of confidence in the industry as a whole.

The necessary powers to avoid financial crises include the power to respond quickly and flexibly to changing circumstances. They also include the power to act quickly to merge distressed institutions before their capital has been completely eroded (while governments typically agonise over possible losses to deposit-holders, few have qualms about losses to shareholders).

In my view, effective powers of enforcement include the following as a minimum:

- the power to inspect;
- the power to request information;
- the power to direct (for example, to cease certain activities);
- the power to remove directors and auditors;
- the power to suspend operations;
- the power to appoint an administrator; and
- the power to transfer engagements.

Ensuring that the regulator has the appropriate powers is no simple task. It requires establishing clear lines of responsibility and accountability between the regulator and the government. It also involves defining as unambiguously as possible the extent and nature of the powers available to the regulator.

In terms of responsibility and accountability, our Australian model has much to recommend it.

APRA has been established as a Statutory Authority with its own Board. Under Clause 8(1) of the APRA Act, 1998, "*APRA is established for the purpose of regulating bodies in the financial sector in accordance with other laws of the Commonwealth that provide for prudential regulation or for retirement income standards, and for developing the policy to be applied in performing that regulatory role*".

Thus, APRA is charged with the development and implementation of regulatory policy. APRA does so independently of the government. The funding for APRA is provided by a levy on industry, so that there is no immediate conflict with the Government over resourcing.[2] In terms of accountability, APRA is required to keep the Government informed about any institutions that it considers to be in financial difficulty and, more generally, about its regulatory policies. In Clause 12, the Act provides that "*where the Government and the APRA Board are unable to agree that a particular policy is directed to the best performance of its functions*", the Government may resolve the issue, subject to tabling the decision and the background to its decision in the House of Parliament. In practice, this gives APRA a high level of autonomy but also a high level of accountability.

This degree of autonomy is consistent with the Basel Committee's Core Principles for Effective Bank Supervision.[3]

In terms of powers, our Australian model has some limitations. APRA currently operates under a number of different Acts of Parliament covering the various institutional groups that it regulates. At this early stage, there are some notable differences in the powers that we have in respect of regulating different financial activities, as well as the ways in which we can exercise those powers.

At the broadest level, APRA appears to have very extensive powers. Under Clause 11 of the Act, "*APRA has the power to do anything that is necessary or convenient to be done for or in connection with the performance of its functions*". While this is a very wide-ranging Clause, it is constrained by the operation of the individual Acts covering the separate industries. While there are many subtleties in the legislation, in broad terms APRA operates under two different models.

In the case of banks, APRA has the power to set and enforce prudential standards. It carries this role out by issuing Prudential Guidelines. These are policy statements that do not have the formal force of law. However, under the powers conferred on APRA by the Banking Act, APRA can direct a deposit-taking institution to comply with

[2] The actual levy is nonetheless determined by the Government each year, after consultation with APRA and industry. Thus the Government remains involved in the process and is conscious of its commitment to cost efficient regulation.

[3] The Core Principles state that supervisory agencies "should possess operational independence and adequate resources (including staffing, funding and technology) to meet the objectives set, provided on terms that do not undermine the autonomy, integrity and independence of the supervisory authority".

a Guideline. In this way, the Guidelines have the informal effect of law. This model, which is sometimes referred to as an "*informal Guidelines*" approach, is very effective and flexible.

In the case of insurance companies and superannuation funds, APRA is required to issue its standards as Regulations within the relevant Acts. The need for this "*Black Letter Law*" approach arises because the relevant Acts only provide APRA with the power to direct a regulated institution to comply with Regulations.

From a regulatory standpoint, the most attractive feature of the Guidelines approach over the Black Letter Law approach is the flexibility that it affords APRA. First, APRA can issue Guidelines quickly, without the need to pass legislation through the Parliament. In practice, after a new Guideline, or amendment to an existing Guideline, is agreed by the APRA Board, it is exposed to industry and other interested parties for discussion before it is implemented; this process usually takes a matter of months, whereas legislative amendments can take years.

Second, there can be no dispute over the interpretation of a Guideline. If there is any ambiguity in the wording of a Guideline, APRA can either issue an Interpretative Note to clarify the matter, or it can amend the Guideline. Importantly, the ultimate jurisdiction for the interpretation lies with APRA. In contrast, where the interpretation of a Regulation comes into dispute, jurisdiction for the interpretation ultimately lies with the courts. Some of Australia's historical regulatory failures can be traced to the inability of the legal draftsmen to draft legislation tightly enough for effective enforcement.[4]

Philosophical support

While legislative backing in the form of autonomy and enforcement powers is critical to the regulator's ability to function effectively, it is equally important that the government and the regulator share the same philosophical stance on regulation. This means sharing a common view about the role and objectives of regulation. It also means keeping open the channels of communication so that the government is aware of issues facing the regulator as well as evolution in the regulator's approach and in the regulated industries.

[4] The collapse of Pyramid Building Society in the late 1980s, for example, was hastened by that institution's ability to find ways around the prudential rules contained in legislation.

At a broader level, a supportive government will also ensure that the regulator has functional links with other regulators and bodies whose policies and decisions influence the effectiveness of the regulator. The most obvious of these is the disclosure regulator. Without adequate disclosure, the prudential regulator's task is almost unmanageable. In the event that the disclosure regulator is unwilling or unable to enforce adequately high standards of disclosure on the regulated industry, the prudential regulator must have the legal power to require information in whatever form and in compliance with whatever disclosure standards it requires.[5]

The commitment and competence of the regulator

Even with a sound regulatory structure, strong government support and extensive powers of enforcement, the regulator will be ineffective unless it has staff with the commitment and skills to carry out the tasks involved.

Staff commitment

An appropriate staff culture is a concept that is easy to discuss but very difficult to achieve. The ideal culture for a regulator is one in which staff are fully aware of and committed to the regulatory philosophy, and to achieving the regulatory objectives. Importantly, the ideal regulatory culture is driven by a commitment to outputs rather than inputs. The reality is that most regulators around the world are staffed by public servants or ex-public servants – people who come from a culture which does not fit readily into what I have just described.

The conversion of culture is one of the biggest tasks currently facing APRA. At its establishment in July 1998, APRA was required to absorb the staff of the then existing regulators of banks, insurance and superannuation. In July of this year, we are expecting to absorb further responsibilities and staff from the state-based regulators of building societies, credit unions and friendly societies. Melding these disparate cultures into one effective unit is a major challenge.

[5] In Australia in 1992, the prudential regulator of building societies and credit unions went so far as to promulgate a specific prudential standard setting out accounting standards for the industry.

As a first step, we will be introducing a new staff structure around the middle of this year. That new structure will better align divisional responsibilities with the integrated nature of our regulatory responsibilities. Thus, for example, we will introduce a new division to deal with complex financial conglomerates and another to deal with specialised institutions. These will replace existing divisions structured along industry lines.

At the same time, we will introduce a new set of terms and conditions for staff employment. This will be structured so as to reward excellence and commitment and to refocus attention away from inputs (such as time spent on the job) and towards outputs (such as objectives achieved).

Staff skills

One of the great difficulties facing every regulator is that salary differentials between the industry and the regulator are such that the most highly skilled staff usually work for the industry rather than the regulator. This makes it extremely difficult for the regulator to keep abreast of frontier developments in products and techniques in the industry.

Given that a fundamental tenet of prudential regulation is that responsibility for risk management lies first and foremost with the boards and management of the regulated institutions, it is not critical that the regulator have the staff skills needed to remain ahead of the industry in terms of identifying and understanding innovations. At the same time, it is important that the regulator does not fall too far behind the industry in terms of technical skills, or it risks being incapable of identifying problems before they become critical.

On balance, these considerations lean towards a model in which staff skills are developed largely on the job. In-house training can play an important role, as can staff exchanges with industry and with other regulators. It is unfortunate that few academic programmes around the world cater for the specific training needs of regulators. We are conscious of this in Australia and are currently working with an Australian university to develop a "tailor-made" graduate programme designed to cater specifically for regulators. While this programme is still in the early stages of development, the features that I expect it to contain are roughly as follows.

The programme will run over five to six years, with staff taking two or three subjects per year. About half the subjects will be conventional MBA subjects (Management, Accounting and so on) while the remainder will be specific to regulation (these will all have a financial orientation and should help build up specific skills in areas such as credit analysis and derivative products).

The subjects will be offered in "intensive" live-in form, with each taking two weeks. APRA will release its more promising staff for up to four weeks per annum on training leave to participate in the programme. We expect that other regulators in the region will also participate, so that the programme should help build up networking among the regulators. Such a programme is not only designed to build up the necessary technical skills among our staff but also, by rewarding our better staff with a marketable qualification, we hope it will attract better quality staff to APRA and that APRA can retain them for a longer period.

Public education as to the role and limitations of regulation

My final ingredient to a sound supervisory framework is possibly the most elusive. As I mentioned earlier, it is important that consumers of financial services are properly educated about the nature of prudential regulation and the limit of any government guarantees of regulated institutions, implicit or otherwise. This involves walking a tightrope between the inherent desire of regulators to minimise the risk to consumers and the need for management and boards of financial institutions to take full responsibility for the risks that their institutions incur. The literature on moral hazard is replete with examples where the regulatory imprimatur has been abused to create an illusion of safety.

In some countries, the government's guarantee is explicitly limited by deposit insurance. In the case of Australia, the extent of the guarantee with respect to deposit-taking institutions is made explicit in the legislation. In the event of a bank liquidation, for example, the legislation limits APRA's responsibilities to ensuring that depositors have priority over other creditors.[6] Despite this explicit limitation of the Australian government's liability, there is little doubt that the public still perceives an implicit government guarantee in respect of banks.

[6] Banks are also required to maintain an excess of domestic assets over deposit liabilities to give substance to the priority provisions.

The issue of public education is important but difficult. Without an informed public it is difficult for any government to stand back from distressed institutions. The danger in such an environment is that there is a tendency to over-regulate to minimise the government's exposure. Over-regulation not only inhibits competition and innovation, but can also cause the very instability that it seeks to avoid.[7] But even with a well informed public, and mechanisms in place to explicitly limit the government's exposure, the reality is that any government is faced with a dilemma in the event that a significant financial institution faces financial distress.

Conclusion

A unique, ideal framework for prudential regulation does not exist. There are many workable configurations of regulatory agencies and divisional structures. What is most important is that the structure chosen be appropriate to the nature and stage of economic development. It is also important that there be consistency across a range of issues that make up parts of the overall framework.

In this paper I have suggested the following issues as key ingredients to a successful supervisory framework:

- a coherent regulatory philosophy;
- a strong government commitment to the regulator;
- a strong commitment and high level of competence among the regulator's staff; and
- education of the public as to the role and limitations of regulation.

[7] Some of the more spectacular institutional crises, including the current Japanese banking crisis and the 1980s Savings and Loan crisis in the US, can be attributed largely to over-regulation (or at least to inappropriate regulation).