Chapter 5 of the Financial System Inquiry Final Report starts with the assertion that ‘Australia needs strong, independent and accountable regulators to help maintain trust and confidence in the financial system’. Perhaps it should have included ‘effective’ as an additional adjective since some key recommendations focus on the effectiveness of the different regulators and the system overall.

To help achieve this objective the Financial System Inquiry (FSI) makes five specific recommendations while batting away a number of alternatives. These are to:

- strengthen the Australian Securities and Investments Commission (ASIC)
- improve the regulator accountability framework
- improve the effectiveness of our regulators
- rebalance the regulatory focus towards competition
- improve the process of implementing new financial regulations.

The recommendations explicitly considered and rejected imply:

- no change to the institutional structure
- no change to the regulatory perimeter
- no additional regulators brought into the Council of Financial Regulators
- no reallocation of functions between regulators
- self-managed superannuation to stay outside the net.

**Were the regulators the big winners?**

There were three basic regulatory issues that needed to be resolved. First, the FSI needed to form a view about whether the current separation between the Australian Prudential Regulation Authority (APRA) and the Reserve Bank would be retained. The second was how to deal with the problems swirling around ASIC, and the third issue was to address concerns with the way the various regulators operated.

The FSI appears to have been influenced by the fact that different countries are experimenting with different regulatory structures and that there is no clear consensus on the appropriate approach. In the absence of this, and given that our system appears to be working well, the FSI recommends no change. This seems sensible.

It has stronger views about what to do with ASIC and, in doing so, incorporates the spirit of the recommendations from the Senate inquiry into the performance of ASIC. These effectively strengthened ASIC, narrowing its brief and strengthening its finances, while rejecting more substantial changes.

With the rapid pace of regulatory change which followed the global financial crisis (GFC), concerns emerged about the mode of operation of the regulators. These were not driven by concerns about how the crisis had been managed but rather with the post-crisis phase, particularly where regulations were introduced without any of the give-and-take of the normal processes of domestic policy formation. There was a concern that APRA was deciding how and when to implement decisions taken by the Basel Committee without serious local input or review. The FSI left operational matters with APRA but instituted a form of oversight to address concerns.

**Greater accountability to government**

Some of the most innovative recommendations in the FSI Final Report relate to the accountability of regulators to government. Specifically the inquiry recommends establishing a new Financial Regulator Assessment Board tasked to undertake annual review of the performance of regulators against their mandates. The assessment board concept arises from the panel’s struggle to find a mechanism which balances the conflict inherent in the principles it sets out of independence and accountability. It hopes that this process will ensure that regulators ‘give stronger and more transparent consideration to competition and compliance cost issues’. To facilitate this, regulators are asked to develop better indicators of how they are performing.

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At the same time, the FSI suggests regulators should get a little more cover. It recommends that government should make more explicit what it expects the regulators to do, particularly by setting out more clearly the government’s appetite for risk in the financial system.

Unfortunately neither recommendation is likely to be effective.

An assessment board which takes its job seriously will report to the Minister that regulator A has done a good job, but regulator B is underperforming. Regulator B will then explain to the Minister that the board is wrong, and it is actually performing its mandate appropriately. The Minister will then have to resolve the issue, and fix the performance, without having either group resign. Well-qualified potential regulators may even refuse to operate under this model.

The most serious alternative considered, with each regulator having a board, and a separation of executive responsibility from board responsibility, was rejected on the grounds that the HIH Royal Commission had recommended against it. Since the separation of board from executive is standard in most of Australia’s commercial sector, it is difficult to see why it is not appropriate for our regulators.

The best option would be to encourage the assessment board to operate rather like a normal board of directors to the regulators. While it will probably not be selecting chief executives, the assessment board could well discuss and consider strategic developments with the regulators, and then report to the Commonwealth Treasurer rather as a normal business board does with corporate shareholders. This would change the operation of the assessment board somewhat from what the FSI envisages, but it is likely to constitute a more effective form of governance.

The recommendation that governments set out in advance a risk appetite statement for the regulators seems unlikely to be effective. Do we seriously believe the government is going to say to ASIC that it is allowed to have three small financial scandals each year, a major scandal every two years? Would the Rudd Government have told APRA just to let Bankwest collapse in accordance with its risk appetite statement of one bank failure per decade?
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That said, the regulators will have to comply with the government’s new Regulatory Performance Framework which will help address some of these concerns. It now requires self-assessments of regulatory performance burdens which will be reviewed every three years and will capture the financial sector regulators.

**Raising regulatory effectiveness**

The inquiry makes a number of recommendations about how the regulators should operate, which are designed to improve their effectiveness. Most intriguingly the panel felt that it was necessary to remind the regulators of the importance of competition: ‘the inquiry believes there is complacency about competition, and that the current framework does not systematically identify and address competition trade-offs in regulatory settings’.

The panel clearly believes that the regulators, and probably APRA in particular, have allowed prudence to dominate their analysis and settings at the expense of the other aspects of their briefs.

Whether this admonition will have any effect is unclear. In the aftermath of the HIH collapse, fingers were pointed at APRA for not paying sufficient attention to the risks in the insurance sector. More recently, ASIC has been criticised by the Senate for not foreseeing problems in several finance companies. The fact that the regulators are blamed for collapses surely means that they will continue to value the stability of institutions above competition between them.

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By contrast, the idea of an initial Hilmer-style external review of existing unnecessary regulatory barriers to completion is clearly appropriate and regular evaluations of regulatory solutions for potential anti-competitive impact is certain to align with the views of the Competition Policy Review currently underway. The panel’s call is not to actively promote competition. The focus is rather on removing barriers to entry, allowing space for competition to develop, and encouraging normal competitive activity. There is no call on the regulators to tilt the table against particular players. Again this seems likely to be consistent with the approach taken by the Competition Policy Review. Such external ‘competition’ reviews of the sector represent a significant positive move.

The call to improve the processes applied when new regulations are implemented is a reflection that regulators are avoiding undertaking proper analysis, consultation and review of the wave of new regulations that Australia has seen post-GFC.

Again though, the recommendations seem unlikely to have much effect: ‘the inquiry recommends that Government and regulators adhere to minimum implementation lead times and monitor impacts more thoroughly post-implementation’.
Post implementation reviews are a waste of time and effort. They sound good from a bureaucratic point of view: the agency should learn from its mistakes. But post hoc reviews are of no value to the industry or little value to the society. The central problem is that a poor regulation, such as the Financial Services Reform Act 2001 (FSRA) when it was introduced, causes the industry to incur millions (possibly hundreds of millions) of dollars in investment and retraining. To decide a few years down the track that it was a mistake does not recoup the investment. And then a decision to reverse the mistake, even to go back to the old rules, requires firms to incur even more costs. Calling for longer lead times has no real impact other than to spread the adjustment costs over more time.

A better process would be to take more time and care initially. This has to involve real engagement with the industry to ensure that new regulations are designed to be as easy to implement and administer as possible.

The inquiry recommends that ASIC and APRA should both be strengthened through increased budget stability built on periodic funding reviews, and with greater operational flexibility. ASIC, APRA and the payment systems function of the RBA should also commit to six-yearly capability reviews. These are helpful recommendations.

The non-recommendations
The Wallis Inquiry established the basic architecture of Australia’s financial regulators. There have been four major changes since then, from which we should learn.

First is the complete change of the focus of ASIC from relying on consumers to make sensible choices, to the current focus where sellers have responsibility for stopping consumers making silly choices. This consumer protection brief in finance looks very similar to the consumer protection brief of the ACCC. Do we need two consumer protection agencies? The inquiry opines that it is necessary for ASIC to keep consumer protection in finance because it sees consumer protection as an important part of ASIC’s toolkit. The logic is weak: every industry could have its own regulator with its own consumer protection function but Australia has chosen to place these powers with the ACCC across a full range of industries with perhaps the only exception being finance. Why is finance different? We are told, without substantial justification, that: ‘The inquiry sees value in an integrated consumer regulator for financial services.’

The second major change was the experience of the GFC. The regulatory model, and nature of cooperation, worked during a period of considerable stress so that broadly we would expect to support it. Experiences in other countries have, however, shown fragilities that we can learn from. The first is the potential impact of prudential policy on stability policy, and the move of prudential policy makers to focus on macroprudential issues. This has led to questions about the separation of APRA-like functions from Reserve Bank-like functions in various jurisdictions and the reintegration of some. At the same time, quantitative easing in various countries has led to questions about just how separate fiscal and monetary policies can be, again with some countries rethinking the relationship between the two.

The inquiry barely reflects on these issues. The key observation is: ‘The Reserve Bank of Australia ... and APRA each have responsibility for financial stability. However, most macro-prudential tools can only be deployed by APRA. This places a strong premium on cooperation between the two agencies.’
The third major recent change has been the emergence of new technologies which have the potential to bypass the regulated institutions. The Wallis Inquiry made the mistake of assuming institutions would not adapt, and that financial markets would have supplanted them by now, which clearly has not happened. The banks, in particular, integrated markets into their business models, especially on the funding side. What is not clear now is whether technology will allow markets to evolve and undercut the advantages banks have developed in matching lenders to borrowers. The panel examined this issue and has basically left it unresolved, other than to give the Reserve Bank a watching brief over the issue and to establish greater coordination between the public and private sector on this (Chapter 3). Since it is too early to tell how the finance industry will develop in the shadow of the institutions, this is probably the most sensible choice.

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The growth of the superannuation sector post-Wallis is reshaping the financial system quite significantly. From a regulatory point of view this has not created particular new issues with APRA continuing to monitor the major institutions within the sector. The self-managed segment, however, lies outside APRA’s brief and the inquiry has decided to leave it largely to its own devices. Its only intervention is to recommend a limit on the use of leverage by self-managed funds on the basis that unlevered funds could do little damage to the system. The financial products that funds use will be captured under the general provision of ASIC, and other products in effect by the ACCC, with the Australian Tax Office responsible for trustee behaviour. This was a pragmatic non-decision by the inquiry and probably the correct one.

The missing issues: transparency and appeals

There are two big missing elements, features one expects of a good regulatory process. There seems to be no requirement for regulators to conduct public hearings or to issue discussion papers; in fact, there is very little emphasis on the transparency of decision making. The emphasis is on reporting and assessing decisions after they have been taken and often after they have been implemented.

Nor does there seem to be any appeal mechanisms envisaged. This is in sharp contrast with, for example, how the ACCC operates. While we do not want appeals against the Reserve Bank’s interest rate settings, it is not clear why other regulatory decisions should not be appealable.

The inquiry touches on the issue of inconsistencies in the mandates of the different regulators but makes no decisive recommendation. The Reserve Bank and the Payments Systems Board have responsibilities to balance core responsibilities against issues like promoting certainty and minimising compliance costs, but it is not clear that these apply to APRA and ASIC at all. This is an area where we could certainly have done with a clear recommendation to fix the suite of mandates.
Overall assessment
The regulatory chapter is one of the weakest in the report. Ironically the non-decisions were probably the best, with no changes recommended to the regulatory structure or the regulatory perimeter. The self-managed superannuation sector has basically been left alone, and the impact of emerging technologies on regulation is to be monitored.

The steps taken to increase accountability seem designed to fail. If the Accountability Board is strong, it will undermine the independence of the regulators and they will work against it or resign. If it is weak, it will have no impact. The best hope is that it is transformed into a more normal board which reports to the Treasurer (as ‘shareholder’).

The call for government to establish (what are effectively) risk appetite statements for regulators is unlikely to succeed. What government will tell APRA it is acceptable to have one failure like HIH every decade, or one major bank every 20 years? This simply seems impractical.

The steps designed to increase regulatory effectiveness also have problems. Asking regulators to pay more attention to competition is unlikely to have any impact when the regulator’s career incentives are all biased against allowing failures to occur; prudence will always take priority.

Similarly the idea of having post-implementation reviews looks as if someone read a textbook on public administration rather than was concerned about the real world. So we do a review in five years’ time and say that a particular decision was wrong. What effect does that have? It has no benefit for the industry, the implementation costs have all been sunk, and the staff responsible are probably promoted. At best, the review might provide a case study for trainee regulators. Taking more care upfront and consulting more effectively with industry seem much more likely to produce good outcomes.

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The whole regulatory section of the final report has little to say about openness, transparency, information sharing, or appeals. This is a major deficiency.