25th IOSCO Annual Conference
Sydney, Australia

PLENARY 3
The Regulator

17th May 2000

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Introduction

Just on a year ago we formed an international group of integrated regulators to share experiences and thoughts among the select few who had brought together the regulation of different institutional groups under the one roof.

At the time, there had just been an explosion of integrated regulators, virtually doubling in number from 5 to 9 over the space of about two years. That I am aware of, the number is now closer to 18 or 20, if we count those who are in the process of restructuring.

With integrated regulation taking on fad status – and in some cases being championed as the solution to a wide range of regulatory failures – I thought it might be useful to spell out the philosophy behind Australia's model of integration and how it differs from others. Indeed, there seems to be as many different models of integrated regulation as there are varieties of Heinz soup and, to the best of my knowledge, ours is still quite unique.

So, in the brief time available I will sketch how we arrived at our model, what we see as its strengths and weaknesses and how we have gone about counteracting the weaknesses.

Foundations of the Australian Model

Many of you will be aware that our present structure came out of a major inquiry that had a very broad mandate to recommend changes to the Government. Since the foundations of our new structure lie ultimately in the objectives of regulation, let me start there.

It is actually quite curious that there is no universally-agreed set of principles for why we regulate. Within the academic literature we usually find regulatory objectives couched in terms such as:

- safeguarding the system against risk;
- protecting consumers against opportunistic behavior by suppliers of financial services;
- enhancing the efficiency of the financial system; and sometimes even
- achieving a range of social objectives (such as increasing home ownership or channeling resources to particular sectors of the economy or population).

While there is nothing objectionable about these objectives *per se*, they tend to start one level too high. Protecting consumers, safeguarding against risk, and enhancing efficiency only make sense after we have first identified why these outcomes do not occur naturally. That is, they start with the presumption that regulation is needed for these outcomes to occur.

In fact, markets in general, are quite effective at producing safe, efficient, welfare-enhancing outcomes – indeed, that proposition is a foundation stone of the market economy. The rationale for regulation arises from the fact that even the best of markets can fail, and for a variety of reasons.

The case for regulatory intervention rests on market failure and the impact of that failure on economic efficiency, safety and fairness. This line of reasoning is a good reminder that the decision to intervene to alter the natural functioning of a market should be justified on the grounds that the cost of the market failure is greater than any costs (either direct resource costs or losses of efficiency) imposed by regulation. It also reminds us that the measures employed by regulators should be those that best address the resolution of the market failures involved.

This line of thinking brought the Review Committee to identify four main sources of market failure:

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

What is interesting about these four sources of market failure is that, by and large, they require different regulatory tools to counteract the market failure. Let me expand briefly.

Anti-Competitive Behaviour

Governments generally support the fostering of competition in the financial sector because of the benefits it brings to the economy overall. These benefits include improved access to capital for business, cheaper credit and housing loans to consumers, a better match between the financing needs of deficit and surplus units, cheaper transactions, and a greater ability to manage risks.

Market forces are the main determinant of competition. The role of competition regulation is to ensure that these forces operate effectively and are not circumvented by market participants. The key measures used in competition policy are:

- rules designed to deal with industry structure (merger or antitrust laws);
- rules designed to prevent anti-competitive behavior (e.g., collusion); and
- rules designed to ensure that markets remain contestable (by ensuring that there is relatively free entry and exit).

Market Misconduct

Financial markets cannot operate efficiently and effectively unless participants act with integrity and unless there is adequate information on which to base informed judgements. Because of this fundamental need, all markets face

potential problems associated with the conduct (or misconduct) of their participants.

The two areas of misconduct that are most common in financial markets are:

- unfair or fraudulent conduct by market participants; and
- inadequate disclosure of information on which to base investment decisions.

Regulation to address these sources of market failure is usually referred to as market integrity regulation. This form of regulation seeks to protect market participants from fraud or unfair market practices. By protecting markets in this way, market integrity regulation seeks to promote confidence in the efficiency and fairness of markets.

Market integrity regulation typically focuses on:

- disclosure of information;
- conduct of business rules (prohibiting insider trading, market manipulation, false and misleading advertising, non-disclosure of commissions etc);
- entry restrictions through licensing;
- governance and fiduciary responsibilities; and
- some minimal financial strength conditions (capital requirements where the nature of the financial promises warrant it).

Asymmetric Information

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 occurs where buyers and sellers of particular products or services will never be equally well informed, regardless of how much information is disclosed.

The issue is one of complexity of the product and of the institution offering it. This problem is common in areas such as drugs and aviation and it is particularly relevant in the area of financial services.

The form of regulation involved in counteracting asymmetric information problems is usually referred to as 'prudential regulation'. 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 faces a 'moral hazard' problem, whereby the implicit guarantee offered by the regulator actually induces the institution to take on more, rather than less, risk.

The incentive problems associated with moral hazard explain the particular approaches that prudential regulators normally adopt to different aspects of prudential regulation.

The primary distinction between the methods used by prudential regulators and those used by competition and market integrity regulators is that the former are largely preventative (i.e., they primarily seek to avoid promises being broken), while the latter are largely responsive (i.e., they primarily involve prosecution of those who break their promises or who disobey the rules).

The measures used by most prudential regulators include:

- entry requirements;
- capital requirements;
- balance sheet restrictions;
- liquidity requirements; and
- customer support schemes (such as deposit insurance and industry guarantee funds).

Systemic Instability

The fourth, and final, source of 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.

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 systemic instability introduces an 'overarching externality' that warrants regulatory attention.

Systemic instability arises where failure of one institution to honor its promises can lead to a general panic as individuals fear that similar promises made by other institutions may also be dishonored. A crisis occurs when contagion of this type leads to the distress or failure of otherwise sound institutions.

Perhaps the greatest vulnerability to systemic crisis is in the payments system. The integrity of the payments system, in which obligations are settled between financial institutions, lies at the very core of the stability of modern financial systems.

The primary defense 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.

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

Drawing the Boundaries

Identifying the sources of market failure and the tools required was probably the easiest part of the review. The much harder part was deciding where to draw the boundaries in allocating regulatory responsibilities to different agencies. The main options were:

- to retain an industry-based structure – perhaps with some minor amalgamations;
- to shift to a functional structure matching regulators with sources of market failure; and
- some form of super regulator that combined several or all of these responsibilities.

Eventually we decided to go with a functional split. Australia now has four regulators – each aligned with correcting one of the sources 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 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; and

- 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.

It all sounds very neat *ex post,* but let me assure you that determining some of the boundaries was far from simple. But I will spare you the story of how we resolved such issues as could banking regulation possibly exist outside the central bank, and whether or not pension funds or securities dealers belonged within the prudential net.

What is unusual about this structure is that each regulator regulates a single function. Thus the ACCC regulates all competition – in the finance sector as well as the non-finance sector. Thus, if an anti-competitive issue arises in the banking sector, the prudential regulator is not involved (at least not directly). Similarly, all issues dealing with the consumer interface of banks and insurance companies (such as disclosure and selling practices) is dealt with by ASIC – again APRA is not involved. Something that the banks and insurance companies have had to get used to that they now have to deal with multiple regulators rather than just one.

Strengths of the Model

Apart from the fact that it is consistent with the underlying principles of why we regulate, this model has a number of strengths relative to the alternatives:

First, it encourages regulatory neutrality. One of the greatest difficulties of institutionally-based regulation is avoiding regulatory bias. This occurs not only where there are multiple regulators for similar types of institutions (such as banks and non-bank deposit-taking institutions) but also where different institutional regulators take responsibility for a given regulatory function just for their group of institutions (eg where banking regulators effectively determine the disclosure practices of banks, while another regulator(s) is responsible for disclosure elsewhere in the system).

Second, relative to the super regulator, it minimizes cultural clashes. It was our assessment, for example, that market-conduct regulation and prudential regulation were so different in their methodologies and scope that bringing them together under the one roof would inevitably lead to tensions between cultures, resource allocation and regulatory focus. Note that, by implication, we made the assessment that the methodologies and scope of say banking and insurance regulation were close enough (or at least should have been close enough) that they would be cultural compatibility.

Third, it is relatively efficient, both in terms of dollar costs and in the sense of economising on scarce regulatory skills, in that it brings together all regulators of a particular orientation and focus into the one agency.

Finally, except for some inevitable fine-tuning has had to take place, this model is designed to minimize regulatory gaps and overlaps. For example, when APRA receives a complaint about a bank or insurance company, unless the issue has prudential implications, it is passed on to ASIC. Likewise, if a new product emerges that looks and smells like insurance, or looks and smells like a deposit, it comes under APRA's purview, regardless of who is offering it.

Weaknesses of the Model

The model also has some weaknesses.

Chief among these is the potential for conflicts of interest among the regulators. These arise from the natural conflicts that exist between the objectives of the different forms of regulation.

The most obvious of these is between prudential regulation and market integrity regulation. For example, a prudential regulator is less likely to pursue market misconduct as vigorously as the market integrity regulator if there is any prospect of the pursuit leading to a prudential problem.

Conflict can also arise between the stability objectives of the prudential regulator and the competitiveness objectives of the competition regulator. A

case in point is the ease with which a prudential regulator can deal with transfers of engagements in merger situations when it is also responsible for competitiveness in the industry. The last thing a prudential regulator wants in a situation of forced merger is to sit through a long drawn-out review of the competitiveness implications, while the institution's capital erodes before its very eyes.

Despite the potential for tension, we believe that there is actually a strong case to force prudentially-regulated industries to meet national standards of conduct and competition. But we have not yet faced a major conflict in this area - we may feel differently if and when we have to deal with a difficult situation.

Some countries have sought to resolve the regulatory conflict by giving all regulatory functions to industry-based regulators. This comes at the cost of regulatory non-neutrality. Others have sought to resolve the regulatory conflict by creating super regulators. This eliminates the conflict at the potential cost of cultural conflict. Indeed, interagency conflicts may simply become interdepartmental conflicts.

My point is that regulatory conflicts will always exist as a consequence of the different approaches and objectives of the different forms of regulation. The rational response is to choose the structure that works best for your particular system and take whatever steps you possible can to mitigate the problems that these conflicts throw up.

Coping with the Weaknesses

We have four main mechanisms for counteracting the weaknesses of our regulatory structure:

- MOUs;
- Cross Board representation;
- Joint working groups; and
- Goodwill.

Like many other regulators, we have sought to formalise the relationships and responsibilities among the four regulators through Memoranda of Understanding. These set out, *inter alia*, our understandings of how the regulators will co-operate with each other under particular circumstances.

Perhaps the main strategic measure for building understanding and co-operation is through the *ex officio* appointment of the Chairman of ASIC, the Governor of the Reserve Bank and the Assistant Governor responsible for system stability to the APRA Board. This makes the APRA Board a regular forum where these regulators are brought together to discuss issues that in many cases cut across the three different agencies. In my opinion this has been one of the resounding successes of the new structure. It has fostered a better understanding of the roles of different agencies and provides for a regular interchange of views.

Indeed the APRA Board representation has been a major catalyst in stimulating the formation of working groups that involve staff members from each of the agencies.

The final mechanism is simply goodwill. I believe that, in the Australian system there is a healthy respect among the regulators, almost no turf disputation (a product of the functional division of responsibilities) and an enormous goodwill to make the system work.

Concluding Comments

Australia is one of a growing number of countries that have elected to integrate certain of their regulatory agencies. Our structure is unusual, if not unique, in that it reflects a genuine attempt to create a functional allocation of regulatory responsibilities aligned with the four sources of market failure that justify regulatory intervention.

Like any structure, ours has some strengths and some weaknesses. Indeed, it would be foolish to promote any one structure as the best, for all financial

systems and for all time. At this early stage, the best that we can say is that our framework seems to be doing the job that it was designed for.