Submission to the Regulation Taskforce

Commissioned by AXA Asia Pacific Holdings and prepared by
Tony Harris in association with Greg Smith
November, 2005

1. Introduction, Summary and Recommendations

This submission to the Regulation Taskforce examines the regulatory arrangements in Australia's financial industry, concentrating on the role of the Australian Securities and Investments Commission and the Australian Prudential Regulation Authority (ASIC and APRA). Given time constraints, it concentrates on how regulatory practices adopted by these agencies fail to achieve government objectives set out in the Government's response to the Wallis Inquiry and its Corporate Law Economic Reform Program. The submission argues that changes to those practices are required to improve regulation in the industry.

The key conclusions in the submission are:

> Although it was not intended by the Government, Australia has a high-cost regulatory system for financial services. This adversely affects the international competitiveness of the industry and the cost-effectiveness of its financial products for Australian consumers;
>
> These costs stem from the unduly robust approaches and practices used by the regulators - in particular their surveillance and compliance models and penalty strategies - which do not match risks and which undermine the principles-based approach to regulation adopted by the Government;
>
> This style of regulation is unhelpful to achieving the fairness and prudential objectives of legislation because, whether or not the regulators intend it, form is emphasised rather than substance;
>
> The government's objectives of increased savings and economic efficiency are similarly adversely affected by the regulators' approaches and practices;
>
> Better, more cost-effective regulation practices are available - without threatening outcomes - and were anticipated when the new regulatory system was established.

These conclusions stem from the following findings:

> A principles-based approach to regulation allows regulators to employ best regulatory practice so that substance is emphasised over form. The Wallis Inquiry, for instance, anticipated flexible regulatory oversight responsive to varying risk, the use of discretion to tailor regulation intensity to the characteristic of individual institutions or groups, and a focus on increasing efficiency and reducing regulation costs. Instead, regulators have preferred black-letter, rules-based instruments imposing heavy, industry-wide regulatory burdens (which are not reviewable by parliamentary or governmental processes) to determine industry activity;

The performance indicators reported by the regulators do not support the Government's and Parliament's intentions as seen in legislation;

Regulators have an underdeveloped capacity to listen to regulated entities. This leads to requirements which are costly and, in many cases, ineffective;

Although legislation provides for ministerial directions, this instrument is too cumbersome to be an effective accountability mechanism for these agencies;

Given regulators' general lack of trust in the industry, it is unsurprising that their actions can be disproportionate to the issues being regulated;

To mitigate costly duplication of having two overlapping regulators, legislation requires APRA and ASIC to co-operate. But lack of effective liaison is evident because their duplicated but differing requirements impose considerable costs on the industry;

Legislation establishing APRA and to a lesser extent ASIC requires each to be investigators, prosecutors, assessors of guilt and determiners of penalty. Court review is often only available after regulators have concluded and acted.

The following structural recommendations flow from this analysis:

The Government establish a statutory council to provide an effective accountability mechanism for APRA and ASIC and to constitute a tribunal;

The Government initiate a comprehensive review of the conduct of regulation of the financial services industry in light of regulatory and industry developments since the 1996 Wallis inquiry and subsequent reforms. This review should focus on the cost-effectiveness of regulatory models and styles (and associated enforcement provisions) adopted by the regulatory agencies and consider means for ensuring the optimum balance between regulatory costs and purpose.

There are also operational recommendations which are developed in the submission and its appendices:

A mandatory code of conduct to guide regulators dealings with industry (with contents as suggested below) be issued and oversighted by the proposed statutory council. Alternatively, they could be made under the Treasurer's powers to issue directions and oversighted on the Government's behalf by Treasury;

It is important for the efficiency of the industry that changes to regulations on actuarial standards, including amendments to accommodate International Financial Reporting Standards (IFRS), not lead to an unjustified increase in capital requirements in the industry - exceeding one billion dollars.

2. The Costs and Benefits of Financial Regulation

As can be seen below, there is ample evidence that the regulatory environment for the financial services sector is costly and is not particularly effective.

This ineffectiveness can be seen from product disclosure statements (PDS) whose length and complexity - they often run to many scores of pages - test the patience of all. This problem was officially identified and a solution proposed in 1998 legislation for prospectuses, the predecessor to PDSs. Notwithstanding that development and legislated requirement that advice be clear and concise, the Government has recently had to refine the operations of the changes legislated in 2001 by the Financial Services Reform Act.

The divergence between goals and practice in the preparation of these statements and other required documents has not arisen because of an industry preference for lengthy, expensive documents. That is the response to regulators which punish mistakes harshly and reward adherence to mandatory requirements which closely prescribe industry activity.

This approach rewards form over substance, in all areas of industry activity, notwithstanding the principles-based approach to regulation chosen by the Government.

This is not a problem unique to Australia. The Prime Minister of the United Kingdom, Tony Blair, said in May this year that, despite the United Kingdom being lightly regulated, "something is seriously awry … when the Financial Services Authority that was established to provide clear guidelines and rules for the financial services sector and to protect the consumer against the fraudulent is seen as hugely inhibiting of efficient business by perfectly respectable companies that have never defrauded anyone; (and) when pensions protection inflates dramatically the cost of selling pensions to middle-income people."

ASIC itself had difficulty in developing clear and concise statements for consumers. On one attempt, ASIC produced a 12 page model Statement of Advice, even after using an unacceptably tight font and after omitting material that was commercially necessary. Adjusted for these factors, the statement would approach 25 pages in length.

The same costly action can be seen in the governance arrangements proposed by APRA for entities which it regulates. APRA argues that these entities require "a higher minimum benchmark of financial strength and risk management than is required for other companies." But that does not mean APRA is justified in imposing on all entities a one-size-fits-all governance regime with detailed, mandatory requirements for board structure, board membership, audit and actuarial services. In a separate process, APRA seeks copies of all board minutes and, if they are judged by APRA to be insufficiently expansive, transcripts of board meetings. These requirements constitute a significant intrusion into the management of these entities.

3.

APRA's stated approach to the issue of fit and proper persons is to prevent the appointment of people like Ray Williams of HIH. That goal requires APRA to become entrenched in the management of its regulated entities, to the point that it wishes to review the personal assessments of senior management and board members.

The HIH experience and its costs shocked regulators, and it is accepted that they would wish to learn from the experience. But regulators should not condition their subsequent approach as if no further entity should fail and as if all responsible officers were the same as some of HIH's management. That costly approach is not justified by effectiveness.

The regulators' involvement in management is expensive: it absorbs considerable time of senior management and board members who say it is distracting them from running the business. As the Prime Minister, John Howard said in October, it is a heavy price to "have the entrepreneur spending more time looking over their regulated shoulder than actually out there in the market place". For meetings with regulators, entities have to provide many senior officers. To meet regulators' disclosure requirements, firms have to produce extensive documentation and even maintain costly systems to provide financial information using IFRS and Australian Accounting Standards.

These costs might be warranted if APRA could guarantee that these processes would prevent further HIH-styled failures. But APRA cannot guarantee that, even if that goal were desirable. HIH had a first class governance system, at least on paper, and its chief executive had some early successes in the industry.

Government did not intend this degree of regulatory intrusion when it accepted a principles-based approach to regulation. If the same disclosure requirements and regulatory oversight were imposed on Australia's important medical services industry, the cost of medical services would increase significantly and their effectiveness, merely in terms of accessibility, would be materially reduced.

A lower cost approach, one which is less intrusive, less directive and more risk-oriented could offer effective prudential and customer protection. It also would be consistent with a principles-based regulatory approach adopted by the government.

There is a further risk that regulatory action by the Life Insurance Actuarial Standards Board (LIASB) established by the Life Insurance Act 1995 will lead to unnecessary costs. The proposed standards, accommodating the IFRS and amending other standards, would lead to an increase of more than $1 billion in the capital requirements of the industry, even though APRA - which is represented on the LIASB - recognises that increased capital is not required for ordinary prudential reasons.

The LIASB issues mandatory actuarial standards. Although these are disallowable instruments, it is unlikely that the Parliament would act against standards without a thorough inquiry. If the proposed standards are enacted, the resulting annual cost of more than $150 million would have to be met by the industry or consumers.

4.

3. Philosophy behind Regulation of Financial Services

The main task set for the Wallis Inquiry by the Government was to recommend regulatory arrangements "which best promote the most efficient and cost-effective service for users, consistent with financial market stability, prudence, integrity and fairness." (See terms of reference.)

In response, the Wallis Report concluded that "a good regulatory system requires the regulator to strike a balance between the efficiency costs of increasingly intrusive regulation and the benefits that such intrusion offers to the effectiveness of regulation. The balance should err, if at all, on the side of efficiency." (See page 320.) This was emphasised by the Wallis Report's assumption that prudential regulation was not to be aimed at eliminating failure. However, regulators have departed from this philosophy.

The Financial Services Reform Act provided wide, generally unconstrained, powers to ASIC and APRA so that they could respond to developments in the industry. Because of its prudential role and a possible occasional need to act quickly, APRA was empowered to make decisions with serious consequences for individuals and firms. But the regulatory foundation for ASIC and APRA was adherence to a principles-based approach to law.

ASIC's manager of financial services regulation described the approach in 2003: "The legislation aims to be principles-based rather than black-letter law. Black-letter law tells you what the law is and how you have to abide by it. Principles-based law tells you what the law is but in large part leaves it to industry to find the way to comply."

An emphasis on principle as opposed to specific rule was intended to allow substance to be more prominent than form. This is captured in views of Dr Simon Longstaff of Sydney's St James Ethics Centre who said principles-based legislation required "company directors and senior executives (to) take personal responsibility for the conduct of corporations that they govern. Alternative systems, based exclusively on 'black letter law' and a weighty system of regulation and surveillance have the opposite effect as they reduce the span of corporate responsibility to a technical question of compliance to a set of rules externally developed and imposed by others." (See St James Ethics Centre.)

A principles-based approach also allows the regulators to tailor their regulatory action to the risk and performance profile of individual firms. Individual firms or groups of firms whose behaviour and structure show that they operate within acceptable risk parameters should be distinguished from those firms which have a high risk profile.

Instead, APRA has used its powers to impose considerable uniform requirements on regulated entities. Its mandatory requirements on the processes which entities have to establish to ensure responsible officers are fit and proper is an 11 page document. Its guidance note on the subject is 12 pages. Its mandatory requirements on governance require 15 pages.

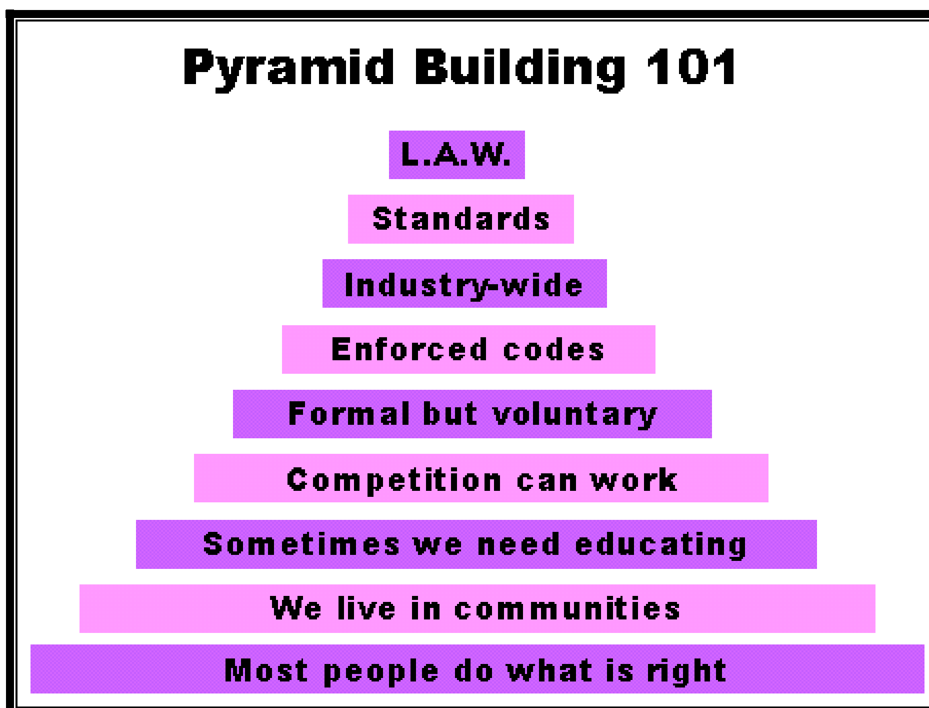
Although it was not intended, the principles-based approach to regulation has allowed APRA to issue mandatory requirements which have the effect of rule creation through subsidiary legislation, without those instruments being subject to parliamentary scrutiny. In contrast, ASIC's issues of accounting standards are disallowable by parliament.

4. The Theory and Practice of Regulation

An advantage of principles-based law is that regulators are able to minimise interventions necessary to achieve the desirable outcome. (See 'Regulation in the Age of Governance', Dr Colin Scott, ANU.) At the lowest levels, guidance and discussions are employed to encourage desired practice. If that proves ineffective and the issues are threatening regulators' objectives, mandatory standards can be imposed.

Under this approach, successively higher levels of regulatory power include the requirement to provide regulators with information, the use of official warnings and sanctions, requirements to undertake education programs, enforceable undertakings, adverse publicity and the use of financial and other penalties. The ultimate last resort penalty available to regulators involves loss of licence and disqualification.

The following version of this hierarchy of power and intervention in its pyramid form is drawn from the Australian Consumers' Association. This model emphasises non-mandatory action to promote wanted behaviour.



The following version, sourced from the Regulatory Institutions Network of the Research School of Social Science at the Australian National University, emphasises a more legal approach to inducing correct behaviour but also posits clear gradations of response.

Each approach has its virtues. Both are better than a style of regulation which only or mainly emphasises close surveillance, intrusion, black-letter law and punishment.

Clearly, regulators need to know what is happening and they must continue to test the activity of regulated agencies against best practice. But obtaining co-operation and consent and promoting best practice can provide better results - lowering costs and encouraging competitive markets - than using punitive tools.

The financial services regulators suggest they employ parts of these hierarchies, but this is only in a blunt rudimentary form. APRA talks about 'suggestions, recommendations and mandatory requirements' to indicate a progression in the degree to which it requires conformity with its ideas. ASIC uses the term 'surveillance' to indicate its adoption of this graduated approach to regulation, although that term has unneeded military connotations. As an ASIC senior manger said, "A regulatory model consisting only of strong enforcement action undermines the goodwill of those subject to regulation. Surveillance aims to encourage and gain voluntary compliance and co-operation."

Each regulator tends to act quickly, even pre-emptively, as a strong enforcer. The threat of enforcement action – and adverse publicity - is used to obtain 'voluntary compliance'.

Such voluntary compliance can be seen in some enforceable undertakings. (A recent example concerns advertisements of a major retailer. The company did not accept that its advertising was misleading but "to address ASIC's concerns", it entered an enforceable undertaking. That was the easiest way to deal with the issue.)

The language used by regulators shows that they have a preference for enforcement. One approach to regulation is to treat information gathering exercises as an opportunity to obtain assurance about industry actions. Another approach, one employed by ASIC, is to use surveillance activities to enforce prescribed behaviour. As a senior ASIC officer made clear, "Put simply, if you know the government regulator (is) going to review what you are doing, you are more likely to do the right thing." Too often, the "right thing" is a narrowly prescribed course of action.

One approach to regulation is to induce corrective action by employing enforceable undertakings only where necessary. Another approach, one which industry complains is often employed in this industry, is to use enforceable undertakings even when acceptable corrective action is underway. A more extreme approach, canvassed in APRA literature, is to eschew enforceable undertakings in preference to imposing punitive actions.

Although APRA shows a preference for using punitive powers, it suggests its limited array of powers is inconsistent with a hierarchical approach to regulation. APRA points out that "There is no capacity under the legislation for APRA to impose conditions on disqualifications or to vary their scope or duration." In recent Senate Estimates, an APRA officer advised that its only powers against individuals are disqualifications.

The absence of a more just and cost-effective range of statutory penalties might stem from the problem that under the Australian Constitution only courts can impose penalties for breaches of Commonwealth law. It seems that the loss of an entity's licence and disqualification of responsible officers is classed as a matter of administrative discretion rather than the imposition of a penalty. To the entity or individual, however, these responses are a major penalty with serious reputation and financial implications.

Nevertheless, regulators can issue warnings rather than disqualifications and produce best practice guides rather than mandatory standards. It is a matter of approach and style and the regulators have clearly shown a preference for a more intrusive, prescriptive and punitive approach, even if that merely involves using adverse publicity.

The issues of enforcement also raise questions of trust. If there is a lack of trust between regulators and regulated entities, the efficacy of a regulation hierarchy is weakened: notwithstanding regulators' stated comments, entities will always fear that any breach can lead to the imposition of a strong penalty or adverse publicity.

Thus, when ASIC proposed that financial advisers could discriminate between new and ongoing clients in order to provide the latter class with less complex disclosures, industry voiced concern that a lack of definitions would expose them to breaches and penalties.

8.

Trust is not enhanced when the regulators choose not to discuss issues with regulated entities. APRA will not meet with a regulated firm when it has issued notices as a forerunner to disqualification. Its literature states that it is unwilling to discuss 'show cause' enforcement action because discussions "can create the potential for confusing or conflicting interpretations and recollections lead to differences of understanding." ASIC has also declined to discuss its concerns, preferring instead to demand written information when an early meeting could have ameliorated concerns or disposed of them.

Regulators' general views of the financial services industry are also inimical to development of trust. The public advice provided by a Commissioner of ASIC that "ASIC is not 'out to get' the advice industry" was given because industry had cause to think it was. One of ASIC's senior staff in its compliance section was quoted as saying she did not have a financial adviser "because I just don't trust them." Officers with these views would necessarily tailor their regulatory actions to reflect that thinking.

5. Regulators' Enforcement Roles

APRA is a prudential regulator and must on occasions act quickly to stabilise problems in one or more industry members. Nevertheless, it is not necessary for timeliness reasons to allow a regulator to act as investigator, prosecutor, assessor of guilt and determiner of penalty (though, as discussed above, this term is avoided in the legislation). For good reason, there are few other bodies in Australia which have these four roles. (The Independent Commission Against Corruption in the NSW Government is another.)

In the main, where it is practical, these functions are separated to reduce the risk that penalties are issued when they are not justified. There is a natural conflict of interest when a regulator undertakes more than one role. The different structure adopted for ASIC partially reflects these concerns. ASIC is obliged in criminal actions to use the office of the federal prosecutor. Even when it pursues civil remedies, ASIC must seek orders from the courts. But ASIC still may exercise the function of investigator, prosecutor, assessor of guilt and determiner of penalty in some of its activities, such as disqualification of company auditors.

APRA's atypical powers expose it to these natural conflicts of interest. When it examines a major possible breach, it is not a disinterested player, especially if its performance indicators (see below) relate to successful adverse actions against industry members. When its investigators determine that a breach has occurred, APRA can become a conflicted party. Its actions thereafter, actions which may lead to severe penalties including the revocation of a licence, can be readily tainted. Its internal processes, including internal appeals mechanisms are meant to mitigate these problems. But as the Government recognises, internal review is a poor instrument for fairness.

Although the Government has introduced new statutory bodies, such as Inspector-General of Taxation, it is rightly reluctant to expand the number of statutory bodies, partly because of cost and efficiency issues. But these arguments have less bite when industry, which pays for the costs of regulation, argues that a further second regulator would improve efficiency. In this case, there is an identified problem in allowing regulators to undertake these four functions and the significant consequences or penalties faced by individuals and entities suggest that an additional body is required.

The proposed body, similar to the United Kingdom Financial Services and Markets Tribunal which is independent of the Financial Services Authority, would receive evidence and recommendations where a regulator wishes to impose significant penalties. Depending on work-load, it need not have full-time commissioners and it may not need more than a few staff.

There need be no concern that the proposed body would adversely affect the speed of processes affecting licence revocation and disqualification. Its considerations would take the place of those existing inside APRA and ASIC and need not extend the timetable.

Existing accountability arrangements for these powerful regulators are not robust. They do not even have a board with non-executive members (one which APRA requires of its regulated entities to reduce the risk of sub-optimal executive behaviour).

A body is thus needed to monitor the actions of regulators and to act as a forum for industry members when they consider regulators' processes are overly costly or ineffective. The proposed tribunal would also monitor adherence to the recommended code of conduct for these regulators, as discussed below. Other bodies dealings with the regulators, the AAT and Federal Court, Estimates Committees, the Ombudsman and the Auditor-General, do not have the same timely or comprehensive oversighting responsibilities.

6. Regulators' Objectives

ASIC's annual report for 2004-05, shows its main three achievements for that year were:

- 'Brought wrongdoers to justice';
- 'Guarded superannuation from suspect schemes and misinformation'; and
- 'Helped more people: 40% more action on reports of crime and misconduct.'

The first performance indicator in this annual report concerned the number of criminals jailed following ASIC action.

ASIC is entitled to respond to the public wish to see that ASIC is looking after the public interest. However, the above achievements and indicators do not align with aims set down for ASIC in law. And there are few, if any, indicators showing that the fairness and efficiency of the markets which ASIC regulates are improving, or that consumers use the information provided for their decisions.

An increase in the number of convictions might be welcomed by the public, but changes in the rate of convictions actually prove very little about the state of the market or the overall success of regulators. In some cases, increased convictions, like increased imprisonment rates reported by state and territory governments, might mean that government agencies have failed in their primary tasks.

ASIC has the advantage that Parliament has set down ASIC's general objectives. It is meant to "maintain, facilitate and improve the performance of the financial system and the entities within that system in the interests of commercial certainty, reducing business costs and development of the economy." It also is required "to promote the confident and informed participation of investors and consumers in the financial system." The degrees to which these objectives have been met are capable of measurement using performance indicators obtained under sampling or other techniques.

In summary, the performance indicators chosen by ASIC say very little about that agency's performance in meeting its objectives. They seem to be aimed at persuading the public about the efficacy of ASIC's work.

APRA's report for 2003-04 echoes some of the deficiencies seen above. As usual, it said that APRA aims "to ensure that, under all reasonable circumstances, financial promises made by institutions we supervise are met within a stable, efficient and competitive financial system." But more pressing aims for that year seem to have been "to restore confidence in APRA" and "ensure the lessons from the HIH failure are fully absorbed." Its 2004-05 report still emphasises its enforcement action, the first subject it canvasses.

APRA does have performance indicators which measure the robustness of financial commitments due and the safety of APRA-regulated liabilities. These are congruent with its objectives but they are at such a high level they cannot be used to determine the extent to which APRA's activities - such as its determination of standards for governance and fit and proper officers – meet its objectives. In other words, APRA performance indicators are irrelevant to measuring or indicating the value of APRA's work.

APRA has a legislative requirement that its activities "balance the objectives of financial safety and efficiency, competition, contestability and competitive neutrality." It would be proper for APRA to report in a clear and measured way how it has addressed, and hopefully met, that requirement.

The above deficiencies at least suggest that the regulatory agencies need to spend considerable more effort to determine, and report on, whether their activities are supported by results, particularly in market performance.

Regulated agencies cause problems when enforcement and other data are misused to suggest that the public should have confidence in their work. Not only can the data mislead, abuse of such data can adversely affect relations with regulated bodies.

11.

Thus, when an industry member advises the regulator that it has discovered a breach and has also identified a solution and the time needed to implement the solution, the regulator should not, without good reason, demand that this be encapsulated in an enforceable undertaking. Moreover, the regulator should not imply publicly that it discovered the breach, developed the solution and imposed the timetable for implementation.

Such behaviour has occurred. It not only gives the public misplaced confidence in the regulator, it can cause the public to have reduced confidence in the industry because of the belief that the industry seldom or never discovers its mistakes and never identifies solutions. This practice also detracts from the essential trust that is needed between regulators and regulated. Both damage market performance.

In some environments, such as air and medical safety, regulators want open and accurate understanding of safety incidents. To achieve this, regulators exempt self-notifications from enforcement action. This is not advocated for ASIC or APRA: a safety incident is typically a passing matter; financial breaches can be ongoing. But the lesson learned by these other regulators can and ought to be an important influence on ASIC and APRA.

7. Need for a Mandatory Code of Conduct

Notwithstanding the additional start-up costs cost to be borne by industry, an additional element of regulation (or regulatory audit) is needed to improve the regulatory activities of ASIC and APRA. This is needed to make these bodies more accountable when they impose ineffective and unreviewable black-letter law on regulated entities and when they act in a sub-optimal manner. To guide and direct regulators, and to capture the benefits of principles-based regulation, a mandatory code of conduct is proposed for regulators.

This should be developed by the tribunal proposed in section 5 above as a principles-based document, in consultation with the regulators and regulated entities. It should cover broad issues such as the need for the regulators' to act fairly, impartially, with integrity and skill. The code of conduct should also address specific issues such as:

> -The use of non-regulatory action such as best practice guidelines, existing industry codes of conduct, education and training in preference to mandatory requirements unless these are demonstrably required;
>
> - The use of principles-based regulatory action in preference to detailed requirements unless these are demonstrably required;
>
> -Where mandatory detailed requirements are necessary, they be consistent with existing statutory requirement;
>
> -The use of a graduated response to breaches in law so that penalties reflect the seriousness and frequency of breaches;

-An approach to publicity which distinguishes between breaches notified by the industry and those uncovered by the regulator;

-An approach to publicity which distinguishes between regulated entities which identify and implement solutions and those which do not;

-The use of effective liaison between regulators to eliminate costly overlapping regulatory action;

-Accountability reporting which requires regulators to show how their actions are directly related to achieving their legislated aims and objectives and are consistent with requirements imposed on industry by other legislation; and

-The need to provide consumers with accurate and unbiased information on regulator and industry performance.

The annual report of the proposed tribunal should comment on the degree to which regulators have implemented the mandatory code of conduct and on any complaints from industry about the regulators' actions and approaches. It should also indicate the action taken by the tribunal to ensure that regulators adhere to the code of conduct.

An alternative model would involve the Treasurer issuing a code of conduct prepared in consultation with the industry and the regulators. Under this model, the Treasury would oversight adherence to the code of conduct, would receive industry complaints and advise the Treasurer on those complaints and would report on adherence to the code.

8 Conclusions

This submission suggests there is a need to modify the regulatory practices of existing regulators to reduce costs and to make regulatory activity more effective.

Although it recommends adding to regulation - through a mandatory code of conduct and a new oversighting statutory body - this is needed to re-orient the approach of regulators away from a prescribed, punitive based approach to one envisaged by the government when it adopted a principles-based approach to regulations.

The recommended changes to the regulatory framework will have significant benefits. They would allow the industry to emphasise substance over form. It would improve trust by encouraging regulators to work with industry members rather than rule them. It would allow diversity in practice - while protecting the Government's fundamental objectives - rather than adherence to detailed standards. And notwithstanding additional regulations, it is expected that overall regulatory costs could be reduced considerably.

Tony Harris, Canberra, 02 6161 1704: Greg Smith, Canberra,