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PARKES ACT 2601

By email: deregulation@pmc.gov.au

Regulator best practice principles and new arrangements for performance reporting

Dear Ms Roussel

The Australian Financial Markets Association (AFMA) welcomes the opportunity to make comment on the consultation on *Regulator best practice principles and new arrangements for performance reporting* (Consultation).

AFMA represents the interests of well over 100 participants in Australia's wholesale banking and financial markets. Our members include Australian and foreign-owned banks, securities companies, treasury corporations, traders across a wide range of markets and industry service providers. Our members are the major providers of services to Australian businesses and retail investors who use the financial markets.

Australia's economic growth and productivity prospects are dependent on the efficient allocation of the resources. Financial markets play a critical role in allocating capital to business and distributing risk across participants in the economy. The financial services industry is one of the most extensively regulated sectors in the economy, being subject to intense scrutiny by multiple bodies including specialist financial regulators (ASIC, APRA and Reserve Bank), general economic regulators (including ACCC, AUSTRAC and ATO) and special purpose bodies (like FASEA and AFCA).

AFMA welcome the work being done by the Department of Prime Minister and Cabinet in reviewing the best practice principles and performance reporting. In a world where regulators are being asked by their communities to do more and more and intervene in

many aspects of social and economic activity, their good governance is a matter of vital importance to the well-being of societies.

1. Introductory observations

1.1. Accountability improves confidence in Regulators

Before turning to the specific matters raised in the Consultation, AFMA would like to highlight its long interest in the quality of regulation. AFMA comes to the Consultation from the perspective of promoting improving oversight of financial markets by regulators. In the same way that modern communities expect regulated entities, such as financial institutions, to meet high standards of behaviour, accountability and efficiency, regulators must also meet such expectations. Given the power granted to regulators and their deep impact on the performance of the financial system, it is important that their governance and performance is open to effective public scrutiny and debate.

Financial market participants concur with the objectives of the financial regulators (set by the Government), respect their authority and typically work constructively and effectively alongside them. This shared interest in the development of financial markets that support confident, capable and well informed investment, saving and risk management provides a solid basis for both the commercial enterprise of financial entities and the affective administration of the law by regulators. Nonetheless, similar to the rules for financial entities, there should be effective checks and balances in the system to ensure regulators meet high standards of behaviour, accountability and efficiency.

Regulators face a challenge in supervising market conduct and enforcing regulation in an industry that is innovative and rapidly changing. For instance, they require the knowledge, technical capacity and know-how to ensure that market integrity and consumers are protected. There is a policy trade-off between ensuring 'consumer protection' and promoting innovation that involves risk. For instance, regulators may be concerned about the ability of investors, particularly retail investors, to understand new products and services, especially if they are in any way complex.

This natural concern about innovation, together with some industry feedback being given to regulators, can reinforce a natural tendency for regulators to be conservative in their actions, and reinforce the status quo. Because innovation usually involves some element of uncertainty or risk for market participants, their clients and regulators in the early stages of its application, this can create a risk of an unduly restrictive regulatory approach to innovation. The outcome will depend on the capacity of government's policy framework and the financial regulators to recognise and address this regulatory bias.

Regulators have a better chance to understand and respond effectively to innovation if they are properly resourced through skilled personnel and support services to confidently assess the market efficiency, integrity and systemic implications of emerging new products and services. Therefore, it is important for regulators to maintain the requisite skill set within their organisation. However, they also need to promote a culture within

their organisation that supports a well-balanced response to innovation, so this skill set is used in a positive way for the economy.

Public trust underpins all aspects of economic activity but is especially important to finance. Any gap in the perceived trustworthiness of financial institutions is counterproductive to economic growth. Equally, any perception of weakness in the quality of the regulatory system (that is, the laws and the way they are administered by regulators), is harmful to economic growth. Uncertainty about how a law is meant apply or about the way it may be applied, or indeed about how it may be changed, by a regulator imposes a significant, and potentially very serious, risk on financial institutions and their employees. This naturally creates risk aversion that is counterproductive to enterprise and innovation, which are key drivers of productivity.

Australia has experienced some difficulty in this regard in recent years. The reason why regulators are strident in enforcing the law is understood and, of itself, this approach is not an issue for the industry. However, in an environment where corporate penalties are much higher, the volume of applicable law has expanded markedly and uncertainty about regulatory compliance expectations is greater, there must be full confidence that the regulators will exercise their greater powers in an efficient and professional manner.

1.2. Value of third part assessment – enhanced FRAA model is good

Back in 2006, the Taskforce on Reducing Regulatory Burdens on Business observed that many business groups considered that the culture and behaviour of regulators were compounding the problems they faced with regulation itself. In the Taskforce's view, regulators, like anyone else, will respond to the incentives in their operating environments. These influences have tended to promote unduly risk-averse approaches. Changes are needed to promote a more balanced approach.

Following on from the 2003 *Review of the Corporate Governance of Statutory Authorities and Office Holders Report* (Uhrig Report) proposal for an Inspector-General of Regulation to be established to review, independently, a regulatory authority's systems and procedures for the administration of legislation, the idea was partly taken up with the creation of an Inspector-General of Taxation (IGT). AFMA has made input to a range of reviews conducted by IGT and has formed the view that the IGT makes a significant and beneficial contribution to the effectiveness of tax administration for Australian business.

When accepting the *Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry* recommendation 6.14, the Government agreed to create an oversight body to report on the performance of ASIC and APRA. Namely, the Financial Regulator Assessment Authority (FRAA). AFMA welcomed this proposal, as it has long advocated for an oversight authority of this type, including in our representations to the Murray Financial System Inquiry.

The purpose of the FRAA must be to support high quality regulation that ensures financial system participants properly observe the law, but without imposing undue costs and restrictions that impede economic enterprise by regulated entities or their clients.

The Government in the Explanatory Memorandum to the exposure draft legislation for FRAA observed that while both APRA and ASIC are accountable to the Parliament, the Financial Services Royal Commission noted that Parliamentary committees, including Senate Estimates, have some limitations in assessing the effectiveness of the regulators (for example, the fields of expertise required to assess the regulators).

Regulators do report regularly to Parliament and the responsible ministry in their policy area on the fulfilment of their objectives and the discharge of their functions, including through meaningful performance indicators. However, Parliamentary oversight by its nature is only fleeting and prone to extraneous influences from the political realm rather than through dispassionate inquisition.

Both APRA and ASIC report extensively on their activities, but these reports are not necessarily subject to rigorous and consistent external analysis. Performance audits by the Australian National Audit Office are conducted on an ad hoc basis. The International Monetary Fund's Financial Sector Assessment Program also includes reviews of the regulators but this is on a five-yearly basis, with a focus on matters related to the resilience and systemic risks of the financial sector not performance as such.

AFMA sees the FRAA as being complementary to the overall regulatory performance framework. While APRA and ASIC are subject to the *Public Governance, Performance and Accountability Act 2013*, this does not require the measures of effectiveness included in the corporate plan to be assessed by an external third party. In the experience of AFMA third-party scrutiny is a critical element of regulator performance assessment.

The FRAA is designed to complement and augment the existing external accountability mechanisms that apply to the regulators, not to duplicate them. Its reports would inform and improve the performance of other accountability mechanisms, such as Parliamentary committees, and would also allow for comparison of regulator performance against their domestic and international peers where practicable.

1.3. Looking at how powers are exercised

The Government has recently emphasised to the financial regulators the need to clearly understand the difference between administration of the law and policy making. AFMA welcomes this development. It is for the Government assisted by the advice of its policy departments to make policy for the country. It is for this reason that we are advocating an additional capability for the FRAA which is to look at the exercise of powers by regulators, including making legislative instruments. Performance assessment in this area may be suitable for more general application.

There has been a line of thinking in Australia that some policy decisions should be made by regulators when unanticipated issues arise for which there is no pre-existing policy, or where the policies, articulated in broad terms, require clarification or fuller definition in application. The difficulty with this situation is the risk of 'mission creep', as regulators relying on their delegated rule-making powers for handling detail may seek to extend the law beyond the intentions of political policy makers. Where financial markets are concerned such rule making can result in substantive interventions in the way markets operate without a conscious public debate occurring through a moderated political process to determine that the right policy is being adopted. Accordingly, the delegation of rule-making powers to regulators must be done in a way to manage this risk.

The separation of administration of the law from the policy making role is an entirely appropriate arrangement. This make for a healthy system where there is a transparent arms length relationship between law making and administration of the law through public dialogue rather than internalising rule-making inside a regulator where it can be subject to organisational dynamics and conflicts of interest.

The third-party reviewer should be able to assess the making of legislative instruments within the scope of review of their powers. This does not impinge on regulator independence, which is about decision-making in individual cases not general application of the law. Assessment of general regulator rule making would not and should not extend to the ability to direct, make, assess or comment on the regulators' specific enforcement actions, regulatory decisions, complaints and like matters.

Specifically, with regard to FRAA this approach will require further development of the Government's proposed model to incorporate all of the following components into its capacities:

1. Direct FRAA to review and report on regulators in regard to:
    a) Conformance with the Government's Statements of Expectations for the regulator;
    b) Consideration of economic growth, international competitiveness and financial system development objectives in their management of regulation;
    c) Exercise of their powers, including making legislative instruments;
    d) Management of competing objectives and related conflicts of interest; and
    e) The professional standards maintained by a regulator, including policies and procedures governing operations, licensing and enforcement, and their adoption.
2. Provide FRAA with the necessary resources and the scope of operation to function effectively.
3. Appoint FRAA members who have senior executive and governance experience and are committed to regulation that both provides the necessary regulatory protections and supports economic activity.

This approach to regulator assessment would promote and assist high quality regulation that would serve the Government's objectives, as reflected in its Statements of

Expectations. FRAA would consider the interests of all stakeholders in the regulatory process in an even-handed way. This would reinforce the legitimacy of the regulatory process, building trust in the efficiency, fairness and predictability of the system for all involved, including consumers, business and the regulated community. In summary, it would ultimately support economic growth and development.

1.4. Statement of Expectations Assessment

Following on from the discussion about the need for regulators to implement and administer the law and not to make the law, it is worth considering what mechanisms may assist clarifying such understandings. The principles dealing with clarity around scope of a regulator's mandate play an important part in ensuring that regulators have a clear understanding of their role.

The Government determines the policy settings for the financial system in accordance with the evolving needs of the community. Since it has multiple policy objectives that at times conflict with each other, policy implementation measures must be calibrated to serve its related priorities. Thus, the Government must communicate to regulators how this should be reflected in the way they administer the law.

Following the recommendations of the Uhrig Report, the Government agreed that Ministers would issue Statements of Expectations to statutory agencies. Through issuing a Statement of Expectation, a Minister is able to provide greater clarity about government policies and objectives relevant to a statutory authority, including the policies and priorities it is expected to observe in conducting its operations. The Statement of Expectations process clearly delineates the role of policy making from that of independent administration of statutory responsibilities.

Over recent years AFMA has observed shortcomings in, and commented on, financial sector regulator governance. The Government has recognised this as an issue with ways to address it that AFMA supports. In this regard, AFMA believes that operational adjustments that entail the Government updating the Statements of Expectations it gives to the financial regulators would assist their performance coupled with assessment against as them part of the reporting framework.

Policy requires adjustment over time, so the Government must regularly update its strategic priorities for the financial regulators and communicate its related expectations of them in a manner that is a clear, capable of assessment and promotes a sound mutual understanding of these priorities.

In order to demonstrate understanding and commitment to the expectations of a Minister, a statutory authority is required to respond to the statement. The response, a 'Statement of Intent', outlines how the authority intends to undertake its operations, and how its approach to operations will be consistent with the Statement of Expectations. Within the powers available, the Minister can seek a modification of the Statement of Intent if it did not address expectations sufficiently.

While there has been follow through on the *ad hoc* preparation of Statements of Expectations for financial sector regulators, they have not been reviewed in accordance with the recommendations of the Uhrig Review.

Statements of Expectations and Intent should be subject to review more frequently; perhaps annually. For instance, a review of the documents would be warranted if a new Minister or a new head of the authority were to be appointed or if there were to be a shift in government approach in a relevant area.

Against this backdrop and given the development of financial regulation, AFMA believes the Government should update the Statements of Expectations for the financial regulators to:

1) Provide clear guidance to the regulators that they should have regard to government economic growth and international competitiveness objectives in their management of regulation;
2) Require regulators to provide guidance on the law and rules they administer that is comprehensive, up to date and presented in a user-friendly manner;
3) Require regulators to administer the law in a manner that appropriately distinguishes between retail clients and more sophisticated wholesale clients; and
4) Require regulators to conduct objective analysis of a global regulatory standard before they apply the standard to the Australian market.

This approach would address current shortcomings and help to ensure that financial regulation operates in a way that supports economic growth while meeting core regulatory objectives. It would also support financial entities being regulated in a manner that is balanced, clear and predictable, which would support innovation and business activity.

2. Response to consultation questions

1) Existing KPIs

Do the existing KPIs still meet the expectations of Government and the community?

The existing KPIs, which are directed to administrative performance, are sensible at a generic level. The thrust of comments above is that the expectations set by the Government for individual regulators and the process for assessment is where attention should be focused.

2) Balancing interests

Do the KPIs address issues around balancing the interests of regulated entities and maintaining important safeguards?

Consistent with the answer to question 1), the KPIs are directed at administrative performance rather than about giving policy direction to regulators. AFMA considers that tools such as Statements of Expectations and assessing adherence to them to be where focus needs to be directed with regard to achieving balance between goals.

3) Lessons learned

Do the KPIs address lessons learned from regulators' responsiveness during COVID-19?

In answer to question 4 below we note that there was a pull back from a highly punitive stance by the financial regulators to a more balanced approach. This meant that the regulatory regime for financial services has operated in a more pragmatic and proportionate way during the COVID-19 period.

AFMA observed that a significant factor underpinning this shift towards better regulation was clear signalling by the Government that it expected regulators to administer the laws under their watch in a manner that would facilitate commercial activity and economic growth. The Treasury also appeared to play its part by exerting greater policy influence by signalling a need for regulatory stances which support economic activity.

Moreover, the financial regulators themselves indicated that they were acutely aware of the need to address the serious economic problems flowing from the pandemic. This all led to a rebalancing of the regulators' priorities so that the pre-existing emphasis on eliminating risk of consumer harm (almost exclusively in some cases) was joined by acceptance of the need to also support economic activity.

Several points flow from this:

- The improvement to quality of regulation will be temporary - other things being equal, the shift to better balanced regulation that incorporates broader community welfare measures, than just consumer protection, will be transitory and be reversed once the economy recovers.
- For real long term change, it is vital for the Government to insist through Statements of Expectations and other communications that the regulators must give proper regard to its economic growth and competitiveness objectives in their management of regulation.
- The FRAA must be equipped to complement higher level Parliamentary oversight by providing an effective ongoing review process to help ensure the Government's objectives are well served in the way that does not hinder the

effectiveness of regulators in fostering an environment that promotes the confident participation of the community in the financial markets.

- The Treasury needs to operate as the key policy adviser to the Government on financial system regulation, so the Government is better positioned to make decisions that support sustainable economic growth.

4) Examples of best practice

Do you have examples of regulator best practice that you would like to see shared and reflected in the expectations of regulators?

As a preamble to the answer to this question we draw your attention to the regulatory doctrine which supposes that Australia's regulatory regime is for the most part based on the 'responsive regulation' paradigm. This paradigm, popularised by US and Australian academics Ian Ayres and John Braithwaite in their 1992 book1, proposes that regulators start from an accommodative stance but step towards being punitive if required.

In this context, AFMA observes that over the last 20 years nominally responsive regulators have moved from an accommodative towards a punitive stance driven by external pressures, such as from the media, Parliamentary Committees, Royal Commissions and the Government itself. There are few if any incentives for them to stay on an accommodative setting. The result has been that Australia now has a highly punitive regulatory regime. Punitive regulatory regimes are antagonistic to business and thereby to economic development. Punitive regulation plays well in the media and politically, for example in narratives which laud 'tough cops on the beat' and celebrate billion dollars fines for what are administrative failings rather than crimes of evil intent. Left unchecked the cumulative effect of regulation skewed to severe punishment and a distrustful attitude to regulated entities is to discourage innovation and risk taking. In contrast, a respected jurisdiction such as Singapore allows their financial regulator to consistently adopt a balanced accommodative stance in order to promote benefits for their economy.

During the COVID-19 period financial regulators moved back to an accommodative regulatory stance. Regulators responded by pausing their programs that constantly create new regulations and schemes. This alone brought substantial relief as it freed up significant resources that became available to deal with the challenges of COVID including remote working risks. A key takeaway from this experience is that an accommodative stance delivers immediate and tangible benefits for business, consumers and the economy.

AFMA suggests that there are benefits available for Australia's economy if there is a long term return by the financial regulators to a more accommodative regulatory

[1] Ian Ayres and John Braithwaite, *Responsive Regulation: Transcending the Deregulation Debate*, Oxford University Press, 1992

stance to bring our responsive regulatory regime back into balance. This is because decision making by financial institutions on commercial risks will be less inhibited by excessive regulatory risk minimisation.

Please contact David Love either on 02 9776 7995 or by email dlove@afma.com.au if further clarification or elaboration is desired.

Yours sincerely

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