31 July 2023

By email.

Dear Sir/Madam

Re: Draft Financial System and Regulator Metrics Framework

AFMA welcomes the opportunity to provide comment on the Draft Financial System and Regulator Metrics Framework.

AFMA commends the important work that FRAA has done with its first two reports – these reports provide an excellent basis for regulator reform and will drive important changes that we believe will benefit Australian investors.

We are cautious about some of the directions of the current metrics project, particularly in the absence of a Panel.

Selection of metrics for assessment of the regulators is a difficult task. When we were approached for input, we declined in part due to these difficulties. Selection of a metric for a regulator creates strong incentives that can readily be at odds with the interests of the industry and the economy.

As the Consultation Paper notes there is currently no initiative internationally for an independent authority to use quantitative metrics to assess regulator effectiveness and capability. This is pioneering work and is a significant challenge.

While some metrics are reasonably straightforward, others can readily be poor proxies or even misleading, while others can create perverse incentives, and in this regard, we note Goodhart's law that when some measures become a target they cease to be good measures.

We suggest that the metrics work should be supported by and align with the strategic approach of the incoming Panel members. As such, AFMA suggests that until such time as the panel is appointed the metrics project should be held in abeyance.

We note that the consultation process so far has solely included public sector organisations and employees, as well as one consumer group. There does not appear to have been input from regulated populations who may well be best placed to report on many aspects of regulator efficiency and effectiveness.

We suggest there is likely benefit in broadening out the consultation process to include regulated populations and private sector firms. AFMA commits to participating in any further consultations.

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At a high level we are concerned that the metrics, considered as a set, are focussed for the most part (29 out of 43 metrics[1] by our count) on assessing the financial system rather than the regulators.

AFMA is of the view this may not be a suitable mix for the goal of financial regulator assessment by the Authority.

The Consultation Paper notes “it is challenging to isolate causal links between developments in the financial system”. We think it is very challenging. Most drivers of the financial system are not regulator related. Often where regulation does drive outcomes they will be in the absence of businesses or sector growth, which are difficult or impossible to measure.

We suggest that the focus on financial system metrics may therefore be misplaced and not sufficiently aligned with goal of regulator assessment. It may also not be in optimal alignment with FRAA’s enabling legislation which is not aimed at assessing the financial system but rather the financial regulators.

As such we would encourage the FRAA to reset the metrics project. It should reduce or remove the metrics aimed at the financial system, and increase the metrics focused on the financial regulators.

To be consistent with the FRAA Act the metrics should be focussed on the regulators rather than the financial system. Metrics for the assessment of the regulators should be focussed on two key areas:

- Regulatory burden created.
- Operational efficiency and effectiveness.

Our suggestions for building out the regulator-focussed metrics include:

- Use of the regulators’ existing Adequacy, Appropriateness and Effectiveness measures, including: numbers and quality of staff, turnover, composition and experience.

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[1] In our assessment the proposed metrics that go the performance of the regulators include:

All six metrics listed under outcome: New entrants are able to enter financial markets efficiently while meeting entry requirements

Plus:

APRA stakeholder survey responses
The percentage change of visitors to ASIC’s Moneysmart website
Number of open requirements overdue by 90 days or more
APRA returns all eligible deposits at ADIs declared under the Financial Claims Scheme
Enforcement timeliness (ASIC)
Enforcement prioritisation (ASIC)
Enforcement efficiency measures (ASIC)
Surveillance efficiency (ASIC)

- Increased use of surveys of the regulated populations. We believe this is more likely to point to the issues that typically arise with regulators. Few of the main issues picked up in the FRAA reports to this point would have been found in the suggested metrics.
- The number and freshness of regulatory rules and guidance.
- The ease of navigation of requirements as explored by the ALRC.

Changed frequency

We note our regret in the Government's decision to change the FRAA's review frequency to five years.

A five-year frequency is unworkable for a continuously operating Authority – reports could not be commenced five years out from their delivery as they would be out of date by the time they were completed. Metric data from the first 2-3 years of the five-year period would for example no longer be valid. The FRAA will be effectively in abeyance for three years out of every five, and this is likely to impact the quality of the reports it does create during its active years.

The currently completed APRA review covers superannuation and excludes APRA's work on the critically important banking and insurance sectors. The timing change means the first review of APRA's banking and insurance functions will not be completed until perhaps 2033, ten years from now and some 12 years after the FRAA was formally established. This would appear contrary to the original aims of FRAA. We would encourage the reworking of the FRAA schedule to move this date much sooner.

AFMA has always been of the view that FRAA oversight should be extended to regulators that oversee the financial system and its participants, including the ACCC and AUSTRAC. The extension to AUSTRAC and ACCC would combine well with a move to a three-year cycle. The inclusion of additional regulators would provide all surveyed regulators with additional time to implement reforms while maintaining a workable reporting cadence.

Conclusion

We reiterate our view that metrics for regulator assessment is a challenging project. At this point there is additional time given the change in report frequency and in the absence of a Panel we suggest work is paused and the way forward reassessed.

Our response to the consultation questions follows this letter. We thank you for the opportunity to contribute to the consultation.

Yours sincerely

Damian Jeffree

Senior Director of Policy

Turning first to the second question:

2. Are the FRAA's characteristics and outcomes of a well-functioning financial system well-designed and useful framing devices for the development of metrics?

Characteristics

Efficiency is of course a desirable outcome, but in a market-based economy it is largely self-correcting and there are risks associated with governments endeavouring to increase efficiency with market interventions. Such interventions, even though well-intentioned, typically increase costs and can thereby decrease efficiency. Firms, and particularly public corporations have multiple mechanisms in place to ensure they focus on creating efficient outcomes both for customers and shareholders. The best contributions governments can make are towards minimising the costs associated with regulation.

As such, efficiency would be best used by FRAA as a desirable characteristic of the regulators/regulatory system rather than the financial system.

When the resilience calibration is left to regulatory forces in AFMA's experience there is typically a skew towards excessive and uneconomic requirements. 'Gold plating' of resilience requirements risks removing market access altogether for some parties or removing the ability for firms to make their own trade-offs between resilience versus cost (as was at risk in stockbroking resilience requirements). In prudential matters it can lead to economically detrimental increases in the cost and availability of capital.

To function effectively as a measurable characteristic of the financial system, resilience needs to be carefully limited to where it is essential and then in a proportionate way.

Fairness is the closest to an unalloyed good. But even here there are risks that policy drift and good intentions around statements of general principle such as "efficiently, honestly and fairly" (s912A(1)(a)) can be seen as implying an ever-expanding set of only-retrospectively discoverable obligations. Standards of fairness need to be predictable in advance, stable, and reasonable.

Outcomes

We generally agree with the outcomes suggested in the Consultation Paper.

In relation to enforcement actions and penalties we suggest that these should be proportionate and should avoid undesirable economic outcomes. Regulators and others are naturally incentivised to maximise penalties as this can improve their metrics and positioning. Recent years have seen some disproportionate penalties and we expect this increase may be existentially challenging for some smaller firms. There should be checks and balances to these incentives to ensure a proportionate outcome.

For larger firms, even where there are no breaches excessive penalties can result in an economically disproportionate and inefficient allocation of resources to avoiding any risks of even unintentional minor breaches. Where larger firms are exposed to extreme fines this can harm outcomes for clients, staff, and shareholders including Australians with exposures through superannuation and indexed funds.

Turning to the other questions:

> 1. Does the FRAA's draft list of metrics enable the FRAA to obtain insights on financial system developments and provide a useful input to evaluating the effectiveness and capability of APRA and ASIC? Are there metrics that the FRAA should consider including in or removing from the framework?

We note our general concerns around the metrics proposed outlined in our letter above. Those comments should be read as part of our answer to this question.

AFMA supports the Consultation Paper's suggestion that only a subset of metrics should be used in any report and the rest should not be published. Many metrics will move for any number of reasons (for example global economic activity, supply shocks etc.) unconnected with the health of the financial system or the performance of regulators. Their publication where a causative link is not confirmed or clearly highly likely could be counterproductive.

AFMA's experience has been that the types of failings that require the most prominent attention in the assessment of regulators are typically not readily represented in simple metrics. As drafted, we are concerned that the metrics may provide a false precision of analysis and may distract from the bigger picture of regulator performance.

Failings that would not readily turn up in the proposed metrics include for example, concerns that a regulator is prioritizing the wrong matters in policy development or enforcement, concerns that a regulator does not have sufficient staff or technology, or that insufficient attention has been given to the treatment of unlisted assets. All key concerns raised in FRAA's first two reviews.

Once a list of metrics is determined, the FRAA should set up a review process to back test which metrics have ongoing adequacy and appropriateness, and which do not. Where metrics are found not to have such value their use should be terminated. An initial review of the final metrics on historical data should be conducted before the metrics are used. For all metrics, all assumptions, methodology and data sources should be made available.

Enforcement metrics

AFMA holds serious concerns over some proposed metrics, particularly those relating to ASIC enforcement.

The proposed focus on (1) the number of ASIC enforcement actions and the numbers of convicted persons, (2) the total fines and penalties and (3) the dollar value of compensation awarded to complainants through AFCA judgements and agreements, (4) compensation or remediation agreed in court enforceable undertakings, are concerning.

Proposed metrics and what indicators they measure are often multi-factorial and open to question. For example, data on the number of litigation cases – this can be an indicator of ASIC's enforcement effectiveness or an indicator that there is a lack of clarity within the regulations or legislation.

In AFMA's view ASIC enforcement of civil (and civil penalty) matters should function in a similar way to the Commonwealth Director of Public Prosecutions (CDPP) processes for criminal matters.

Decisions to pursue civil prosecution should be made at arms-length, entirely on the merits of the case and the public interest with strict adherence to principles such as those in *Prosecution Policy of The Commonwealth Guidelines for The Making of Decisions in The Prosecution Process*. As with the CDPP's work on criminal matters for other agencies, separation of such decision making into a body independent of the investigating regulator would be preferable and provide protections for the regulator.

The use by FRAA of numbers of convictions and total size of fines and compensation, for example, risks incentivising the overly aggressive pursuit and inflation of minor matters, the maximising of fines, sentences and other penalties and thereby compromising the motivations of regulators.

At a minimum the presence of these metrics could call into question regulator motivations, an undesirable state of affairs.

AFMA strongly objects to the use of these metrics as proposed.

Market concentration metrics

AFMA also queries the proposed two market concentration metrics – the Herfindahl Hirschman Index and Share of market. Selection of these metrics may be a pre-commitment to FRAA holding a negative and unjustified view on the health of certain markets.

Australia is, for most markets, and certainly most financial markets, relatively small. Small markets naturally have limits on the number of high-quality competitors they can support. For example, outside of finance it is unlikely that Australia could ever support ten full-service international airlines. There are not enough ticket buying passengers to finance the number of planes, and the inefficiencies of duplication of back-office services would lead to *higher* rather than lower ticket costs and risk *lower* safety standards.

For the financial markets that AFMA represents there is little value in having large numbers of undercapitalised marginally profitable participants. Contrary to the suggestion inherent in the metrics, large numbers of competitors will not produce high quality service and outcomes, as like the airline example, they will lack the scale to make the necessary investments to operate at a global standard.

Where prudential matters are also factored in there are significant national downside risks to having marginally profitable firms that lack scale.

Yet these metrics, if used, would always tend towards suggesting that the markets are too concentrated and that this is a poor national outcome. We suggest this would be unjustified and potentially counterproductive.

As such we recommend against these metrics.

Market microstructure metrics

AFMA acknowledges the importance of bid/ask spreads as an important measure of market health. Yet used alone and without substantial background study on the particulars of the market in question they can readily be misleading. Determining market health is a complex undertaking.

As an example, last year working with ASX, AFMA members carefully reviewed the state of the bond futures market after a change was made to the tick size.

Consideration of bid/ask spreads was a key part of this review. In an effort to rebuild market liquidity the tick size was doubled from 0.5bps to 1bps. The market still continued to trade at the minimum spread so the spread on a bid/ask basis doubled. On the simple bid/ask spread metric the market was thereby *worse-off* by a factor of two.

However, a consideration of many more factors including liquidity at touch (adjusted for the natural bunching of price points), depth at top five price points, total order book depth, open interest, average daily volume, volatility and other measures, along with a consideration of the likely impact of macro trading factors suggested the measure may have benefited the market. The increased spread assisted market makers' participation in the market and this is likely to have contributed to the (adjusted) increased depth at touch. Even with this level of sophistication of analysis there were a range of views amongst market experts, and no clear trigger for a return to the previous tick size as foreshadowed by ASX.

In this example a bid/ask spread doubled yet most considered the market improved in the short term, this demonstrates the complexity of using bid/offer spreads in even a single market and how it can readily be misleading. As such we caution against using it for the purpose of assessing market competitiveness.

Similarly, volatility of bid/ask spreads (equity) while an important measure can be driven by any number of macro and micro economic factors, local and global trading conditions, monetary policy, technological change and market microstructure construction and changes.

We suggest that more sophisticated qualitative assessments from market participants are preferable to a primitive and prone-to-mislead metric such as bid/ask spread.

Market cleanliness

AFMA has previously raised serious concerns about so-called ‘market cleanliness’ measures. We strongly object to the use of these measures as speculative and prone to harming the good name of well-functioning markets based on debateable academic theories.

The suggestion that their adoption by the FCA is supportive is a weak ‘argument from authority’ and goes no way towards addressing the failings of the underlying theory. Australia is sophisticated enough to make its own assessments of such theories.

The assumption that movements in stock prices prior to market sensitive announcements can be assumed to be information leakage is wrong in its assumptions about how markets work.

As an example of how wrong this theory and measures can be, consider a situation where analysts and stock market observers can see the sense in a takeover by one company of another. There is no leakage of information but from the increasing logic of the takeover given commodity or other movements traders start taking positions that move the share price of company to be acquired upwards. This would be taken as a measure of market corruption by the market cleanliness measures but in fact is an example of the market working efficiently. AFMA is aware of examples of this type.

Consider too, recently in FICC markets the end of the RBA’s Yield Curve Control program. There is not, and nor should there be, any suggestion that there was leakage of information about the potential abandonment of the program. Traders just increasingly took a view that the program was unsustainable and likely to be cancelled. This view was reflected in the price action that pre-empted the end of the program. This example of market efficiency would be wrongly branded as market corruption by the so-called ‘market cleanliness’ measures.

There is a risk of an own goal against Australian financial markets through the adoption and use of these deeply flawed measures.

Licence timeliness

AFMA supports the proposed licence timeliness measures as simple clear objectives for the regulators to achieve. We also support this being extended to licence adjustments.

Credit growth

Credit growth is another factor that while an important input must be carefully interpreted in light of the broader economic picture and recent year numbers in order to contribute to an understanding of the financial environment.

Net foreign debt liabilities of private financial corporations to GDP

Australia’s growth has been significantly financed by foreign debt since before its federation.

We query whether a broadly negative characterisation of foreign debt is appropriate. Access to foreign debt might also indicate the connectivity of private Australian financial corporations to international money markets and thereby a diversification of associated funding risk.

We would see the statement “A comparatively high ratio could indicate higher exposure to risks in international financial markets but could also indicate comparatively underdeveloped debt markets in Australia” as speculative and without adequate grounding as a claim.

AFCA metrics:

The annual percentage change in complaints to AFCA regarding financial firms
The share of AFCA complaints decided in favour of the consumer

The main driver of increases in complaints to AFCA are increases in financial distress, and this is driven more by the economic cycle than by regulatory or financial system matters. For example, the June quarter saw a 31% rise in AFCA complaints, reportedly due to cost of living pressures.

AFCA complaints should be decided strictly on their merits. We caution against the suggestion that data about the regulators can be gleaned from the percentage of complaints decided in favour of the consumer. AFMA also suggests it may not be appropriate to create incentives that might risk influencing an authorities’ decision-making processes.

3. Should the FRAA note more explicitly the metrics that may provide direct insights on APRA and ASIC’s effectiveness and capability?

AFMA holds that the metrics should focus exclusively on measures that provide direct insights the effectiveness and capability of regulators that oversee the financial system and its participants.