

Reforming Australia's Twin Peaks to Better Protect Consumers and Deter Market Misconduct

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Consumer and market abuse in the Australian financial system has reached crisis levels, leading to the establishment of the Financial Services Royal Commission (FSRC [Royal Commission]). Evidence of misconduct and abuse prior to the establishment of the FSRC was serious enough, but that evidence has paled by comparison to the revelations aired at the FSRC during 2018. As a result, it is necessary to re-examine Australia's vaunted 'Twin Peaks' regulatory architecture to determine what reforms must be undertaken to prevent a reoccurrence of market and consumer abuse and disregard for the law on the scale revealed thus far.

Of greatest concern has been the ineffectual, and at times collusionary response from the Australian Federal government agencies charged with protecting consumers. We present our findings to date on the state of consumer protection and market misconduct in Australia in light of the interim findings of the FSRC. In addition, we address one of the identified failures in our consumer protection regime: lack of enforcement by the financial system regulators.

The FSRC has released its Interim Report dated 28 September 2018 (Interim Report 2018), and invited public submissions. Paragraph 5.2 of Chapter 8 of the Interim Report (p. 299) posed the question, 'Should there be annual reviews of the regulators' performance against their mandates?' Our research addresses that question with a focus on the benefits of establishing a Financial Regulator Assessment Board (FRAB) to undertake annual reviews of overall regulator performance against their mandates. Such a Board was recommended by the Australian Financial System Inquiry (FSI) in 2014 (Recommendation number 27 of the FSI Final Report [Financial System Inquiry 2014]).

Hypothesis

Our research conducts a deep theoretical treatment of regulatory capture, and demonstrates that many of the deficiencies identified by the FSRC's Interim Report, and ventilated in testimony before the FSRC, are explained by the extensive body of existing scholarship on regulatory capture. We provide examples from the Australian context. Some of the subtleties of capture we address (such as ideational or ideological capture) allow us to inform the reader of the nuances involved in constructing an effective and robust framework of regulatory oversight. We alert the reader to the body of evidence indicating that while regulatory capture is a risk in the regulation of all industries, nowhere is it more prevalent than in the financial industry. Indeed, evidence suggests

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that financial regulators ‘fall first, and fail hardest’. To this end we provide internationally comparative evidence.

With the opportunities for capture discussed and demonstrated, both in the range of opportunities and the subtleties of the temptations, we then conduct an internationally comparative, cross-jurisdictional analysis of one method to deter and prevent regulatory capture – a board of oversight (FRAB in the Australian context) the purpose of which is to enhance regulator efficacy by acting as a check and a balance against capture. This analysis draws upon contributions such as those of Adams, writing in the late 1800s, who observed the manner in which the Railroad Commissions in the US had been captured by regulatees. We present the work of other scholars who have made notable contributions to our understanding of how such a board of oversight could be envisaged, so as to address in its design and in its operation deterrence of capture, including the kind of leveraged capture which would include the capture of the board of oversight itself. This includes the work of McCraw , Breger et al , Pagliari , and others, on a ‘Sunshine Commission’, and Barth et al on a ‘Sentinel’.

Our findings also address a further issue, that of the life-cycle of regulatory agencies – they begin with ‘determination and youthful exuberance [but] pass inexorably into middle-age and finally senescence’.

A Regulator for the Australian Financial Regulators

Currently in Australia accountability mechanisms exist. For example, APRA, the financial system stability regulator, is to a degree answerable to the Treasurer. In addition, both APRA and ASIC are accountable to Federal Parliament by way of submission of Annual Reports, and by way of testimony before Parliamentary committees. Nonetheless these mechanisms have proved to be largely ineffectual.

In its final report, the Commonwealth government-constituted FSI proposed (at recommendation 27) that the Federal government create a new Financial Regulator Assessment Board (FRAB) to provide annual reports on the performance of both APRA and ASIC and the payment-system-regulation function of the Reserve Bank of Australia (RBA). The proposed Board would assess regulators against their mandates and priorities, listed in their Statements of Intent (SOIs).

While the FSI noted that Parliament reviewed regulators’ annual reports, parliamentary scrutiny was ad hoc and focused on particular issues or decisions. This, the FSI concluded, made effective monitoring of the regulators difficult, especially considering the complexity of the regulators’ mandates.

The FRAB would be comprised of between five and seven part-time members with industry and regulatory expertise, but to the exclusion of current employees of regulated entities. Various other mechanisms would be employed to ensure that Board members were sufficiently skilled, objective, impartial, and unconflicted.

They would serve staggered, limited terms to ensure continuity, and to ensure that the membership is refreshed with sufficient regularity. Individuals who provide leadership in regulatory agencies over an extended period of time will quite naturally influence the

way in which that Agency undertakes its role. Even the most vigilant and impartial regulator will possess certain cognitive biases. By refreshing the membership of the Board on a regular basis the cognitive biases of a given individual will not affect disproportionately the policies and the conduct of an agency.

Currently other, partial, examples of such boards of oversight include the Inspector General of Taxation in Australia, and to a limited degree, the Financial Policy Committee in the United Kingdom. The United States Government Accountability Office (GAO) serves as a further, limited, and partial example. While the GAO is an independent, professional agency that evaluates the performance of government institutions, it is primarily focused on financial efficiencies.

Advantages of a FRAB for the Australian Financial Services Sector

The benefits to Australia of the establishment of an FRAB are clear, and would include enhanced accountability, improvements in the regulator's culture, prevention of regulatory capture, and enhanced capacity to prevent financial crises – all of which bear either directly or indirectly on consumer outcomes.

A Board would test and probe prevailing orthodoxies, such as those alluded to in evidence before the FSRC.

In the United States, Barth, Caprio and Levine advocated for an expert panel of oversight called a 'Sentinel' that would, acting on the public's behalf, provide informed, expert, and independent assessment of financial regulation. Such an expert panel is similar to the FRAB that we propose, and our recommendations borrow heavily from the 'Sentinel' proposal.

Barth, Caprio and Levine's proposal envisaged (i) an authoritative institution, independent of short-term politics and independent of the financial services industry; (ii) with the power to demand and obtain information necessary for assessing and monitoring the regulators; (iii) with the multidisciplinary expertise necessary to process that information; (iv) with the prominence to deliver such assessments to the public and its elected representatives; and (v) in an on-going manner capable of affecting the open discussion of financial regulatory policies.

Barth et al argue that each of these characteristics 'is necessary for improving the still seriously flawed financial regulatory institutions operating around the world today.'

The FRAB should have an unfettered power to gain access to any information it deemed necessary for evaluating the state of financial regulation, including the power to compel information from regulated entities.

Because financial crises are unpredictable, and therefore difficult to foresee, such an expert panel of review would assist ASIC and APRA to foresee the unforeseeable.

Oversight from highly-experienced individuals, appointed for a fixed-term, and independent, would be able to provide recursive reviews that would continually measure

regulators against their mandates, and in so doing, provide a more fixed benchmark against which to make that measurement.

Responses to Criticisms of the FRAB Proposal

The costs are unjustifiable: Estimates of the costs of remediating just the instances of misconduct where fees-for-no-service were charged exceed \$1 billion. Estimates of the costs to the financial sector of addressing the issues that gave rise to the FSRC, as well as the total costs of remediation, exceed \$6 billion. The costs of rescuing a failed bank can be multiples greater still; the costs of a financial crisis orders of magnitude greater.

The solution to ineffective regulators is to provide them with more power: We argue that additional powers ceded to regulators will be of no benefit where the problem is an unwillingness to enforce even existing laws. This is reflected in the FSRC's Interim Report.

Conclusion

Accordingly, the introduction of a FRAB in Australia would serve as a timely and highly effective adjunct to the current Australian Twin Peaks financial regulatory architecture comprising APRA and ASIC.

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