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Occupational Constraints of the Prudential Regulator

PRUDENTIAL MANDATE

Prudential regulation seeks to ensure that financial intermediaries can meet their obligations to beneficiaries ('consumers') under all reasonable circumstances, as a general guarantee against failure entails unacceptable moral hazard and taxpayer costs.

The prudential regulator achieves its aim through licensing, on and off-site supervision and risk-based assessments and enforcement. Legislative powers are granted to obtain information, review the strategy, risk management systems and their implementation in institutions and outsourced service-providers, commence enforcement action and manage insolvent providers. Unbridled regulatory action or abuse of power is checked through tribunals, courts, industry consultations and parliamentary scrutiny.

Prudential regulation differs from tax, competition and market conduct regulation in its reach and application. It is easy to miss its nuanced constraints, leading to ineffective outcomes.

The prudential regulator's primary task is to protect the interests of consumers. They are among the competing interests of shareholders, investors, distributors, employees, tax authorities and the community at large, including global markets.

It is sensible to work collaboratively with other stakeholders when things are normal. The business of intermediaries is to operate profitably and to provide a risk-adjusted return to entrepreneurs by servicing customers sustainably over the long term. It is critically in the regulator's interest for this process to work smoothly.

Thus, the regulator needs to balance its actions not to harm other stakeholders in normal times. Here is necessary alignment between institutional and regulatory perspectives. The regulator works for the same shared aims.

In practice, things diverge. Institutions get their risk assessments, execution or both wrong; the proverbial 'rogue' operatives proliferate; Rumsfeldian 'unknown unknowns' intervene; regulatory rules, often devised with hindsight, prove unequal in addressing emerging risks; lessons of past failures fade in memory, with inappropriate risk-taking resuming. In such cases, the regulator works with the intermediary in respect of identified issues, if given a reasonable prospect of securing consumer interests.

At any time, many problems are being worked on, unknown to the consumers or the broader market, like the vast unseen goings-on beneath the ocean surface. When they are resolved, the consumers or the public will never know: the institution itself will not publicise it, and the regulator cannot. Only failures will ever become public knowledge.

Only if cooperation fails, does the regulator work against the institution. Enforcement is often the last resort of the prudential regulator.

STYLE OF OPERATION

The complexities of modern financial intermediation demand a close yet professional relationship, whereby the institution can approach the regulator as soon as a problem is identified.

Many formal responses are available to the regulator: statutory investigations, licence restrictions, 'enforceable undertakings', disqualification of individuals and licence suspensions / cancellations. Prudential relationships benefit from deliberate ambiguity, from the perspective of better safeguarding consumer interests. APRA's Supervisory Oversight and Response Systems (SOARS) is based on a continuum of supervision and intervention strategies, with successive steps becoming progressively more formal and legal. If an entity believes that a regulator is limited only to enforcement, the regulator's influence in achieving optimal outcomes may wane.

Imagine a serious difference between the regulated entity and the regulator, where prudential, market conduct and tax regulators are respectively involved.

- The tax regulator sends a bill, threatening punitive action if not paid by the deadline.
- The market conduct regulator sends a legal notice.
- The prudential regulator phones an executive to discuss concerns and canvass resolution options, recorded informally (depending on severity). Only if things threaten consumers' interests, does the tone change to formal.

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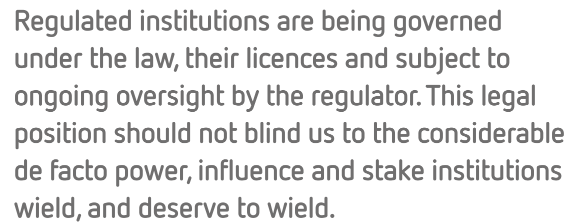

Spot the difference? The prudential regulator is not practising 'wet-lettuce' therapy here, but acting in the enlightened pursuit of its mandate. It works, mostly.

It is not coincidental that the prudential regulator is populated by accountants, actuaries and economists, while the market conduct regulator is dominated by lawyers. The tax regulator has lawyers, supported by debt recovery experts.

Mistakes can and do occur. Intervention too early or too late, measures that are too light or harsh, applied inappropriately could backfire. A system of checks and balances including peer reviews, with identified internal escalation triggers is essential.

POWER BALANCE

Regulated institutions are being governed under the law, their licences and subject to ongoing oversight by the regulator. This legal position should not blind us to the considerable de facto power, influence and stake institutions wield, and deserve to wield.

In addition to the de jure protections to guard against arbitrary or excessive regulatory action, industry lobbies, captains of finance and large institutions enjoy access to political leadership as well as opinion-makers. Only a naive regulator would ignore this.

A call from a systemically important intermediary could set off repercussions on industry regulation. Often such intervention could be useful in presenting a different, yet valid, perspective. Where they are driven by collateral motives, robust defence, backed up by sound past performance, should help the regulatory objective.

THE RULE OF LAW

The bastion of any sound system, the rule of law is aimed at transparent rules, enforced without fear or favour and subject to the rigour of proof and procedural fairness. Regulators are as much subject to its oversight as the regulated.

In its application to the rule of law, the prudential regulator faces the following handicaps:

- Unlike other agencies, the prudential regulator's stock-in-trade is not just proven legal offence, but includes a large measure of fuzzy risk assessment. The legal rigour of proof required to secure a court judgement involves greater certainties than fuzzy actuarial probabilities. Unfortunately, the judiciary in general is not trained in risk management.
- The system often treats the rights of intermediaries to earn profits on par with consumer rights, failing to differentiate the former's confected rights and the latter's inherent rights.
- Alternative dispute resolution mechanisms lack the power to order compensation for consequential damages. Such damages, given the long term nature of many financial contracts, could be large.
- Institutions take matters to the Administrative Appeals Tribunals if they are aggrieved with a decision, seeking a merits review. Hindsight could influence this process. Also, there is no provision for the affected consumers to intervene.
- Secrecy obligations on the regulator are stringent. There is no corresponding obligation on the institution not to play the media.
- The public perception of a homogenous regulatory regime where all agencies cooperate with each other in consumers' interest is not necessarily realistic. Regulators are not always free to talk to other regulators.

IN TIMES OF STRESS

Most regimes cater for normal times in their laws, rules and standards. During stress, these rules often prove inadequate. Rumour and innuendo affect market outcomes as much as real events.

Stressed times call for coordinated decision-making, away from the media glare. Those who must decide, in the heat of the moment and with imperfect information, need protection against hindsight wisdom.

SUGGESTED WAY FORWARD

The prudential regulator could do with several enhancements:

- Remove legal and practical barriers to information sharing in defined circumstances, as incipient stress is assessed.
- Use the exception to secrecy as necessary. As a start, de-sensitised war stories must be published annually to deter unacceptable conduct and better inform the public.
- Impose reciprocal a secrecy obligation on institutions, a breach constituting waiver.
- Allow Alternative Dispute Resolution agencies to award consequential damages.
- Just as institutions can fight consumers with consumers' money, consumers should have recourse to such funds to fight the institution, subject to defined parameters. While the regulator is often the first stop for such legal action, it would be useful to provide symmetry for aggrieved consumers when the institution fights them with their money.
- Train lawyers, in particular judges, in the fuzzy subject of risk management.
- When the regulator is forced into enforcement mode, penalties should not be paid out of funds belonging to consumers. In superannuation with little or no shareholder capital, this is a real risk. Serious offences must punish the wrong-doers, not the victims.
- The compensation packages of regulators should be better aligned with the market place from which they resource themselves.
- Consider punitive, exemplary and aggravated damages in regard to the worst forms of financial skullduggery, some showcased by the GFC.
- To balance the foregoing, regulatory officials proven of criminal negligence should not be let off easily either.

In the media and the political system, there is rarely any tolerance for false negatives (regulators missing issues that become problems). Tolerance for false positives (regulators finding issues that turn out not to be problems) rises and ebbs, following a broader political / economic cycle accompanied by calls for more / less intrusive regulation. Financial systems must deal with this paradox. **A**

For the full paper, see http://fsi.gov.au/files/2014/08/Venkatramani_Ramani.pdf