

CHAPTER 3: AUSTRALIA'S EXISTING REGULATORY FRAMEWORK

Overview

- Australia's existing regulatory framework is supported by only a limited safety net for consumers of some financial products.
- To promote efficiency, the current regulatory framework presumes that consumers knowingly bear the consequences of counterparty risk associated with their chosen financial institutions.
- However, the prudential framework also recognises that many consumers will not be in a position to assess and monitor the risks in dealing with financial institutions. Instead, the Australian Prudential Regulation Authority (APRA) plays an important role as their delegated monitor in the case of prudentially regulated financial institutions.
- Consumers can purchase a range of financial products from non-prudentially regulated suppliers which may be close substitutes to many of those offered by prudentially regulated institutions. Consumers willing to bear the counterparty risk associated with such suppliers in pursuit of higher returns are able to do so.
- The existing safety net is not designed to ensure that consumers will not lose money in the event that their prudentially regulated financial institution fails. Arrangements vary across sectors and different outcomes would be expected in each case.
- Australia's prudential framework exhibits differences between deposit-taking, life insurance, general insurance and superannuation in terms of the intensity of capital and other risk management requirements; the powers that APRA may exercise; and the protection provided to consumers in insolvency.
- There are some existing compensation and guarantee arrangements in place that are relevant to consider in the context of a limited explicit guarantee.

Regulatory philosophy

3.1 Australia's financial system is governed by a number of interrelated components constituting a regulatory framework that reduces the probability and impact of failure by select classes of financial institutions.¹ The components include generic, principles-based requirements for all corporations, other rules applying to commercial endeavours as well as some quite specific requirements aimed at addressing particular financial system problems.

3.2 Each of the components of the regulatory framework has quite distinct objectives. Introduction of any guarantee scheme as part of a limited 'safety net' would complement the regulatory framework and its implications can only be assessed by understanding how it would interact with the other components.

3.3 The role of the financial system is to facilitate the settlement of trade in goods and services; to marshal accumulated savings toward investments; to facilitate productive risk-taking and enable wealth portfolio adjustments to achieve desired risk-return characteristics; and to allocate risks to those who can bear them most efficiently.

3.4 The system can be viewed as a diverse array of financial transactions and financial promises made by financial institutions to various stakeholders. Such promises include those to pay monies to depositors, policyholders or investors and promises to manage assets on behalf of, and in the best interests of, others. A key feature of financial promises is that they involve a future commitment which may not always prove possible to honour.

3.5 Risk is an inherent feature of the financial system in a competitive market. Some of the risks faced by consumers include:

- institutional (counterparty) risk – where promises of repayment are not kept because of unexpected default by the counterparty;
- market risk – where an investor has exposure to fluctuations in the market value of financial assets or fluctuations in the earnings from those assets; and

1 The focus of this Study is on financial institutions regulated by the Australia Prudential Regulation Authority (APRA). The term 'financial institution' is taken to mean an APRA-regulated financial institution.

- agent risk – where a trusted party fails to act in the principal's best interest by making poor investment decisions, providing poor or negligent advice, failing to handle an investor's funds honestly (for example, fraudulent conduct and theft) or having inadequate systems and controls which create the possibility of loss due to operational risk.

3.6 Ideally risk is accurately priced, adequately compensated by expected returns, and knowingly taken on by those with the best capacity to manage it. In practice, most countries erect some form of regulatory framework to ameliorate problems faced by (some) participants in identifying risk and to deal with some adverse consequences of risk-taking. Like those in other countries, the Australian financial regulatory framework does not aim to ensure that all financial promises are kept. The framework is designed to allow risk to be taken, and for financial gains and losses commensurately to accrue to those who knowingly take risks.

3.7 A financial product's quality depends upon the offering firm's current and future financial health. By contrast, in physical product markets, quality is often more closely related to past investment and operational decisions. The resulting question of how to ensure trust and confidence in the future actions of financial firms is crucial to the efficient operation of the financial system. The prudential framework can play an important role in establishing and maintaining such trust and confidence.

3.8 When financial products are purchased their quality or the soundness of the promise involved is uncertain and may remain so for a considerable time. In espousing its vision for the design of the Australian financial system regulatory framework, the Financial System Inquiry (FSI) focused upon the 'intensity' of the promise attached to financial products.

3.9 The concept of intensity of promise can be applied to the principal and the earnings associated with a financial product as well as the type of entity offering the product.

3.10 The most intense forms of promise (a capital-certain promise) relate to a guaranteed repayment of claims on demand, such as for a transaction or at-call savings account, upon maturity of a term deposit or for valid claims under life insurance or general insurance policies. Less intense forms of promise might be argued to attach to investment products sold by a financial institution where the value of the product is exposed to market risk, but nonetheless is an obligation of the supplier as a counterparty.

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3.11 In contrast, the promise associated with a typical superannuation investment, managed fund or other collective investment is that the trustee or manager will act in the member's or investor's best interest. This does not mean that the trustee absorbs any risks; fund members or investors may be exposed to fluctuations in value in accordance with market movements. While the exposure to market risk means that the promise is not as intense, the promise that funds will be responsibly managed in the members' best interests is relatively intense.

3.12 The typical policy response to these issues is to seek to ensure that at least some categories or classes of financial firms only make 'intense' promises that they are capable of, and will remain capable of, honouring. This tends to encourage an expectation of longevity in such firms offering these financial products, or that the demise of such firms and exit from the industry will occur in an orderly fashion. This can be expressed as the objective of financial safety.

3.13 While financial safety is important, so too is the objective of efficiency. An efficient financial system achieves its transactional and allocative functions at an appropriate cost. In this sense, it plays a supporting role to real economic activity, providing a given level of service at minimum cost. An efficient financial system allows the consequences of risk-taking to be realised. It allows the best-managed endeavours to prosper; mismanaged endeavours to exit and new endeavours to be created in response to perceived profit opportunities.

3.14 Similarly, opportunities need to be available for investors to knowingly take risky positions, if they so desire, in the knowledge that they may gain or lose as a result. In this regard, it can be expected that there will be some institutions not subject to the same degree of regulatory oversight as others offering apparently similar financial products – and for which the intensity of the promise is recognised as less. For example, a B-rated corporate bond promises repayments of interest and principal, similar to the promises in a bank term deposit, but is – or should be – recognised by investors to involve a higher probability of default and consequently offer a higher expected return.

3.15 In summary, a widely held vision of an efficient financial system is one that is competitive and contestable, offers a broad spectrum of risk and return opportunities, promotes and rewards innovation, punishes failure and avoids artificial regulatory distortions. Consistent with the FSI vision, Australia's financial sector regulatory framework is geared to delivering these outcomes.

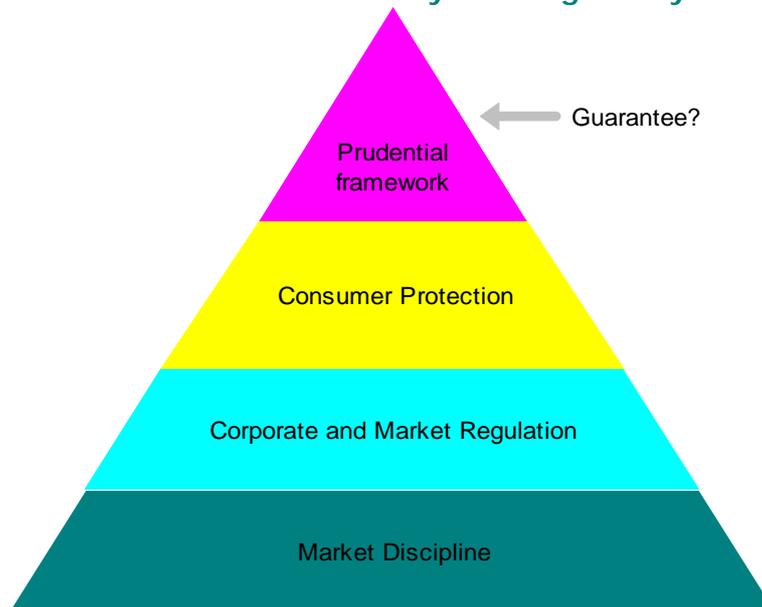
3.16 The potential role for an explicit guarantee depends upon the soundness of the regulatory framework. There is a spectrum of possible views on how an explicit guarantee might interact with the existing arrangements ranging from:

- where the prudential framework is sound, a guarantee could complement existing arrangements, serving as a 'safety net' should the other components fail to achieve their objectives; or
- where the prudential framework is weak, a guarantee could undermine the regulatory framework, impacting adversely upon incentives and altering the profile of financial system risks.

The regulatory framework

3.17 Australia's financial system regulatory framework comprises a number of distinct but complementary components. Each of these is described in turn, in order from the general to the more specific. Figure 3.1 provides a visual representation.

Figure 3.1: Australia's financial system regulatory framework



Market discipline

Financial promises and performance are assessed on their merits

3.18 Market discipline is the foundation of Australia's regulatory framework. Given the complexity and volume of transactions taking place within the financial system, those best placed to make an assessment of the quality of a financial promise are those who most directly stand to gain or lose from it. Market discipline is exercised by counterparties to financial transactions, sophisticated investors, customers, other creditors and shareholders alike.

3.19 Effective market discipline depends upon the effective dissemination of information together with the capacity to make accurate assessments of risk. Not all customers, particularly in the retail context, can be expected to possess the required information and skill to exert market discipline.

Corporate and market regulation

Facilitates orderly operation of companies and ensures adequate and timely disclosure of information to the market

3.20 The corporate regulation framework, administered by the Australian Securities and Investments Commission, governs requirements for starting, running and 'winding-up' companies. This includes requirements for registration, establishing the company's objectives and scope of operation, lodging annual statements and solvency resolutions, record-keeping, auditing requirements, rules surrounding meetings and protecting the interests of a company's members and creditors.

3.21 For any company, responsibility for meeting its liabilities rests squarely with its board of directors and management. Certain obligations are imposed on a company's directors in terms of their general duties and standards of conduct.

3.22 Each year the directors are required to express their opinion as to whether there are reasonable grounds to believe that the company will be able to pay its debts as and when they become due and payable. The role of independent auditors brings external scrutiny to this process.

3.23 In general, financial institutions regulated by APRA are required to be established as companies. In the case of superannuation, the responsible entity

or trustee is also generally required to be established as a body corporate or to be established for approved purposes. Such bodies are subject to a range of fiduciary requirements established under separate legislation and the common law.

3.24 Companies that choose to quote their securities on the stock exchange are subject to a number of further obligations that promote transparency to their shareholders or other security holders and ensure the market is made aware of significant developments.

3.25 The Australian Stock Exchange requires listed entities to immediately disclose any information that might affect the price of its securities to ensure that the market is fully informed. The markets also establish other forms of best practice for listed firms, including on such matters as desirable aspects of corporate governance.

3.26 In addition, many financial institutions gain access to capital from wholesale markets by issuing debt securities. The holders of these securities perform an important role in monitoring the health of financial institutions. In order to raise capital from retail investors, the financial institution would have to meet additional disclosure requirements under the *Corporations Act 2001* and would normally require a credit rating, a process which brings further scrutiny to bear on its operations.

3.27 The ongoing monitoring role performed by financial markets brings heightened scrutiny to the financial position of listed companies.

Consumer protection

Addresses the relative imbalance of information available to unsophisticated investors

3.28 Retail investors are afforded a level of protection above wholesale investors, reflecting their relative disadvantage in exercising market discipline and lesser ability to gather and analyse the information relevant to complex financial decisions. Retail financial consumers are also unable to diversify their risks in many circumstances, notably when purchasing general and life insurance policies, but also in their exposure to a single superannuation trustee.

3.29 Requirements exist for firms offering financial products to fully disclose the inherent risks to retail investors, for example, that those products

with exposure to market risk may fall in value. However, the information disclosed to retail investors in relation to product features and associated risks is unlikely to correspond to the information required to make an accurate assessment of the financial health of the provider at any point in time.

Prudential regulation, supervision and failure management of financial institutions

Reduces the probability and impact of failure of regulated entities

3.30 A general justification for prudential regulation and supervision is that the community's tolerance for financial institution insolvency is lower than may be accepted for firms operating in other parts of the economy. It may also serve to add to the stability of the financial system.

3.31 The Australian prudential framework applies an additional level of external scrutiny to financial institutions to that provided by a firm's board or market discipline. Banks, insurance companies and superannuation funds, credit unions, building societies and friendly societies are all subject to a range of additional requirements and supervision by APRA.

3.32 The prudential framework comprises a number of elements:

- *prudential regulation* – standard setting to define what constitutes minimum acceptable behaviour and promote sound risk-management practices by firms;
- *prudential supervision* – to facilitate early detection of financial difficulties in regulated firms and to monitor and enforce compliance with prudential regulation;
- *comprehensive intervention and resolution strategies* – to handle regulated firms in difficulty, including the ability for APRA to issue directions to a company, to replace the management of such companies and to effect a merger or a 'transfer of business' from the failing company to a healthy company; and, as a last resort
- *the ability to apply for winding-up* – to allow the closure of a regulated company and distribution of its assets before the potential losses become too great. The process of winding-up any company, but particularly financial institutions, can be lengthy, complex and expensive.

3.33 APRA-regulated financial institutions (other than superannuation funds) are generally required to have a diverse ownership base.² This is intended to reduce the institution's capacity to favour related parties and provide greater surety that an institution is able to access additional shareholders' capital when required. Many are therefore established as listed companies with their shares and other securities traded in secondary markets. It must also be noted that many financial institutions, particularly those smaller ones, are not publicly listed companies.

3.34 Aspects of the prudential framework that are most relevant to considering the efficacy of introducing limited explicit guarantees are discussed below. The Australian prudential framework is explained in more detail in Appendix 3.1, particularly addressing its application in each of the prudentially regulated sectors.

3.35 Australia's prudential regulation framework is industry-based, with the requirements for authorised deposit-taking institutions (ADIs), life insurance companies (including friendly societies), general insurance companies and superannuation funds established under separate legislation.

Capital adequacy, solvency and other risk management requirements

3.36 The relevant industry legislation provides for a range of standards which govern the operation of financial institutions.

3.37 The standards recognise the primary responsibility of the board and management of the institution to systematically assess and manage the risk that it faces according to the scope of its operations. For example, the risks of an entity that operates as part of a conglomerate group require special consideration.

3.38 A range of other prudential requirements apply to how capital is measured, to liquidity management and lending practices (including large exposures, exposures to related entities, classification of impaired assets and provisioning policy) and to deal with a diverse range of business situations faced by institutions. APRA is also able to request institutions to meet higher minimum requirements.

² These requirements are found in the Financial Sector (Shareholdings) Act 1998.

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3.39 In practice, a financial institution facing financial difficulty should normally be identified by APRA as having breached requirements under the legislation or prudential standards before it reaches the point of insolvency or illiquidity. In addition, for many APRA-regulated institutions, the board of the institution has an obligation to inform APRA of any breach or potential breach of certain requirements.

3.40 Appendix 3.2 provides a summary of some relevant standards.

APRA's failure management powers

3.41 APRA has powers for dealing with a range of circumstances including actual or prospective breaches of the relevant Acts, prudential standards, prudential regulations or operating standards. APRA also has the capacity to issue directions, although the relevant prerequisites and nature of directions differ across the sectors. The range of directions that APRA may give allow it to effectively influence the operations of a financially stressed or ailing institution with the objective of returning it to a prudentially sound position.

3.42 In certain circumstances, particularly for ADIs, APRA has the power to assume control of an ailing institution, thereby temporarily replacing the role of the board and management. While it does not have such powers in relation to life insurers or general insurers, APRA does have the capacity to petition a Court for orders to be given to an external administrator of such companies. In the case of superannuation, APRA has powers to suspend a trustee and appoint an acting trustee.

3.43 There are also specific legislative provisions (for example, transfers of business and provisions of a similar nature for insurance and superannuation) that allow for a financial institution's business to be restructured or transferred. This might facilitate a healthier firm or firms taking over the troubled firm's financial promises. In many cases, all or a material part of the business of the failed institution can successfully be transferred to another firm without significantly impacting upon customers.

3.44 Appendix 3.3 summarises APRA's failure management powers.

3.45 Liquidity support mechanisms exist in Australia that are intended to support solvent but illiquid firms. These are explained briefly in Box 3.1.

Insolvency

3.46 When dealing with the insolvency of a financial institution, the prudential framework tries to ensure that there is sufficient leeway to identify and manage the exit of a troubled institution before significant losses to certain stakeholders accrue. However, this is not always possible and the customers and other creditors of a financial institution may not always be repaid in full.

3.47 Instances of widespread contagion and market failure need to be distinguished from the occasional failure of an individual firm. Insolvency is a perfectly normal occurrence in competitive markets. However, for financial institutions, there is a concern to ensure that failure does not transmit to other financial participants or give rise to undue complexity or cost as it is resolved.

3.48 In the infrequent event that a financial institution does enter liquidation, there are a number of special rules (such as depositor preference, rules surrounding the distribution of statutory fund assets and reinsurance 'cut-through' provisions) designed to deal with the remaining assets and liabilities of the institution. The application of these rules would generally be determined by the Courts in the event of insolvency. (These provisions are detailed in Appendix 3.4).

3.49 For example, depositor preference arrangements provide for the proceeds from liquidating the assets of a bank, building society or credit union to first meet liabilities to depositors, in priority to other creditors. This can occur prior to entering the liquidation process that would meet the claims of other creditors.

3.50 For life insurers, the legislation provides that the assets of a statutory fund are first used to meet liabilities to policyholders (of that fund) above other unsecured creditors.

3.51 For general insurers, reinsurance cut-through provisions (contained in Section 562A of the Corporations Act) hypothecate the proceeds of reinsurance contracts to claims under the underlying insurance policies. A number of similar arrangements apply in relation to privately underwritten statutory insurance, whereby State statutory authorities (nominal defendants/nominal insurers) may enjoy priority over reinsurance assets.

3.52 In the winding-up of a superannuation fund, the fund's assets are distributed in accordance with the Superannuation Regulations. In general, this provides that the costs of administration and winding-up are met in priority to liabilities to members.

Box 3.1: Liquidity support

The Reserve Bank of Australia's emergency liquidity support role

The Reserve Bank of Australia (RBA) has primary responsibility for safeguarding the stability of the Australian financial system. In pursuing this mandate, the RBA's objective is to ensure that disturbances in any part of the financial system do not threaten the health of the economy. This task is closely linked to the RBA's other policy obligations, including the maintenance of low and stable inflation and a robust payments system.

Where financial disturbances do arise, however, the RBA is able to provide emergency liquidity support to the financial system. The need for this 'lender-of-last-resort' capacity reflects the fact that ADIs may be particularly vulnerable to sudden and unexpected demands on them for funds. It is the responsibility of an ADI's board and management to ensure the ADI has sufficient liquidity to meet its obligations as they fall due. If an ADI has concerns about its current or future liquidity profile it must inform APRA of the problem and of the steps it is taking to rectify the situation. In formulating liquidity management policy, ADIs should not assume that the RBA would provide support if they faced problems.

Liquidity problems with an individual ADI may have significant implications for the whole financial system if, for example, other institutions have substantial counterparty exposures to the troubled ADI, or if its problems undermine confidence in other institutions. To counteract such problems, the RBA is able to use its balance sheet to provide liquidity support if it is of the view that it is dealing with a fundamentally sound financial institution whose failure to make payments would have serious implications for the rest of the financial system; the RBA's balance sheet is not available to support insolvent institutions. The RBA's preference in dealing with such circumstances is to make funds available to the market as a whole through its domestic market operations.

The RBA will consider applications for emergency liquidity support from any institution supervised by APRA. This accords with the division of responsibilities within Australia's regulatory arrangements whereby the RBA has the mandate for overall stability of the financial system and APRA has responsibility for the prudential oversight of individual financial institutions.

Box 3.1: Liquidity support (continued)

The Memorandum of Understanding between the RBA and APRA requires that there be close and effective cooperation between the two agencies during periods of financial stress.

Industry support mechanisms

Credit union members have access to the Credit Union Financial Support System (CUFSS)³ which is a voluntary, industry-funded scheme that provides liquidity and, possibly, capital support in the event of financial difficulties. This system is designed to keep an institution afloat temporarily.

Guarantees of certain retail financial products

Defines the impact of failure for certain customers and enables earlier restitution

3.53 A range of narrowly targeted compensation arrangements currently exists in the Australian financial system. For the most part, these arrangements are concerned with agent risk – that is, loss suffered due to the deliberate actions of an individual or entity, such as fraudulent conduct and theft. They do not address cases where promised payments associated with certain products have not been honoured due to financial institution insolvency.

3.54 Table 3.1 summarises the existing compensation arrangements in the Australian financial system. The focus on agent risk means that these schemes would complement rather than duplicate any guarantee scheme focused on counterparty risk.

3.55 The nominal defendant and nominal insurer schemes that exist in some States and Territories are one exception. These have served in the past to cover insolvency-related losses under privately underwritten statutory insurance schemes (for example, Compulsory Third Party (CTP) motor vehicle insurance and Workers' Compensation). An explicit guarantee scheme could either replace or complement these arrangements. The relevant issues are discussed further in Chapter 10.

3 CUFSS is an APRA-certified support mechanism (under Section 11CB of the *Banking Act 1959*).

Table 3.1: Summary of compensation arrangements

Product/Service	Existing regulatory framework	Name of arrangement	Compensation categories	Funding arrangements
Examples in prudentially regulated sectors				
Superannuation	<i>Superannuation Industry (Supervision) Act 1993</i> Commonwealth law	Part 23	Fraudulent conduct and/or theft.	Levy on industry (post-funded).
Compulsory insurance classes (CTP, Workers' Compensation and Builders' Warranty)	Statutory insurance schemes State/Territory law Private underwriters regulated under the <i>Insurance Act 1973</i> Commonwealth law	Nominal defendant/insurer arrangements	Uninsured defendants, unidentified defendants and insolvent private underwriters.	Pre- and post-funded as part of insurance premiums. In some instances special purpose levies have been charged to industry or consumers.
Examples in financial services sector				
Financial service licensees and representatives ⁴	Chapter 7 (Section 912A, Section 912B ⁵) <i>Corporations Act 2001</i> Commonwealth law	Financial services licensees ⁶	Breach of obligations by financial services licensee or their representatives.	To be licensed, financial service providers licensees must make private provision to compensate consumers for breach of obligations. This can be through professional indemnity insurance or a similar mechanism ⁷ .
Brokers operating on the Australian Stock Exchange	Chapter 7 Division 4 <i>Corporations Act 2001</i> Commonwealth law	National guarantee fund	Breach of contract guarantee, unauthorised transfer, incorrect certificate cancellation and insolvency.	Currently funded to a level not requiring further collection of levies. Provision does exist to levy participants.
Brokers operating in other financial exchanges ⁸	Chapter 7 Division 3 <i>Corporations Act 2001</i> Commonwealth law	Operators of other financial markets	Defalcation and fraud against retail clients.	Financial markets must make provision to compensate retail clients for defalcation or fraud (all markets still have in place a fidelity fund).

4 Securities dealers and investment advisers, brokers, life insurance and general insurance companies, superannuation funds, deposit-taking institutions and their agents and employees.

5 The requirement under Section 912B will take effect from March 2005.

6 Subject to transitional arrangements.

7 The final details are still to be determined.

8 Including the Newcastle and Bendigo Exchanges, Sydney Futures Exchange and the Australian Stock Exchange futures market.