

APRA and the RBA: Issues in regulation

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Key points

Most decisions taken by APRA for prudential reasons have a wide range of other consequences

It is not clear that APRA does, or is able to, make appropriate trade-offs

- A number need to be rethought with a broader perspective

APRA's mandate is too narrow both in term of its objectives and its scope to do this

Some realignment of regulation is called for, probably folding APRA back into the RBA

Such a move has four advantages:

- allowing a more broadly-based consideration of financial regulation
- coordinating better macro-prudential and monetary policies
- enhancing the ability of regulators to deal with the increasing importance of markets and likely emergence of shadow banking
- allowing the RBA to provide liquidity support for a regulated super fund facing a run

An alternative to achieve some of these would be to change APRA's mandate

Recommendations on specific regulations

- 1: *Review the behavioural assumptions about the stickiness of deposits including as they relate to deposits from regulated superannuation funds*
- 2: *Review the competitive impact of prudential regulation as occurred under National Competition Policy and using the same criteria*
- 3: *Scrap the deposits tax and lower the deposit guarantee*
- 4: *Recommend that ABS publish more detailed statistics on the financial sector*
- 5: *Require cost-benefit analyses to be explicit about the trade-off they are making between growth and stability*
- 6: *Require any regulatory change which is likely to cost more than \$100m to be subject to a cost-benefit analysis (and conducted by a party independent of the regulator)*
- 7: *Abandon post-implementation reviews in areas with a large consumer interface in light of the very high costs of implementation of regulations*
- 8: *Trade-off stricter regulation for less intense supervision – to some extent the two functions are substitutes*
- 9: *Require APRA to publish internationally harmonized capital ratios*
- 10: *Avoid regulation which favours or penalizes particular business models*
- 11: *Require APRA to align its treatment of minority equity positions taken by Australian banks with international practice*

Recommendations on regulatory design

- 12: *Specify that the RBA alone should be responsible for macro-financial policy including macro-prudential policy*
- 13: *Reintegrate APRA with the RBA to better regulate the interface between markets and institutions*
- 14: *Allow the RBA to provide liquidity support for prudentially regulated superannuation funds*
- 15: *Reintegrate APRA with the RBA to allow a more balanced assessment of prudence with other policy concerns. Alternatively, broaden APRA's mandate*

Issues in regulation

1. Introduction

One of the main outcomes of the Wallis Inquiry was a complete restructuring of the financial system regulators. The most important of these was the decision to create a separate prudential regulator, APRA, and to give it oversight of both ADIs and the large superannuation funds.

Since the failure of HIH the prudential supervisory system appears to have worked well.

There has only been one important subsequent regulatory failure with the collapse of Bankwest, a bank which was unable to fund its business and which subsequent experience has proven to have been buying growth by taking unreasonably high lending risks. Even if it has been able to fund itself, the quality of its lending may have resulted in its failure anyway.

But a low level of failures only represents one side of the regulatory problem. Regulators make rules. Those rules can stop bad things happening but they can also stop good things developing. In evaluating the performance of the regulatory model it is not enough to look just at problems prevented, we also need to consider what positive things might have happened but for the regulations.

This submission makes three central points:

- Most decisions taken by APRA for prudential reasons have a wide range of other consequences
- It is not clear that APRA does, or is able to, make appropriate trade-offs
- APRA's mandate is too narrow, and some realignment of regulation is called for.

2. What has been distorted by regulations

The main potentially negative impacts of regulation are those which have impacted

- Competition
- Growth
- Efficiency
- Transparency
- Diversification
- International expansion
- Distribution of wealth

Competition

There are two different concerns with how regulation impacts competition:

- The impact on existing competitors
- The impact on potential entrants.

The regulator imposes different capital standards on different sorts of institutions, and changes to regulation will impact differently the different players. Firms are likely to have to change their business

models to accommodate changes in regulation, and some business models might cease to be viable. One clear example is when regulations change the regulatory weight given to on-line deposits by altering assumptions about how quickly they might run off in a crisis. As a result banks which rely on the on-line model for funding will lose out to banks which have a strong branch network to garner deposits. Similarly the treatment of deposits by regulated superannuation funds in banks could be changed to enhance the deposit base of the banks and improve the stability of the system. These are regulatory decisions which change the terms of competition in the industry.

Recommendation 1: Review the behavioural assumptions about the stickiness of deposits including as they relate to deposits from regulated superannuation funds

In similar vein, the Bank of Queensland has been particularly vocal lately about how decisions concerning how much capital banks with different business models have to hold, and which alter the shape of competition in the sector. To the extent that the rules are public, institutions can decide for themselves which business model they want to follow. Some banks like Bendigo are pursuing advanced accreditations for their risk models and hence lower capital requirements while BOQ is not. To the extent this is a deliberate choice of business model there is no particular public interest concern.

More important is the issue of whether the rules the regulator imposes raise barriers to entry inappropriately. Most of the entry into the banking system has been by foreign banks with few local non-banks seeking deposit taking status. Onerous and intrusive regulation may well be a cause of the slow pace of entry. It is difficult from the outside to know why firms have failed to enter the main banking market but regulation has the capacity to raise such barriers.

Recommendation 2: Review the competitive impact of prudential regulation as occurred under National Competition Policy and using the same criteria

A decision to impose a tax on deposits (as part of the deposit insurance proposals) will reduce the pool of deposits, lower the return paid to depositors and reduce the size of the aggregate pool of deposits. It will make entry less likely both through the direct effect of making it harder for entrants to raise deposits, but also by reducing the total profit pool and reducing the number of banks the system can sustain. Since people already assume their deposits are guaranteed there is no welfare gain derived from imposing the tax to fund the guarantee.

The decision to provide deposit insurance up to \$250,000 also has clear implications for competition both within the banking system and between banks and non-banks. From a depositor's point-of-view all banks are now equally safe so competition for deposits will be largely based on price, enhancing competition within the ADI sector but disadvantaging the safer banks. It also has the effect of reducing the potential for non-banks to compete with banks across a range of activities as they now will find it harder to raise funds. Clearly a much smaller limit would be desirable from a competitive viewpoint.

Recommendation 3: Scrap the deposits tax and lower the deposit guarantee

Growth

The Australian financial system has grown spectacularly over the last twenty years, virtually doubling its share of a much larger national value added. The sector now represents around 10 per cent of GDP. This raises concerns over whether the sector is too large, and if it is too large as a result of decisions taken by the regulator.

I have argued elsewhere (Maddock 2013) that we need to decompose the growth into the components in the banking system, the superannuation system, and in financial markets separately in order to address the questions of whether the sector is too big. Disappointingly the ABS does not provide data which would let us unpack the separate components – a poor state of affairs when finance is 10 per cent of national product.

Recommendation 4: Recommend that the ABS publish more detailed statistics on the financial sector given its weight in the economy

Nevertheless my paper argues that most of the growth in the banking sector has been driven by the decisions by households to pay more for housing and not by any particular decision by banks or regulators. The regulator could have slowed this growth by imposing particular capital requirements but chose not to. While many critics will argue that the decision was a poor one, and renders the Australian economy more liable to a banking crisis, I do not believe that is the case. Nevertheless the underlying principle again is that the regulator has adopted a position which has profound influences on the shape of the sector.

Here, many are of the view that growth was promoted at the expense of prudence – it is a big trade-off.

Recommendation 5: Require cost-benefit analyses to be explicit about the trade-off they are making between growth and stability

Efficiency

Even well-designed regulation can be costly. If we assume the regulations around Basel III are good ones, and being well implemented by the banks, the total implementation cost appears to be require them to spend some two to three billion dollars more than they might have spent otherwise just in systems spend (Maddock 2014a). It is a difficult counterfactual since banks are likely to have spent more on their internal risk models in 2014 than they spent in 2004, just because they know more about risks since the financial crisis. In addition to the technology spent there is an additional ongoing compliance spend.

Whatever the true calculation, the cost of complying with the new regulations will be very large. It adds to the cost structure of the economy and actually reduces its efficiency (while conjecturally improving its sustainability). APRA has decided this is a worthwhile trade-off for reducing the risk of a potential future crisis. Clearly this is arguable.

The decision was made with no public consultation, a cursory regulatory impact statement, but will have a significant impact on the growth of the Australian economy for decades to come.

Following Wallis, the industry was required to comply with the Financial Services Reform Act of 2001, (FSRA). The focus was on individual responsibility, and on institutions to ensure individuals had all the information they needed in order to make their own decisions and take personal responsibility for them. The institutions all rewrote their product disclosure statements, produced manual, revised their compliance systems and retrained staff: it almost certainly cost more than one billion dollars to comply. Then the official community changed its mind. Individuals were no longer required to take personal responsibility for their decisions; the onus was switched back to the provider. Under the National Consumer Credit Protection Act on 2009, institutions had to ensure their staff did not sell products which were inappropriate for the borrower/purchaser. Retraining, realignment and redoing all the PDSs are probably costing at least another billion dollars.

The fundamental proposition is that regulatory decisions are very expensive.

Even well-designed regulation can add significantly to costs. The hoped-for benefit might be in less product wrongly bought and or sold, often based on concerns about personal losses, and hence distributional issues transcending efficiency issues. Poorly designed regulation, as in the FSRA case, just adds to costs, reducing the efficiency of the economy.

Recommendation 6: Require any regulatory change which is likely to cost more than \$100m to be subject to a cost-benefit analysis (conducted by a party independent of the regulator concerned)

The current approach, whereby regulations can be exempted from review before the fact if they are subject to an after-the-fact review, is inappropriate. As I demonstrate in Maddock (2014a) implementation costs in finance can be multiples of the ongoing costs of regulation. Even then, a finding that the regulations was inappropriately burdensome is of little use, since the cost of unwinding the regulation incurs a second round of heavy implementation costs.

Recommendation 7: Abandon post-implementation reviews in areas with a large consumer interface in light of the very high costs of implementation of regulations

The discussion around the net stable funding ratio proposal is salutary. Regulators had announced that there would be a net stable funding ratio imposed on banks to reduce the amount of maturity transformation they could undertake. All the banks began to prepare for it. Now it is suddenly off the agenda. Why? Well the IMF did some modelling of the way banks would respond to the package of Basel III policies and realized that the net stable funding ratio was likely to halve the volume of loans in the US economy if it was applied there (“We find an inverted U-shaped relationship between capital requirements and bank lending, efficiency, and welfare, with their benefits turning into costs beyond a certain requirement threshold. By contrast, liquidity requirements reduce lending, efficiency and welfare significantly” (De Nicolò et al (2012))). The whole Basel III package is quite extreme and based on limited and disputed modelling. Fortunately a major crisis appears to have been averted by the regulators suddenly back-tracking on their commitment.

So regulators changing their minds about things can impose very big deadweight losses on the economy. A clear current concern is the way in which regulators globally are in the process of changing their minds

about a wide range of issues.

The model of regulation of the Australian deposit taking institutions has been by graduating supervision so that it is very intense for the most strategic institutions and relatively less intrusive for the others. Under the Basel III we are moving towards a rules-based system. APRA has already announced its D-SIFI rules, forcing large banks to hold more capital than small banks.

The question APRA must answer is how it will wind back its supervisory intensity. It makes no sense for Australia to have the same capital rules as other countries, and a much more intrusive system of supervisions.

Recommendation 8: Trade-off stricter regulation for less intense supervision – to some extent the two functions are substitutes

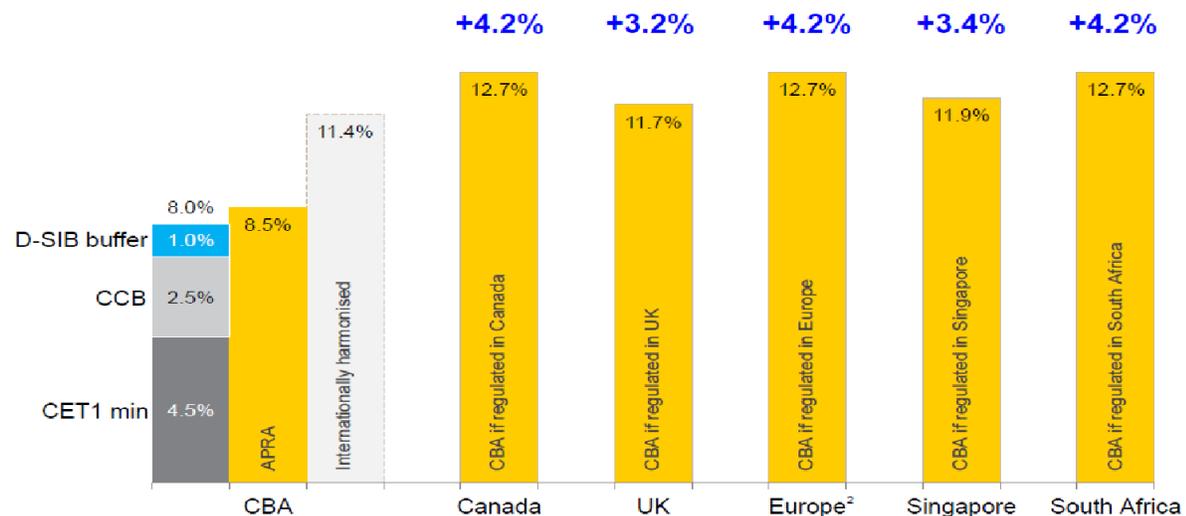
Transparency

Australia has capital rules which appear to be the same as those imposed in other countries but are actually much more stringent. The analyst pack produced for the CBA results provides some illustration.

The chart shows the CBA's actual capital ratio as measured by APRA at 8.5% but reveals that if APRA used the internationally harmonized approach the published number would have been 11.4%. Even more tellingly as measured by the Canadian regulator it would have been 12.7%; as it would have been under European and South African rules.

It is not clear what purpose is served by APRA's under-the-counter approach. If it wants the Australian banks to be safer than banks in other parts of the world, it should announce explicitly the higher capital standard. Then investors everywhere would know that the Australian banks were complying with a stricter standard and be able to invest, borrow or lend accordingly. To ostensibly comply with global rules but actually be stricter without telling anybody protects APRA but serves no public purpose.

Figure 1: APRA's hidden conservatism



Recommendation 9: Require APRA to publish internationally harmonized capital ratios

Diversification

The Australian financial system is characterized by conglomerates. European banks usually have similar business models. Clearly they find some benefits from the agglomeration of businesses despite the common academic finding that conglomerates often trade at a discount. This suggests the entities are of the view that there is economic value to be had from the association of businesses. If this is the case, forcing the businesses to de-link would be welfare reducing and should be avoided.

The regulator should ensure that elements can stand alone, and no impact one another in the advent of a crisis. Nevertheless it is possible to design regulation which penalizes conglomeration – this would be another instance where (prudential) regulation and economic efficiency clash.

Recommendation 10: Avoid regulation which favours or penalizes particular business models

International expansion

The financial sector is a large component of the economy but one which exports few of its services. As Australia's earnings from commodity exports gradually decline, Australian living standards will also decline unless we can increase the sales of other goods and services. Finance should play a part in this. Mark Johnson's report, "Australia as a Financial Centre: Building on our Strengths", outlined a set of steps which could be taken to promote the export of funds management services.

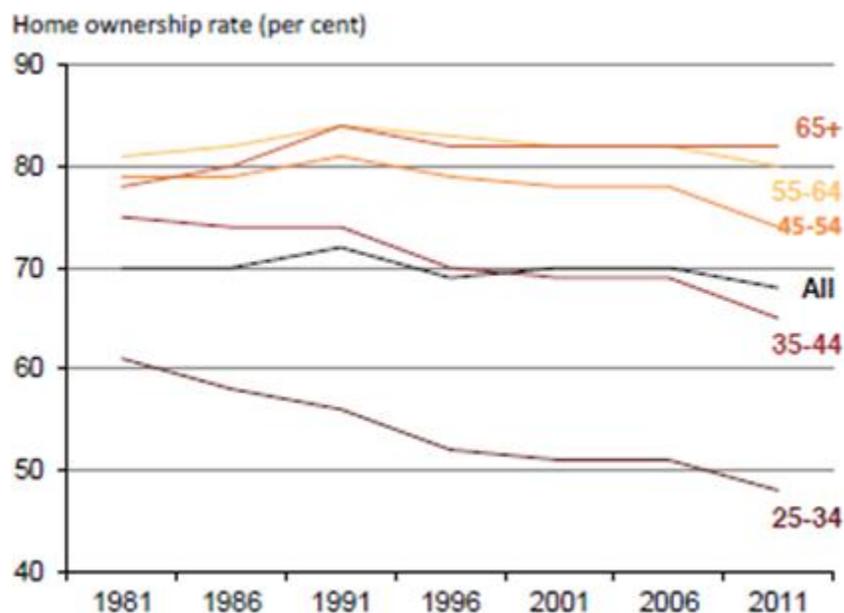
Some of APRA's rules on the treatment of minority investments by Australian banks in offshore institutions act as another barrier. By imposing stricter rules than do offshore regulators on the capital which must be set aside for such partial acquisitions, APRA raises the effective price local banks must pay for offshore acquisitions. As a result they are almost always outbid by foreign banks which can fund the acquisitions more cheaply. The means that the highly successful strategy pursued by Spanish banks Santander and BBVA to grow internationally is not available to Australian banks.

Recommendation 11: Require APRA to align its treatment of minority equity positions taken by Australian banks with international practice

Distribution

It is quite notable in the Australian housing market that people buying houses tend to come from the older and richer segments of the population (see Figure 2). This probably makes commercial sense for lenders but regulation too may well have played a part. While the effect is unclear it seems possible that regulation (or guidance) has also provided incentives for lenders to behave this way: this would include the need to have mortgage insurance for high LVR loans, tight caps on the proportions of low-doc loans in a lender's portfolio, and other restrictions which make it harder to lend to young people and migrants who have not had the opportunity to build their wealth.

Figure 2: Home ownership rates and age



Source: Grattan Institute

3. Regulatory design issues

There are three other broad areas which reinforce the case for a closer alliance of APRA and the RBA and which to me suggest their amalgamation would be desirable.

Macro-prudential policy should be the domain of the RBA

Like all financial crises, the most recent experience has led to an upsurge in regulation, most of it under the broad classification of Basel III. One aspect of this has been the drive of prudential regulators to move into the field of macro-prudential regulation (Littrell 2013). By this they mean “taking away the punchbowl when the party threatens to get out of hand”. For example, if credit growth is excessively rapid, the prudential regulator will impose additional pro-cyclical capital requirements on banks or take similar action. In addition to protecting particular institutions from risk, the net effect of this will be to slow growth in the economy.

If the prudential regulator is trying to slow growth in the economy, how should the RBA respond? : Conceivably by cutting interest rates to stimulate the economy. This would be a silly position for the regulators to get themselves into.

There are a number of ways of resolving this but the most obvious one is to say that macroeconomic credit policy should be the responsibility of the RBA, and restrictions might be implemented either through imposing credit limits of one sort or other on institutions, or through more normal interest rate policies. But we need one party to be responsible for monetary policy not two.

The IMF view appears to be captured in a recent research paper: “Ultimately, a policy impasse could be

avoided by introducing a hierarchy between the policies, where one authority has the power to override the decision of the other. But establishing such a hierarchy is not straightforward and entails costs in the form of loss of independence of one of the two policies” (Osiński et al 2013). Integrating the institutions seems more appropriate.

Recommendation 12: Specify that the RBA alone should be responsible for macro-financial policy including macro-prudential policy

The growth of markets and the relative decline of institutions

The Wallis Inquiry foresaw the gradual displacement of financial institutions by financial markets. What it failed to foresee was the way in which the two would become more tightly integrated.

This creates problems for the separation of APRA from the RBA. It is quite obvious that banks can, for example, limit their risks by holding more capital or by engaging in a series of market transactions. It seems clear that the RBA is much better placed to monitor market activity and developments because monetary policy is carried out through markets, so that the RBA is deeply involved in the markets on a daily basis while APRA focuses on institutions.

As markets evolve, as for example if peer to peer lending grew markets activity would grow and institutional based lending contract. Banks conceivable could be weakened as deposits flowed out and into these alternative markets. APRA as an institutional based regulator is not well equipped to deal with the increasing weight markets are likely to play in the financial system.

Australia’s experience during the 1960s and 1970s was that tight regulation of banks led to important financial activities to grow outside the regulated system (Maddock 2014b). It is clearly possible that macro-prudential issues will arise from markets, one of the RBA’s areas of expertise, rather than institutions (APRA’s focus). As a former Bank of England executive expresses it: “It isn’t enough to focus on large systemic institutions or on banks more generally. Activities and markets matter for stability too” (Tucker 2014).

Recommendation 13: Reintegrate APRA with the RBA to better regulate the interface between markets and institutions

The RBA and liquidity support for the superannuation sector

Tom Valentine’s analysis of the reasons for separating APRA out from the RBA argued that the Wallis Inquiry saw the need to include the large superannuation funds within the prudential net, but did not want people to infer that the superannuation funds were being supported or guaranteed in any way by the RBA (Edwards and Valentine 1998).

With explicit deposit insurance, the nature of the RBA support for the ADIs is quite clear. There can be no suggestion that the superannuation funds would be captured within the deposit-insurance framework.

The second main leg of support to the ADIs from the RBA lies in its willingness and ability to provide

liquidity support to solvent but illiquid institutions. Under the current model, superannuation funds can be subject to runs in the same way that banks are. Our super funds are effectively undertaking the same sort of maturity transformation as banks, holding money that can be withdrawn at any time, and using it to invest in longer term assets. Moving the prudentially-regulated superannuation funds into the world of the RBA and the potential for liquidity support seems entirely appropriate.

Recommendation 14: The RBA should be willing to provide liquidity support for prudentially-regulated superannuation funds, and has the ability to do so whereas APRA does not.

4. Regulatory structures

The purpose of establishing APRA as specified in its Act was that:

“In performing and exercising its functions and powers, APRA is to balance the objectives of financial safety and efficiency, competition, contestability and competitive neutrality and, in balancing these objectives, is to promote financial system stability in Australia”.

The only outcome then that APRA needs to worry about is “financial system stability”.

By contrast the RBA objectives are:

“It is the duty of the Reserve Bank Board, within the limits of its powers, to ensure that the monetary and banking policy of the Bank is directed to the greatest advantage of the people of Australia and that the powers of the Bank ... are exercised in such a manner as, in the opinion of the Reserve Bank Board, will best contribute to:

- a. the stability of the currency of Australia;
- b. the maintenance of full employment in Australia; and
- c. the economic prosperity and welfare of the people of Australia.”

The RBA quite clearly has the broader and more inclusive mandate while APRA has to promote financial system stability while considering some other things. APRA has no real guidance as to how to make those trade-offs, and no brief to consider the welfare of the people of Australia in making its decisions.

Section 2 of this paper points out a number of concerns with the trade-offs being made by APRA. The remedies would appear to be to require much greater transparency around APRA’s decision making, a broadening of APRA’s mandate so that it could take into account the broader issues, or a recognition that the functions of AFRA could just as well be handled within the RBA but they would be handled in an environment which is required to take a broad rather than a narrow perspective.

Recommendation 15: Reintegrate APRA with the RBA to allow a more balanced assessment of prudence with other policy concerns

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