Occupational constraints of the prudential regulator

Ramani (SG) Venkatramani

Prudential regulation

1. The major impetus for prudential regulation stems from the inherent informational asymmetry between consumers and providers of financial products such as banking, insurance and superannuation. The complexity of information that often requires advanced knowledge (apart from any inherent or deliberate opacity) heightens this need, even as financial illiteracy is compounded by disengagement and inertia on the part of consumers.

2. In an effort to protect consumer interests, promote a climate for innovative products and services and maintain market confidence, national authorities have established prudential regulators, which complement the work of competition, market conduct and financial stability agencies.[1]

3. As a basic definition, prudential regulation aims to ensure that financial institutions can meet their obligations to beneficiaries under all reasonable circumstances. There is no guarantee, given the unacceptable moral hazard[2] on the taxpayer. Extreme events such as the GFC have strained this assumption (when institutions 'too big to fail' have been bailed out to avoid a melt-down in the economy)[3].

4. The prudential regulator achieves its aim through licensing, on and off site supervision and risk-based assessments and action, including closure. Legislative powers are enacted to obtain information, review institutions and outsourced service-providers, commence enforcement action and manage insolvent providers. Administrative tribunals and Courts often act as checks[4] on unbridled regulatory action or abuse of power. In regard to making prudential standards or other

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[1] In Australia, we have the Australian Prudential Regulatory Authority (APRA), along with (Australian Competition and Consumer Commission (ACCC), Australian Securities and Investment Commission (ASIC) and the Reserve Bank of Australia (RBA).

[2] The primary responsibility for prudent management rests with the regulated entity itself, and most regimes only provide for limited public compensation through deposit insurance, for example. In Australia, fraud-related superannuation fund losses could be compensated through a post-facto levy on other funds. Despite the legalities, systemic concerns from losses have prompted Government bail-outs (as in HIH in Australia) creating an expectation, if not precedent.

[3] Contrary to popular claims, Australia has not been immune. Banks were loaned the Government's AAA credit-rating (initially free of cost), which caused a liquidity strain on superannuation and mortgage funds.

[4] In Australia, such checks include: administrative review by tribunals, ministerial portfolio oversight as well as Parliamentary scrutiny.

regulatory impositions, industry consultations and parliamentary reviews provide some balance[5].

5. This paper explores the practical constraints which affect the work of the prudential regulator (hereafter called the regulator) in delivering its statutory mandate, either through inherent nature of the work, legislated requirements or behavioural imperatives. In doing so, it aims to distinguish prudential regulation from other types of state regulation (such as market conduct, competition, privacy or tax). In my experience, it is often easy to miss this nuanced distinction in public comment, leading to ineffective outcomes. This needs to be remedied.[6]

6. While I have drawn from my own Australiana and international experience in writing this paper, as highlighted in the footnotes, the general thrust is applicable for general prudential regulation, with necessary adaptations.

7. I have benefited from the input of three respected experts in regulation, international risk-based supervision and the law. The inferences remain, however, my own.

How well-equipped? Is it working as well as it should?

8. How well-equipped is the regulator in doing its job vital to the economy? While this would vary between national regimes, and within regimes over time, there are certain inherent constraints on the regulator arising from its mandate, style of operation, power balance between industry and the authorities and the rule of law. Above all, as in all aspects of human endeavour, we must allow for behavioural idiosyncrasies.

9. This article discusses them, so that they are better understood, and where possible appropriate changes are made.

The mandate

10. The prudential regulator's primary task is to protect the interests of beneficiaries (depositors, policyholders and super fund beneficiaries). In practice, their interests are among the interests of shareholders, investors, distributors, employees, tax authorities and the community at large, including the global markets. In a stress situation, they come into conflict.

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[5] In Australia, in addition, the Productivity Commission exercises oversight by requiring regulatory impact statements.

[6] In Australia, this is topical, given the ongoing Financial Systems Inquiry (chaired by David Murray).

11. The regulator must prioritise beneficiaries, subject to those laid down by the law. Often, the law gives primacy to their interests[7]. To ensure its practical effect, standards are imposed and enforced. For example, the requirements for executive compensation, post GFC, have targeted inappropriate risk-taking by boards and management.

12. It is sensible to work collaboratively with other stakeholders when things are normal. After all, the business of any regulated institution is to operate profitably and provide a risk-adjusted return to entrepreneurs by servicing customers on a long term, sustainable basis, as signalled by market information. It is in the regulator's interest for this process to work smoothly.

13. This is why the regulator needs to balance its actions not to harm other stakeholders in normal times. Curiously to many, it would be concerned by loss-leaders in a portfolio, checking to ensure that the institutional viability is not thereby compromised[8]. Here we can perceive a degree of alignment between institutional and regulatory perspectives.

14. But in times of stress, such alignment breaks down. When regulatory insolvency[9] looms, consumer interests must be placed first. To do so, the regulator is forced to work with the very people who might have brought about the crisis (through poor strategy, lax execution, misalignment with long-term goals, fraud, conflicted arrangements, incompetence or criminal negligence).

15. This markedly differs from the market conduct, competitor or tax regulators who can, and often will, take an enforcement approach to institutional wrong-doing. Often, the prudential regulator has to bite its lip and work with the perpetrators. Only when all else fails, does enforcement become the last resort.

16. The public do not often appreciate this subtle difference, putting all regulators in 'the gun-toting, trigger happy' category. Think of a cop faced with a gun-wielding

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[7] In Australia, the law places the interests of depositors, policyholders and fund members on priority.

[8] I recall the consternation when group life insurance was being offered at uncompetitive rates to superannuation funds given the latter's increasing market muscle. Here the regulator responsible for the viability of both industries needed to tread a fine line.

[9] Note the different gradations of insolvency, for the purposes of this paper: cash-flow insolvency, accounting insolvency and regulatory insolvency. To keep ahead of looming trouble, regulatory insolvency is the most stringent, as it involves prudential margins: in banking, capital cushions above BASEL norms; in insurance, target capital ratios above legal minima; in superannuation, Operational Risk Financial Reserves.

mad man threatening innocent lives. Saving the innocents is more important than getting the offender. If they could be saved, even the criminal's escape becomes acceptable.

17. Depicted thus, it is easy to understand how the regulator works **for** the same shared aims of sustainable profitability through aligned times; to ensure it continually, it is necessary to focus on shared objectives and foster a working relationship. It is hard to describe this benign phase as regulator working **for** the institution, but it comes close.

18. In practice, however, things diverge. Institutions get their risk assessments or execution wrong; the proverbial 'rogue' operatives proliferate; Don Rumsfeldian 'unknown unknowns' intervene; regulatory rules, often devised with hindsight, prove ineffective to deter imprudent conduct in addressing emerging risks. In such cases, the regulator works **with** the intermediary in respect of identified issues.

19. For all those quick to critique regulators with the benefit of hindsight, it is important to realise how many problem cases are being worked on at any given time to remedy identified issues, like the vast unseen goings-on beneath the ocean surface. When they are resolved, as most are, the public will never know: the institution will not like to publicise it, and the regulator is often prevented by law from doing so[10].

20. The result? Only failures will ever be noted and become public knowledge. Think of running a public hospital, where you cannot publicise your many cures, but every failure is on the front page of the local rag. Such is the regulator's state.

21. Only if these fail, does the regulator work **against** the institution. Enforcement is often the last residual resort of the prudential regulator.

Style of operation

22. To engender a mindset that facilitates working for beneficiaries, the approach is more consultative and inclusive than other agencies. The complexities of modern financial intermediation demand a close yet professional relationship, whereby the institution must be encouraged to approach the regulator when a problem is identified, rather than when it is intractable. Then they work together to reinforce mutual priorities and track execution. Taking legal action becomes an option that neither party prefers, nor is it in consumers' interests.

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[10] Section 56 of APRA Act, 1998 ensures secrecy, subject to exceptions.

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

24. The tax regulator sends a bill, threatening punitive action if not met by the deadline. The onus is on the recipient to prove non-liability.

25. The market conduct regulator sends a legal notice, requiring action failing which legislated consequences will follow.

26. The prudential regulator calls an appropriate senior executive, seeking a meeting to discuss concerns. The meeting canvasses resolution options, recorded in an informal letter. Only if things threaten consumers' interests, does the tone change to formal.

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

28. 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.[11]

29. When things get tough, transitioning from the collaborative to the confrontational style could challenge the prudential regulatory team.

30. Apart from 'regulatory capture'[12] addressed through periodical portfolio changes, it is difficult to change gears in this way. One way to deal with this is in the enforcement stage, where the front-line supervisory team is replaced by trained litigators. Additionally, internal peer reviews, periodical external reviews (by say the Auditor General) and publication of regulatory decisions (in an anonymous basis) will also help.

31. The IMF undertakes Financial Sector Assessment Programme (FSAP) resourced with global subject matter experts, at the request of national regimes to provide an assessment against international best practice.

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[11] This is not a criticism of the three styles, but an acknowledgement of their different mandates and the need to adapt commensurate styles of operation. Enforcement agencies must be different to prudential regulators dedicated to encouraging good practice.

[12] In a mutation of 'the Stockholm Syndrome", the regulator starts identifying with the regulated institution and ignores the different perspective needed: a serious risk for the regulator.

32. 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, would be essential.

Power balance

33. The theoretical construct is the regulated institutions are being governed under the law, their licences and subject to ongoing oversight by the regulator. The regulator has the apparent power to assess and act. This legal position should not blind us to the considerable *de facto* power, influence and stake institutions wield, and in a modern market-based economy, deserve to wield. After all, consumable goods and services are provided by the institutions in the economy. By no means are they subservient to the regulatory whim, nor should they be.

34. In addition to the *de jure* protections to guard against arbitrary or excessive regulatory action, industry lobbies, captains of finance and large institutions all have access to political leadership as well as opinion-makers. It would indeed be a naive regulator who would ignore this. The industry's financial, political and policy leverage shapes the regulatory landscape including powers and how and when they are exercised.

35. A phone call from a systemically important Bank could set off[13] its own repercussions on industry regulation. Often such intervention could be useful in presenting a different, yet valid, perspective. Where they are driven by collateral motives (lessening competition, reducing consumer protection or engendering the reputation of the regime) robust defence backed up by sound past performance helps the regulator.

36. International requirements[14] or professional standards (accounting, actuarial, IT)[15] are invariably enlisted as allies.

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[13] As it has, in my experience.

[14] BASEL, IAIS and IOPS set global standards or provide guidance for banking, insurance and superannuation industries. Note the differential applicability of their guidance, with IOPS still evolving given the intrinsically national nature of superannuation.

[15] International professional standards have to work with national legal requirements. In addition, there are circumstances when the professional standards are not aligned to regulatory outcomes. For example, when the International Financial Reporting Standards were promulgated some years ago, many regulators decided to adopt different measurements for their purposes, e.g., overdue loans.

The Rule of law

37. 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.

38. In its application to the rule of law, the prudential regulator faces the following handicaps:
    - Unlike other enforcement agencies, the prudential regulator's stock-in-trade is not just proven legal offence alone, but includes a large measure of risk assessment. Risk includes imprudent behaviour that exposes beneficiaries to adverse outcomes, and when the likely outcome is assessed as beyond the range of tolerance, action is necessary. The legal rigour of proof required to secure a Court judgement involves greater certainties rather than fuzzy actuarial probabilities. Unfortunately, the judiciary in general is not trained in risk management.
    - I recall an actuary who ran a derivatives portfolio without stop-loss limits, and when the regulator disqualified him, he was able to argue that as the regulator stopped him before material damage, he was not at fault. He won. [16]
    - The system treats the rights of intermediaries to earn profits on par with consumer rights, failing to differentiate from the formers' manufactured rights and the latter's natural or inherent rights. Add the considerable financial, political and reputational clout of the industry relative to consumers, the balance is skewed against the latter.
    - Alternative dispute resolution mechanisms in many regimes[17] provide an informal and low-cost mechanism to consumers and must be welcomed. But they often lack the power to order compensation for consequential damages. Such damages, given the long term nature of many financial contracts, could be large with compounding.
    - Institutions can and do take matters to the Administrative Appeals Tribunals (AAT) where they exist,[18] if they are aggrieved with a decision, seeking a merits review. The AAT gets into the shoes of the decision-maker and reviews

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[16] In my prudential rage, I fantasized about mandatorily consigning the judges' own superannuation savings to the tender mercies of the errant actuary, but alas, that would have been *ultra vires*!

[17] In Australia, the Financial Ombudsman Service and the Superannuation Complaints Tribunal serve this role. They cannot offer consequential damages. There is also some criticism that industry-funded resolution vehicles are beholden to the industry rather than consumers.

[18] As in Australia.

the matter, and substitutes its decision in lieu of the initial decision. Hindsight could influence this process. Also, there is no provision for affected consumers to intervene[19], as often proceedings are held in confidence.

- Secrecy obligations on the regulator are stringent: except for limited defined circumstances, the regulator cannot disclose institutional matters. This is founded on the wholesome principle that commercial matters should be held in confidence and ongoing dialogue between the institution and the regulator is necessary. There is no corresponding obligation on the institution of course not to go public, however, on any matter it feels strongly about.[20]

The English poet Thomas Gray may not have been contemplating the prudential regulator's perilous position when he wrote his famous elegy, but his words seem resoundingly apt:

"Full many a gem of purest ray serene
The dark, unfathomed caves of ocean bear
Full many a flower is born to blush unseen
And waste its sweetness in the desert air."

- The public perception of a homogenous regulatory regime where agencies cooperate with each other in consumers' interest is not necessarily the reality. This is so even if we discount obvious, if human, turf wars. For instance, the aims of prudential regulation (save the consumers, working behind the scenes) could conflict with market regulation (hang out the offenders, pity about the collateral damage). In addition, in many regimes[21], government agencies are not always free to talk to other regulators. A serious prudential issue that the tax authority stumbles upon cannot be shared.[22]

In times of stress

[19] This is critical: after all, regulatory decisions disputed in tribunals concern consumers. Institutions will only take decisions against their interests for resolution. What if the decision is anti-consumer either by the regulator in the first instance itself, or in proceedings before the tribunal? In my view, this asymmetry must be addressed.

[20] In my experience, in Australia, the legal exception to secrecy obligations has not been used. This is a useful remedy against recalcitrant intermediaries, and deserves to be used to remind the industry that the obligation is not absolute.

[21] As in Australia, except in very limited circumstances. The tax authority cannot disclose matters to other agencies.

[22] In fairness, there are advantages in assuring the industry of such separation between agencies through prohibited communications, as it fosters voluntary flow of information which might otherwise not eventuate. In stress, this becomes a handicap.

39. Most regimes cater for normal times in their laws, rules and standards. During stress, these rules often prove inadequate. Information flow is not always reliable. Rumour and innuendo affect market outcomes as much as real events.

40. Stressed times call for coordinated decision-making, away from the glare of the media. Those who must decide, in the heat of the moment and with imperfect information, need protection against hindsight reviews. Barriers to information sharing need to be dismantled.

Suggested way forward

41. While no system can be perfect and ensure targeted outcomes at all times, the prudential regulator could do with several enhancements:

- Remove legal barriers to information sharing in defined circumstances as incipient stress is assessed.
- Use the exception to secrecy as necessary. Institutional privileges should be subordinate to consumer interests. As a start, de-sensitised war stories must be published annually in the regulator's annual reports to deter unacceptable conduct and better inform the public.
- Impose reciprocal a secrecy obligation on institutions, a breach of which must constitute waiver of any privilege. With the regulator being prevented from disclosure (or choosing not to, or being unable to exercise any exceptional powers), it is perverse for an institution to play the media without fear of response. The regulator then has an arm tied behind its back.
- 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. I acknowledge this calls for a complex re-think of existing legal processes, but in the realm of risk assessment and pre-emptive action where prudential regulators must practise their craft to deliver on their mandates, the tools of common law have been too blunt. An injection of the civil law pursuit of truth, rather than the adversarial system, would not be out of place.

- When the regulator is forced into enforcement mode, care must be taken that any penalties do not worsen the security of consumers. In superannuation with little or no shareholder capital, this is a real risk. The law could be changed to prohibit penalties being paid by the institution out of consumers' money.[23]
- The compensation packages of regulators must be aligned with the market place from which they must resource themselves. I understand the US Securities and Exchange Commission adopts this practice and offers valuable training as well to encourage skilled resources into the agency.[24]
- There is a case to consider for imposing punitive, exemplary and aggravated damages in regard to the worst forms of financial skulduggery, some showcased by GFC and since. The sceptical public often justifiably consider that the offenders are let off lightly, relative to blue collar crimes. Manipulating LIBOR in my view is akin to poisoning the water resources of a community, and must be treated as such.
- To balance the foregoing, regulatory officials proven of criminal negligence should not be able to move offshore as they often do, or simply live off their superannuation. Moving the rotten apples out of the basket is just not enough.

42. Regulators asleep at the wheel pose a threat to the system. Equally, regulators constrained by the system need help to deliver on their mandate.

43. Ending on an Australian note, the current Financial System Inquiry has its work cut out. Over to you, David Murray.

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[23] In Australia, when Media Super was fined for misleading disclosure, the fine did not apply to the trustees who made the wrong decision. It went to members who were already affected. In my view this is a travesty.

[24] In Australia, APRA has been less constrained by public sector pay structures. This has however changed for the worse when APRA was brought under the Financial Management and Accountability Act, 1997 imposing a public sector regimen.