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Financial Crisis Management – Power and Accountability

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The Australian Treasury released a consultation paper on September 12, 2012 canvassing views on a wide range of proposals to improve the power of the prudential regulator (APRA) for dealing with regulated financial institutions at risk of failure. Some of the changes involve harmonization of powers across the different categories of regulated institutions, but others involve quite substantial increases in APRA's power. While appearing generally warranted (and reflecting international developments and standards), there is no attention paid in the consultation paper to the necessary links between power and responsibility. The proposals give APRA significant discretion to use available powers, but are silent on the question of accountability and performance appraisal for decisions made about such use.

The Global Financial Crisis identified a range of problems in the failure management and resolution powers of financial regulators globally. While Australian regulators were not confronted with the need to manage the exit of failing or failed prudentially regulated institutions (banks or other ADIs, insurance companies, friendly societies, superannuation funds), the international experience focused attention on whether APRA's powers were adequate. With the development of international standards against which national financial systems will be judged, and the need for international regulatory coordination in dealing with complex institutions operating across national borders, appropriately strengthening APRA's powers has become important.

Legislative changes in recent years have addressed a number of shortcomings in APRA's powers[1], but many more changes are signaled in the Treasury consultation paper issued in September 2012.[2] While those changes are presented as "Strengthening APRA's Crisis Management Powers", and undoubtedly relevant to dealing with (or preventing) a financial crisis, they relate primarily to actions which APRA can take in dealing with any individual troubled financial institution under its regulatory radar.

The proposed changes involve some degree of harmonization of powers across the range of institutions supervised and also aim to ensure consistency and clarity between various pieces of sector-specific legislation and more general legislation such as the Corporations Act 2001. They address, *inter alia*, issues such as APRA's powers to give binding directions, appointing external managers to troubled institutions, and ultimate resolution/wind-up powers including compulsory transfers of business.

No doubt there will be many concerns expressed about the expansion of regulatory powers, although two aspects of the changes should be noted. First, they only apply to prudentially regulated institutions. Second, they generally relate only to actions which APRA might take when such an institution is perceived to be in financial distress (or worse), when APRA needs to take actions to protect the interests of those stakeholders for whom the imposition of prudential regulation is designed to protect. While those limitations are consistent with and enhance APRA's ability to meet its responsibilities there are some wider ranging consequences worthy of note.

One issue is that the regulated institutions involved often undertake a much broader range of activities than those giving rise to prudential stakeholder-protection concerns. Those activities may be undertaken through a wide range of business organizational and legal structures which, in principle, suggests that institutions wishing to shift other activities outside of the regulatory yoke could do so by appropriate structuring of their business arrangements.

[1] Discussion of many of these changes can be found in ANZSFRC (2011) "The Global Financial Crisis and Financial Regulation in the Antipodes", Chapter VI of World in Crisis: Insights from Six Shadow Financial Regulatory Committees From Around the World. http://finance.wharton.upenn.edu/FIC/FICPress/crisis.pdf

[2] The Treasury Strengthening APRA's Crisis Management Powers, September 2012. http://www.treasury.gov.au/ConsultationsandReviews/Submissions/2012/APRA

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However, while it may be only the continuity or safety of particular economic functions or financial products and services which prudential regulation seeks to achieve, it is ultimately the institutions involved whose failure threatens that objective which must be regulated and supervised. And whereas the original focus of prudential regulation was "micro" oriented on safety of individual institutions, greater emphasis is now being given to risks to systemic stability from spillovers and interrelationships due to financial institution failures.

One feature of the proposed changes is to extend APRA's failure management powers to the broader group of which a regulated institution is a part. This encompasses non-operating holding companies (NOHCs) which have a prudentially regulated institution as a subsidiary, as well as subsidiaries of a prudentially regulated institution.

The application of powers to the broader group reflects both the potential for conflicts of interest between group members which can create impediments to speedy and successful resolution, when part of the group is in financial distress, as well as the potential for spillovers and contagion between members of the group. Notably, however, there is no discussion of whether there might be merit in prescribing limitations on allowable group structures (and interrelationships) involving prudentially regulated institutions which could influence how such failure management powers might best be designed and expanded.[3]

A second consequence of the proposed changes is that while they relate to APRA's powers in dealing with a failing institution, stakeholders (shareholders, investors, customers etc) will take the potential of future APRA actions into account in current dealings with any (currently robust) regulated institution. Because APRA's powers involve decision making which affects allocation of losses and wealth transfers in a failing institution, this can be important in determining the terms on which stakeholders will deal with any institution where there is some future risk of failure. Where such

[3] In the UK, government proposals to "ring-fence" retail banking within group structures have been announced, while the Volcker rule contained in the US Dodd-Frank Act aims to prevent depository institutions from undertaking proprietary trading. See ACFS FRDP 2012-04 Britain's Banking Reforms: Is this the future shape of banking? (September 2012) for more detail. http://www.australiancentre.com.au/britains-banking-reforms-is-this-the-future-shape-of-banking/.

decisions involve discretion (rather than application of pre-determined rules) they can impose an additional source of risk for potential stakeholders.

A third consequence relates to that discretionary nature of APRA's powers. Discretionary power should be accompanied by accountability and performance assessment to determine whether those powers have been used appropriately. At the broad level, the prudential regulator can make two types of errors – failing to identify and act early enough in the case of a troubled institution, or wrongly identifying a sound institution as troubled and imposing unwarranted interventions on its activities. At a more specific level, reallocations of wealth and social costs associated with resolution of a failed institution should be subject to public purview – at least after the event.

There is no real discussion in the consultation paper of how such accountability is to be achieved, nor of the availability of information to be provided. Clearly, speed and secrecy are important in dealing with a troubled financial institution (and underpin the proposals to provide some relief from continuous disclosure obligations of ASX-listed financial institutions which are in financial distress and with which APRA is dealing). But ex-post disclosure of the processes, terms and conditions involved in final resolution of a failed institution should be mandatory.

Similarly, there is no discussion of the extent to which rules might be preferable to discretion in some circumstances. For example, APRA can appoint a statutory manager to an ADI if it considers that it "may become unable to meet its obligations; may suspend payment; or it is likely that the ADI will be unable to carry on business in Australia consistent with the interests of depositors or financial system stability in Australia". This involves a judgment call on the part of APRA, which must be based on information available to it, and which could lead to either forbearance (about which much discussion occurs in the US context) or premature intervention (which may be more likely in Australia) by the regulator.

Such uncertainty over regulatory response is likely to influence managerial decision making within regulated financial institutions which are at risk of becoming financial distressed. Whether requiring APRA to undertake such actions when certain pre-specified, verifiable, triggers (such as some significant breach of minimum capital requirements) would have preferable effects on decision making in regulated institutions is worthy of further consideration.

There are many legal issues and matters of detail associated with the proposed changes to APRA's crisis management powers which will elicit comment and response. How those powers will be applied

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in practice (albeit hopefully rarely), what are the implications for management decision-making and incentives in regulated institutions of the discretion provided to APRA, and how performance of APRA in implementing those powers is to be judged are also issues worthy of more detailed analysis.

This FRDP was prepared by Kevin Davis, Research Director of the Australian Centre for Financial Studies.

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