Financial Crisis Management – Power and Accountability

The Australian Treasury released a consultation paper[1] 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. 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.

The changes appear generally warranted and reflect: (a) the development of international standards against which national financial systems will be judged; (b) recognition that APRA's failure management powers – although largely untested – were inadequate for dealing with complex financial institutions; and (c) the need for international regulatory coordination in dealing with complex institutions operating across national borders.

However, 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 the enhanced powers in dealing with troubled institutions, but are silent on the question of accountability and performance appraisal for decisions made about such use.

While the expansion of regulatory powers applies only to prudentially regulated institutions and relates only to actions which APRA might take when such an institution is perceived to be in financial distress (or worse) they do have some important general consequences.

One issue is that while it may be only the continuity or safety of particular economic functions or financial products and services which prudential regulation seeks to achieve, these are often provided by financial institutions with complex business structures and engaged in a much wider range of activities. It is ultimately those more complex institutions whose failure threatens the prudential objective (and may also threaten systemic stability) which must be regulated and supervised.

Thus, 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

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

prudentially regulated institutions which could influence how such failure management powers might best be designed and expanded.[2]

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 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.

[2] 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/.

How APRA's enhanced powers will be applied in practice (albeit hopefully rarely), how regulatory discretion (versus rules) affects management decision-making and incentives in regulated institutions, and how performance of APRA in implementing those powers is to be judged are also issues worthy of more detailed analysis.

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