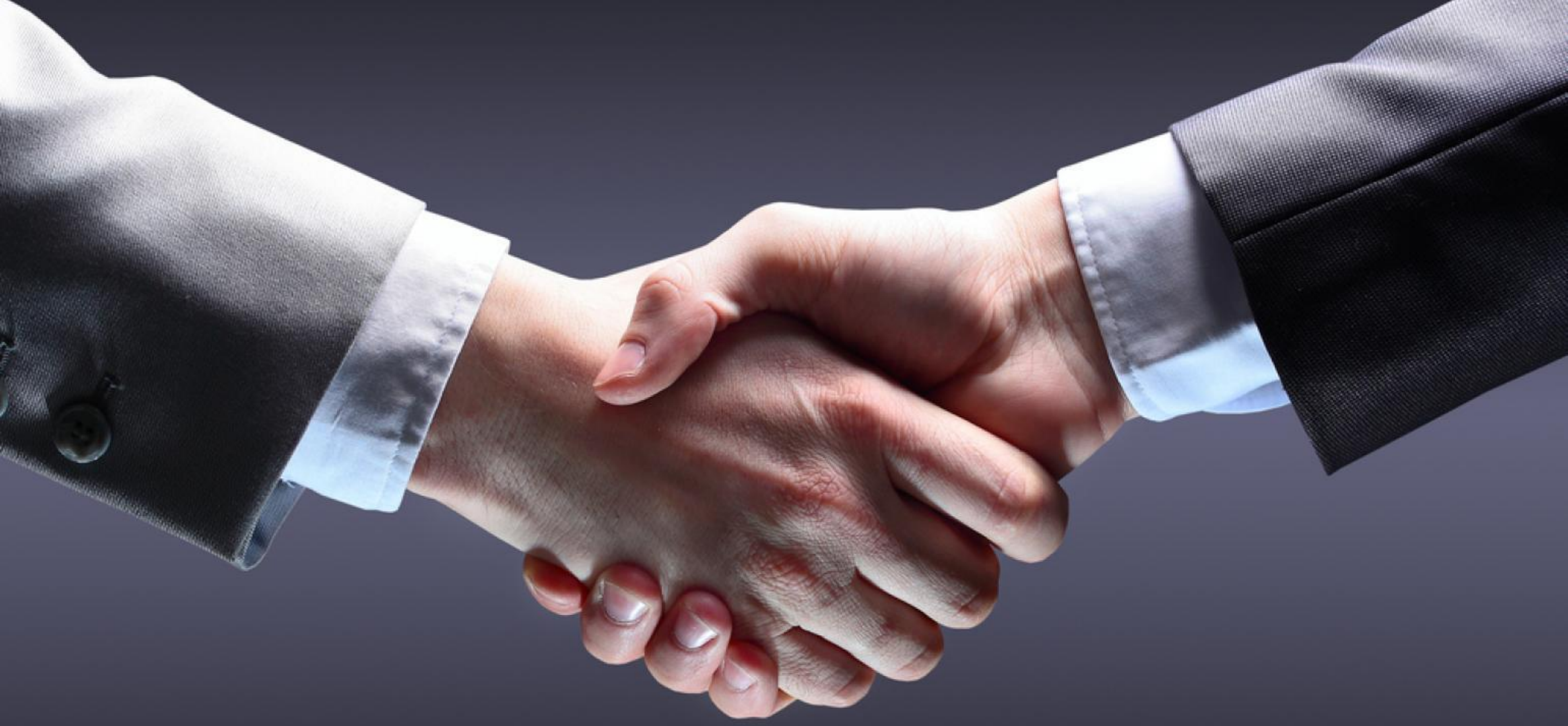

Consumer Protection & Financial System Stability

Under Australia’s Twin Peaks Model of Financial System Regulation.

Conclusion

- Australia uses the TP system, which is 1 of 4 systems currently in use world-wide
- It is by every measure the best system
- It is NOT however perfect, nor is it on its own an effective guarantee of either consumer protection or system stability
- So why bother studying it?
- because it does work better than the others, and has fewer failures and fewer theoretical weaknesses than the others.
- TP has failed as a system in the Netherlands, and it has suffered critical points of failure in Australia - especially as regards the financial advice scandals affecting consumers in Australia
- So the point of my talk is to tell you about TP, but to do so honestly and with integrity: to tell you about where it is strong, and where it is weak, and where it can be improved.
- Put simply: yes, indeed, please copy Australia, but please do not make the mistakes we have made.

“This [Twin Peaks] model has now been held up as the most effective model to address the flaws in unregulated or thinly regulated markets where the most problematic issues arose in the GFC”

- Coffee and Sale, 2009

INTERNATIONAL MONETARY FUND

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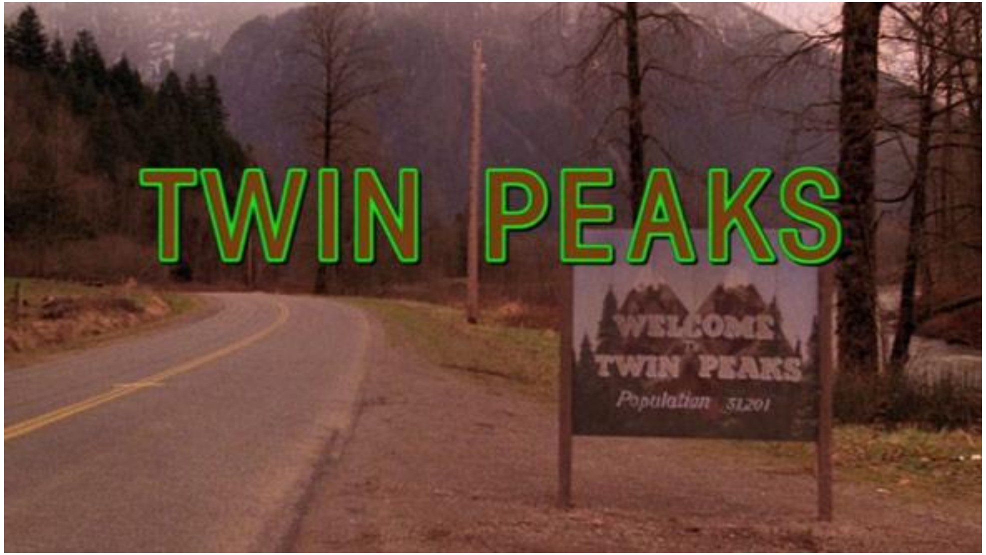
Australia 2014
G20

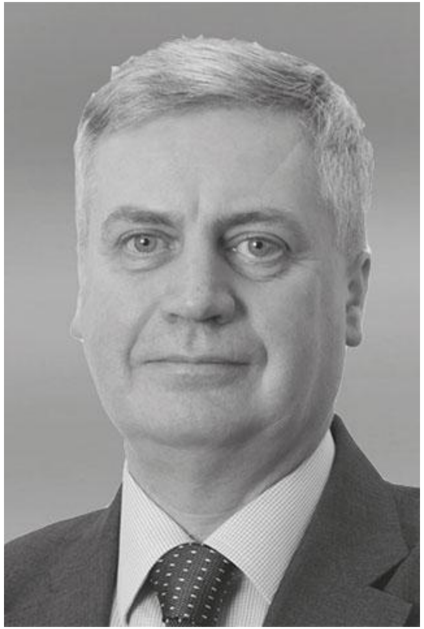
“As a regulatory structure, it is the envy of many in other countries, and more recent regulatory architecture reforms in other countries are often based on what is described as the Australian ‘twin peaks’ approach …”

- Erskine, 2014

What is Twin Peaks?

A David Lynch mini-series? No!

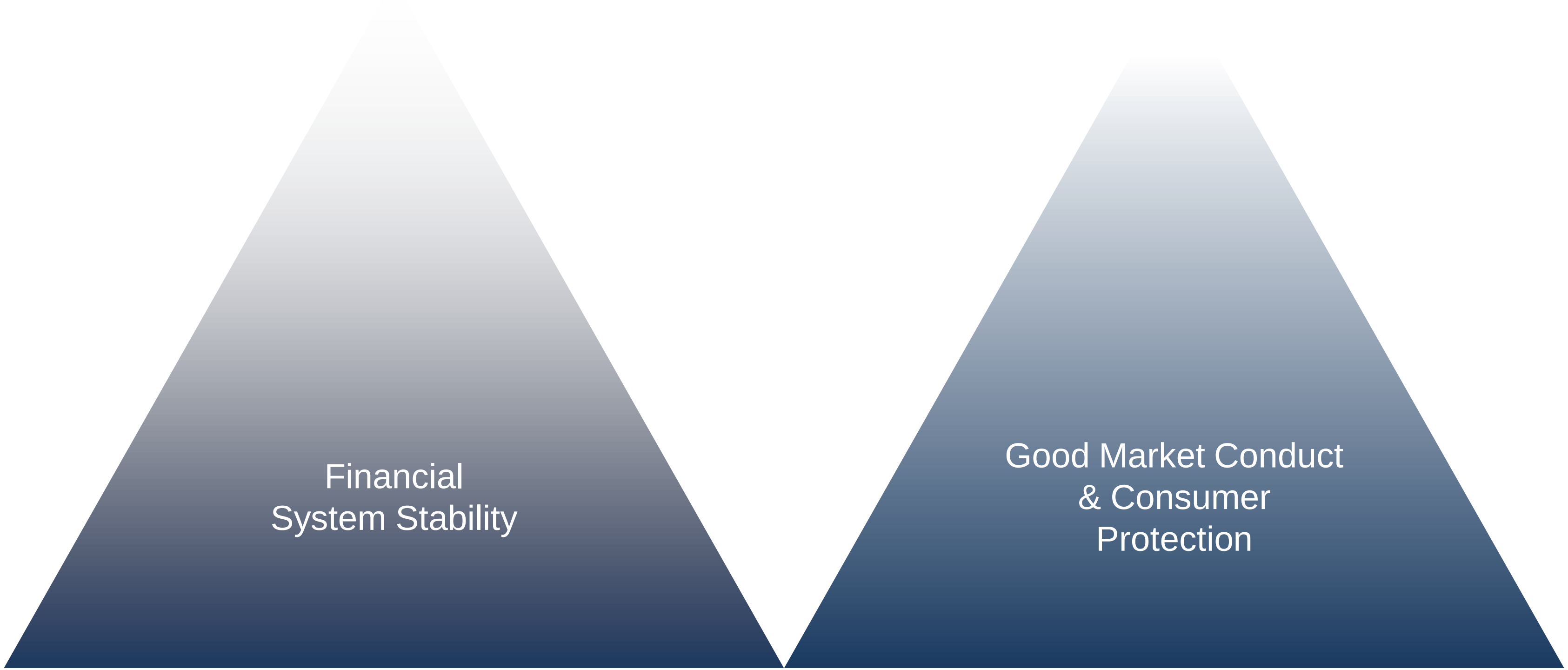




Developed by Dr Michael Taylor when he was at the Bank of England

Despite being proposed by an Englishman, for the UK, it was first adopted by Australia in 1997

Envisages two peak regulators



The Australian Model

Australia has therefore used it the longest, and recently we subjected the model to a rigorous, 14 year review, called the Financial System Inquiry.

The forms it takes in Australia

AUSTRALIA APRA

AUSTRALIA ASIC

Australian Securities & Investments Commission

What are the advantages?

- Regulators can be more effective, with each having clear objectives (outcomes) that do not overlap;
- Regulators can, as a result, be more accountable and more focused on achieving those outcomes;
- It creates checks and balances between agencies, and their objectives;
- It allows each regulator to create its own culture that best suits its objectives; and
- It allows each regulator to acquire expertise specifically required to meet its objectives.

Risk-based paradigm

…pick important problems and fix them.

Problems with this paradigm

- the assumption that regulators are smart enough to ‘foresee the unforeseeable’. Put differently, there is an assumption that regulators will know from where the next financial crisis will come and, consequently, correctly identify which types of risks and what forms of conduct to prioritise. But, as was seen during the GFC, this assumption is not always correct:

  … indeed with respect to the global financial crisis more broadly, assumptions that had been made as to how markets would react in particular scenarios proved significantly misplaced, with risk events that had been anticipated to occur once in several lives of the universe were occurring every day.

- the model itself may incorrectly prioritise which risks to avoid, as distinct from a failure to identify the risk at all, and this was evident from the conclusions reached in the aftermath of the failure of HIH;

- there exists the potential for process-induced myopia. That is to say, a focus on the process upon which risk-based regulation relies, without paying sufficient attention to issues that are outside the scope of what is covered by the process.

  If little scope is given in practice for those engaged in working within the framework to work outside it where they see the need, the framework will always be prey to events that those working within it were not given the room to say they had seen.

- Anecdotal evidence suggests that criticism of the APRA, and challenges to the organisation's prevailing orthodoxies are in danger of being met with hostility;
- there is, as a consequence, a lack of predictive certainty for the regulatees, as to what forms of conduct will be sanctioned and what forms not;
- this in turn encourages a capricious regulatory environment, particularly where different individuals in the regulators take different approaches, or have different priorities;
- an unpredictable regulatory environment, brought about by changes in the prevailing political climate;
- the potential for regulatees to encourage regulatory forbearance by either arguing that the proposed sanctions pose a greater risk to the regulated entity and therefore the entire financial system, than the misconduct itself; or
- the potential for regulatees to encourage forbearance by arguing that similar conduct was expressly authorised by the regulator in the past, (constituting, as it did then, an acceptable risk);
- what Llewellyn refers to as the 'Christmas tree effect', in which the regulator's remit steadily increases – as perceptions of risk increase - with a wide array of ancillary functions, both to the point of over-burden and to the point of distraction from what should be core activities;
- perceptions of risk are exactly that: perceptions. While APRA has attempted to create a methodology around the assessment of risk, and to lessen the impact upon the assessment of risk of individual perceptions, risk assessment is not and never will be as '"rational" [or] as consistent in substance as its form suggests.'

Over-arching paradigm: Principles-based

"A principles-based approach does not work with individuals who have no principles."

*- Hector Sants**

*Hector Sants, Chief Executive Officer, Financial Services Authority. Quoted in Larry Elliott & Jill Treanor, "Revealed: Bank of England disarray in the face of financial crisis", 'Economy', The Guardian 7 January, 2015.

Two important things I want to mention:

- Yes! Australia did really well! – But we had a mining boom, vanilla banks not exposed to derivates, and expansionary fiscal policy (huge infrastructure investment)

- No! Netherlands adopted Twin Peaks 2nd, in 2002, did disastrously badly during the GFC

Failures in Australia that pertain to consumer protection…

The Financial Advice Scandals

- Why this is important?

- G.F.C.
  - Subprime disaster was a consumer protection failure: Low-doc, No-doc, LIAR loans
  - Subprime metastasized into a financial crisis which became a fire-storm that swept the globe.
  - So…. DON'T UNDERESTIMATE CONSUMER ABUSE AS A SYSTEM STABILITY THREAT

The Financial Advice Scandals

- An absolute disaster on the part of ASIC – (the market conduct and consumer protection body)

- Disgraceful failure

- Australian Senate has excoriated ASIC

The Financial Advice Scandals

- ASIC in bed with the banks
- BFF (best friends forever)
- Took 18 months before they did anything about a scandal affecting potentially millions of Australians, worth billions of dollars, and including outright document fraud, theft, and misleading and deceptive conduct

Why did ASIC act eventually?

What’s the solution to weak enforcement?

- MAS – the Monetary Authority of Singapore
  – no one messes with the MAS

> *‘The Singaporeans have transcended the limitations of compliance and the heretofore dominance of risk management systems designed in terms of minimizing the risk to the institution. Instead, it has very consciously aligned the ‘end’ - market integrity - with the ‘purpose’ of risk management - protecting the public interest. Firms are assessed on their demonstrable capacity to protect the public interest. This very clever exercise in regulatory engineering, combined with demand to report suspicion rather than evidence of wrongdoing and power of compulsion, creates a Panopticon effect. It may also lead to warranted confidence in banking industry exhortations that they are committed to professional integrity. It is a framework that is deserving of attention and emulation.’*

> *‘“The inspections and reprimands from the Monetary Authority of Singapore are everything,” a European banking veteran said. “Not respecting the rules risks huge fines, and even prison.”*

My idea….

Incentivize compliance

ASIC to keep a percentage of whatever fines it levies. In other words: the more you punish (bad behaviour) – the more money the regulator will have in its budget

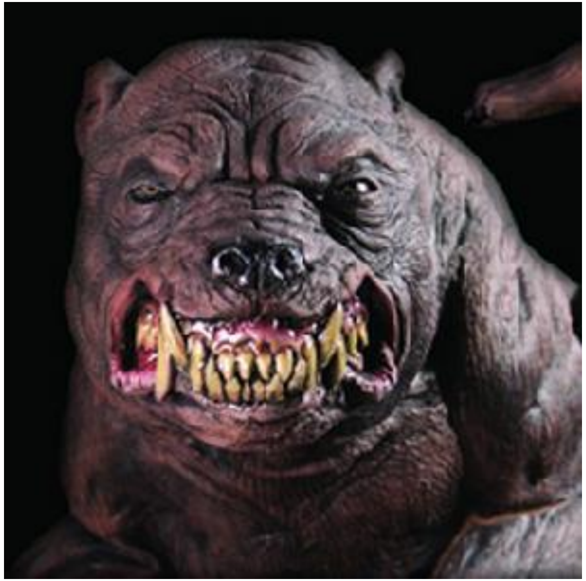
Concluding remarks

- This matters! GFC!

- Twin Peaks is great, but its not perfect.

- Culture of the regulators, capacity to prevent regulatory capture and providing incentives are all very important.

A poodle? Or a hell-dog?



- Put simply, don’t take your eye of your priorities: protect the financial system at a macro level, and at a micro level (consumers)

Thank you