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# A bridge too FRAA

## AN INVITED SUBMISSION ON THE TREASURY LAWS AMENDMENT (BETTER TARGETED SUPERANNUATION CONCESSIONS) BILL 2023

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# Introduction

## SCHEDULE 5

1. In its explanatory memorandum, Treasury has stated that:

> *Schedule 5 to the Bill amends the FRAA Act to reduce the frequency of FRAA's reviews of ASIC and APRA to every five years. This lessens the regulatory burden on ASIC and APRA and allows for more comprehensive reviews by the FRAA… Schedule 5 to the Bill is estimated to have minimal financial impact. This proposal would result in savings in the years between reviews, where no panel members or consultants are appointed. Savings would accumulate from 2023-24, but may not be fully realised until later years.*[1]

2. This proposed amendment is profoundly **wrong-headed and counter-productive**, and the savings achieved would be akin to ***penny wise, but pound foolish***.

    2.1. This piece of advice will outline 'why'.

# Background

## IN THE ABSTRACT

3. Financial regulation is **different** from the regulation of other industries – it is unique – and for various reasons:

    3.1. Effective financial regulation is **exceptionally difficult to achieve**:

        3.1.1. Financial products and services are **conceptual, not tangible**. Consequently, it is far **more difficult for a financial regulator to define** what is being regulated, than it is for a regulator of oil and gas, for example. Financial products and services are ideas – most often in the form of promises. In as many ways as there are to **explain an idea, so there are as many ways to define a product or service**.
        3.1.2. Each time a vendor **changes the description** of a product or service, they **change the definition**, and with it the **laws that apply** (or whether the law applies at all).

[1] The Parliament of The Commonwealth of Australia, House of Representatives, (2022–2023), *Treasury Laws Amendment (Better Targeted Superannuation Concessions and Other Measures) Bill 2023 Superannuation (Better Targeted Superannuation Concessions) Imposition Bill 2023, Explanatory Memorandum*, (Circulated by authority of the Assistant Treasurer and Minister for Financial Services, the Hon Stephen Jones MP), at 3, available at: <https://parlinfo.aph.gov.au/parlInfo/download/legislation/ems/r7133_ems_2d7466e4-4cb5-4ac2-8eb3-442bf6394a43/upload_pdf/JC011632.pdf;fileType=application%2Fpdf#search=%22legislation/ems/r7133_ems_2d7466e4-4cb5-4ac2-8eb3-442bf6394a43%22>.

3.1.3. As a result, financial regulators are forever stuck "**fighting the last war**"[2] – playing *whack-a-mole* **trying to keep pace with regulatory arbitrage** (the practice of changing the description – and therefore definition – of a product or service).

3.1.4. Moreover, the **financial industry innovates faster** and at greater scale than any other industry. That further exacerbates the challenge regulators face.

3.1.5. Consequently, **financial regulation** is an endeavour that is **littered with failures** throughout its history, and internationally. Indeed, they occur with depressing regularity.[3]

3.2. Regulators **fall prey to capture**.

3.2.1. Indeed, all regulators fall prey to capture – that is to say, **subservience to the industry that they are required to police**. Moreover, history has demonstrated that regulators of the financial industry are often the first to fall prey to capture, and when they do, they fall further and fall faster than regulators of other industries.

## IN THE PARTICULAR

4. Post-GFC, it has been recognised that a **failure to deter market misconduct and consumer abuse** can also become a **source of financial crises**. As such, effective conduct regulatory enforcement is a pre-requisite for a **stable, functioning, efficient, productive and fair** financial industry.

4.1. **The global financial crisis metastasised out of the US Subprime disaster**. That crisis was the result of market misconduct and consumer abuse – reckless and predatory lending – on a hitherto unseen scale. Subprime loans were re-packaged into collateralised debt obligations (CDOs), which were then on-sold to systemically important banks the world over.

4.1.1. When interest rates re-set on loans that had been extended without adequate – or at times any[4] – due diligence, defaults were wide-spread, and the value of the CDOs, of which they were components, **collapsed**.

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[2] Schwarcz, Steven L., "Systemic Risk", *The Georgetown Law Journal*, Vol. 97, no. 1, 2008, pp: 193-249, at 248, available at: <http://papers.ssrn.com/sol3/Papers.cfm?abstract_id=1008326> .

[3] US Savings and Loans Crisis (1980s); Junk Bond Crisis (early 2000s); Mexican Peso Crisis (1994); Asian Crisis and Russian Rouble Crisis (1998); Global Financial Crisis (2008); European Debt Crisis (2009), to name but a few.

[4] Some loans were deemed "low doc", others "no doc". In the case of the latter, loans were extended – effectively – on the basis that the borrower had a pulse. Others included mortgages on mobile homes. When those defaulted, borrowers simply drove away in the bank's security.

4.2. Our conduct regulator, ASIC, has been **criticised for its weak enforcement and inefficacy**: in the 2014 **Senate Report**,[5] the 2014 **Financial System Inquiry**,[6] the 2015 **Capability Review**,[7] and extensively by the **FSRC**.[8]

4.2.1. These have included observations that ASIC **is weak in enforcement,**[9] **and captured**.[10]

## THE SOLUTION

5. A rich and extensive field of scholarship has developed over the past 160 years, analysing regulator efficacy and, in particular, financial regulator efficacy, and the problems of regulatory capture.

5.1. Dating back to the 1860s, and in response to the capture of the railroad commissions in the United States, Charles, Francis Adams, Jnr argued for the creation of a "Sunshine Commission" to act in oversight of the Railroad Commissions, and mitigate capture.[11]

5.2. As a solution to the challenges that face financial industry regulators, such as ASIC and APRA, a "**regulator to regulate the regulator**" has been echoed numerous times, across decades, by the most eminent scholars in the field: Levine; Barth, Caprio and Levine, and McRaw to name but a few.[12]

5.3. Barth, Caprio and Levine provide the following, useful explanation of what such a board of oversight should do:

> *(i) an authoritative institution, independent of short-term politics and independent of the financial services industry; (ii) with the power to demand and obtain information necessary for assessing and monitoring the 'Guardians of Finance' (the regulators); (iii) with the multidisciplinary expertise necessary to process that information; (iv) with the prominence to*

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[5] Commonwealth Parliament of Australia, in its Senate Economics References Committee, (June 2014), "Performance of the Australian Securities and Investments Commission", pp 1-519, available at: <http://www.aph.gov.au/Parliamentary_Business/Committees/Senate/Economics/ASIC/Final_Report/~/media/Committees/Senate/committee/economics_ctte/ASIC/Final_Report/report.pdf>.

[6] Commonwealth Government of Australia, in its Treasury, (November 2014), "Financial System Inquiry Final Report", pp 1-320.

[7] The Australian Government in its Treasury, (4 December 2015), "Fit for the future. A capability review of the Australian Securities and Investments Commission. A Report to Government", pp 1-186, available at: <https://static.treasury.gov.au/uploads/sites/1/2017/06/ASIC-Capability-Review-Final-Report.pdf>.

[8] Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry, (1 February 2019), "Final Report", Vol. 1, Financial Services Royal Commission, pp 1-492.

[9] Commonwealth Parliament of Australia, in its Senate Economics References Committee, (June 2014), op cit., at xvii.

[10] Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry, (1 February 2019), op cit., at 424.

[11] Schmulow, Andrew, Karen Fairweather & John Tarrant, (1 February, 2019), "Restoring Confidence in Consumer Financial Protection Regulation in Australia: A Sisyphean Task?", *Federal Law Review*, Vol. 47, no. 1, pp: 91-120, at 100ff; Schmulow, Andrew, Paul Mazzola & Daniel de Zilva,( 25 September, 2021), "Twin Peaks 2.0: Avoiding Influence Over an Australian Financial Regulator Assessment Authority", *Federal Law Review*, Vol. 49, no. 4, pp: 505-527, at 506ff.

[12] Schmulow et al, (2019), Ibid.

> *deliver such assessments to the public and its elected representatives; and (v) in an on-going manner capable of affecting the open discussion of financial regulatory policies.*[13]

6. In Australia, **two Commonwealth Government Inquiries** have reinforced this solution, by calling for the creation of a board of oversight over ASIC and APRA: the 2014 **FSI**[14] and the 2018 **FSRC**.[15]

7. Against this backdrop, – the challenges that regulators in this space face, their dismal track-record, the equally damned track record of, in particular ASIC, the intellectual and statutory authority of those who have stipulated a solution (**arms-length, specialist, biennial reviews**) – **any significant deviation** from that **should only be supported if backed by compelling evidence**.

# Weighing the evidence

8. In its explanatory memorandum,[16] Treasury asserts that these reforms will [lessen] *the regulatory burden on ASIC and APRA …* [allow] *for more comprehensive reviews … would result in savings.*

9. These reasons are **wrong-headed** and **fail to address the overarching purpose of the FRAA**: to **improve the efficacy** – **particularly the enforcement efficacy** – of our regulators, especially ASIC. That is the **paramount purpose** behind the creation of the **FRAA**, a purpose borne of extensive and highly **critical reviews**, **formal recommendations** by government inquiries, and the **demonstrable inefficacy** of our regulators, culminating in the FSRC. Treasury simply walks past, and fails to address that purpose at all.

> *A nationally representative study commissioned by The University of Melbourne in the wake of the Royal Commission found that over half the population (**54% of Australians**) had been negatively affected by misconduct and other issues with financial service providers over the past five years. The combined costs to Australian households of these issues is estimated at **$201 billion**, while remediation costs to industry as a result of the Royal Commission have been estimated at **$10 billion**.*[17] *[Emphasis added].*

10. Put differently, the **burden on ASIC and APRA from biennial reviews** is less important than the **burden on consumers and the economy as a result of misconduct**, caused in turn by firms emboldened by the view that their actions will attract little or no consequences. For this, and other reasons, it is important to keep the FRAA true to its overarching purpose: **expose inefficacy and support enhanced regulator efficacy**.

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[13] Ibid.

[14] Recommendation 27, Commonwealth Government of Australia, in its Treasury, (November 2014), op cit., 239.

[15] Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry, (1 February 2019), op cit., at 41.

[16] The Parliament of The Commonwealth of Australia, House of Representatives, (2022–2023), op cit.

[17] Breidbach, C, C Culnane, A Godwin, C Murawski & C Sear, (August 2019), "FinFuture: The Future of Personal Finance in Australia", The University of Melbourne, published by The University of Melbourne, Melbourne, VIC, pp 1-70, at 19, available at: <https://www.unimelb.edu.au/__data/assets/pdf_file/0004/3145612/FinFuture_White_Paper.pdf>.

10.1. Consequently, any changes to the current regime that are **not focused on enhancing the FRAA's overarching aims** should be **rejected**.

11. But, assuming for a moment, that biennial reviews do incur a greater burden, that in and of itself **incorrectly frames the purpose** – at least the optimal purpose – to be served by oversight: it **should not be a burden**. It should be a **collaborative and iterative purpose of continual and recursive reviews**, driving ever **great enforcement efficacy**.

12. The assertion regarding the **cost savings is illusory**. As the above quoted passage from the *FinFuture White Paper* demonstrates, the detrimental effects of financial industry misconduct on society **far outweigh the savings** achieved (by not operating a three-person board, such as the FRAA).

13. The assertion made in relation to **more comprehensive reviews** is, similarly, **untenable**. ASIC has struggled to regain the public's confidence (as evidenced by yet another Senate Inquiry), despite numerous reviews, and numerous bouts of re-organisation. As such ASIC would be better served by more frequent reviews – ones that produce more ***bite-sized*** **recommendations for ASIC to tackle**. The longer the periods between reviews, the greater and more extensive will be the recommendations for ASIC to tackle, and **less will be the likelihood** that ASIC will be able to **address those criticisms meaningfully**.

14. But more importantly, if reviews are conducted at **five-year intervals**, **significant gaps** in enforcement will remain **unidentified** for five years. What will be the impact on consumers and the economy if potentially significant gaps in regulator efficacy are left unaddressed for that length of time? Five years is sufficient to allow very significant forms of harm to arise, and regulator inefficacy to remain unaddressed. **These amendments do not address that shortcoming at all**.

14.1. In some instances, gaps could remain for more than five years: in some instances, a **decade**. If, after five years, a gap in regulator efficacy and/or enforcement is identified, it will be **another five years** before there is an assessment of whether and to what extent that previously identified gap had been addressed.

14.2. It simply cannot be a tenable proposition: that **significant conduct problems**, **misconduct**, **widespread fraud and theft**, or **threats to the stability of the financial system**, as a result of inefficacy from our regulators, should remain unaddressed for up to a **decade**.

15. ASIC and APRA are already subject to annual reviews by Senate Estimates. If the question was asked, *should these also be reduced to once in five years, in order to reduce regulatory burdens*, it is expected the answer would be in the negative. The expected grounds for such a rejection are instructive: Parliamentary **oversight, and accountability** by a Commonwealth Authority, to "we the people", **takes precedence over desires to reduce regulatory burdens**. Put simply: accountability comes first.

15.1. However, and that said, Parliament, and its Members, alone, are **not capable** of exercising adequate oversight over ASIC and APRA. This is by no means to cast aspersions on Parliamentary Members. Rather it is a reflection of the **degree of specialisation** needed to understand the functioning of a regulator as complex as ASIC, or one with a remit as difficult to achieve as APRA's (one author describes the Prudential Regulator's task of having to foresee where the next crisis will come from as needing an ability to "see around corners"[18]).

15.2. For that, **specialists are required**: ones who understand:

- the regulatory craft;
- in the case of ASIC , to understand the legislative environment in which the regulator operates (ie the requirement to act as a "model litigant");
- or to understand the micro-prudential tightrope that a regulator such as APRA must walk;
- the intricacies of running a large, Commonwealth authority;
- how to assess and evaluate enforcement; and
- the current state of scholarship and the latest research findings that speak to the tasks of each regulator, etc.

15.2.1. Indeed, this task is so specialised that only a handful of individuals, adequate to the task, come to mind: Professors Alan **Fels** and Graeme **Samuel**, Rod **Sims** and AUSTRAC CEO Nicole **Rose**.

15.2.2. Evidence in support of this view is to be found in the **2019 Treasury Capability Review of APRA**,[19] which serves as an excellent example of what *can* be achieved. Led by Professor Graeme Samuel, it is an outstanding, forensic, insightful, deep and forthright assessment of APRA, including matters as amorphous as its culture.

15.2.3. Reports such as Treasury's APRA Capability Review, conducted biennially, would **prove invaluable for Parliamentary Members** in pursuit of meaningful, purposeful – and supportive – oversight of ASIC and APRA. In turn, the regulators would be provided with an **opportunity to address findings**, and **demonstrate their progress** two years later, when the next review fell due.

15.2.4. That in turn would be a **feasible timeframe**: long enough to **demonstrate progress** and change, but not **so long as to render the exercise a nullity**.

# Conclusion

16. The **necessity** of oversight of our financial regulators, some may argue, is **settled**.

[18] Ford, Cristie, "Macro- and Micro-Level Effects on Responsive Financial Regulation", *University of British Columbia Law Review*, Vol. 44, no. 3, 2011, pp: 589-626, at 590.

[19] Commonwealth Government of Australia, in its Treasury, (28 June 2019), "Australian Prudential Regulation Authority. Capability Review", pp 1-146, available at: <https://treasury.gov.au/sites/default/files/2019-07/190715_APRA%20Capability%20Review.pdf>.

17. The **current timeframe** for reviews in the *Financial Regulator Assessment Authority Act*, it is argued, is **optimal**. It comports with recommendations made by two **Commonwealth Inquiries** and is **supported by research** in the field.

18. The proposed changes **fail to demonstrate** how they address the **core function** of the **FRAA**: **enhancing regulator efficacy**. The **savings** the proposed changes claim are **illusory**.

19. As such, it is the author's view that the **proposed change should be resisted**, and the FRAA should **continue to conduct biennial reviews**.

# Author's expertise

20. The author is an Australian academic, specialising in regulator efficacy; regulatory enforcement; combatting misconduct in retail financial markets; financial system regulation; the 'Twin Peaks' financial system regulatory model; the UK's Treating Customers Fairly framework (located within the UK's Twin Peaks regime); and financial regulatory theory. The author has written and published widely on ASIC. The author has provided advice on these topics to various governments and NGOs (South African National Treasury; New Zealand Financial Markets Authority; UK House of Commons House of Lords All Party Parliamentary Group; CGAP/World Bank; Parliament of Europe; Parliament of the Republic of South Korea; Ministry of Finance of the Federal Republic of Brazil etc) and, by invitation, to Australian Inquiries (Royal Commission of Inquiry into Misconduct in the Banking, Superannuation and Financial Services Industry; Senate Committees; Australian Law Reform Commission; Financial Regulator Assessment Authority; Commonwealth Treasury). The author's **invited submission to the Banking Royal Commission** (**establish a board of oversight over ASIC and APRA**) was **reflected in Recommendation 6.14** of the Royal Commission Final Report: establish a Board of Oversight over ASIC and APRA.