28th Asian Shadow Financial Regulatory Committee Statement

July 15, 2016 – Sydney Australia

Funding the real economy: Are there lessons for Asia from the Australian financial regulatory experience?

The Australian financial regulatory structure

(1) Financial regulatory structure in Australia is heavily influenced by three major government inquiries: the Campbell Report in 1981 led to the floating of the Australian dollar and the deregulation of the financial sector. The volume and quality of financial services in Australia dramatically improved as a result. The Wallis Report in 1996 led to the creation of the Australian Prudential Regulation Authority (APRA), and the current form of the Australian Securities and Investments Commission (ASIC). The Murray Report in December 2014 made recommendations in key areas to enhance financial resilience, protect retirement income, and promote innovation. In response to the recommendations, the government established a Financial System Program in October 2015 to improve the Australian financial system.

(2) The APRA supervises prudential institutions such as deposit takers, insurance companies, and retirement funds. The ASIC is Australia's corporate, market, and financial services regulator. The division is along functional lines. Traditionally prudential regulation is undertaken by the central bank. However the primary function of the central bank is making monetary policies and its primary relationships are with banks. The Wallis Report concluded that it would be difficult for the central bank to carry out prudential supervision efficiently and flexibly for the wide range of financial institutions, e.g. insurance, investment funds, superannuation funds, etc. The separation between the regulator and the lender of last resort also strengthens the message that there is no automatic financial support in the event of insolvency.

An alternative to the twin-peak structure is the mega regulator model. It has a single regulator undertaking prudential supervision, market regulation, and consumer protection. A mega regulator is likely to improve regulatory consistency and reduce the scope for regulatory arbitrage. On the other hand, it may have too much power and leads to "one-size-fits-all" regulation. The Wallis Report considered the alternatives and concluded that the twin-peak structure will best serve the Australian economy.

Other regulatory components are established to provide flexible and low cost coordination across regulatory agencies.

- Council of Financial Regulators is chaired by RBA. It is an informal body in which members (RBA, APRA, ASIC, and the Treasury) share information and coordinate actions. It also advices the government on long-term financial architecture.
- Financial Sector Advisory Council is a group of experts from the private financial sector providing advice to the Treasurer.

(3) The financial system is a key factor affecting economic growth and stability. The Australian economy weathered the Asian financial crisis (AFC) in 1997-98 and the global financial crisis (GFC) in 2008-09 very well. While the Australian dollar suffered significant depreciation during the AFC, the average GDP growth rate from 1996 to 1999 was over 4%. During the recent GFC, Australia was able to maintain positive growth, with the lowest growth rate of 1.2% in the third quarter of 2009. In fact the Australian economy has maintained positive economic growth for 25 years, with the last economic recession occurred in 1991.

(4) There remain significant weaknesses in Australia's financial system as pointed out in the Murray Report: "Taxation and regulatory settings distort the flow of funding to the real economy; it remains susceptible to financial shocks; superannuation is not delivering retirement incomes efficiently; unfair consumer outcomes remain prevalent; and policy settings do not focus on the benefits of competition and innovation."

Regulatory structures in other Asian countries

(1) Several countries in Asia have a single financial regulator: the Monetary Authority of Singapore, the Financial Supervisory Service in South Korea, and the Financial Services Authority in Indonesia.

(2) Several countries have the twin-peak structure similar to Australia. These include Hong Kong, Japan, and New Zealand. The key difference, however, is that prudential regulation is carried out by the corresponding central banks.

(3) China has specialized regulators for banks (China Banking and Regulatory Commission), for financial markets (China Securities Regulatory Commission), and for insurance companies (China Insurance Regulatory Commission). It was reported recently that China had asked UK for advice on creating a financial super-regulator.

Issues to consider by other Asian countries

(1) Forward thinking on financial regulation
- Actions driven by crisis management, e.g. bail-outs of systematically important financial institutions (SIFIs), tend to weaken the effectiveness of financial regulation. Post-crisis reports and reviews tend to be unduly influenced by interest groups affected by the crisis and by political pressure for taking actions to address the immediate causes. In his review of the global regulatory reform since the GFC, Professor Kevin Davis, a member of the Murray Report committee, points out that "much of the subsequent regulatory agenda arguably reflects a need to be seen to be tackling perceived weaknesses rather than implementation of a well-researched optimal regulatory solution."
- The Australian Financial System Inquiry (FSI) reports are forward thinking in nature, not post-mortem analyses. They are formulated after wide consultation with academic, industry, and consumer groups. In writing the Murray Report, the committee received over 800 submissions, held hundreds of stakeholder meetings, and met with global financial institutions and regulators from different

jurisdictions. Many international participants noted that a key strength of the Australian system was the holding of the periodic, comprehensive, and independent inquiries into the financial system.

- The FSIs had solid financial support and wide terms of references. Their recommendations were implemented by governments from both major political parties, and have shaped the financial regulatory structure in Australia today.

(2) Regulatory philosophy:

- For the financial market regulation, there are two distinct approaches: (i) the disclosure-based approach; and (ii) the merit-based approach. The merit-based approach involves the value-judgement on the part of regulators. In contrast, the underlying regulatory philosophy of the disclosure-based approach is that the role of market regulator is limited to the promotion of disclosure and let the market do the merit evaluation for its investment decisions.
- In many of the Asian economies, market regulation has been relying too much on the value judgement of market regulators, which impedes the smooth operation of the financial system.
- One good lesson Asian economies gain from the Australian regulatory response to the recent global financial crisis is the promotion of wide spread disclosure of short selling, securitization, credit default swaps markets, hedge funds (D'Aloisio, 2009). The name of the game is the "Disclosure" in the market not the "Value Judgement" on the part of regulators.

(3) Regulatory structure:

- In Australia, prudential regulation is carried out by an independent agency, not the central bank. In addition to banks, prudential regulation covers insurance companies, managed funds, and retirement funds which do not have direct business relationship with the central bank. The separation enables the RBA and the APRA to focus on their primary objectives and clarifies the lines of accountability for the regulatory task. While each country should choose a regulatory structure base on their own economic and financial development, the potential benefits of an independent prudential regulator should be considered by other Asian countries. The twin-peak structure of financial regulation is widely regarded as a key reason why Australian financial institutions survived the global financial crisis of 2007-08 better than most others in the OECD countries.

(4) Regionalization of Financial Sector

- We observe considerable progress in the Asia-Pacific region in the area of trade integration. Unfortunately, financial sector integration still lags behind.
- Subsequent to the Asian financial crisis, the development of regional bond markets in Asia was the highest priority agenda among financial market policy makers. They viewed this development as an alternative vehicle for domestic savings mobilization and also as a critical means of mitigating the dual mismatch problems of currency and maturity. This initiative was spearheaded by the APEC Finance Ministers and the ASEAN+3 Finance Ministers. More recently, The ASEAN Banking Integration Framework, which aims to liberalize the banking market by 2020, could help pave the way for further regional integration.

- Unlike the regionalization or globalization of equity markets in the Asia-Pacific region, three major weaknesses are observed in these initiatives: (i) the public sector has been the driving force of these programs with limited participation of private sector institutions; (ii) too much emphasis is placed on harmonization while harmonization itself is not the necessary and sufficient condition for regional integration; and (iii) the elimination of impediments to capital flows in the region has been largely ignored.
- An Asia Region Funds Passport (ARFP) was initiated by the Australian Government to promote growth in funds management and other financial services across the region. This program will minimize the amount of red tape faced by fund managers across the region. The Memorandum of Co-operation (MoC) on the establishment and implementation of the ARFP comes into effect as of June 30, 2016. This document was signed by representatives from Australia, Japan, Korea, New Zealand and Thailand. This initiative is new and it holds excellent promise for future expansion. It is a concrete step towards closer coordination between public and private sectors.