Melbourne Climate Futures

Thursday 6 July 2023, Ms Rebekkah Markey-Towler

This submission provides recommendations to the Financial Regulator Assessment Authority (FRAA)'s consultation to improve its methodology to assess regulator effectiveness and capability. These recommendations are derived from the researcher's PhD work to evaluate regulatory responses the intersections between climate change and mortgage lending. The researcher is part of the University of Melbourne's Melbourne Climate Futures (MCF) initiative. MCF brings together academics from across all disciplines at the University, to develop evidence-based and practical solutions to climate related challenges.

THE UNIVERSITY OF MELBOURNE

Submission to the Draft Financial System and Regulator Metrics Framework

This submission responds to the following questions from the FRAA's consultation: *Are the FRAA's characteristics and outcomes of a well-functioning financial system well-designed and useful framing devices for the development of metrics? Are there metrics that the FRAA should consider including in or removing from the framework?*

The FRAA's characteristics and outcomes of a well-functioning financial system are a useful framing device to develop metrics to assess regulator effectiveness and capability. Using characteristics and outcomes as a framing approach aligns with regulatory scholar Karen Yeung's definition of effectiveness as "the extent to which a regulatory scheme is successful in achieving its collective goal or goals".[1]

Nevertheless, these characteristics and outcomes (and metrics) might be further developed beyond those specified in the 2014 Murray Inquiry. The Murray Inquiry provided that the financial system's purpose is "to facilitate sustainable growth in the economy by meeting the financial needs of its users", and that it achieves this most effectively when it operates in a way that is efficient, resilient and fair.[2]

The below therefore provides additional outcomes, as well as an additional characteristic, of well-functioning financial systems that could inform the FRAA's framework to evaluate regulator effectiveness and capability.

These additional characteristics and outcomes have been derived from a review of financial regulator objectives in Australia and the UK, as well as broader research.

Gaps and recommended additions are included in bold.

Efficiency

Outcomes	Relevant regulator objectives
Markets are competitive	*Australian regulator objectives* • "to balance the objectives of […] and efficiency, competition, contestability and competitive neutrality" (APRA Act s 8(2)). • "competition in the financial system" (ASIC Act s 1(2A)).
New entrants are able to enter financial markets efficiently while meeting entry requirements	
Finance is available	*UK regulator objectives* • "ensuring that the relevant markets (financial markets, markets for regulated financial services) function well" (FSMA Act 2000 s 1B(2), FCA). • "so far as is compatible with acting in a way which advances the consumer protection objective or the integrity objective, discharge its general functions in a way which promotes effective **competition in the interests of consumers**" (FSMA Act 2000 s 1B(3), FCA). • "promoting effective **competition in the interests of consumers in the markets**" having regard to needs of different consumers (including information for informed
Different stakeholder interests (including those of society, individuals, communities, institutions, and the environment) are balanced over time, reflecting changing circumstances	

[1] Karen Yeung, *Securing Compliance: A Principled Approach* (Hart Publishing, 2004) 30.
[2] David Murray, *Financial System Inquiry: Final Report* (Commonwealth of Australia, November 2014) xv <https://treasury.gov.au/sites/default/files/2019-03/p2014-FSI-01Final-Report.pdf>.

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	choices), ease of access for consumers (including those with social and economic deprivation), ease for consumers to change service providers, ease for new entrants to enter the market, and encouraging innovation (FSMA Act 2000 s 1E(1)(2), FCA).

Recommendation: Broaden the outcomes of an efficient financial system to go beyond economic interests or the interests of consumers to include a range of stakeholders.

At present, the framework provides that an efficient financial system is one that serves economic interests.

The Consultation Paper states that "[a]n efficient financial system allocates Australia's scarce financial resources for the greatest possible benefit to the economy, supporting growth, productivity and prosperity. The concept of efficiency also covers minimisation of average production costs and innovation".

In the UK, the Financial Conduct Authority (FCA) has adopted a more specific definition of efficiency, as is appropriate for their regulatory mandate. One of their objectives is that competition is in the interests of consumers.

However, this submission suggests that an efficient financial system might go beyond serving economic interests (as per the Consultation Paper) or the interests of consumers (as per the FCA's approach) to include a range of stakeholders.

As such, another outcome for the FRAA's proposed framework could provide that: "Different stakeholder group interests (including those of society, individuals, communities, and institutions) are balanced over time, reflecting changing circumstances".

This approach also recognises that these interests may be in conflict with each other and will need to be balanced and/or prioritised at different points in time, depending on the particular circumstances.

To measure this outcome of an efficient financial system, metrics could include qualitative assessment of the impacts of the market or regulator interventions on particular stakeholder groups.

Resilience

<table>
<tr><th>Outcomes</th><th>Relevant regulator objectives</th></tr>
<tr><td>The financial system is safe and stable</td><td rowspan="3">Australian regulator objectives
• "prudential regulation" (APRA Act s 8(1) (a)). Defined as "financial safety and stability of institutions and the broader financial system" (APRA website).
• "financial safety, [and] to promote financial system stability in Australia" (APRA Act s 8(2)).
• "maintain, facilitate and improve the performance of the financial system and the entities within that system in the interests of commercial certainty" (ASIC Act s 1(2)(a)).
• "promote the confident and informed participation of investors and consumers in the financial system" (ASIC Act s 1(2)(b)).

UK regulator objectives
• "protecting and enhancing the integrity of the UK financial system" including its soundness, stability and resilience, […], orderly operation of financial markets, and transparent price formation (FSMA Act 2000 s 1D(1)(2), FCA).
• "promoting the safety and soundness of PRA-authorised persons" by ensuring PRA-authorised persons carry on business in a way that avoids adverse effect on UK financial system stability, minimise effect of PRA-authorised person's failure on UK financial system stability, and ensure ring-fenced bodies not affect continuity of core services (FSMA Act 2000 s 2B(2), PRA).</td></tr>
<tr><td>Participants are confident in the financial system</td></tr>
<tr><td>Financial institutions are safe and stable</td></tr>
</table>

Recommendation: Broaden the outcomes of a resilient financial system to include the safety and stability of financial institutions.

It is positive that the current framework identifies the stability of the overall financial system as a core outcome that regulators ought to work towards.

As put in the Consultation Paper, a "resilient financial system adjusts to changing circumstances while continuing to provide its core functions, even during severe shocks". This reflects learnings about the systemic risks posed by events like the Global Financial Crisis, the COVID-19 pandemic and climate change.

However, the current proposed framework does not include an outcome that financial institutions in particular, as well as the financial system more generally, act in a way that ensures safety and stability.

This broader understanding—that a resilient financial system includes not only financial stability but also individual institutional stability—is already reflected in the Consultation Paper: "[t]he resilience of a financial system is maximised when financial institutions maintain adequate solvency and liquidity, correctly price risk, scan for emerging risks and plan for unforeseen negative events".

As such, another outcome of the framework might provide that "Financial institutions are safe and stable". In addition, the outcome "The financial system is stable" might also be broadened to include "safe and stable".

To measure this outcome of a resilient financial system, metrics could include a qualitative assessment of the information provided pursuant to entities' existing disclosure and corporate governance requirements such as their disclosure of climate-related financial risks.

Fairness

<table>
<tr><th>Outcomes</th><th>Relevant regulator objectives</th></tr>
<tr><td>A culture of fairness is cultivated</td><td rowspan="4">Australian regulator objectives
• "take whatever action it can take, and is necessary, in order to enforce and give effect to the laws of the Commonwealth that confer functions and powers on it" (ASIC Act s 1(2)(g)).
• "administer the laws that confer functions and powers on it effectively and with a minimum of procedural requirements" (ASIC Act s 1(2)(d)).
• "monitoring and promoting market integrity and consumer protection" (ASIC Act s 12A).
• "receive, process and store, efficiently and quickly, the information given to ASIC" (ASIC Act s 1(2)(e)).
• "information is available as soon as practicable for access by the public" (ASIC Act s 1(2)(f)).

UK regulator objectives
• "securing an appropriate degree of protection for consumers" having regard to different degrees of risks, different degrees of experience/expertise, need for timely information and advice that is accurate and fit for purpose, consumer responsibility for their decisions, financial service providers should provide an appropriate level of care in light of the degree of risk and consumer capability, and different consumer expectations (FSMA Act 2000 s 1C(1)(2), FCA).
• "protecting and enhancing the integrity of the UK financial system" including [...], not used for financial crime, not used for market abuse, [...] (FSMA Act 2000 s 1D(1)(2), FCA).
• [...] consumer responsibility for decisions, senior management compliance responsibilities [...] (FSMA Act 2000 s 3B(1)(a)-(h)).
• [...] publish information, and transparency in the exercise of functions (FSMA Act 2000 s 3B(1)(a)-(h)).</td></tr>
<tr><td>Market participants adhere to, and regulators act in a way that promotes adhere by market participants to, standards of ~~integrity and~~ fairness including integrity, honesty, transparency, accountability and non-discrimination</td></tr>
<tr><td>Regulators identify and act against misconduct</td></tr>
<tr><td>Where consumers suffer loss or harm because of misconduct, they can secure redress</td></tr>
</table>

Recommendation: Broaden the outcomes of a fair financial system to include that "a culture of fairness is cultivated".

Current outcomes of a fair financial system are arguably framed in a way that is more reactive rather than proactive, especially in terms of consumer protection. In particular, two of the three existing outcomes focus on when things have already gone wrong, for example, where there is misconduct or where consumers have experienced loss or harm.

This is at odds with the broad definition of fairness provided in the Consultation Paper. This states "[f]air treatment occurs where participants act with integrity, honesty, transparency and non-discrimination. A financial system operates more effectively when participants can enter transactions with confidence that they will be treated fairly. Standards of fairness include compliance with the law, adherence to fiduciary duty and ethical behaviour, and equal and non-discriminatory access to financial services."

As such, the FRAA might include an outcome of a well-functioning financial system that proactively cultivates a culture of fairness ensuring, inter-alia, market integrity and consumer protection.

To measure this outcome of a fair financial system, metrics could include qualitative assessment of initiatives led by regulators, the regulated entities and both working together.

Recommendation: Amend one of the outcomes to reflect the broader definition of fairness in the Consultation Paper.

One of the outcomes of a fair financial system is arguably more narrowly framed than is provided in the Consultation Paper. This outcome only includes the values of fairness and integrity whereas the Consultation Paper states that "[f]air treatment occurs where participants act with integrity, honesty, transparency and non-discrimination".

Indeed, as one example of these broader values of fairness, the importance of transparency in a fair financial system is affirmed by regulator objectives in Australia and the United Kingdom. One of the objectives of ASIC is to provide information to the public, thereby ensuring transparency and accountability.

As such, this submission recommends that the FRAA's outcome on fairness could be broadened to provide that "[m]arket participants adhere to, and regulators act in a way that promotes adhere by market participants to, standards of integrity and fairness including integrity, honesty, transparency and non-discrimination", as well as accountability.

To measure this outcome of a fair financial system, and beyond metrics already provided, metrics could include investor and consumer sentiment, provision of information to the public, and enforcement actions undertaken.

Responsiveness

Outcomes	Relevant regulator objectives
The financial system is responsive to changing circumstances in a way that ensures sustainable growth **Regulators take proactive steps to monitor, and respond to, changing circumstances**	*Australian regulator objectives* • "**maintain, facilitate and improve the performance of the financial system and the entities within that system** in the interests of commercial certainty, reducing business costs, and the efficiency and **development of the economy**" (ASIC Act s 1(2)(a)). *UK regulator objectives* • **use regulator resources** in the **most** efficient and economic way, burdens not **disproportionate** to benefits, desirability of **sustainable growth** in economy of UK in medium or long-term, […], recognising **different business types/objectives** […] (FSMA Act 2000 s 3B(1)(a)-(h)).

Recommendation: Add responsiveness as a key characteristic of a well-functioning financial system and outcomes under this characteristic.

The FRAA's characteristics of a well-functioning financial system—efficiency, resilience and fairness—are appropriate to evaluate regulator effectiveness and capability. However, these characteristics are arguably more reactive than proactive to changing circumstances.

For example, resilience, as a characteristic of a well-functioning financial system, focuses on ensuring that the system is able to withstand shocks. However, it does not necessarily encourage regulators and market participants to take proactive steps to be aware of and respond to changing circumstances. Such changing circumstances could include, for example, the risks and opportunities associated with climate change.

As such, the FRAA might consider an additional characteristic of a financial system that is responsive to changing circumstances.

Responsiveness is understood to be more than just responsiveness to firms' compliance behaviours (as defined by Ayers and Braithwaite[3] and Baldwin and Black[4]). By responsive, this submission means that the entire financial system (including regulators and other participants) is responsive to new developments. The financial system is responsive in order to ensure sustainable growth in the short, medium and long-term.

To measure the responsiveness of the financial system, metrics might include qualitative assessments of new regulator activities and broader indicators of economic, environmental and social growth and wellbeing.

[3] Ian Ayres and John Braithwaite, *Responsive Regulation: Transcending the Deregulation Debate* (Oxford University Press, 1992).

[4] Robert Baldwin and Julia Black, 'Really Responsive Regulation' (2008) 71(1) *The Modern Law Review* 59.