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Market Failures and Regulators – why are regulators always blamed for market failures?

The Australian HIH Insurance collapse case.

Introduction

This paper is not intended to be, and cannot be in the time available, a comprehensive analysis of the many issues raised by the collapse of HIH. I plan to make some observations about what this collapse has to tell us about expectations of regulators when things go wrong, how coordination among regulators with overlapping roles matters and the crucial importance of regulatory "style" or technique to the successful discharge of regulatory responsibilities. Necessarily the backdrop of my remarks will be prudential supervision rather than securities or "conduct" regulation.

The following are attached to this paper as background and are taken from the report of the inquiry that followed HIH's collapse:

(1) Brief Corporate History of HIH
(2) Royal Commission Terms of Reference
(3) Regulatory Framework
(4) Operational Statistics
(5) Policy Recommendations

On 1 July 1998 the Australian Securities and Investments Commission (ASIC) and the Australian Prudential Regulatory Authority (APRA) commenced operations. The Treasurer of the Commonwealth of Australia, the Hon. Peter Costello, MP, when launching the new financial system regulators, stated that it represented "a landmark in the history of corporate and financial regulation in Australia". Under the new arrangements, ASIC (which had in effect been in existence as the Australian Securities Commission from 1 January 1991 but with a narrower range of responsibilities) assumed responsibility for market integrity and consumer protection across the financial system, including investment, insurance and superannuation products. APRA would provide prudential regulation of superannuation insurance and deposit-taking institutions. APRA was created out of a merger of the Insurance and Superannuation Commission and that part of the Reserve Bank of Australia that had been responsible for the supervision of the banking industry.

Less than three years later, on the evening of Thursday 15 March 2001 provisional liquidators were appointed to the HIH Insurance Group, at the time the second largest general insurer in Australia.

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Royal Commission

The failure of HIH was calamitous and it became inevitable that the Government would have to conduct an inquiry into the causes of the collapse and who was responsible. A Western Australian Supreme Court Judge, the Hon Neville Owen, was appointed to conduct the inquiry.

A Royal Commission has very wide powers of investigation. A flavour of the exhaustive nature of the work undertaken by the Commission's can be seen from attachment (4) "Operational Statistics".

The Terms of Reference (attachment (2)) made the regulatory performance of APRA and ASIC a key part of the Commission's focus requiring Owen J., among other other matters, to "inquire into ..... the appropriateness of the manner in which powers were exercised and responsibilities and obligations were discharged under Commonwealth [and State and Territory] laws".

Of course the setting up of the Commission itself represents a very unusual step. In Australia at least, while the legal system provides for a number of avenues through which a regulator may be held accountable, it is very rare for regulators to be subject to the intense scrutiny of a judicial inquiry. Generally, accountability comes from companies and individuals being able to raise concerns with independent bodies (for example the Ombudsman or the Privacy Commissioner), through judicial or administrative review of regulatory decisions and through the oversight provided by committees of Parliament set up for that purpose.

Blaming regulators - should we be concerned?

First some general remarks about why "are regulators always blamed for market failures "? This proposition is the session's working assumption. Experience certainly seems to suggest that when things go wrong during the course of a regulated activity, fingers are pointed in the direction of the relevant regulator(s). As a result, there is a tendency for regulators to feel that that they are unfairly or unrealistically perceived, not only by those whose interests they are there to protect, in particular the retail player, but even more gallingly by governments. Why is this so?

The answers to these questions are not obvious. Most thoughtful people would accept that it cannot be the role of any regulator to ensure that bad things do not happen. Regulators do not control markets nor are they in a position to prevent corporate collapses. Yet, in the past 10 years we are have seen, particularly in the UK and Australia, a steady increase in the litigation risk of regulators arising out of the manner in which they perform their core business.

Some of this litigation activity can be attributed to a greater willingness on the part of those unhappy with regulatory decisions to litigate if their interests have been adversely affected by regulatory action. However, increasingly, and HIH provides another example, the regulator is being called to account for the losses of depositors or policy holders arising out of alleged incompetence or negligence.

Long gone are the days (if they ever in truth existed) when prudential regulators could remain quietly in the background, setting frameworks and laying out guidance for institutions. Prudential regulation has become a risky business for those involved in it. In my view, this

has followed the extraordinary growth in the amount and profile of financial services regulation reflecting, as is certainly the case in most developed economies, the importance governments have placed on individuals taking a more active role in planning for their own retirement incomes and the significance that personal investment in general has assumed.

This has created some important expectations which regulators will need to work hard to manage, particularly where retail interests are involved. HIH provides a fascinating case study in analyzing what the "prudential" function should be and whether law enforcement is an important feature of that function.

An enormous communication challenge lies in attempting not only to accurately describe the regulatory role being played, but to do so in away that leaves confidence that it is being adequately performed.

One of the reasons regulators may be so readily blamed (much like perceived increases in violent crime in a city are often said to be "caused" by inadequate policing), is the lack of a transparent model that everyone has confidence in, which can measure whether a regulator is adequately performing. Without such a model, blaming a regulator when things go wrong is facilitated. HIH, in its defense, tried to elaborate this argument, but with very limited success.

Essentially, while regulators everywhere would like to be better resourced, they are usually armed with the powers necessary to detect and act early upon indications of things going wrong that are generally not available to the market or the media. A failing enterprise will not necessarily be saved as a result of the efforts of a diligent regulator. However, is not the community entitled to expect that appropriate mitigating steps will be taken early, all with a view to inspiring confidence in whatever supervisory system has been put in place and with a view to not making things worse by inaction or by inappropriate action?

The HIH story, at bottom, is one of inaction driven by a culture that saw prudential supervision too narrowly, so that as more serious issues emerged at HIH (or with reasonable diligence should have been detected), the regulator did not display the leadership that the community expected of an organization that ought to have been engaged with all the issues. So, while criticism of regulators often follows market failures, that criticism is likely to be more muted if the regulator is taking such action as is reasonably open to it to address issues.

The Commission's Findings

In the HIH case, the findings made against APRA went to its failure to properly recognize early enough signs of significant problems at HIH and a failure to take appropriate action.

A flavour of Owen J.'s views emerges from the following extracts from his conclusions:

- I am not particularly critical of APRA's supervision of FAI and the HIH group in the period 1 July 1998 to March 2000. It is perhaps unfortunate that the regulatory changes were introduced according to such an ambitious timetable. It was almost inevitable that there would be some sort of lacuna in the regulatory approach. It is during this period that the systemic handicaps began to emerge. APRA had also to confront the legacies left to it from the ISC (Vol. 3, at page 436).

- By August 2000 the 'information circle' was closed in that APRA had enough evidence to begin considering more aggressive regulatory action. By this stage, APRA should have taken steps to find out the true position of HIH's OCP and statutory solvency position. Accordingly, APRA should have initiated processes to discuss whether an independent actuarial valuation under s. 48A of the Insurance Act was warranted. For these purposes, it should have conducted a more thorough review of the past returns of the HIH group with a view to understanding the development of its position to date. Such a review of APRA material should have uncovered the extent of the problems of netting-off for solvency purposes. Requests for information arising out of the credit-risk visit should have been pursued more aggressively. APRA could also have explored other avenues of information such as market and industry sources, statutory accounts filed with ASIC, the reports of overseas regulators and reports of external auditors and actuaries. APRA should have given more thought to the scope of its other legislative powers, such as those under s. 115. Indeed, a prudential regulator acting appropriately would have explored all the options, both formal and informal, for gaining information on HIH before considering the more serious step of appointing an inspector under s. 52 of the Insurance Act (Vol. 3, at page 438).

- From September or October 2000 to 15 March 2001 APRA's regulation of the HIH group was inadequate and not of the standard to be expected of a regulator in APRA's position, even taking into account its parameters and handicaps at the time. Whilst some staff produced good analyses, there was a systemic failure in APRA to escalate the issues they identified to an appropriate level. Throughout 2000 and 2001 APRA missed every opportunity to act upon the warning signs that HIH was heading towards statutory and commercial insolvency (Vol. 3, at page 442).

As it happened, among the regulators involved, APRA bore the brunt of adverse findings, following Owen J.'s analysis of the performance of State and Federal regulators with some oversight responsibility for HIH. However, Owen J. made it plain at the beginning of his report that "APRA did not cause or contribute to the collapse of HIH; nor could it have taken steps to prevent the failure of the company. A regulator cannot be expected to provide a guarantee that no company under its supervision will ever fail." Indeed. Yet APRA's performance failed to meet expectations . Essentially, APRA had a view of itself and its powers, that was at odds with community expectations and the views of the Commission.

<u>The benchmarking issue</u>

Owen J. made it clear that he was not inquiring into APRA's overall performance - just its performance with respect to HIH. This approach enabled the Commission to examine in great depth APRA's approach to HIH without examining whether APRA's achievements across all of its responsibilities might have put its failings with respect to HIH in a more favourable light. Perhaps it would be difficult to do this given the magnitude and severity of the collapse.

It is well to pause at this point to question the fairness and validity of such an approach. How much significance should be attached to one major failure? It is clear that Owen J.'s analysis revealed, in his view, a range of deficiencies which prevented APRA from performing

optimally in the case of HIH. Does this mean that the quality of the discharge of the balance of its prudential and regulatory responsibilities are likely also to be flawed. Are there other "HIHs" out there?

In a speech delivered on 22 November 2002, before the Commission had finally reported, the then Chairman of APRA, Dr Jeffrey Carmichael sought some comfort from this line of thinking in stating:

> "....., the focus on problem institutions fails to recognize that the vast majority of institutions under APRA's care are well managed and meet their obligations. APRA has some 4,000 institutions under its charge, managing over 1 1/2 trillion dollars of assets. If we measure performing institutions as a percentage of all institutions, the "performing entity ratio" is currently 100%. Even in 2001, with HIH and CNAL, the ratio was 99.9%. Measuring the ratio in terms of assets rather than institutions paints a similar picture."

Dr Carmichael's approach is understandable however, in my respectful view, does not go far enough in acknowledging a mismatch of expectations about what I would call regulatory style or technique. While it is true that the failure of one or two institutions does not necessarily point to a fundamentally flawed regulatory approach - the size and suddeness of HIH's collapse suggests a need for a reappraisal by APRA of its approach. In his speech, Dr Carmichael sought to draw a distinction between between what a market or conduct regulator does (such as ASIC) and the work of a prudential regulator (such as APRA). In short, conduct regulators are meant to be enforceers ("heads on pikes" to use Dr Carmichael's expression) while a prudential regulator is meant to be more like a doctor:

> ".....a prudential regulator is focused primarily on rehabilitation. The prudential regulator does have an enforcement role, but it is the last resort, rather than the main resort. To illustrate my point, at any point of time, there are somewhere between 100 and 200 financial institutions in the 'infirmary' at APRA. Around 20% of these by number, and a higher percentage of these by assets under management are, in the normal course of supervision, returned to active duty. The vast majority of others are merged voluntarily with other, stronger institutions."

In public statements since the Commission reported in April 2003, APRA has adopted what it has described is a "more interventionist culture."

No one likes to be unfairly judged. One of the issues raised by the HIH failure from a regulator's point of view is what benchmarks should be adopted for measuring a regulator's success or failure. The Commission did not examine this issue ("I do not consider my task involves identifying an immutable benchmark"). Predictably Owen J. took a legalistic and analytical approach to a particular failure, carefully assessing what facts were known or reasonably knowable by the regulator and then determining what action was open to the regulator in light of the powers and responsibilities that it had (".... my task is to assess the appropriateness of APRA's supervision of HIH in the circumstances with which it was confronted").

Much work remains to be done not only in coming up with meaningful benchmarks but in winning acceptance of them by governments and the general community. Essentially, the challenge lies in being able to demonstrate that even when things occasionally go wrong, the

relevant regulator should still be regarded as being successful in general in discharging its responsibilities (some very interesting work has been done on this, see Malcolm K. Sparrow, The Regulatory Craft).

It is beyond this paper to attempt a summary of all of Owen J.'s findings. In general, Owen J. did not find that APRA had been misled, rather, that at critical times it knew or should have known facts that should have caused it to take action. These matters ranged over a variety of issues: for example overstatement by HIH of its assets and a failure by APRA to appreciate problems with HIH's re-insurance program.

The Palmer Report

Another interesting feature of the HIH matter was the approach APRA took to defending itself in the Commission. In addition, like everyone else, to instructing a substantial team of lawyers, APRA commissioned an expert report from John Palmer. Mr Palmer was given access to all of APRA's records and witnesses. His report, which in many places was very critical of APRA, was provided to Owen J. who found it of great assistance and unless he expressed otherwise, was accepted and endorsed at him. Notably, there were several occasions when APRA argued against the findings of its own expert in submissions to the Commission.

Owen J.'s Policy Recommendations

In attachment (5) I have extracted from the Commission's report all of its policy recommendations. You will see that in addition to expressing views for improving regulation of general insurance, Owen J. had some important contributions to make in the areas of corporate governance and financial reporting and assurance.

In what follows, I highlight some of the recommendations that seem to me of most interest for present purposes.

- Governance Structure and Independence of APRA

  Issues of this nature do not often attract public attention, let alone understanding, yet the manner in which APRA was set up and its relationship with government, turned out to be an area which led Owen J. to make several significant recommendations (see in particular 18, 19 and 22). The Commission's attention to the subject shows that there is much that a government can do which can either prevent or enhance a regulator's capacity to perform efficiently and self-confidently. Owen J. observed:

  > "In principle, governance arrangements should ensure that the allocation of responsibility for a function is clear and coincides with the accountability for the performance of that function. The relevant person or body should be set clear and appropriate objectives and be held responsible for meeting those objectives. In APRA's case there is some dissonance and lack of clarity." (Vol. I, at page 208)

  While not as forcefully put as it might have been, Owen J.'s views about the need for a regulator to be able to make operational decisions free from political or government involvement are notable. "…. The interposition of the Treasurer in day-to-day prudential

decisions about general insurers appears to me to be unnecessary. It also runs the risk of blurring the lines of accountability for those decisions."

Ultimately regulators and their decisions need to be, and be seen to be, independent. While there will always be concerns about regulators becoming too powerful, accountability can come in a number of forms so that an appropriate balance may be achieved.

- APRA's Approach to Prudential Supervision

Recommendation 26 addresses directly the question of regulatory style or technique. Owen J. noted the need for a regulator to be seen not only as consultative, but as willing to take action: "….. there is a danger however that over reliance on consultation and encouragement by a regulator and a lack of commitment to demand compliance with prescribed standards will impair overall effectiveness."

One aspect which Owen J. stressed and I believe is particularly important, is that regulators need to have a profile, to be noticed and heard, if they are to be credible. This is, of course, a complex issue. Here is what Owen J. said about it:

> Another aspect of the consultative approach to prudential regulation of insurers is that it is generally carried out discreetly so as not to give rise to concern in the market. There is the potential that market awareness of regulatory intervention will exacerbate the problems being experienced by the company in question. The analogy of a 'run' on a bank is oft quoted. On this basis, discretion by a prudential regulator in the way it intervenes with a company so as to minimise the risk of premature market upset is to be commended. But there is also a risk that any delay in taking necessary action while a company is given an opportunity to address its problems may lead to greater losses for policyholders and other creditors. It may be the case that earlier and more rigorous intervention by the regulator to wind up the institution would have resulted in lower losses for policyholders.
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> In any event, the scope for the discreet approach traditionally favoured by some prudential regulators has become somewhat constrained by the large emphasis now placed on disclosure in corporate regulation. For public listed companies, continuous disclosure of material developments to the market has become a corner stone of public policy. APRA will need to be very careful that, in any non-public intervention with a company under financial pressure, it does not become implicated in any failure by the company to keep the market appropriately informed.
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> This issue ultimately is one of judgment on the part of the prudential regulator. In many instances this judgment will be finely balanced. In the case of HIH, as I have canvassed in Chapter 24, APRA did not effectively deal with this question until very late. (Vol. I, at paper 220 – 221)

In my view the question of discretion or "moving quietly" poses a significant cultural challenge for APRA. If it is accepted that management of expectations and clear understanding of roles and objectives is crucial to a regulator's (perceived) success, then

communication and appropriate and frequent use of the media, becomes vital. This also implies a fundamental shift away from traditional prudential thinking that being seen to be taking aggressive action can itself cause more harm than good.

- Cooperation with ASIC and the Regulatory Framework

  Several recommendations go to achieving a strengthening of the role of APRA as the lead insurance regulator and improving the flow of information and coordination among regulators. Again, these issues do not normally attract a lot of public attention, but are important preconditions to effective and efficient regulation.

Liability

Legislation generally grants regulators and those working for them immunity from suit. For example, in ASIC's case , no " action or other proceeding for damages for or in relation to an act done or omitted in good faith in performance or purported performance of any function, or in exercise or purported exercise of any power...." may be taken against the Commission or its staff.

However, such provisions do not shield regulators from the scrutiny of a Royal Commission. Recent litigation in the UK arising out of the collapse of BCCI against the Bank of England is testing the limits of liability of regulators and their staff against the backdrop of European Community Law and English law (Three Rivers District Council v. Bank of England).

In short, the House of Lords has allowed the case against the Bank of England to go to trial on the basis that there was sufficient evidence to test whether various steps taken (or not taken) by the Bank in the licensing and supervision of BCCI amounted to the tort of misfeasance in public office. The House of Lords did not allow an alternative claim, based on an argument that the Bank of England had not met its Community Law obligations as set out in the First Banking Directive, to proceed. It was ultimately held that the depositors must fail on this aspect of the claim largely because (contrary to the depositor's assertion) the Directive was not intended to confer legal rights upon them.

Increasingly, both in Australia and elsewhere, regulators are being required to account for the way in which they discharge their responsibilities. APRA itself was sued by the liquidator of HIH but it is understood the writ was never served and the proceedings have been withdrawn. Notably Section 58 of the Australian Prudential Regulation Authority Act 1998 provides that in the absence of bad faith, neither APRA itself nor a staff member is subject to "…. any liability to any person in respect of anything done, or omitted to be done, in the exercise or performance ….. of powers, functions or duties conferred or imposed on APRA …."

Expectations - a gap?

Nothing is more calculated to lead to dissatisfaction and a perception of regulatory failure than a mismatch of expectations between what a regulator considers its role to be and the expectations of government and the general community.

Regulators need to be able to have a clear view of how they intend to administer their statutory responsibilities and, as far as practicable and appropriate, it is important that if not community acceptance, then community understanding is achieved, of what the regulator

perceives its role to be and why it considers the method it has adopted of discharging it, is the best.

I note that APRA's website shows its staff are often giving speeches that explain and amplify how APRA has decided to go about its work. For example, in one speech delivered in May this year, after the Commission handed down its report, an APRA officer said: "APRA's mission is to minimize regulated entity failure to meet financial promises to protect creditors ….. Failure minimization does not mean failure elimination." This is a very important and fundamental message and one which, as a former regulator, I am of the view cannot be repeated enough. No one ever seems to readily understand and accept the inevitability of failures. So even with APRA adopting the more proactive approach (I assume more enforcement activity) that this speech went on to say would characterize APRA's approach in future, APRA and regulators everywhere must continue to expect that working on the expectation gap is a challenge.

In my view, this is a continuous and iterative process of communication and engagement with all stakeholders. Without such a process, and particularly in the absence of generally accepted and well established benchmarks, a regulator is likely to find itself in great difficulty when things (as they inevitably do) to wrong. By actively engaging government and the regulated and general community, a regulator can build confidence and understanding. Without engagement blaming the regulator when things go wrong becomes the politically natural default position, with all the unfairness that will entail to the regulator and its (then) embattled staff.

Concluding Observations

Regulatory failure is a harsh expression that masks more fundamental questions. What do we expect of our regulators and how do we know when they have performed or failed? These issues are becoming more acute as financial services assume even more significance in the development and prosperity of countries.

In my view, drawing distinctions between "prudential" supervision and "conduct based" supervision are not a helpful way of thinking about the issues. Rather regulators ought to analyzing what is the best way of administering and discharging their statutory responsibilities, giving full effect to the powers that have been conferred on them to do so, with whatever resources that have been made available. An appropriate regulatory approach or style will emerge from engaging stakeholders and communicating the resulting approach to the general community.

More work needs to be done among regulators to develop a frame work or benchmarks for performance and expectation management. The courts and inquiries such as the HIH Royal Commission can provide glimpses into how to think about the issues, but are quite an unsatisfactory way of providing a systematic way forward to resolving concerns about regulatory failure. Such an enterprise, it seems to me, is of vital importance to regulators everywhere.

Attachments

13 November, 2003