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DOCTORAL THESIS

The Uneasy Mandate of the Reserve Bank of Australia for Financial Stability: Challenges for Governance and Accountability.

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The Uneasy Mandate of the Reserve Bank of Australia for Financial Stability: Challenges for Governance and Accountability

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A *Abstract*

This thesis argues for the reform of the regulatory framework of the Reserve Bank of Australia (RBA) for its financial stability responsibility. The mandate of the RBA for financial stability is an uneasy mandate, being both informal, but also decentralized and shared. It therefore creates challenges for the governance and accountability of the RBA as the regulator with the ultimate overall responsibility for financial stability in Australia. The current regulatory framework lacks clarity about the RBA's responsibility for financial stability. These difficulties are compounded by the elusive nature of the concept of financial stability and the fact that the RBA is a central bank, with a unique character and potentially competing mandates.

A preponderance of soft law regulatory measures control and influence the execution of the RBA's financial stability mandate. The thesis suggests that the emphasis on soft law regulation results in the regulatory framework being inadequate, with both the RBA and the Australian Government risking the legitimacy and credibility of the RBA in its pursuit of financial stability. As the current measures to 'regulate the regulator' are not optimal, this thesis proposes necessary reforms to the regulatory framework. These suggested reforms have a legal focus and reflect emerging international best practice in the regulation of financial stability.

The original contribution to knowledge that this thesis makes is firstly in the detailed critical analysis of the regulatory framework of the RBA's financial stability obligations and the governance and accountability mechanisms that regulate the RBA as regulator. Secondly, it highlights both the potential problems for the RBA as a central bank with an informally formulated financial stability responsibility and the risks arising from the legal framework for governance and accountability, affecting the RBA's legitimacy and credibility. Finally, the thesis makes a contribution to academic discourse through proposals for improvements to the RBA's regulatory framework in regard to financial stability and provides the rationales for such improvements.

Key words:

Reserve Bank of Australia, financial stability, regulatory framework, mandate, accountability

Declaration by author

This thesis is submitted to Bond University in fulfilment of the requirements of the degree of Doctor of Philosophy.

This thesis represents my own original work towards this research degree and contains no material that has previously been submitted for a degree or diploma at this University or any other institution, except where due acknowledgement is made.

Louise Parsons

B *Declaration of author contributions*

No co-authored publications are directly included in this thesis. The research for the thesis however informed some co-authored publications. These are listed in Section C: Research outputs and publications during candidature.

Publication co-authored	**Statement of contribution**
Nil	Not applicable

C *Research outputs and publications during candidature*

Journal Articles

Parsons, Louise, ‘Competitive Mooting: An Opportunity to Build Resilience Skills for Legal Practice’ (2018) 1(4) *Australian Journal of Clinical Education*

Parsons, Louise, ‘Bitcoin: Consumer Protection and Regulatory Challenges' (2016) 27(3) *Journal of Banking and Finance Law and Practice* 184

Parsons, Louise, ‘Competitive Mooting as Clinical Legal Education: Can Real Benefits be Derived from an Unreal Experience?’ (2016) 1(1) *Australian Journal of Clinical Education*

Parsons, Louise and Jack Leonard, ‘Australia as an Arbitration-Friendly Country: The Tension between Party Autonomy and Finality’ (2014) 7(2) *Contemporary Asia Arbitration Journal* 359

Farrar, John H and Louise Parsons, ‘Globalisation, the GFC and Paradigm Shift’ (2013) 32(12) *Banking & Financial Services Policy Report* 14

Farrar, John H and Louise Parsons, ‘Globalisation, the Global Financial Crisis and the Reinvention of the State’ (2012) 24(2) *Singapore Academy of Law Journal* 367

Book Chapters and Books

Farrar, John H and Louise Parsons, ‘Financial Stability After the Global Financial Crisis: Globalisation, Nationalism and the Potential Demise of a Rules-Based Order’ in John H Farrar, Bee Chen Goh and Vai Io Lo (eds), *Scholarship, Practice*

and Education in Comparative Law: A Festschrift in Honour of Mary Hiscock (Springer, forthcoming)

Covell, Wayne, Keith Lupton and Louise Parsons, *Covell & Lupton Principles of Remedies* (Lexis Nexis, 7th ed, 2018)

Parsons, Louise, 'Domestic Regulatory Architecture for the Protection of Financial Stability after the GFC: Global Order or Disorder', in Leon Wolff and Danielle Ireland-Piper (eds), *Global Governance and Regulation: Order and Disorder in the 21st Century* (Routledge, 2018)

Parsons, Louise, 'Regulating Australia's Financial Stability in the National Interest' in John H Farrar, Mary Hiscock and Vai Io Lo (eds), *Australia's Trade, Investment and Security in the Asian Century* (World Scientific, 2015)

Parsons, Louise, 'Developments in Central Banking after the GFC: Central Banks, the State, Globalisation and the GFC' in John H Farrar and David Mayes (eds), *Globalisation, the Global Financial Crisis, and the Reinvention of the State* (Edward Elgar, 2013)

Conference Papers/abstracts (Published and/or presented)

Galloway, Kate and Louise Parsons, 'Blockchain: Principles, Processes, Practices' (Seminar, Bond University Faculty of Law Twilight Seminar, 22 March 2018)

Parsons, Louise, 'Cryptocurrencies and Consumer Protection: Questions but Not Many Answers' (Seminar, Banking and Financial Services Law Association Twilight Seminar, 1 August 2017)

Parsons, Louise, 'Back to the Past to Meet the Future: The Benefits of Competitive Mooting in a New Era of Legal Practice' (Conference Paper, Australasian Law Teachers' Association Conference, July 2017)

Parsons, Louise, ‘Central Banking in the Era of Cryptocurrencies and Blockchains: Law, Power and Control’ (Conference Paper, Transnational, International and Comparative Law and Policy Network Conference, Bond University, May 2017)

Parsons, Louise, ‘Bitcoin – Sending Money Home’ (Conference Paper, Banking and Financial Services Law Association Annual Conference, Queenstown New Zealand, 27-29 August 2016)

Parsons, Louise, ‘Global Financial Stability Regulation and the Mandates of Central Banks Five Years after the Crisis: Order or Disorder?’ (Conference Paper, Transnational International and Comparative Law and Policy Network Conference, Bond University, 31 July – 1 August 2015)

Parsons, Louise and Jack Leonard, ‘Australia as an Arbitration-Friendly Country: Can Parties Have Their Cake and Eat It Too?’ (Conference Paper, Taipei International Conference on Arbitration and Mediation, August 2014)

Parsons, Louise, ‘Financial Stability and the National Interest: Whose Head is on the Block?’ (Conference Paper, ‘The Australian “National Interest” in the Asian Century: Trade, Investment and Security’, Bond University, 26 - 27 September 2013)

Parsons, Louise, ‘Learning Techniques and Law Students – Learning to Learn or Learning to Survive and Thrive’ (Conference Paper, London International Conference on Education, 4 - 6 November 2013)

Parsons, Louise, ‘Developments in Central Banking after the GFC: Central Banks, the State, Globalisation, and the GFC’ (Conference Paper, Globalisation, the Global Financial Crisis and the Reinvention of the State Conference, Bond University, 28 - 29 July 2011)

Farrar, John H and Louise Parsons, ‘Globalisation, the Global Financial Crisis and the Role of the State’ (Conference Paper, Globalisation, the Global Financial Crisis and the Reinvention of the State Conference, Bond University, 28 - 29 July 2011)

Book review:

Parsons, Louise, ‘Book review: “Banking Law in Australia by Alan Tyree; and Banking Law in Australia by Robin Edwards’”’ (2012) 24(1) *Bond Law Review,* 165

D *Ethics declaration*

No ethics approval was required for the research reflected in this thesis.

E *Important copyright information*

No published manuscripts were included for publication within this thesis.

F *Acknowledgements*

Dedication

I dedicate this thesis in loving memory of my dear friend Hélène Gelderblom (Rosenblatt) (27 November 1963 – 7 April 2018). When I enrolled for a PhD, I asked her for advice as she had recently successfully completed her PhD thesis. Her advice was simply: ‘Don’t’. She told me later that during her entire PhD candidature she was haunted by a wolf in her dreams. When I was ready to give up my candidature, she however continued to encourage me to just keep going and to complete the thesis. Thank you. I’ll always miss you, and your wit, wisdom and warmth, Hélène.

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A special thank you is due to Bryan Parsons who was always patient and understanding with a mother who was perpetually busy with research and writing. Thank you for graciously accepting PhD materials strewn all over the dining-room table, for tempting me into some fantastic ‘head-clearing’ activities, and for helping sort out problems with Word! Thank you also to Michael Parsons and Grace Patterson for their love and care, and kind support. Thank you also, Michael, for helping make the figures and diagrams more aesthetically pleasing.

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I could not have completed the thesis without all of your help and assistance.

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H *List of tables*

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K *List of appendices*

L *Abbreviations*

Abbreviation	**Term/phrase**
ACCC	Australian Competition and Consumer Commission
ADI	Authorized Deposit-Taking Institution
ANU	Australian National University
APRA	Australian Prudential Regulation Authority
APRA Act	*Australian Prudential Regulation Authority Act 1998* (Cth)
ASIC	Australian Securities and Investments Commission
ASIC Act	*Australian Securities and Investments Commission Act 2001* (Cth)
ASX	Australian Securities Exchange
ATO	Australian Taxation Office
AUSTRAC	Australian Transaction Reports and Analysis Centre
BEAR	Bank Executive Accountability Regime
BIS	Bank for International Settlements
BOE	Bank of England
Campbell Inquiry	Financial System Inquiry (1981) (Australia)
CBA	Commonwealth Bank of Australia
CDO	Collateralised Debt Obligation

CCP	Central Counterparty/Central Counterparties
CFR	Council of Financial Regulators
CJEU	Court of Justice of the European Union
Corporations Act	*Corporations Act 2001* (Cth)
Cth	Commonwealth
ECB	European Central Bank
EFTPOS	Electronic Funds Transfer at Point of Sale
ELA	Emergency Liquidity Assistance
ESA	Exchange Settlement Account
ESRB	European Stability Reserve Board
EU	European Union
FIU	Financial Intelligence Unit
FOI	Freedom of Information
FRBNY	Federal Reserve Bank New York
FSAP	Financial Sector Assessment Program
FSB	Financial Stability Board
FSOC	Financial Stability Oversight Committee
GDP	Gross Domestic Product
GFC	Global Financial Crisis
gSIFI	Globally Systemically Important Financial Institution

Hayne Commission	Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry
IAC	Inter Agency Committee
IMF	International Monetary Fund
LOLR	Lender of last resort
LNP	Liberal-National Party, also referred to as the Liberal National Coalition
KPIs	Key Performance Indicators
MOU	*Memorandum of Understanding*
Murray Inquiry	Financial System Inquiry (2014) (Australia)
NPA	Note Printing Australia Limited
PGPA Act	*Public Governance, Performance and Accountability Act 2013* (Cth)
RBA	Reserve Bank of Australia
RBI	Reserve Bank of India
RBA Act	*Reserve Bank Act 1959* (Cth)
RTGS	Real Time Gross Settlement
SARB	South African Reserve Bank
SIFI	Systemically Important Financial Institution
SSF	Securities Settlement Facility/Facilities
TBTF	Too Big to Fail
UK	United Kingdom

UN	United Nations
US/USA	United States of America
Wallis Inquiry	Financial System Inquiry (1994) (Australia)
WW1	World War 1

Preface

'Does the goal of financial stability need to be better defined than it is at the moment? If so, by whom? Should the central bank have complete independence to pursue its goal of financial stability with whatever instruments it so chooses, including when the distributional implications of some of those instruments are much starker? The questions do not have a straightforward answer. I would hope they would be a hot topic for students today in the way that central bank independence was when Adam Posen and I were PhD students'.[1]

Dr Guy Debelle

Deputy-Governor, Reserve Bank of Australia

[1] Guy Debelle, 'Central Bank Independence in Retrospect' (Speech, Bank of England Conference, Independence: 20 Years On, London, 28 September 2017) <https://www.rba.gov.au/speeches/2017/pdf/sp-dg-2017-09-28.pdf>.

CHAPTER 1

Introduction

Financial stability is a longstanding responsibility of the Reserve Bank and its Board …[1]

… this responsibility derives from its broad charter which extends to the 'economic prosperity and welfare of the people of Australia'.[2]

I The Reserve Bank of Australia's Regulatory Framework for Financial Stability: Background

This thesis analyses the regulatory framework of the Reserve Bank of Australia (RBA) for financial stability and considers how the RBA as a regulator is regulated in respect of its financial stability responsibility.

The two quotations at the start of this chapter provide an oversimplified and inaccurate account of the regulatory framework of the RBA's financial stability obligation, which this thesis exposes and critiques. It has become accepted that financial stability is a longstanding responsibility of the RBA, as noted in the first quotation. However, whether that obligation derives from its charter as suggested by the second quotation, what that obligation entails, and how it is ensured that the RBA indeed pursues and achieves that obligation, are more nuanced considerations. They are at the heart of this thesis: what the RBA is required to

[1] The Treasurer and the Governor of the Reserve Bank, *Statement on the Conduct of Monetary Policy* (Statement, 30 September 2010) <http://www.rba.gov.au/monetary-policy/framework/stmt-conduct-mp-5-30092010.html>.

[2] Graeme Thompson, 'Regulatory Policy Issues in Australia' in Malcolm Edey (ed), *The Future of the Financial System* (Alken Press, 1996) 252, 259.

achieve, and how the Australian government ensures that the RBA achieves its objectives.

These questions are to be considered in light of the fact that the RBA does not have an express, legislated financial stability mandate. The RBA further also shares financial stability responsibilities with other regulators, most importantly the Australian Prudential Regulation Authority (APRA). Since the creation of APRA in 1998, the regulatory framework for financial stability in Australia has effectively remained unchanged. Even in the aftermath of the GFC, when there was a significant emphasis on financial stability responsibilities, no changes were effected to the regulatory framework or mandate of the RBA for financial stability. The far-reaching Financial System Inquiry (2014) (Australia) (Murray Inquiry)[3] concluded in November 2014 that no major change was required in the Australian financial regulatory system and made no recommendations in respect of the RBA's financial stability mandate. What the Murray Inquiry did however recommend was that the government needed to develop a process to assess the performance of regulators.[4] The latter recommendation was not adopted by the Australian government,[5] and no changes have been made to the financial stability mandate of the RBA or the governance of the financial regulators in Australia since 2014. This situation is of concern and is addressed in this thesis.

The Global Financial Crisis (GFC) is important background to this thesis and its conclusions in respect of the Australian regulatory framework. Financial stability,

[3] See Commonwealth, *Financial System Inquiry* (Final Report, November 2014) <http://fsi.gov.au/files/2014/12/FSI_Final_Report_Consolidated20141210.pdf> (Murray Inquiry Final Report).

[4] 'Australia's regulatory architecture does not need major change; however, the Inquiry has made recommendations to improve the current arrangements. Government currently lacks a regular process that allows it to assess the overall performance of financial regulators': Ibid xxi.

[5] The government stated: 'The Government **agrees** with the Inquiry's objective of strengthening the regulator accountability framework but does not support the creation of a new Financial Regulator Assessment Board': Commonwealth, *Improving Australia's Financial System: Government Response to the Financial System Inquiry* (Response, 20 October 2015) 23 <https://treasury.gov.au/publication/government-response-to-the-financial-system-inquiry/>. The reasons cited included the adequacy of the requirements in the *Public Governance, Performance and Accountability Act 2013* (Cth) (PGPA Act), as well as the intended reconstitution of the Financial Sector Advisory Council'.

and how regulation can achieve financial stability, were important issues in the GFC. The GFC made securing financial stability a priority internationally. Central banks were pushed into the spotlight as the most natural and appropriate guardians of financial stability. There were both calls for central banks to be responsible for financial stability, and reassurances by governments, such as the Australian government, that the central bank was already responsible for financial stability.[6]

Some important questions arose as a consequence. How do central banks ensure or promote financial stability? How does a financial stability mandate relate to and affect a central bank's other key mandate, that of monetary policy? How would a government be able to mandate the central bank in an effective way with a financial stability objective as well as hold the central bank accountable for a financial stability mandate? Given the impact of financial instability – as was demonstrated by the apocalyptic events of the GFC – it is important to consider what the Australian government can and should do to establish an effective regulatory framework for financial stability.

The regulatory framework for financial stability represents a government's '*architectural choices for a public policy regime*'.[7] The regulatory design implemented by the Australian government in mandating and equipping the RBA for its financial stability task has not received much attention academically or politically after the GFC. The mandate and actions of the RBA in respect of financial stability have not been in the spotlight before or after the Murray Inquiry and the Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry (Hayne Commission). That does not mean that it could not become an important political or legal issue in future, as has been the case in other countries. For example, in response to perceived failures in financial responsibility obligations during the GFC, some countries such as the United

[6] See The Treasurer and the Governor of the Reserve Bank (n 1).

[7] Paul Tucker, *Unelected Power: The Quest for Legitimacy in Central Banking and the Regulatory State* (Princeton University Press, 2018) 72 (emphasis added).

Kingdom (UK) and the United States of America (US), reviewed the roles of their central banks and financial stability regulators. Action was even taken against the Bank of England (BOE) on the basis of the tort of misfeasance.[8] The RBA could also be subjected to increased scrutiny resulting in potential reputational damage if any discrepancy is revealed between what the RBA was expected to deliver and what it actually delivered. This could be problematic, because, as will be argued in this thesis, it is not clear as to what the RBA is required to do in relation to financial stability, how it should go about its task, and which steps have been taken to ensure that the RBA does in fact accomplish the objectives of the Australian government.

The hypothesis of this thesis (as described below) was formed against this backdrop. Even though there have not been any recent financial stability crises in Australia, and there has not been any indication that the RBA has not adequately performed its tasks in relation to financial stability, the questions about the adequacy of the regulatory framework for the RBA's financial stability mandate are still important and relevant. The manner in which regulators are regulated can have significant long-term implications for the government, the electorate, and for the regulators themselves as well as those that they regulate (the regulatees). The issues raised in this thesis pose questions in relation to the legitimacy of the regulator and how democratic and rule of law principles are affected by the existing regulatory framework.

II Research Question and Hypothesis

The hypothesis of this thesis is that the regulatory framework of the RBA's responsibility for financial stability is based on an 'uneasy' mandate that does not support the governance and accountability of the RBA as Australia's financial stability regulator.

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[8] See *Three Rivers District Council v Governor and Company of the Bank of England (No 2)* [1996] 2 All ER 363; *Three Rivers District Council v. Governor and Company of the Bank of England (No. 3)* [2000] 3 All ER 558.

This thesis argues that the regulatory framework of the RBA's responsibility for financial stability provides it with an informal, shared and decentralised mandate, which does not appropriately support the governance and accountability of the RBA. The thesis argues that a strong regulatory framework will promote the governance and accountability of the RBA as an independent regulatory agency, as well as support democratic principles and the rule of law. The current regulatory framework is not reflective of best practice in the regulation of financial stability regulators internationally and falls short because of an imbalance between the use of 'hard law' and 'soft law' controls and influences in the governance of the RBA. How the Australian government has chosen to regulate the RBA in its responsibilities for financial stability is therefore not optimal. The Australian government has chosen to adopt tools of regulation that are for the most part vague and non-specific, thereby creating difficulties in, for example, holding the RBA clearly accountable for its activities.

The examination of the regulatory framework of the RBA for financial stability in this thesis therefore addresses a variation of the question 'who regulates the regulator', or 'who watches the watcher', by asking 'how is the Australian financial stability regulator regulated?'.

The thesis concludes that the regulatory framework of the RBA's financial stability responsibility should be improved. The regulatory framework does not provide the Australian government with the necessary regulatory tools for the governance and accountability of the RBA when measured against best practice in the regulation and governance of regulators, and appropriate regulatory design precepts.[9] Although the regulatory framework has some strengths, it fails to address important challenges and does not capitalise on certain opportunities. In particular, the way in which the financial stability responsibility has been assigned to the RBA does not effectively use hard law regulatory tools such as a statutory mandate. The practical and theoretical consequences are undesirable, and the

[9] The five design precepts proposed by Paul Tucker for delegating to trustee-like independent agencies such as central banks are used. Tucker (n 7) 110.

effectiveness of many of the tools of regulation used by the Australian government are assessed as low. The thesis proposes three key recommendations for legislative change at the end.

III Focus and Scope of the Thesis

A *The 'Level of Regulation' Investigated by this Thesis*

This thesis will focus on how the Australian government regulates the financial stability regulator in Australia. This thesis therefore considers the tools of regulation used by the Australian government to create and regulate the RBA as a regulatory agency responsible for financial stability. The regulatory 'level' is accordingly the regulatory mechanisms that are used by the state for the creation, operation and governance of the financial stability regulator, ie the regulatory mechanisms between the state (represented by the Australian government) and the RBA (the institution created by government to act in certain ways in the Australian markets and economy). See Figure 1.1 below.

Figure 1.1 – Level of regulation investigated by this thesis

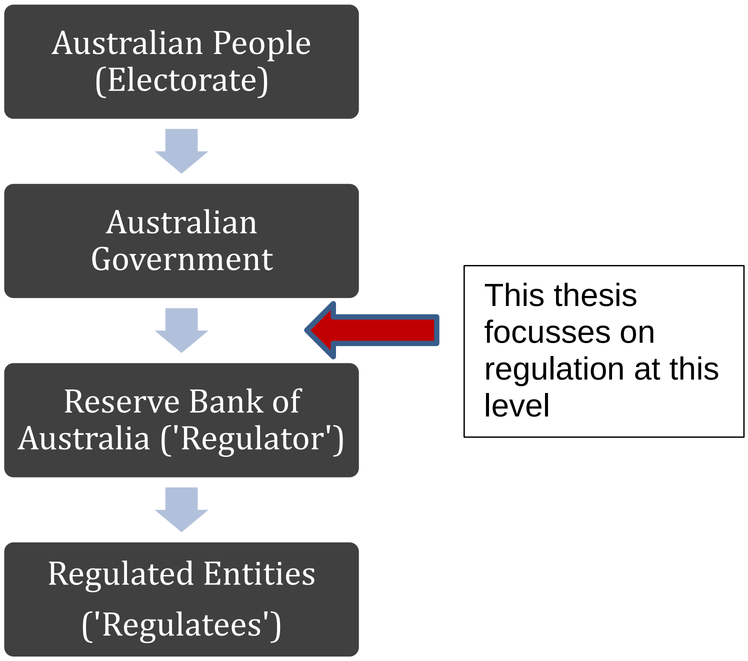

Figure 1.1
This figure sets out the different levels or tiers of regulation as identified for the conceptual framework of this thesis. The focus of this thesis is on the regulation of the RBA as financial stability regulator (the regulation of the regulator)

B *Specific Exclusions/Limitations to the Scope of this Thesis*

The scope of this thesis is limited to the regulatory ‘level’ identified above as between the Australian government (represented by Parliament) and the RBA. It does not focus on the regulation of the markets and financial institutions in the financial markets themselves and does not consider regulation by the RBA and/or APRA of banks and financial institutions (regulatees).

This thesis also focusses on the RBA as the regulatory agency responsible for financial stability and does not consider the role of APRA (or any other regulatory agency or stakeholder) in financial stability *except* to the extent that those regulators impact the functions and responsibilities of the RBA. Although the RBA has overall responsibility for financial stability, only APRA as prudential supervisor can utlilise some key financial stability tools. Although the interaction with both APRA and the Australian Securities and Investments Commission (ASIC) is a relevant factor in how the RBA gives effect to its obligations, APRA and ASIC are only discussed to the extent relevant for the analysis of the RBA's financial stability responsibility.

This thesis focusses on the regulatory framework and does not address problems of actually procuring financial stability. The law and legal framework however play important roles in that regard. The regulatory architecture of how regulators are created, empowered and governed, have a direct influence on financial stability per se, but that is not the focus of this thesis. This thesis focusses on how the Australian government *regulates* the RBA in relation to its financial stability responsibility.

C *Terminological Clarification*

In this thesis the following key phrases are used the manner described below.

'Regulatory framework':

This thesis is about the 'architectural choices for a public policy regime',[10] as noted above. The phrase 'regulatory framework' is accordingly used in this thesis to encompass the entirety of the regulatory design of the RBA as financial stability regulator. It includes the 'regulatory architecture' of the RBA and the other relevant regulators as well as the 'regulatory tools' of government in the form of governance and accountability mechanisms. The phrase 'regulatory architecture' refers to the manner in which the Australian government has structured the RBA as the financial stability regulator, including its institutional character, structure,

[10] Tucker (n 7) 72.

objectives, functions, powers, and tools. It also involves the relationship(s) created between the RBA, other regulators and the Australian government itself.

The phrase 'regulatory framework' includes the formal legislation promulgated by the Australian government to both empower and control the RBA and therefore includes 'formal' elements of law, ie hard law. The framework also encompasses all other regulatory elements that may originate in soft law. The regulatory framework also includes the hard law and soft law regulation of the interaction between the RBA and other regulators and the complementarity, overlap and gaps between their roles. For example, memoranda of understanding, official statements, and operational practices, as well as governance, transparency and accountability mechanisms that have an effect on the conduct of the RBA, are also considered as part of the 'regulatory framework'.

In Australia, the Australian government is the main architect of the regulatory framework for financial stability, although other parties also play important roles in constructing, implementing and influencing the regulatory framework, as well as in providing controls for and influences on the financial stability role of the RBA. The Australian government's role in the creation of the regulatory framework is not always active, and the government does not prescribe all aspects of the financial stability role.

'Regulation':

In this thesis the word 'regulation' is accordingly also used broadly. The thesis adopts the view that 'government regulation is only one element of power or social control in a society'[11] and only one tool of control of a regulator. It acknowledges that 'power structures are complex, dynamic and fragmented'.[12]

[11] Ibid 5; See also Julia Black, 'Critical Reflections on Regulation' (2002) 27 *Australian Journal of Legal Philosophy* 1; See also Barak Orbach, 'Regulation: Why and How the State Regulates' (Foundation Press, 2013): 'Regulation is state intervention in the private domain, which is a byproduct of our imperfect reality and human limitations': at 2

[12] Arie Freiberg, *The Tools of Regulation* (Federation Press, 1st ed, 2010) ('Tools') 5.

The dominant focus in this thesis is government regulation, ie government measures or interventions that are 'intentional and systematic',[13] and are taken with a specific goal in mind (in this case, the regulation of the responsibility for financial stability). This thesis also recognises and identifies other forms of regulation of conduct, such as non-statutory ways of altering behaviour,[14] historically developed roles, and the role of personal power as well as the strive for excellence and prestige. In particular, where the behaviour of institutions and the persons acting for the institutions are not regulated by hard law, regulatory power may lie in other forces, and behavioural factors may be the most fundamental influences on conduct.

Regulation is accordingly seen to be 'a specific set of commands'[15] and also a 'deliberate state influence'[16] and 'all forms of social or economic influence'.[17] It includes both enabling and facilitating commands and influences, but also all restrictive and preventative commands and influences.[18] References to 'regulation' in this thesis therefore includes (but are not limited to) legislation, memoranda of understanding, principles adopted by international organisations such as the International Monetary Fund (IMF) and the Financial Stability Board (FSB), and self-regulatory measures adopted by institutions. This thesis analyses the extent to which the regulation of the financial stability regulator is achieved

[13] Ibid 4.

[14] Regulation can include 'all mechanisms of social control or influence affecting behaviour, from whatever source, whether intentional or not': Robert Baldwin, Colin D Scott and Christopher Hood (eds), *A Reader on Regulation* (Oxford University Press, 1998) 4. In this thesis the behavioural factors of personality and the search for prestige will be analysed. See also Arie Freiberg, *Regulation in Australia* (Federation Press, 2017) 205.

[15] Ibid 3.

[16] Ibid.

[17] Ibid.

[18] Ibid.

through traditional legal regulatory mechanisms (hard law)[19] as opposed to other complementary regulatory forces (soft law) and evaluates its effect.[20]

'Regulator/regulatory agency':[21]

In this thesis, the word 'regulator' and the phrase 'regulatory agency' are used interchangeably. They are both used to designate an institution that has been created by government as a formal regulator, ie an institution with the statutory powers to issue regulations (delegated/subordinate legislation). In Australia, the RBA, APRA and ASIC are generally referred to as the 'government financial regulators'.[22] All three 'financial regulators' are created by statute and have the statutory authority to issue regulations. The RBA however only issues regulations in relation to the payments system, and monetary policy is implemented without traditional 'regulation' but through banking mechanisms (the raising of interest rates).[23] It is therefore acknowledged that the term 'regulator' may not be an entirely accurate description of the role of the RBA in relation to financial stability.[24]

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[19] Hard law consists of regulatory mechanisms with binding legal force.

[20] Quasi legal mechanisms that do not have binding legal force can operate as soft law. See Rolf H Weber, 'Overcoming the Hard Law/Soft Law Dichotomy in Times of Financial Crises' (2012) 1(1) *Journal of Governance and Regulation* 8; See also Deborah E Rupp and Cynthia A Williams, 'The Efficacy of Regulation as a Function of Psychological Fit: Reexamining the Hard Law/Soft Law Continuum' (2011) 12(2) *Theoretical Inquiries in Law* 581.

[21] This phrase is frequently used in the European Union (EU): See Baldwin et al (n 15) 396-9.

[22] Sheelagh McCracken, John Stumbles, Greg Tolhurst and Olivia Dixon, *Everett and McCracken's Banking and Financial Institutions Law* (Lawbook, 9th ed, 2017) 20.

[23] A central bank is not a 'regulator' in the strict sense of the word in respect of monetary policy because it does not compel regulated entities to act in a certain way through the use of regulation. Rather, it acts like a bank, and the increase in interest rates changes behavior. It may act as a regulator in respect of payment systems, for example.

[24] The RBA nevertheless employs a spectrum of regulatory mechanisms. It uses economic, transactional, and informational regulation, as well as authorization, and enforcement and sanctions, although not all the regulatory mechanisms are relevant in the context of financial stability. See Freiberg (n 14) for a discussion of these different forms of regulation.

IV Significance and Importance of the Research

This research is significant because of the importance of financial stability to Australia and the importance of the regulatory framework of the financial stability regulator.

By making the RBA responsible for financial stability, the Australian government delegates an important public function to an institution that is not part of government and is not subject to the control of, for example, a minister that is part of a democratically elected parliament. The institutional and legal design of the regulated entity – the RBA – is therefore important. How this public function has been delegated to the RBA is the key issue in this thesis.

A *The Importance of the Regulatory Framework for Promoting Financial Stability in Australia*

The regulatory framework for promoting financial stability in Australia is important for a number of reasons. Firstly, financial stability is critical to Australia's welfare. Financial stability is in Australia's national interest, and financial stability is a public good.[25] It is therefore an important consideration for the Australian government. Secondly, the role of the RBA as the responsible regulator needs to be constructed in such a manner that the government's public policy objectives will be met. The legitimacy and credibility of the RBA as the relevant regulator is affected by its underlying legal framework.

[25] See Chapter 2.

1 *Financial Stability is in Australia’s National Interest and a Public Good*

The Australian government is (and should be) concerned with financial stability as a matter of national interest. As financial stability has an impact on welfare and has objectives related to public policy, financial stability is in Australia’s national interest.[26] The Australian government has for example taken Australia’s financial stability into account when assessing foreign investment applications. When announcing that permission for the foreign acquisition of the Australian Securities Exchange (ASX) had been denied, the then Treasurer linked Australia’s financial stability directly with Australia’s national interest. He stated that ‘it's in Australia's *national interest* to ensure the ongoing strength and *stability of our financial system* so that it remains well placed to support our economy into the future’.[27] This and similar actions in which the Australian government and its representatives act for the benefit of the Australian population and Australia as a nation, support the designation of financial stability as a national interest.[28]

Financial stability is both a national and international public good.[29] Financial stability as well as monetary stability are preconditions for sustained economic growth and prosperity. Accordingly, achieving and preserving financial stability is now considered to be a ‘key policy objective in our societies’.[30] At the height of

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[26] See Louise Parsons, ‘Regulating Australia's Financial Stability in the National Interest’, in John H Farrar, Mary Hiscock and Vai Io Lo (eds), *Australia's Trade, Investment and Security in the Asian Century* (World Scientific, 2015) 251.

[27] Wayne Swan, ‘Foreign Investment Decision’ (Media Release No 030, The Treasury, 8 April 2011) <http://ministers.treasury.gov.au/DisplayDocs.aspx?doc=pressreleases/2011/030.htm&pageID=003&min=wms&Year=&> (emphasis added).

[28] See Parsons, (n 26). The concept of ‘national interest’ is nevertheless somewhat vague: See Joseph Frankel, *National Interest* (Palgrave Macmillan, 1970).

[29] See C B Blankart and E R Fasten, ‘Financial Crisis Resolution – The State as a Lender of Last Resort?’ 2009 29(3) *Economic Affairs* 47.

[30] Peter Praet, ‘The (Changing) Role of Central Banks in Financial Stability Policies’ (Speech, Annual Internal Banking Conference, 10 November 2011).

the GFC, the IMF and the G20, both key international institutions involved with finding solutions to the GFC, noted that one of the key lessons of the GFC was that there should be a much more pronounced focus on financial stability, with a broader responsibility for, and oversight of, financial stability both in domestic economies and internationally.[31] The importance of financial stability as a policy objective increased during and after the GFC.

In light of the events and consequences of the GFC, and the strong response from international organisations and domestic governments and regulators, it would therefore be reasonable to expect that the regulatory framework and architecture in domestic jurisdictions would post-GFC reflect the importance of financial stability. After all, the institutional underpinnings – that is, the structure, role and administration of the government-mandated regulators – are critically important,[32] revealing the extent to which financial stability is a key consideration for the government.

Subsequent Australian governments have always recognised the importance of financial stability.[33] Nevertheless financial stability did not expressly form part of the three separate commissions of inquiry launched into the Australian financial

[31] G20, *G20 Seoul Summit Leaders' Declaration 2010* (Seoul, 12 November 2010) <https://www.ilo.org/wcmsp5/groups/public/---dgreports/---dcomm/documents/statement/wcms_146479.pdf>; See also International Monetary Fund, 'Lessons of the Financial Crisis for Future Regulation of Financial Institutions and Markets and for Liquidity Management' (Policy Paper, 4 February 2009) <https://www.imf.org/en/Publications/Policy-Papers/Issues/2016/12/31/Lessons-of-the-Financial-Crisis-for-Future-Regulation-of-Financial-Institutions-and-Markets-PP4316>.

[32] See Erland W Nier, Jacek Osiński, Luis I Jácome and Pamela Madrid, 'Institutional Models for Macroprudential Policy' (Staff Discussion Note No 11/18, International Monetary Fund, 1 November 2011) <https://www.imf.org/external/pubs/ft/sdn/2011/sdn1118.pdf>.

[33] For example, the Wallis Inquiry recognised the role of the RBA in financial stability (see Commonwealth, *Financial System Inquiry* (Final Report, March 1997) <https://static.treasury.gov.au/uploads/sites/1/2018/07/01-fsi-fr-Prelim.pdf> (Wallis Inquiry Final Report). The Australian Government at that time included an express responsibility for *financial system stability* in the suite of legislation following the Wallis Inquiry (*Reserve Bank Act 1959* (Cth) s 10B). Australia's financial stability has also been recognized internationally and Australia has been rated as one of the world's best performing financial centres, in part because of its 'strength in financial intermediation and our financial stability': See Commonwealth, *Backing Australian FinTech* (Report, March 2016) <https://fintech.treasury.gov.au/files/2016/03/Fintech-March-2016-v3.pdf>.

system over the past ± 35 years, nor was the Hayne Commission[34] tasked with financial stability issues. Nevertheless, considerations of financial stability impliedly formed part of the establishment of each.[35]

The Murray Inquiry is of particular importance for this thesis, because its objective was to undertake a review of the Australian financial system and its regulators after the GFC. The Australian government, when initiating the inquiry, did so informed by the events and lessons from the GFC. The government's terms of reference for the Murray Inquiry however did not expressly focus on financial stability, but emphasised matters and problems indirectly related to financial stability, including 'how the financial system could be positioned to best meet Australia's evolving needs and support Australia's economic growth'.[36] The Murray Inquiry was further tasked with making recommendations to 'foster an efficient, competitive and flexible financial system, *consistent with financial*

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[34] See Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry, *Terms of Reference* (14 December 2017) <https://financialservices.royalcommission.gov.au/Pages/Terms-of-reference.aspx>. The Hayne Commission addressed issues of potential systemic importance and the role, function and governance of regulators, and its findings may result in legislative reform, in the same manner as the Campbell Inquiry, the Wallis Inquiry and the Murray Inquiry. Then Prime Minister Malcolm Turnbull, when announcing the Hayne Commission, emphasised: 'We need to *maintain the stability of our banking and financial system*, all Australians, consumers, small businesses, farmers, shareholders, must have confidence and trust in the financial system': See Claire Bickers, 'Australia's Major Banks Call for 'Properly Constituted' Inquiry into the Financial Services Sector', *News Corp Australia Network* (online, 30 November 2017) <https://www.news.com.au/finance/business/banking/australias-major-banks-call-for-properly-constituted-inquiry-into-the-financial-services-sector/news-story/ebac85c6474c092e629744a31d22aa5a> (emphasis added).

[35] Each of these Inquiries required at least some consideration of financial stability. The Campbell Inquiry of 1981 was aimed at investigating the financial system as a whole, and stability of the financial system was therefore a specific consideration: See Commonwealth, *Australian Financial System: Committee of Inquiry* (Final Report, 1 September 1981) <https://treasury.gov.au/publication/p1981-afs/> ('Campbell Inquiry Final Report'). The Wallis Inquiry of 1996 also recognised the importance of financial stability: See Commonwealth, *Financial System Inquiry* (Final Report, March 1997) <https://static.treasury.gov.au/uploads/sites/1/2018/07/01-fsi-fr-Prelim.pdf> (Wallis Inquiry Final Report). Similarly, the scope of the Murray Inquiry was broad: See *Financial System Inquiry* (Final Report, November 2014) (Murray Inquiry Final Report) (n 3).

[36] Announcing the final terms of reference: Joe Hockey, 'Financial System Inquiry' (Media Release, Treasury of the Commonwealth, 20 December 2013) <http://jbh.ministers.treasury.gov.au/media-release/037-2013/>.

stability, prudence, public confidence and capacity to meet the needs of users'.[37] The Murray Inquiry considered financial stability to some extent, and the first chapter in its report deals with 'Resilience', effectively a synonym for financial stability.[38] The opening paragraph of this chapter highlights the cost of financial crises, and therefore the economic rationale for financial stability. It notes that the 'average total cost of a crisis is around 63 per cent of annual gross domestic product (GDP), and the cost of a severe crisis is around 158 per cent of annual GDP ($950 billion to $2.4 trillion in 2013 terms)'.[39] There is accordingly no doubt about the current relevance of the regulation of financial stability.

National policy and views on financial stability are of course political in nature[40] and these may change along with changes in the governing political party. Subsequent Australian governments may have different stances on and approaches to economic policy,[41] and policy shifts can sometimes be subtle. For example, the recent inclusion of the phrase 'including financial stability' into the most recent Statement on the Conduct of Monetary Policy jointly issued by the Australian government and the RBA,[42] may reflect a subtle shift in focus. A strong

[37] Ibid (emphasis added).

[38] Financial System Inquiry, Murray Inquiry Final Report, (n 3) 33.

[39] Ibid 10.

[40] See Bronwen Morgan and Karen Yeung, *An Introduction to Law and Regulation: Texts and Materials* (Cambridge University Press, 2007).

[41] For example, the Australian Treasury's Corporate Plan demonstrates an important change from the policies of the previous Labor government in departing markedly from the previous so-called "wellbeing" framework: Commonwealth, *Corporate Plan 2016–17* (Corporate Plan, 31 August 2016) <https://treasury.gov.au/publication/corporate-plan-2016-17/>; See also David Uren, 'Reserve Bank, Treasury Plans Sharpen Economic Policy Focus, *The Australian* (online, 22 September 2016).

[42] The Seventh Statement on the Conduct of Monetary Policy (2016) highlighted the importance of financial stability as a policy objective for the Australian Government by a small change made to the previous (Sixth) Statement on the Conduct of Monetary Policy. In the sentence dealing with the objectives of monetary policy, the phrase 'including financial stability' has been inserted: See The Treasurer and the Governor of the Reserve Bank, *Statement on the Conduct of Monetary Policy* (Statement, 19 September 2016) <https://www.rba.gov.au/monetary-policy/framework/stmt-conduct-mp-7-2016-09-19.html>.

regulatory framework however provides stability and durability in the role of the financial stability regulator.

2 *Financial Stability as a Central Bank Priority*

Financial stability is important for the RBA, and the RBA is said to have always had financial stability as a core function.[43] The RBA's obligation under the *Reserve Bank Act 1959* (Cth) (*RBA Act*) to consider employment and welfare in Australia,[44] can be interpreted to support a mandate for financial stability. The RBA has therefore interpreted the *RBA Act* 'to imply a mandate to pursue financial stability'.[45] The Australian government has also made the 'implicit goal' of financial stability 'express' on 'a number of occasions'.[46] These points are discussed in more detail in Chapter 3.

3 *Regulatory Legitimacy and Credibility*

As a regulator, the RBA's conduct and behaviour are important considerations – as they are for all financial regulators. The Hayne Commission for example recently delivered a damning criticism of the Australian financial regulators (particularly of ASIC but also of APRA) for the manner in which they failed to adequately fulfil their mandates. The regulators were heavily criticised for not

[43] See the first speech by the new Assistant Governor (Financial System) of the RBA: Michele Bullock, 'Has the Way We Look at Financial Stability Changed Since the Global Financial Crisis?' (Speech, Bloomberg Breakfast, 14 March 2017).

[44] The reason is the 'serious damage to employment and economic prosperity that can occur in times of financial instability': Reserve Bank of Australia and Australian Prudential Regulation Authority, *Macroprudential Analysis and Policy in the Australian Financial Stability Framework* (Report, September 2012) 2 <https://www.rba.gov.au/fin-stability/resources/2012-09-map-aus-fsf/pdf/2012-09-map-aus-fsf.pdf>.

[45] Ibid.

[46] Ibid.

acting against instances of misconduct in the banking, superannuation and financial services sectors.[47]

When the behaviour of a regulator is scrutinised the starting point is the regulatory framework, ie its founding legislative framework, including how the regulator can be held accountable under that regulatory framework. The Hayne Commission for example adopted that approach in considering the role of ASIC as market conduct regulator. On a fundamental level, the actions of a regulatory agency are only seen to be legitimate if the actions amount to the proper fulfilment of a task appropriately assigned.[48] The question of regulator legitimacy is therefore also closely associated with the credibility of the regulator, which has important practical consequences for the regulatees. These are important issues for the RBA as the financial stability regulator.

The legal fundamentals of the regulatory framework are important because they determine the legitimacy of the regulator and its actions. As the RBA can be categorised as an 'unelected power',[49] the formal legislative framework is important to support democratic principles and the rule of law.[50] The Australian government and society have a long history of democracy, and also of respecting the rule of law.[51] The regulatory (ie legal) framework of financial stability in Australia should therefore not be based on anything other than the principles of the rule of law. A preponderance of soft law instruments in the RBA's regulatory

[47] See *Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry* (Interim Report, 28 September 2018) <https://financialservices.royalcommission.gov.au/Pages/reports.aspx#interim> ('Hayne Commission Interim Report') and *Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry* (Final Report Volume 1, 1 February 2019) <https://financialservices.royalcommission.gov.au/Pages/reports.aspx#final> ('Hayne Commission Final Report').

[48] Regulators need legitimacy. See Organisation for Economic Co-operation and Development, *Principles for the Governance of Regulators* (Public Consultation Draft, 21 June 2013).

[49] See Tucker (n 7).

[50] 'The rule of law underpins the way Australian society is governed. Everyone – including citizens and the government – is bound by and entitled to the benefit of laws': 'Rule of Law', *Australian Government Attorney-General's Department* (Web Page) <https://www.ag.gov.au/About/Pages/Ruleoflaw.aspx>.

framework for financial stability may undermine the operation of the rule of law principle.[52]

B *Threats to Financial Stability and Financial Stability Regulators*

During and in the immediate aftermath of the GFC, the concept of financial stability assumed a very high priority world-wide and attracted much attention politically, academically and practically. Even though media, political and regulatory interest may have waned somewhat, academic and financial interest remains.[53] In view of potential threats to financial stability in future, complacency about financial stability now would be misplaced. Threats to financial stability are discussed in Chapter 8.

A particularly important consideration that constitutes a threat to financial stability regulators per se and that also underpins this thesis, is the increase in the public scrutiny of regulators.[54] If the outcome of an investigation into a regulator's actions is unfavourable, the reputational harm that can follow can have significant consequences and may damage its credibility. If the regulator is the central bank, the reputational consequences can be even more damaging because of the importance of trust and esteem for central banks in all of their functions.[55] Therefore, setting the regulator up appropriately with solid policy, legal and governance frameworks to avoid reputational harm is important.[56]

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[52] See Chapters 4 – 9 in this regard.

[53] For an interesting analysis of how the post-GFC research conducted by the RBA reflects concerns about financial stability, see John Simon, 'Ten Years of Research – What Have We Learnt Since the Financial Crisis?' (Speech, Economic Society of Australia (QLD) and Griffith University Symposium, 7 March 2019) <https://www.rba.gov.au/speeches/2019/sp-so-2019-03-07.html>.

[54] See Chapter 7. See also Annelise Riles, *Financial Citizenship: Experts, Publics, and the Politics of Central Banking* (Cornell University Press, 2018) 39: 'So today, the central bank is on the public's radar. Populist attacks are framed explicitly as attacks on the expertise of central bankers'.

[55] See Chapter 3.

[56] See R C Lodha, 'Reputational Risk - A Risk Which is Often Ignored', *Banking Frontiers* (Web Page, 11 July 2016) <https://bankingfrontiers.com/reputational-risk-a-risk-which-is-often-ignored/>.

C *Overall Significance and Importance of the Research*

1 *Contribution to Knowledge*

The need for and significance of research into the role of central banks in financial stability has recently been highlighted by Dr Guy Debelle, Deputy Governor of the RBA.[57] He noted that this area of research is as significant now as the research into the independence of central banks was in the late 20th century.[58] This thesis therefore makes an important contribution to the body of knowledge about the regulatory framework of central bank financial stability responsibility, and the conclusions drawn in relation to the Australian framework are also relevant and informative for other jurisdictions.

No systematic analysis of the regulatory framework of the RBA as financial stability regulator and the legal effects of that regulatory framework, including governance and accountability mechanisms, has been published. This thesis therefore fills a gap in the existing research in that it specifically examines the legal consequences of the current regulatory framework in relation to the accountability of the RBA. This research complements recent work by Australian academics, including Drs Andrew Godwin, Sheelagh McCracken, Ian Ramsay and A Schmulow, who in their work on the Australian financial system regulatory framework and the Twin Peaks system consider important ancillary aspects of the RBA's financial stability mandate.[59] It also complements the very recent work

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[57] Guy Debelle, 'Central Bank Independence in Retrospect' (Speech, Bank of England Independence: 20 Years On Conference, 28 September 2017) <https://www.rba.gov.au/speeches/2017/pdf/sp-dg-2017-09-28.pdf>.

[58] Ibid.

[59] See for example Andrew Godwin, 'Surveying the Twin Peaks of Australia's Financial System' in Sheelagh McCracken and Shelley Griffiths (eds), *Making Banking and Finance Law: A Snapshot* (Ross Parsons Centre of Commercial, Corporate and Taxation, 2015) 11; Andrew Godwin and Ian Ramsay, 'Twin Peaks: The Legal and Regulatory Anatomy of Australia's System of Financial Regulation' (Working Paper No 074/2015, Centre for International Finance and Regulation, August 2015) <https://apo.org.au/sites/default/files/resource-files/2015/08/apo-nid67377-1188281.pdf>; Andrew D Schmulow, 'Approaches to Financial System Regulation: An

of Prof Sheelagh McCracken on the history and modern legislative framework of the RBA.[60]

2 *Significance and Impact*

The conclusions of this thesis are significant because of the importance of the role of the RBA in financial stability, and the importance of certainty and predictability in the RBA's role in financial stability. The final conclusions of this thesis are also significant because the study exposes deficiencies in the Australian government's approach to the regulation of an issue which is important to the Australian public. The outcome of this research may inform future law reform and could provide a technical legal perspective on the regulation of one of Australia's most important financial regulators. This thesis thereby contributes to academic literature on the governance of the RBA through proposals for improvements to the RBA's regulatory framework.

V Research Methodology

The research question does not lend itself to a single research methodology. Researching the regulation of a regulator is a sui generis undertaking and involves law, regulation more broadly, and some interdisciplinary research elements including elements of sociology and political economy. To the extent that this research proposes changes to the regulatory framework, it is aligned with the law reform methodology. The doctrinal research method is the starting point.

International Comparative Survey' (Working Paper No 53/2015, Centre for International Finance and Regulation, 2015) <https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2556545>.

[60] See F Decker and S McCracken, 'Central Banking in Australia and New Zealand: Historical Foundations and Modern Legislative Frameworks' in Peter Conti-Brown and Rosa María Lastra (eds), *Research Handbook on Central Banking* (Edward Elgar, 2018) 245.

A *Doctrinal Research Methodology*

Doctrinal research will be adopted to analyse the legislative framework of the RBA for financial stability.

Doctrinal research is the traditional research methodology employed in law.[61] As a methodology it aims to 'systematise, rectify and clarify the law on any particular topic by a distinctive mode of analysis of authoritative texts that consist of primary and secondary sources'.[62] In this instance, the authoritative texts were legislation, and some other formal documents issued by the RBA, the Australian government and, where relevant, other parties. Using the doctrinal methodology, a researcher typically first collects a body of case law, and then proceeds to analyse it, together with relevant legislation, with a view to describing the body of law and how the law applies.[63] It essentially determines what the doctrine is. As there is an absence of case law about the financial stability mandate of the RBA, the doctrinal method therefore was applied only insofar as it was possible.

As part of the doctrinal methodology, the research process therefore involves first establishing what the legal responsibility of the RBA is for financial stability, by analysing the relevant sections the *RBA Act*, the founding legislation of the RBA. Thereafter, secondary sources are consulted, including second reading speeches, explanatory memoranda, and other documents that explain the rationale behind the relevant legislation. Academic commentary in books and journal articles are also identified, collected and analysed. The research extends to include any other documents that may be binding (in some way, even if not a strictly legal way) on the RBA, such as the RBA's own public statements of its

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[61] See N J Duncan and T Hutchinson, 'Defining and Describing What We Do: Doctrinal Legal Research' (2012) 17(1) *Deakin Law Review* 83; See also Mike McConville and Wing Hong Chui (eds), *Research Methods for Law* (Edinburgh University Press, 2nd ed, 2017) 20-2.

[62] Mike McConville and Wing Hong Chui (eds), *Research Methods for Law* (Edinburgh University Press, 2007) 4.

[63] See Duncan and Hutchinson (n 61) 83.

powers, obligations, functions, role and purpose in relation to financial stability, as well as memoranda of understanding the RBA has entered into with other regulators and the Treasury.

In the purest form of the doctrinal methodology, the law is limited to the law itself;[64] there is no consideration of policy interests, and there is no 'overarching theoretical perspective'.[65] The 'pure' doctrinal research methodology treats the law as a 'self-contained system'.[66] Pure doctrinal research of the RBA's financial stability responsibility will however be insufficient in this research project. The financial stability responsibility of the RBA is not limited to or expressly contained in traditional 'hard law' sources, and therefore the doctrinal method on its own is inadequate. Being limited to hard law sources is a recognised deficiency of the doctrinal method, and the fact that doctrinal research does not take into consideration 'the broader social and political context'[67] of law and regulation has been identified as one of its shortcomings. The doctrinal analysis will therefore be augmented in this research with some elements drawn from the law reform methodology, comparative law research method, and interdisciplinary research. The research is further situated within regulatory theory to the extent necessary to address the research question.

Doctrinal research interacts well with the law reform methodology and it is used to supplement the doctrinal approach in this research. Doctrinal research on its own can lead to research proposing law reform,[68] prompting the researcher to consider the problems that affect the law, and 'the policy underpinning the existing law, highlighting, for example, the flaws in such policy. This in turn may

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[64] For example, inconsistencies in the law itself may be pointed out.

[65] Ibid 30.

[66] Ibid 32. Teubner for example argued that law is an autopoietic system and is self-contained: See Gunther Teubner, *Law as an Autopoietic System* (Blackwell, 1993).

[67] McConville and Chui (n 62) 5.

[68] Ibid.

lead the researcher to propose changes to the law (law reform)'.[69] The doctrinal approach is therefore combined with a law reform methodology in this thesis, which is discussed in more detail below.

This research can also not be entirely limited to Australia and the Australian legal framework. Given the unique nature of central banks, and the fact that the RBA shares more characteristics with other central banks than with other domestic regulators or financial institutions, the regulatory frameworks of other central banks for financial stability will also be considered. The relevant elements of comparative law research are discussed below.

In addition, the study of the regulation of a regulator of necessity involves a broader practical and regulatory reality as well as the relationship between the regulator and the state. The scope of doctrinal research was therefore broadened to include historical, sociological, political and public policy aspects but only to the extent necessary to address the research question. The historic realities of the GFC that brought financial stability into sharp focus internationally cannot be ignored, and similarly, the history of the RBA and its historical role in financial stability should be taken into consideration. The history of law and regulation is important in doctrinal research and when investigating potential law reform. It is also always necessary to consider policy issues and determine why certain legislation was enacted[70] – that is also the case here. A historical analysis of the law also opens up a sociological and political dimension to the understanding of the law.

Further, the research question requires of this thesis to be both descriptive and evaluative, and as such it cannot be confined to doctrinal research. Doctrinal research alone cannot do justice to these aspects of the enquiry and additional research approaches are adopted. Doctrinal research nevertheless remains

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[69] Ibid.

[70] See McConville and Chui (n 61) 21.

highly relevant in this research, as the starting point for all legal research is to first establish what the existing law is.[71]

The complementary and supplementary research methodologies will now be discussed in turn.

B *Law Reform Methodology*

The purpose of this thesis is to expose possible shortcomings in the regulatory framework of the RBA, and to recommend changes to that framework if these are necessary or desirable. The use of a law reform methodology is therefore relevant and appropriate to this research.

Law reform involves 'the alteration of the law in some respect with a view to its improvement'.[72] The typical law reform process involves research, expositional publications and consultation with stakeholders.[73] Law reform commissions utilising a law reform research methodology will complete a thorough doctrinal review.[74] The law reform methodology is therefore a natural supplement to the doctrinal methodology. In the law reform process, initial research and consultation are followed by a broader review of the area, and a comparative study of the position in other jurisdictions that also includes an assessment of the successes and failures of those jurisdictions.[75] The various interested (public and

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[71] Ibid.

[72] W H Hulbert, *Law Reform Commissions in the United Kingdom, Australia and Canada* (Juriliber, 1986) 6 citing the Oxford Companion to Law; See also John H Farrar, 'Law Reform Commissions' in Peter Cane and Joanne Conaghan (eds), *The New Oxford Companion to Law* (Oxford University Press, 2008) 683 ('Law Reform Commissions'). Farrar notes that '[l]aw reform means legal change of a non-incremental nature usually effected by statute. It normally connotes improvement…'.

[73] For example, issue papers, discussion papers, working papers, submissions, interim, final and annual reports: See Terry Hutchinson, *Researching and Writing in Law* (Thomson Lawbook Co, 3rd ed, 2010) 66-70.

[74] Ibid 66.

[75] Ibid 67.

private) parties may be included in the suggested amendments or reforms.[76] Although the work of law reform commissions is not always adopted by governments, it may influence government policy[77] and therefore the law reform methodology will take policy issues into consideration. As a research methodology, it is therefore well suited to this thesis.

Hutchinson's flow-chart of the research process in law reform projects[78] informs the research process of this thesis although the exact process is not followed strictly. The steps identified by Hutchinson are:

- an identification of the problem and the reasons why it is a problem (this includes 'why is it a problem, what are the consequences, what is the law, is the law being applied correctly, has the law created the problem, has the law attempted to solve the problem, how should the law be changed?'[79]). A significant part of the research for this thesis focuses on these issues, using doctrinal analysis, and what has been identified as benchmarks of emerging best practice internationally;
- consultation with those affected (directly or indirectly), including industry groups, academics, the public, etc. This research does not involve consultation, but the views of academics and others in research and position papers are important sources for this study;
- consultation of sources from other jurisdictions, including foreign legislation, and expert and academic publications as well as additional empirical research if possible and necessary. This step is fully adopted and implemented, by referencing existing and already interpreted empirical data. New independent empirical research falls outside of the scope of this thesis;

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[76] Ibid.

[77] Ibid.

[78] Ibid 68.

[79] Ibid.

- in-depth reflection on common theses, suggestions, and alternative solutions. This reflective step is evident in this thesis in the analysis of the RBA's regulatory framework; and
- finally, the publication of one or more reports (which would be the output of a law reform commission), but is not directly relevant in this research.

The research therefore draws on the law reform methodology but does not include all steps in the traditional law reform methodology. It also does not adopt a theoretical approach.[80] The conclusions reached and recommendations made at the end of this thesis are not in the nature of mere legal formalism, but have practical consequences in addition to the theoretical consequences. The conclusions therefore do not fall within the category described by Farrar as 'technical, 'lawyers' law' reform'.[81] The conclusions and recommendations are set out in Chapters 8 and 9.

C *Comparative Law Research Methodology*

The comparative law methodology has been described as follows: [82]

> The essence of comparative law is the act of comparing the law of one country to that of another. Most frequently, the basis for comparison is a foreign law juxtaposed against the measure of one's own law. But, of course, the comparison can be broader: more than two laws, more than law, more than written words.

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[80] Conducting law reform research without articulating the political or philosophical positions informing the analysis has been criticized: Susan M Armstrong, 'Evaluating Law Reform' (2006) 10 *University of Western Sydney Law Review* 157. The justification of this thesis and its significance demonstrate that the overarching approach in this thesis has practical and legal importance. Armstrong also points out that the starting point for any law reform discussion should be a basic question of jurisprudence, namely, what is the nature and purpose of law: at 158. In this thesis, the nature and purpose of the law is to regulate a regulator in order to give effect to the broad social benefits associated with financial stability. The thesis concludes with recommendations for legislative action. As the RBA is acting as a mandated agent of the Government for an important purpose, 'hard law' is best suited.

[81] Farrar, 'Law Reform Commissions', (n 72) 683-4.

[82] Edward J Eberle, 'The Method and Role of Comparative Law' (2009) 8(3) *Washington University Global Studies Law Review* 51, 52; See also John C Reitz, 'How to Do Comparative Law' (1998) 46(4) *American Journal of Comparative Law* 617, 620.

> The key act in comparison is looking at one mass of legal data in relationship to another and then assessing how the two lumps of legal data are similar and how they are different. The essence of comparison is then aligning similarities and differences between data points, and using this exercise as a measure to obtain understanding of the content and range of the data points.

In the classic comparative law approach, the structural elements and culture that influence law,[83] and other 'legal formants'[84] of the particular country are also taken into consideration in the comparison drawn. Although comparative law was initially used in the area of private law only, there is now a growing body of work in comparative constitutional law,[85] and comparative law is increasingly relevant to areas of law of international concern such as data privacy, because comparative law can be of assistance in 'important public policy questions, questions that often transcend national borders'.[86]

Comparative legal method is beneficial together with the law reform methodology. One of the benefits of adopting a comparative approach is that it becomes possible to 'reassess the underlying principles that make up the legal order and determine what, if anything, needs to be done, nationally, regionally or internationally'.[87]

Some use of a comparative approach is necessitated by the nature of the RBA as a central bank. The regulatory framework for the RBA as the financial stability regulator in Australia cannot be effectively evaluated in isolation, without considering the manner in which other central banks or other financial stability

[83] Eberle (n 82) 52: See also Reitz (n 82) 622.

[84] This is the term used by Sacco: Rodolfo Sacco, 'Legal Formants: A Dynamic Approach to Comparative Law II' (1991) 39(1) *American Journal of Comparative Law* 343, 385.

[85] Eberle (n 82) 54; See also Reitz (n 83) 619.

[86] Eberle (n 82) 54.

[87] Eberle (n 82) 55; See Reitz (n 83); See also McConville and Chui (n 61) 163-4.

regulators have been regulated in respect of their financial stability responsibility in other jurisdictions. Central banks are unique institutions as there is typically only one central bank in each domestic jurisdiction.[88] From a legal perspective there are more similarities between central banks in different countries, than between a central bank and other banks in the same country. A comparative analysis can therefore only be done on an international basis.[89]

A comparative approach is accordingly only adopted in two respects in this thesis. First, it is used at a very high level in the description of benchmarks of emerging best practice in the regulation of financial stability regulators internationally. Second, a comparative approach is adopted when comparing the regulatory framework for financial stability of the RBA with the regulatory framework for financial stability of comparable central banks. This thesis therefore only involves some aspects of the comparative law research methodology. A full comparative law methodology is outside of the scope of this thesis and is also not adopted by the international regulatory institutions such as the FSB and the IMF in their peer and thematic reviews of the regulatory frameworks of the G20 member countries.[90]

The particular comparative approach adopted in this thesis is a thematic comparison. This is a specific descriptive approach within the broad comparative law research methodology involving comparison based on identified themes.[91]

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[88] The case of the European Central Bank (ECB) is unique and domestic central banks in the European Union (EU) play a different role to other central banks.

[89] This is because there is only one national central bank per jurisdiction, and only a single financial stability regulatory framework in any given jurisdiction.

[90] See Chapter 8.

[91] 'When one tries to improve one's own legal system, be it as a legislator or as a scholar, it has become obvious to look at the other side of the borders. However, importing rules and solutions from abroad may not work because of a difference in context. Hence, a more thorough contextual approach may be required. One may also want to inquire to what extent a legal evolution in one's own country finds parallel developments in other countries': Mark van Hoecke, 'Methodology of Comparative Legal Research' (2015) *Law and Method* 1, 3. That was the approach adopted in this thesis. Law was not uncritically imported from other jurisdictions, but the Australian legal framework was evaluated in light of relevant developments in other countries.

The research for this thesis involves comparing the Australian legal framework to emerging global trends and in particular emerging 'best practice' for the regulation of financial stability regulators. It does not select a single jurisdiction for the purpose of a full comparison with the Australian legal position. Given the purpose of this research, a classic application of the comparative law research methodology is not required and not adopted.[92]

A comparative methodology of the nature conducted in this research – ie comparing the RBA's regulatory framework to international best practice and then assessing whether or not the Australian framework is optimal or not – is consistent with the generally accepted methodology in this area of reviewing and evaluating domestic regulatory frameworks.[93]

D *Interdisciplinary Research Methodology*

The research question of this thesis clearly delineates that it is the '*regulatory framework*' of the RBA as a financial stability regulator that will be investigated. The focus is on legal regulation. The research for this thesis is therefore not conducted using a full 'interdisciplinary' research methodology,[94] for example a law and economics model. The research question is not ideally suited to interdisciplinary research. Research questions that are suitable for interdisciplinary research include those that (1) have insights developed by two or more disciplines, (2) may not be adequately addressed by one discipline alone, or (3) is at the interface of various disciplines.[95] Although financial stability is a matter of interest to the pure economic disciplines and also to studies in the

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[92] For example, the statutes establishing other central banks were not investigated in depth in such a manner that it required a deep analysis of the particular domestic jurisdiction.

[93] See also Chapter 8.

[94] Interdisciplinary research has increasingly been described as a discrete, if developing, methodology: See Allen F Repko, *Interdisciplinary Research: Process and Theory* (Sage, 2008).

[95] Ibid.

political economy, a legal/regulatory approach to the research question, supplemented with some interdisciplinary elements, answers the question sufficiently. The thesis accordingly does not adopt a law and economics methodology. Where appropriate, though, reference is made to economic principles and the political economy of central banks, but only to the extent that those insights inform this study.

It is however not possible to adequately address the research question without venturing outside of the traditional 'legal' or 'doctrinal' methodology, and the research involves elements of the socio-legal approach. Socio-legal research involves a 'broader social and political context with the use of a range of other methods taken from the social sciences and humanities'.[96] Regard is had to the historical, political, economic and philosophical contexts to the extent that the law is a function and product of historical, political, economic and philosophical contexts.

This thesis also involves issues of public policy. Public policy however lacks the methodological focus of the social sciences and the study of public policy faces a 'multiplicity of methodological challenges'.[97] It does not have the same methodological focus of the social sciences, and combines 'an analytical with a normative perspective'.[98] The nature of public policy as a research discipline has been recognised as a unique and identifiable, interdisciplinary academic discipline, drawing on 'history, economics, political science, governance,

[96] McConville and Chui (n 61) 5.

[97] 'Methods of Public Policy', *Willy Brandt School of Public Policy at the University of Erfurt* (Web Page) < https://www.brandtschool.de/research-and-phd/methods-of-public-policy/>.

[98] Ibid. It is arguable that public policy is a doctrine at large, and as such it appears from time to time in the law, as for example the law of contract and torts. It is properly a study in political science which is regarded as one of the social sciences. Some consider public policy to be a methodology in itself: 'Being a synthetic meta-discipline within the social sciences, public policy research is an inherently methodological form of inquiry and the integration of different perspectives on social reality as well as the merging together of theoretical understanding and practical engagement is its primary object': ibid.

sociology and law as components of public policy theory development.[99] Public policy is also a well-recognised extension of the traditional doctrinal research.[100]

VI Thesis Overview

The thesis will progress as follows.

Chapter 2 analyses what 'financial stability' entails for regulatory purposes, and examines why and how, as a concept, it involves regulatory difficulties. As a concept, financial stability has no generally accepted definition, and its meaning may change depending on the context. Financial stability as a concept requires interpretation and lacks precision, thereby rendering it difficult for a government to create legal certainty for the regulatory agency responsible for financial stability. When tasking a regulatory authority with a particular task – in this instance 'financial stability' – what the regulatory authority is required to achieve, should be clear. This chapter therefore provides important context for the analysis of the RBA's responsibility for financial stability in the balance of the thesis.

Not only is financial stability an elusive concept, but central banks per se are sui generis organisations. In examining central banks and their roles after the GFC, **Chapter 3** provides additional context for this thesis. The allocation of a financial stability regulatory role affects, and is affected by, the unique nature of a central bank. Central banks have important public functions, but are also uniquely independent, because of their monetary policy responsibility. The potential conflict and synergy between the monetary policy and financial stability responsibilities are analysed in this chapter, as well as the view adopted strongly after the GFC that central banks should be responsible for financial stability. The

[99] Heike M Grimm, 'Introduction: The Added Value of Public Policy Research in the Global South' in Heike M Grimm (ed), *Public Policy Research in the Global South: A Cross Country Perspective* (Springer, 2019).

[100] Terry Hutchinson, 'Developing Legal Research Skills: Expanding the Paradigm' (2008) 32(3) Melbourne University Law Review 1065, 1083-4.

post-GFC perspectives as well as the governance and accountability impacts are canvassed in Chapter 3 as part of the broader context for this thesis.

The financial stability responsibility of the RBA is then analysed against this background. In **Chapters 4 and 5** the misleading certainty and simplicity of the RBA's financial stability responsibility suggested by the two quotations at the start of this chapter are challenged. **Chapter 4** deals with the extent to which the RBA's mandate for financial stability is informal. It highlights that the RBA's express statutory responsibility for financial stability is limited to the payments system. It demonstrates how there is no concrete, clear, overarching mandate for financial stability in the RBA's enabling legislation. The financial stability mandate can at best be implied generally from the enabling legislation, but the most important sources of the mandate – or confirmations of the mandate – come from informal documents and statements. There is a preponderance of soft law origins of the financial stability mandate, and an absence of key hard law sources.

Chapter 5 deals with the shared and decentralised aspects of the financial stability mandate of the RBA. The financial stability functions are shared between the RBA, APRA and the Council of Financial Regulators (CFR) in the main, although ASIC and the government also have meaningful roles. Coordination, cooperation and collaboration between regulators are therefore of the utmost importance. This chapter analyses the extent to which this shared and decentralised responsibility is also informal, because of the informal structure of the CFR as well as the informal regulation of the cooperation and collaboration between the responsible regulators.

Chapters 6 and 7 critically analyses the legal framework and in particular the range of controls and drivers of the RBA's financial stability actions. It demonstrates how notwithstanding the vast number of controls and influences on the RBA that could all influence what and how the RBA operates, none of the hard law mechanisms directly compels the RBA to pursue financial stability, and they are therefore ineffective regulatory controls. The gap left as a consequence of the informal and shared and decentralised mandate is thereby enlarged. These chapters examine the governance and accountability mechanisms of the RBA, most of which are general in nature, and are therefore not exclusive to the financial stability function. These chapters analyse the extent of external and internal ‘controls’ and ‘influences’ on the activities of the RBA in relation to governance and accountability, reflecting what is described as a continuum of governance, transparency, and accountability. As a consequence of the gaps in the governance and accountability framework, it is possible that behavioural (sociological and psychological) factors as drivers of the RBA’s behaviour could play a disproportionately important role.

Chapter 8 provides both practical and theoretical considerations for adjusting the RBA’s regulatory framework. It compares the regulatory framework of the RBA with international benchmarks of international best practice for financial stability. These benchmarks are those endorsed by important international institutions such as the FSB, G20, Bank for International Settlements (BIS) and the IMF, as well as by experts, and from the current practices of the G20 member countries. The RBA’s regulatory framework is also compared with the design precepts for the regulation of central banks as proposed by Paul Tucker. This chapter also investigates the possible effectiveness of control through the so-called fourth branch of government. This chapter defends the reasons for regulatory improvements, including regulator legitimacy, democratic principles and the underpinnings of Australia that is a country that respects the rule of law. The thesis argues that the balance between hard law and soft law mechanisms in the regulatory framework should be adjusted.

Chapter 9 provides specific recommendations for legislative adjustments to the financial stability framework. In particular, the thesis concludes by recommending that the RBA be provided with an explicit statutory mandate for financial stability, that the interaction of APRA and the RBA be clarified in legislation, and that the role of the CFR be formalised and integrated into the RBA. The chapter concludes with an overview of the arguments presented in this thesis.

CHAPTER 2

Financial Stability: An Elusive Concept

'To borrow a phrase, we don't want "the stability of a graveyard"'.[1]

I Introduction

The RBA is the financial regulator responsible for financial stability in Australia. What 'financial stability' means, however, is not clear, and there is therefore an inherent uncertainty about the extent of the RBA's responsibilities. The elusiveness of the concept leads to difficulties in a number of areas but poses particular problems when mandating a regulator such as the RBA with financial stability. This chapter will analyse the concept of 'financial stability', how and why it can have different meanings, and why creating a definition is complex.

In this chapter, Part II sets out how and why financial stability remains an elusive concept, and how the concept itself has led to confusion. Part II B deals with the significance of financial stability as an elusive concept from a regulatory perspective, and analyses both the advantages and disadvantages of defining financial stability. A working definition of financial stability for this thesis is proposed in Part III A, after which the difficulties that are encountered when attempting to define financial stability are analysed. Some arise from the foundational concepts of finance and stability themselves (Part III B); others from the fact that financial stability can be interpreted broadly or narrowly (Part III C). Part IV sets out the methodological difficulties in defining financial stability, which combined with the inherent characteristics of financial stability lead to significant

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[1] Wayne Byres, 'Achieving a Stable and Competitive Financial System' (Speech, Australian Financial Review Banking & Wealth Summit, 29 April 2015).

challenges when such an elusive concept forms part of a regulator's mandate. The definitional difficulties are therefore not just of theoretical importance but have real consequences for the regulatory framework of the RBA for financial stability.

II An Elusive Concept

A *Conceptual Confusion: An Absence of Consensus on and Clarity of the Meaning of 'Financial Stability'*

The lack of a generally accepted definition of 'financial stability' is quite remarkable given the importance of financial stability, and the prevalence of the term in the media, and in economic, financial and political literature.[2] There is currently no general consensus in Australia or internationally as to the meaning or definition of the term 'financial stability',[3] despite the fact that governments, regulators, and the media use the term frequently. The term is often simply used without any clarification of its intended meaning, including in academic research and writing as well.[4]

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[2] 'Financial stability' as a search term peaked on Google at the height of the GFC, but its prevalence dropped back to roughly pre-GFC levels from 2013: See Chapter 3 Part III A. Financial stability continued to be important since the 1990s: See Garry J Schinasi, 'Safeguarding Financial Stability: Conceptual Issues and Policy Challenges' (Conference Paper, Annual Symposium of *Moneda y Crédito* on Monetary and Financial Stability: Harmony or Conflict?, 6–7 November 2006) <https://www.ecb.europa.eu/events/pdf/conferences/cecwe_conf/Schinasi_paper.pdf?fda0d9c9df617c000e82456ff201ada5> ('Safeguarding Financial Stability').

[3] Internationally there is no settled definition of financial stability: Andrew Crockett, ''The Theory and Practice of Financial Stability' (1996) 144(4) *De Economist* 531, 532. See also Gunnar Bårdsen, Kjersti-Gro Lindquist and Dimitrios P Tsomocos, 'Evaluation of Macroeconomic Models for Financial Stability Analysis' in Charles A E Goodhart and Dimitrios P Tsomocos (eds), *The Challenge of Financial Stability: A New Model and its Applications* (Edward Elgar, 2012) 32, 34: 'Academics and policy-makers have suggested a *potpourri* of definitions'.

[4] For example, see Ricardo Correa, Garud Keshav, Juan M Londono and Nathan Mislang, 'Sentiment in Central Banks' Financial Stability Reports' (Discussion Paper No 1203, Federal Reserve Board, March 2017) <https://www.federalreserve.gov/econres/ifdp/files/ifdp1203.pdf>.

The lack of conceptual clarity, and the paucity of studies into what the term means, are even more noteworthy given that financial stability has become an increasingly important topic in economic, financial and academic literature internationally[5] since the 1990s and particularly after the GFC. In the 1990s, central banks increased their focus on financial stability and commenced the publication of financial stability reviews.[6] Nevertheless, a definition of financial stability was not formalized or even considered in much detail in the 1990s including by the central banks in their financial stability reviews. Similarly, during and after the GFC, even though the importance of financial stability increased,[7] and the need to protect financial stability was expressed at the highest political level, such as by the G20 and by national leaders,[8] its meaning was mostly ignored, or assumed. Now, more than ten years after the start of the GFC there is still no consensus on what financial stability entails, and it is generally not clarified.

1 *Australia*

In Australia the concept has been given little formal attention. Although the RBA, APRA, the CFR and the Treasury all play a role in financial stability,[9] only the

[5] The term financial stability was likely only used in this context as from 1994: William A Allen and Geoffrey Wood, 'Defining and Achieving Financial Stability' (Special Paper No 160, London School of Economics Financial Markets Group, April 2005) 1 <http://www.lse.ac.uk/fmg/assets/documents/papers/special-papers/SP160.pdf>.

[6] See Martin Čihák, 'Central Banks and Financial Stability: A Survey of Financial Stability Reports' (Paper, Seminar on Current Developments in Monetary and Financial Law, 23-27 October 2006) <https://www.imf.org/external/np/seminars/eng/2006/mfl/mc.pdf>.

[7] The work of the G20 and creation of the Financial Stability Board evidence this. See Douglas W Arner and Michael W Taylor, 'The Global Financial Crisis and the Financial Stability Board: Hardening the Soft Law of International Financial Regulation?' (2009) 32(2) *University of New South Wales Law Journal* 488.

[8] See for example, Kevin Rudd, 'The Global Financial Crisis' (February 2009) *The Monthly* <https://www.themonthly.com.au/issue/2009/february/1319602475/kevin-rudd/global-financial-crisis>.

[9] See for example Australian Prudential Regulation Authority, ''Protecting Australia's Depositors, Insurance Policyholders and Superannuation Fund Members', (Brochure) 4 <http://www.gtm.apra.gov.au/AboutAPRA/Publications/Documents/APRA_Brochure.pdf>; *Memorandum of Understanding on Financial Distress Management between the Members of the Council of Financial Regulators*, signed 18 September 2008 (Memorandum of

RBA has provided a description – but not a formal definition – of financial stability.[10] The RBA describes what financial stability is as follows on its website:[11]

> A stable financial system is one in which financial institutions, markets and market infrastructures facilitate the smooth flow of funds between savers and investors. This helps to promote growth in economic activity.

The 2016 Murray Inquiry into the Australian financial system considered financial stability in its inquiries and recommendations and asked whether '[a]gainst the background of developments overseas, … Australia should change its institutional arrangements for making and implementing financial stability policy'.[12] The Murray Inquiry noted that in Australia 'financial stability' is equated with 'resilience' and that these notions are treated as matters of macroprudential stability. The final report stated that 'Australia has long adopted what could be called a "macro-prudential" approach to supervision under the rubric of financial stability'.[13] However the Murray Inquiry did not attempt to define financial stability, neither did it identify a need for a clear definition.

Understanding) <https://www.cfr.gov.au/financial-institutions/crisis-management-arrangements/pdf/mou-financial-distress-management.pdf>.

[10] Neither APRA nor ASIC have provided formal definitions of financial stability. For a definition related to APRA's work, see Charles Littrell, 'What is the Difference Between Macro Prudence and Macroprudential Supervision?' (Speech, Annual Macquarie University Centre for Financial Risk, 1 July 2013) <https://australiancentre.com.au/wp-content/uploads/2016/04/D1P3-Macro-prudence-Charles-Littrell-APRA.pdf>. The difference between macro and micro prudential supervision is also discussed in Rosa M Lastra (ed), *International Financial and Monetary Law* (Oxford, 2nd ed, 2015) 114-5.

[11] Reserve Bank of Australia, 'Financial Stability', *Reserve Bank of Australia* (Web Page) <https://www.rba.gov.au/fin-stability/>.

[12] Commonwealth, *Financial System Inquiry* (Final Report, November 2014) 234 <http://fsi.gov.au/files/2014/12/FSI_Final_Report_Consolidated20141210.pdf> (Murray Inquiry Final Report). The absence of a more theoretical approach by a commission of inquiry is somewhat surprising.

[13] Ibid 233.

2 *International*

Internationally the concept ‘financial stability’ also has no generally accepted definition.[14] Only a relatively small number of attempts have been made to define financial stability formally and to ‘characterize it in an analytically meaningful way’.[15] For example, in 1997, although the theme at the prime central banking conference in the United States, the annual Jackson Hole Symposium held by the Kansas Reserve Bank, was ‘Maintaining financial stability in a global economy’, the term financial stability was used without any analysis of its meaning.[16] Even in the academic literature on central banks there is no real analysis or definition of financial stability.[17]

At the highest international level, the international bodies giving guidance to countries on financial stability, such as the G20, the FSB and its precursor, the Financial Stability Forum,[18] have also not defined financial stability. The FSB relies on an intuitive approach to the understanding of the concept financial stability and has not defined financial stability in its charter.[19]

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[14] Crockett (n 3) 532: ‘There is, as yet, no generally accepted definition of financial stability’. See also Pawel Smaga, ‘Assessing Involvement of Central Banks in Financial Stability’ (Policy Paper, Centre for Financial Stability, 23 May 2013) <http://www.centerforfinancialstability.org/research/Assessing_052313.pdf>.

[15] Dimitrios P Tsomocos, ‘Equilibrium Analysis, Banking and Financial Instability’ in Charles A E Goodhart and Dimitrios P Tsomocos (eds), *The Challenge of Financial Stability: A New Model and its Applications* (Edward Elgar, 2012) 61, 83.

[16] In the foreword to the published proceedings of this symposium, Thomas M Hoenig, then President of the Kansas Federal Reserve Bank, seemed to identify financial stability with avoiding the risk of failed institutions and the possibility of contagion and systemic risk. See Thomas M Hoenig, ‘Foreword’ (Speech, Wyoming Symposium on Maintaining Financial Stability in a Global Economy, 28–30 August 1997).

[17] The work by Hilary Allen, William A Allen and Geoffrey Wood, and Ana Vlahović are some exceptions.

[18] Financial Stability Board, ‘History of the FSB’, *Financial Stability Board* (Web Page) <http://www.fsb.org/about/history/>.

[19] ‘Charter of the Financial Stability Board’, Financial Stability Board (Web page, June 2012) <http://www.fsb.org/wp-content/uploads/FSB-Charter-with-revised-Annex-FINAL.pdf>.

More than twenty years after 1997, and even after the devastating consequences of the GFC highlighted the importance of financial stability, the term is continuously used without clarification or examination and there is (still) no single definition that has been adopted worldwide.[20] Conceptual clarification has been neglected.

B *The Regulatory Importance of Conceptual Clarity of the Concept Financial Stability*

The lack of conceptual clarity in regulation/legislation about what financial stability entails, is problematic. For example, although central banks engage in and are held responsible for financial stability, they use the term financial stability in a pragmatic and generally uncritical manner. The term is also often not defined in their mandates.[21] It is therefore not clear what they are responsible for, as 'financial stability' can have a wide range of different meanings. Meanings can vary from an ordinary layperson's understanding to complex theoretical/economic meanings.[22] The concept therefore requires clarification because of its importance when used in regulation. Although it may be difficult to create a single generally accepted definition of financial stability because of national

[20] A number of authors have highlighted the absence of a general definition. See for example Luiz A Pereira da Silva, Adriana Soares Sales and Wagner Piazza Gaglianone, 'Financial Stability in Brazil' (Working Paper Series No 289, Banco Central do Brasil, August 2012) <https://www.bcb.gov.br/pec/wps/ingl/wps289.pdf>; See Hilary J Allen, '"What is "Financial Stability"? The Need for Some Common Language in International Financial Regulation' (2014) 45(4) *Georgetown Journal of International Law* 929 ('What is "financial stability"'); See Morozova Irina Anatolyevna and Sahabutdinova Liliya Ramilevna, 'Financial Stability Concept: Main Characteristics and Tools' (2013) 22(6) *World Applied Sciences Journal* 856.

[21] See Ana Vlahović, 'Challenges to the Implementation of a New Framework for Safeguarding Financial Stability' (2014) 3(3) *Journal of Central Banking Theory and Practice* 19, 23. For example, a study conducted by Smaga in 2013 revealed that as at 30 June 2012 six of the 27 EU Member States did not have a definition of financial stability.

[22] M M Romaniak notes that different groups have different definitions of financial stability. Central banks tend to focus on systems and the systemic aspects of financial stability. There are however different scientific approaches and different conceptions of financial crises: See M M Romaniak, 'Financial Stability: The Problem of Interpretation' (2016) 4 *Business Inform* 21.

differences,[23] differences in outlook,[24] different economic theories,[25] or even different times,[26] conceptual clarity can be enhanced through adopting particular definitions in particular contexts.

The lack of conceptual clarity has important consequences for the governance of the regulator(s) charged with financial stability, and for the public policy and societal objectives of financial stability policies implemented by the regulator. By providing conceptual clarity (for example through a definition or description), the government can make the underlying public policy goals and purpose of government visible to the regulator and the electorate. Conceptual clarity matters in principle, also in Australia, even though Australia's recent stable financial and economic history may make it seem unnecessary.[27]

Conceptual clarification will now be discussed in relation to its importance for the regulatory agency tasked with financial stability, importance to society in general and its importance from a regulatory perspective.

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[23] Smaga attributes the absence of a single definition to the uniqueness of financial crises and national financial systems, notwithstanding increasing globalisation and liberalisation of financial markets: Smaga, (n 14) 14.

[24] It is true that it is perhaps not possible to devise a single definition that is acceptable to all stakeholders, in all contexts, and at all times, because the role of the stakeholder, the context and also the time in which the phrase is used may play a role in the definition of financial stability.

[25] For example, monetarist economists such as Milton Friedman and Anna Schwartz only consider a crisis to be a true financial crisis if it resulted from a banking panic, which is indicative of a 'major source of contraction in the money supply'. Non-monetarist economists such as Minsky and Kindleberger are however of the opinion that a much broader range of circumstances, extending beyond banking crises, could give rise to financial crises. These circumstances could include 'declines in asset prices, failures of both large financial and nonfinancial firms, deflations or disinflations, disruptions in foreign exchange markets': See Frederic S Mishkin, 'Anatomy of a Financial Crisis' (1992) 2(2) *Journal of Evolutionary Economics* 115, 116 ('Anatomy of a financial crisis').

[26] Financial stability is not an ahistoric concept, but is influenced by the times in which it is used, and the characteristics of the most recent financial crisis.

[27] See Commonwealth, *Backing Australian FinTech* (Report, March 2016) 9 <https://fintech.treasury.gov.au/files/2016/03/Fintech-March-2016-v3.pdf>. In 2013 Australia's banking system was 'typically rated among the two or three soundest in the world', and although Australia has known long-term prosperity and stability, 'in a statistical sense, given there is a non-zero chance of systemic bank failure, it is arithmetically inevitable that at some point Australia will face a banking and/or economic crisis': See Littrell (n 10) 3.

1 *Institutional Importance*

Without conceptual clarity a range of difficulties arise for both government and the financial stability regulator. Regulators have a core responsibility to administer regulation in such a way that it achieves the underlying social and economic policy objectives of those that appoint them,[28] and 'in accordance with the powers and authority given to [it] through legislation and government direction'.[29] In Australia, the RBA and the Australian government therefore need a clear and shared understanding of what financial stability means,[30] in order to ensure that the responsibilities are properly given and executed.

Clarity is important for the *legitimacy and authority* of the regulatory agency. If regulator is responsible for financial stability, a definition of financial stability clarifies the authority of the regulator and legitimises the actions it takes in pursuit of the financial stability goal. A definition also assists in clarifying the *scope* of the regulator's powers and duties. It has been pointed out that[31]

> [t]he governance arrangements of a regulator are critical. The legal remit of the regulator, the powers it is given, how it is funded and how it is held accountable are all key issues that should be carefully designed if the regulator is to succeed in combining effective regulation with high standards of integrity and trust.

Clarity also aids *strategic and operational governance* of the regulator as an institution. The objectives and goals of a regulator/regulatory institution shape its internal as well as external decisions. A definition of financial stability will assist

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[28] Australian National Audit Office, *Administering Regulation: Achieving the Right Balance* (Practice Guide, 2014) 3 <http://nla.gov.au/nla.obj-494731946/view>, referencing: Organisation for Economic Co-operation and Development, *Recommendation of the Council on Regulatory Policy and Governance* (Report, 2012) <http://www.oecd.org/gov/regulatory-policy/49990817.pdf>.

[29] Ibid.

[30] Central banks are different from other government financial regulators because of their banking functions: See Charles A E Goodhart and Rosa María Lastra, 'Populism and Central Bank Independence' (2018) 29(1) *Open Economies Review* 49; See also Martin F Hellwig, 'Financial Stability, Monetary Policy, Banking Supervision, and Central Banking' (Conference Paper, ECB Forum, 25 May 2014) 5-6.

[31] Organisation for Economic Co-operation and Development, *The Governance of Regulators: OECD Best Practice Principles for Regulatory Policy* (OECD, 2014) 9.

in identifying the *objectives* that the regulator is required to pursue and achieve. Clearly defined objectives guide organisational management and governance, including decisions about the use and allocation of its budget and resources. How financial stability was defined has for example had a direct impact on the organisational structure of a financial stability department at a central bank.[32] Overall, clearly defined objectives can guide a regulator's strategic direction, its employment practices, and relationships with other regulatory agencies.

A definition of financial stability may also indicate what are the *powers* of the regulator, especially where no specific express powers have been provided. It will contribute to the governance and direction of the regulator and is of particular importance for a government regulator, because a[33]

> well-governed organisation will clearly understand what it is required to achieve, will be organised to achieve it through the success of its executive management and will focus on ensuring it achieves its goals [and] …. produce effective outcomes.

A definition of financial stability also matters for *accountability* and compliance. It plays an important role in assessing whether the regulator has in fact achieved its goal(s) and it will provide a yardstick for determining the agency/institution's success or failure in meeting its objectives.[34] This is important when the institution must be transparent and report on its activities, be evaluated in respect of its successes, and be held accountable for its failures, particularly where it is accountable to Parliament and the public.[35] Without a definition of financial stability, it may be difficult to determine whether or not the institution has succeeded in its financial stability goal(s). As a failure of the mandated institution such as the RBA to meet its objectives can have important personal

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[32] Smaga (n 14) 20.

[33] Commonwealth, *Review of Corporate Governance of Statutory Authorities and Office Holders* (Report, 27 June 2003) 2 <http://www.finance.gov.au/sites/default/files/Uhrig-Report.pdf> (Uhrig Report).

[34] Ibid.

[35] See Chapters 7 – 9 below.

consequences for high-ranking RBA officials (for example, in certain circumstances the Governor of the RBA can be removed from office[36]), inaccurate determinations of ‘failure’ should be avoided. As pointed out by the OECD,[37]

> [r]egulators are playing an increasingly important role in delivering economic and societal objectives as well as being tasked with regulating more complex situations. At the same time the role of regulators is being continuously examined, especially at times of crisis or when issues arise that create public concern.

It is of particular importance that ‘such regulators are key state actors with responsibilities and therefore are accountable for the delivery of policy outcomes’[38] not just to government, but also to stakeholders such as the general public.

Although different stakeholders may have different views as to the precise meaning of ‘financial stability’, the mandate of the financial stability regulator (eg the central bank) should be clear. Clarity will protect both the central bank and the stakeholders seeking to hold the central bank responsible for failure to procure financial stability and any ensuing losses. In England, for example, legal action was brought against the BOE for alleged failures in its legal duties.[39] It is not impossible that individuals or public interest groups may seek similar redress against other central banks for failure to perform their functions.

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[36] See *Reserve Bank Act 1959* (Cth) ss 24-5.

[37] Organisation for Economic Co-operation and Development, *The Governance of Regulators: OECD Best Practice Principles for Regulatory Policy* (OECD, 2014) 15.

[38] Ibid.

[39] See *Three Rivers District Council v Governor and Company of the Bank of England (No 2)* [1996] 2 All ER 363; *Three Rivers District Council v. Governor and Company of the Bank of England (No. 3)* [2000] 3 All ER 558; See Johann J de Jager, ‘Three Rivers District Council v Governor and Company of the Bank of England: A Red Flag or a Red Herring for Bank Supervisors in South Africa’ (2001) 13(4) *South African Mercantile Law Journal* 531; See Tom Howe and Andrew Berger, ‘Misfeasance’ [2012] (98) *Legal Briefing* <http://ags.gov.au/publications/legal-briefing/br98.html>; See also Mark Aronson, 'Misfeasance in Public Office: A Very Peculiar Tort' (2011) 35(1) *Melbourne University Law Review* 1.

A definition of financial stability also has technical importance for persons engaged professionally in financial stability, including economists, academics and experts employed by central banks and other mandated institutions. Without a definition and without conceptual clarity, they may find it hard to develop 'useful analytical frameworks' that can be used to examine financial stability policies.[40] For example, the 'definition of financial stability has obvious impacts on the scope of the financial stability [report]' of a central bank.[41]

Lastly, a clear definition may on its own *further the goal of achieving financial stability*, especially if it adds *transparency* to the actions of the regulator, such as a central bank. For example, a central bank responsible for financial stability may give an indication of what it considers to be signs of instability[42] by what it includes in its definition of financial stability, and stakeholders may therefore be able to infer from this definition when the central bank is likely to intervene to prevent financial instability.[43]

2 *Societal (Public) Importance*

From the perspective of the Australian government, clarity in definition is not only important for the reasons cited above, but also for the ability of the government to justify its own actions in the furtherance of financial stability. Financial stability is in the national interest of Australia,[44] and also constitutes an international

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[40] Garry J Schinasi, 'Defining Financial Stability' (Working Paper No 04/187, IMF International Capital Markets Department, October 2004) 3 <https://www.imf.org/external/pubs/ft/wp/2004/wp04187.pdf> ('Defining Financial Stability').

[41] 'The broader the definition of instability, the more potential threats to stability (and the longer the report)': Čihák (n 6) 13.

[42] Smaga (n 14) 14.

[43] Ibid.

[44] See Louise Parsons, 'Regulating Australia's Financial Stability in the National Interest', in John H Farrar, Mary Hiscock, & Vai Io Lo (eds), *Australia's Trade, Investment and Security in the Asian Century* (World Scientific, 2015) 251.

public good,[45] warranting a definition. Financial stability is important from a public policy perspective,[46] and a lack of stability may justify government intervention in the economy. Intervention may be dependent on when a certain definitional threshold is met. In capitalist, market-based economies, government intervention in the markets can be met with public resistance,[47] and a definition of financial stability may be of assistance. As financial stability is in the national interest of Australia,[48] and also constitutes an international public good,[49] clarity in definition is also important for the Australian government to justify its own actions in the furtherance of financial stability, if needed.

3 *General Regulatory Importance: The Advantages and Disadvantages of a Definition of Financial Stability*

Conceptual clarity about what financial stability is, is advantageous for the accountability of the regulatory agency (such as the RBA) to its public stakeholders, including the general public and national and international financial market participants. In the absence of conceptual clarity and a definition, different stakeholders and interest groups may interpret the concept of financial stability differently, and they may hold different views as to whether the RBA or the government has properly fulfilled its duties in relation to Australia's financial stability. For example, the general public may equate financial stability to economic prosperity, growth, price stability, stable inflation and/or low interest

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[45] Financial stability is a public good: Hilary J Allen, 'Putting the "Financial Stability" in Financial Stability Oversight Council' (2015) 76(5) *Ohio State Law Journal* 1087, 1152 ('Putting Financial Stability in the FSOC'). If a public good is only defined as such because it is something that can only be provided by public institutions, then financial stability may not be a true public good if it can be provided by the private market: See Alon Harel, *Why Law Matters* (Oxford University Press, 2014), 2.

[46] Čihák (n 6) 2.

[47] President Obama for example promised the US public that after the GFC there would be no more bail-outs. See Frank James, 'Obama: Financial Bill Means "No More… Bailouts, Period"', *The Two-Way* (Blog Post, 15 July 2010) <https://www.npr.org/sections/thetwo-way/2010/07/15/128549117/obama-financial-bill-means-no-more-bailouts-period>.

[48] See Parsons (n 44).

[49] Financial stability is a public good: Allen, 'Putting Financial Stability in the FSOC' (n 45) 1152.

rates. The financial markets may equate financial stability to the absence of shocks to the financial system, or an absence of bank failures. Each of these stakeholders may, if there is no settled definition of financial stability, hold their own views as to the precise meaning of the concept, the mandate of the RBA and also its purpose/objectives in safeguarding financial stability. Whether or not the regulatory agency such as the RBA then has succeeded in achieving its objectives, will depend on the meaning each stakeholder has of what financial stability is. Formal conceptual clarity will be of assistance.

A formal definition of financial stability can however create some regulatory difficulties. If the definition of financial stability does not cover specific events, the responsible regulator may not be empowered to act. A definition that allows for flexibility in interpretation would therefore be preferred. A fixed definition of financial stability could also lead to potential moral hazard. If a detailed definition of financial stability were for example to give an indication as to when a bailout may likely be provided to illiquid financial institutions, market participants may act accordingly and demonstrate less discipline, relying on liquidity assistance or lender of last resort (LOLR) actions.[50]

Further, defining financial stability can restrict the choices of a regulatory agency. A definition that is too restrictive may also limit the actions that a mandated regulatory agency such as a central bank may wish to take in order to prevent financial instability. Some ambiguity may in effect provide more flexibility to a central bank in times of crisis.[51]

Similarly, a financial stability definition may also hamper the analysis or assessment of economic or financial conditions and a determination of financial instability. It has been argued that[52]

[50] Financial institutions are regulated so as to avoid relying on central bank bail-outs.

[51] Smaga (n 14) 14.

[52] Ibid 19.

> financial stability is such a complex phenomenon, that the lack of a strict scope of the definition leaves the necessary flexibility in its analysis (allows to grasp new forms of instability) and does not limit the spectrum of analysis, making it possible to identify potential sources of risk.

Accordingly, it would be preferable to have a broader, less defined description of financial stability if it will allow for a larger variety of financial conditions to be classified as 'financial stability' or 'financial instability'.

On balance, it is however useful and important to have a definition of financial stability, even if there is no framework, no set of models, or even no clarity as to the concept of equilibrium, and even if the definition would not be of the type that the discipline of economics would normally 'demand and use'.[53] From a practical, regulatory perspective, it is only when there is clarity as to what financial stability entails that the 'efficacy of financial stability-related standards and practices can be improved'.[54]

III Definitional Difficulties

Financial stability is difficult to achieve, and it is 'difficult even to define'.[55] The difficulties in creating a definition arise from the inherent subject matter, the manner in which the definition is constructed, and also its scope. These will be discussed below.

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[53] Schinasi, 'Defining Financial Stability' (n 40) 4.

[54] Allen, 'What is "financial stability"' (n 20) 931.

[55] Financial stability 'is 'harder yet to measure': Charles A E Goodhart and Dimitrios P Tsomocos, 'Introduction', in Goodhart, Charles A E, and Dimitrios P Tsomocos (eds) *The Challenge of Financial Stability A New Model and its Applications*, (Edward Elgar, 2012) 1; See also: Lars Heikensten, 'The Riksbank and Risks in the Financial System' (Speech, Risk Management Conference, 16 November 2004) <https://www.bis.org/review/r041117b.pdf>: '[T]he concept of stability is slightly vague and difficult to define'; See Allen and Wood, 'Defining and achieving financial stability' (n 5) 1; See also generally Schinasi, 'Defining Financial Stability' (n 40) 3.

A. A Working Definition of Financial Stability

It is useful to start the discussion of the definitional difficulties by providing a preliminary working definition of financial stability. The term ‘financial stability’ will generally be used in accordance with the meaning as per this working definition in the balance of this thesis:

> **Working definition** -
>
> Financial stability describes the conditions in the financial system when funds flow in such a manner that productive investment opportunities can be utilised without disruption for the benefit of society at large.

The working definition was created based on the following two definitions of financial stability. The first is that of former central banker and economist Frederic Mishkin,[56] who described financial stability as follows: [57]

> Focusing on information problems leads to a definition of financial instability: *Financial instability occurs when shocks to the financial system interfere with information flows so that the financial system can no longer do its job of channeling (sic) funds to those with productive investment opportunities.* Indeed, if the financial instability is severe enough, it can lead to almost a complete breakdown in the functioning of financial markets, a situation which is then classified as a financial crisis.

[56] Anatolyevna and Ramilevna (n 20) 856.They cite Mishkin: Frederic S Mishkin, ‘Global Financial Instability: Framework, Events, Issues’ (1999) 13(4) *Journal of Economic Perspectives* 3 (‘Global Financial Instability’).

[57] Mishkin, ‘Global Financial Instability’ (n 56) 6 (emphasis unchanged).

The second definition is one recently proposed by lawyer and academic Hilary Allen,[58] who adopts a more legal/regulatory approach. According to Allen, financial stability means[59]

> a state of affairs wherein (1) financial institutions and markets are able to facilitate capital intermediation, risk management and payment services in a way that enables sustainable economic growth; (2) there is no disruption to the ability of financial institutions or markets to carry out such functions that might cause harm to persons (wherever they may be resident) who are not customers or counterparties of those financial institutions, nor participants in those financial markets; and … financial institutions and markets are able to withstand economic shocks (such as the failure of other markets and institutions, or a chain of significant losses at financial institutions) so that … there will be no disruption to the performance of the functions … and … no harm will be caused to the persons set forth [above].

B. Financial Stability as a Possible Contradiction in Terms

Firstly, financial stability cannot and should not be interpreted to mean a fixed state. In fact, financial *stability* may be a misnomer, and even a contradiction in terms, especially when the concept is broken down into its constituent parts,[60] namely 'financial' (or 'finance'), and 'stability'. Finance by its very nature requires excesses and shortages (ie instability). There has to be an excess on the one side (savings) and a shortage on the other (investment opportunities) for finance to work. Similarly, the concept of 'stability' presupposes the possibility of movement, change and instability, and is therefore defined by its opposite. The concept of 'stability' cannot exist without the notion of 'instability': stability depends on instability. The concepts finance and stability and the way in which

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[58] See Allen, 'What is "financial stability"' (n 20).

[59] Allen, 'What is "financial stability"' (n 20) 935; and replicated in Allen, 'Putting Financial Stability in the FSOC' (n 45) 1147.

[60] Schinasi points out that before one tries to define financial stability, it is useful to consider some concepts as prerequisites: Schinasi, 'Defining Financial Stability' (n 40) 4.

they impact on the financial stability definition will now be examined in more detail.

1 *The Nature of Finance*

The nature of finance, as an inherently uncertain, trust-based and unstable system, influences the notion of financial stability. To illustrate this point, it is necessary to look at the fundamental characteristics of 'finance'. (It is also important to consider the nature of finance in relation to the scope of a financial stability objective and the narrow or broader interpretations of the concept financial stability – see below.)

(a) Finance, the Financial System and the Importance of Finance

Finance can be defined as 'the system that includes the circulation of money, the granting of credit, the making of investments, and the provision of banking facilities'.[61] In particular, finance is concerned with the allocation of resources, as well as resource management and investment. It allows surplus funds to be used for productive investment opportunities, and therefore involves sophisticated structures of lending and borrowing.

The financial system includes intermediaries and markets that facilitate the flow of funds between lenders and borrowers, and involves financial institutions, instruments and services.[62] The system connects lenders – typically savers –

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[61] 'Merriam Webster Dictionary - 'Finance' (Web Page, 2019) <https://www.merriam-webster.com/dictionary/finance>. Tyree et al describe the financial system as follows: ''The financial system of a country facilitates the flow of funds from savers to borrowers and provides a convenient means to conducting transactions': Alan Tyree, P M Weaver and W S Weerasooria, *Weerasooria's Banking Law and the Financial System in Australia* (LexisNexis, 6th ed, 2006) 3.

[62] 'The financial system is complex, comprising many different types of private-sector financial institutions, including banks, insurance companies, mutual funds, finance companies, and investment banks': Frederic S Mishkin and Stanley G Eakins, *Financial Markets and Institutions* (Pearson 2012) 46. The three key components of the financial system are markets, intermediaries and infrastructure: Peter Černák, 'Assessment and Monitoring of Financial Stability' (Bachelor Thesis, University of Economics Prague, 2008)

with borrowers who spend the money. The flow of funds between these two groups is facilitated by financial intermediaries and the financial markets. Whereas lenders and borrowers connect directly in the financial markets, funding is transferred indirectly through financial intermediaries. The financial system is depicted in Figure 2.1 below.

Figure 2.1 How the financial system works

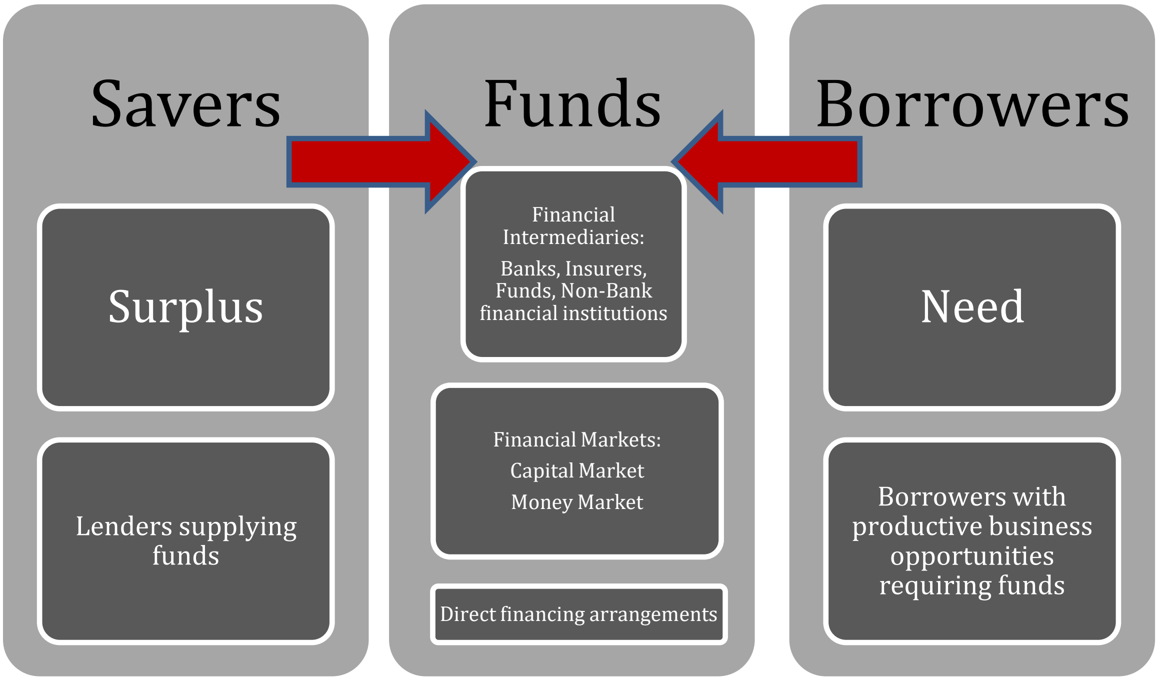

Figure 2.1 The components of the financial system - lenders, borrowers, intermediaries, institutions, markets, products etc

<https://vskp.vse.cz/6860_assessment_and_monitoring_of_financial_stability>. Hudson points out the importance of the history of the word 'finance', meaning 'to end'. In Hudson's view finance is therefore 'concerned with providing a person with the wherewithal to act by means of providing her with sufficient money (or its equivalent) so that she can achieve her goals': Alastair Hudson, *The Law of Finance* (Sweet & Maxwell, 2nd ed, 2013) 7.

Finance is a vital component of modern economics as it enhances 'the private and social benefits of fiat money'[63] and makes economic growth possible.[64] Finance provides a better store of value than fiat money,[65] because finance includes promises to pay and the potential of charging interest. Throughout history, finance has therefore been able to mobilise savings, allocate resources, facilitate investments, provide payments and also mitigate risk. Finance also increases the availability of liquidity, which can be used for consumption, exchange and production,[66] and makes economic growth possible. Finance has resulted in considerably more social welfare gains than what fiat money alone could provide.[67] Finance accordingly provides beneficial services and outcomes that can be classified as both private and public goods.[68]

(b) Key Characteristics of Finance and the Financial System

The three key characteristics of finance that play an important role in conceptions of 'financial stability' and contribute to the difficulties in definitions and descriptions are (i) finance's systemic nature, (ii) its inherent uncertainties and

[63] Schinasi, 'Defining Financial Stability' (n 40) 5.

[64] Ulrich Bindseil, 'Central Banking, Liquidity Risk, and Financial Stability' (Lecture, Technical University of Berlin, Summer 2009) 4.

[65] The current economic system is a system based on money (not on a system of barter). Money nevertheless does not function well as a store of value, even though money (fiat money) is 'universally accepted as the economy's unit of account and means of payment'. It is however a good store of value in 'the very short run or during episodes of financial distress and dysfunctions': See Schinasi, 'Defining Financial Stability' (n 40) 4.

[66] Schinasi, 'Defining Financial Stability' (n 40) 5.

[67] Ibid.

[68] Finance is considered to be a public good. Money however also performs similar public functions: See Brigitte Unger, Daan Van Der Linde, and Michael Getzner (eds), *Public or Private Goods?: Redefining Res Publica* (Edward Elgar, 2017); Financial stability must be treated like a public good, because the financial system is linked to the real economy by providing credit, benefitting both households and businesses: Bill Mitchell 'The Central Bank Must Treat Financial Stability as a Public Good', *Bill Mitchell Modern Monetary Theory* (Blog Post, 29 June 2011) <http://bilbo.economicoutlook.net/blog/?p=15104>.

the fact that it is founded on trust, as well as (iii) its inherent instabilities and propensity for crises.

(i) Systemic Nature of Finance

Unlike the agricultural or manufacturing sectors, finance is a system.[69] It includes intermediaries and markets that facilitate the flow of funds between lenders and borrowers, and involves financial institutions, instruments and services.[70] The fact that finance is a system places a particular slant on the concept of financial stability as it increases the potential for instability, because the stability of a system relies on the stability of both the individual actors/participants and also of their interconnections.

A brief consideration of the realities of the financial system illustrates the complexities involved in determining and defining financial stability. Banks and financial institutions are interconnected through payment systems.[71] Payment systems are typically currency-specific, making them intricately connected.[72] The payments system links participants in a network, and banks and financial institutions channel liquidity 'to the rest of the financial sector and into the economy as a whole'.[73] The systemic aspect of the payments system is further strengthened by the fact that banks and financial institutions directly or indirectly depend on access to central bank liquidity.[74] Lastly, the fact that all participants in a given currency area have confidence in the currency and in the central bank further cements the systemic nature of the financial system.[75]

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[69] The same terminology is not used in other industries – there is for example no 'agricultural system' and no 'manufacturing system'. The systemic nature of finance is however important.

[70] See Černák (n 62).

[71] Tommaso Padoa-Schioppa, 'Central Banks and Financial Stability: Exploring a Land in Between' (Conference Paper, ECB Central Banking Conference, 24-25 October 2002) 6.

[72] Ibid.

[73] Ibid 7.

[74] Ibid 5.

[75] Ibid 7.

(ii) Inherent Uncertainties in Finance and the Need for Trust

Two important features of finance that create uncertainty and a need for trust, and negatively influence financial stability, are firstly, its intertemporal dimension, and secondly, information asymmetry.

The intertemporal dimension of finance is one of its key aspects and introduces questions and issues about trust into transactions.[76] It fundamentally affects notions of stability. Promises to pay in the future (eg promises to repay a loan, as in finance) introduce elements of uncertainty, and therefore trust becomes an issue.[77] Modern finance involves 'human promises to pay back specific amounts of fiat money in the future'[78] and as a substitute for money, provides 'temporary and reversible intertemporal means-of-payment and store-of-value services'. Uncertainty and a lack of trust therefore arise in finance transactions[79] because a promise to repay a loan in finance is different from a cash payment.[80] Trust can be 'fragile',[81] and when trust fails or proves to have been misplaced, or even if

[76] A loan made in the present is repayable in the future. Future payments are uncertain, and loans are therefore generally subject to an examination of the trustworthiness of the borrower.

[77] This occurs in a simple IOU but also in a more complex deposit, investment or credit contract: Schinasi, 'Defining Financial Stability' (n 40) 5.

[78] Ibid. Further, this reflects the relationships between lenders and borrowers, and it reflects that finance provides methods to effect payment at future times.

[79] These are not typical problems when a cash payment is made using fiat money. The only real risk with a cash payment is counterfeit.

[80] Typical risks in finance include default risk, market risk, and liquidity risk. In modern finance the risks that accompany these promises to pay and the level of trust in each transaction are nevertheless mitigated, because they are quantified and priced, but the element of risk remains. Schinasi states that 'modern finance provides societies with effective, albeit imperfect, mechanisms for transforming, pricing, and allocating economic and financial uncertainties and risks': Schinasi, 'Defining Financial Stability' (n 40) 5.

[81] Ibid.

doubts about trust arise, the welfare of individuals, society and the real economy can be negatively impacted.[82]

Although the intertemporal and trust aspects of finance have always been part of finance, some additional risks have developed in recent years, as evidenced in the GFC (see Chapter 3), because of the expansion in finance. Information asymmetries in finance are also problematic for financial stability.[83] Asymmetric information can lead to negative selection and moral hazard[84] that can work against financial stability:[85]

> Information asymmetry is nevertheless a necessary component of the process of the flow of funds from savers to productive investment opportunities. In fact, 'finance arises *due to* information asymmetries, without which there would not only be no crises but also no return for financial intermediaries.

(iii) Inherent Instability and Propensity to Crises

The nature of finance itself as well as its inherent uncertainties are therefore part of the reason that the financial world is prone to crises. Financial crises have been described as 'hardy perennial[s]'.[86] The impact of globalisation and the liberalisation of controls allowing the free flow of capital across borders and rapid financial innovations have further contributed to increased risk in modern finance in a global financial system.[87]

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[82] Examples include the breach of an investment contract and non-fulfilment of payment obligations: Schinasi, 'Defining Financial Stability' (n 40) 5.

[83] Asymmetric information exists in a situation 'when one side does not have accurate information, which leads to wrong selection and/or, in [the] case of a bank [for example], the selection of a borrower prone to risk taking': Vlahović (n 21) 21.

[84] Ibid.

[85] Ibid.

[86] See Robert Z Aliber and Charles P Kindleberger, 'Financial Crises: A Hardy Perennial' in Robert Z Aliber and Charles P Kindleberger (ed), *Manias, Panics, and Crashes: A History of Financial Crises* (Palgrave Macmillan, 7th ed, 2015) 5.

[87] See Gerard Caprio, 'Occupying the Wrong Street? The Social Productivity of the Financial Sector: Some Comments' in Douglas Darrell Evanoff, Cornelia Holthausen, George G Kaufman

As noted above, the notion of *instability* is however inherent in the concept of financial stability. It is the availability of savings (excess) to satisfy the need for funds (scarcity) on the part of producers, ie those with productive opportunities, that create the fundamentals of the financial system. The financial system therefore depends on a lack of balance and some instability to make it work, and therefore finance could not operate if everything was in a fixed state. Economist John Maynard Keynes thought that instability was unavoidable. He noted that[88]

> … apart from the instability due to speculation, there is the instability due to the characteristic of human nature [including] … spontaneous optimism rather than mathematical expectations … [and] animal spirits ….

Similarly, the positive benefits of finance and wealth also require some amount of *risk***,** and risk brings a measure of instability. Financial stability may in fact *require* some risk:[89]

> Risk taking is indeed a necessary condition for the creation of wealth. The ultimate values of all assets rest on their ability to produce goods and services in the future. And the future … is uncertain and hence all investments are risky.

2 *The Nature of Stability and Financial Stability*

'Stability' is a more nebulous and elusive concept than 'finance'. 'Stability' in the context of finance can best be described as one or more point(s) along a *continuum*. The continuum extends from extreme instability and perpetual flux on the one side, to immutable stability or a fixed state on the other side: [90]

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and Manfred Kremer (eds), *The Role of Central Banks in Financial Stability: How Has it Changed?* (World Scientific, 2013) 297.

[88] Thomas Keynes, *The General Theory of Employment Interest and Money* (Macmillan, 1936) 161-2.

[89] Alan Greenspan, 'Opening Remarks' (Speech, Wyoming Symposium on Maintaining Financial Stability in a Global Economy, 28–30 August 1997); Pawel Smaga, 'Assessing Involvement of Central Banks in Financial Stability' (Policy Paper, Centre for Financial Stability, 23 May 2013) 19 <http://www.centerforfinancialstability.org/research/Assessing_052313.pdf>.

[90] Schinasi, 'Defining Financial Stability' (n 40) 8.

> Since the financial system is in a perpetual state of flux and transformation, the concept of financial stability does not refer to a single, sustainable position or time path to which the financial system returns after a shock, but rather a range or a continuum. This continuum is multidimensional: it occurs across a multitude of observable, measurable variables that can be used to quantify (albeit imperfectly) how well the financial system is performing its facilitative functions.

Similarly, financial stability is a phenomenon involving the concept of equilibrium.[91] Although the notion of ‘equilibrium’ invokes a state of ‘stability’, it does not refer to a fixed and permanent state. In the context of financial stability, then, stability more accurately refers to a specific quality of a state of affairs that is variable by its very nature.[92] Stability can only mean that the variations will be within certain (usually narrow or predicted/predictable) parameters.[93]

A good way to look at the need for ‘stability’ in an area which is inherently ‘instable’, is to consider defining the parameters within which instability will be acceptable. Certain ‘boundaries’ could be defined beyond which an unacceptable level of financial instability will exist. This may be a way to solve the definitional conundrum. Such a conceptualization is not dissimilar from the concept of the ‘snake in the tunnel’, being the way in which currency exchanges were described and regulated after the Second World War.[94] It is also similar to the concept of

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[91] This economic model for the analysis of financial stability was created by Goodhart and Tsomocos. See Goodhart and Tsomocos, (n 55) 1. For example, a model for financial stability has been based on the ‘canonical General Equilibrium with Incomplete Markets (GEI) model’. See Tsomocos, (n 15) 61.

[92] See Bindseil, (n 64).

[93] This description of stability is reminiscent of the analogy of the ‘snake in the tunnel’ approach – see below.

[94] See Roy Jenkins, *European Diary 1977-1981* (Collins, 1989). The snake in the tunnel concept was used to describe efforts to stabilise currency fluctuations in the European Monetary Union. ‘Under this mechanism, Member States' currencies could fluctuate (like a snake) within narrow limits against the dollar (the tunnel) and central banks could buy and sell European currencies, provided that they remained within the fluctuation margin of 2.25%’: Angelos Delivorias, *A History of European Monetary Integration* (Briefing, March 2015) 3 <http://www.europarl.europa.eu/RegData/etudes/BRIE/2015/551325/EPRS_BRI(2015)551325_EN.pdf>. See also Étienne Deschamps, ‘The European Currency Snake’, *CVCE* (ePublication, 8 July 2016) <https://www.cvce.eu/content/publication/1997/10/13/d4f8d8aa-a518-4e56-9e19-957ea8d54542/publishable_en.pdf>.

price stability, which in many countries, including Australia, is defined by virtue of an inflation target, which is expressed as a range.[95] Such a model could be an economic model, or merely a descriptive model incorporating the type of parameters described in Hilary Allen's definition.[96]

In conclusion, from the analysis of the components of the concept 'financial stability', it is clear that some level of instability is inherent in *both* the concepts of 'finance' and 'stability'. Defining financial stability, when instability is an inherent part of it, poses some fundamental difficulties.

C. The Unclear Scope of Financial Stability

It is not only the definitional uncertainty that results from an inherent instability that makes it difficult to define or describe financial stability. There is also a fundamental uncertainty about what the scope of financial stability is.

Financial stability can be construed narrowly or broadly. At its *narrowest*, financial stability can refer to the stability of only some institutions within the financial system, such as banks, and may be equated with an absence of liquidity problems within those institutions, or an absence of banking crises. At its *broadest*, financial stability can refer to broad economic stability and prosperity and can be construed to mean continued and predictable economic prosperity and growth. The scope of 'financial stability' would under this definition extend beyond the institutions, markets, systems and instruments that make up the financial system.

From a regulatory perspective, the approach taken with the definition has an important implication for the regulatory agency responsible for financial stability, eg the central bank, because answers to the question as to whether or not the

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[95] See for example Reserve Bank of Australia, 'Inflation Target', *Reserve Bank of Australia* (Web Page) <https://www.rba.gov.au/inflation/inflation-target.html>.

[96] Allen, 'What is "financial stability"' (n 20) 935; and replicated in Allen, 'Putting Financial Stability in the FSOC' (n 45) 1147.

regulator has achieved its task of procuring financial stability will be different depending on whether financial stability is defined with a broader or narrower focus. This problem of the scope of the financial stability definition arises because there is no widely accepted model or analytical framework with which to assess financial stability.[97]

The effect of the uncertainty of the scope of the definition therefore needs examination as it is one of the main difficulties in defining financial stability.[98]

1 *A Narrow Scope*

When understood narrowly, 'financial stability' refers to stability in the financial system that involves financial transactions, including payments in and investment of money through transactions between lenders and borrowers, and investors and sellers. In short, it could simply mean the absence of a bank run,[99] or the absence of a crisis in the *financial* sector,[100] as opposed to other sectors of the economy. The narrow view is the prevalent view of financial stability.[101]

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[97] Schinasi, 'Defining Financial Stability' (n 40) 3.

[98] See Čihák (n 6) 10; See also Schinasi, 'Safeguarding Financial Stability' (n 2).

[99] A 'bank run', or 'run on the bank' occurs when a large number of bank depositors withdraw their deposits (in cash, or cash equivalents) resulting in the financial institution not being able to repay all deposits claimed on demand, or at all (becoming insolvent). It is the consequence of the factional reserve banking system. To combat the risk of a run on the bank, banks hold assets that can be liquidated quickly and at a predictable return, such as gold and government bonds.

[100] 'The definition of financial stability is, in general, more controversial. What it generally means is the joint stability of the key financial institutions operating within financial markets and the stability of those markets. For the financial institutions, this generally means that they are sound, meaning they have sufficient capital to absorb normal, and at times abnormal, losses and sufficient liquidity to manage operations and volatility in normal periods of time': Garry J Schinasi, 'Responsibility of Central Banks for Stability in Financial Markets' (Working Paper No 03/121, International Monetary Fund, June 2003) 4 ('Responsibility of Central Banks').

[101] A study completed in 2013 of 27 definitions of financial stability definitions confirmed that the concept financial stability in those definitions was mostly used in this narrower sense. See Smaga (n 89); See also Vlahović (n 21).

(a) Financial Stability Versus Financial System Stability

The issue of the scope of financial stability is complicated by the fact that the terms 'financial stability' and 'financial system stability' are sometimes used interchangeably, and ostensibly synonymously.[102] As there is a difference between 'finance' and the 'financial system', it cannot be assumed that the terms 'financial stability' and 'financial system stability' are necessarily synonyms, even if the narrow scope of the definition of financial stability is adopted. 'Finance' refers to broad and general practices of capital intermediation, ie of borrowing and lending, while the 'financial system' refers to the 'institutional units and markets that interact, typically in a complex manner, for the purpose of mobilizing funds for investment and providing facilities, including payment systems, for the financing of commercial activity'.[103] The financial system therefore involves money, financial contracts, financial markets and financial intermediaries.[104] Even though the concept 'financial system stability' is therefore concomitantly narrower in scope than 'financial stability', the difference in meaning has sometimes been ignored, and financial stability has at times simply been equated to financial system stability.

In Australia, the tendency at the level of the RBA and the government appears to be to consider financial stability narrowly. For example, the RBA's description of financial stability on its website makes reference to the 'financial system', without clarification of the meanings of the terms 'financial system' or 'financial system stability'.[105] The *RBA Act* also refers to financial system stability without defining

[102] See for example the RBA's definition above.

[103] International Monetary Fund, *Financial Soundness Indicators: Compilation Guide* (Guide, March 2006) <https://www.imf.org/external/pubs/ft/fsi/guide/2006/pdf/fsiFT.pdf> as referenced in Allen, 'What is "financial stability"' (n 20) 944.

[104] The role of money and the role of the financial system are linked. John Stuart Mill considered money to be 'a machine for doing quickly and commodiously, what would be done, though less quickly and commodiously, without it': See Milton Friedman, 'The Role of Monetary Policy' (1968) 58(1) *American Economic Review* 1, 12;See also Bindseil (n 64) 3.

[105] It may therefore possible to conclude that there is no or no significant difference between the concepts financial stability and financial system stability in the eyes of the RBA.

the ‘financial system’ or ‘stability of the financial system’, but the use of the term ‘financial stability’ intimates that a narrower interpretation is required.[106] Similarly, the Murray Inquiry used both the phrases ‘financial stability’ and ‘financial system stability’ effectively synonymously in the context of financial stability, but defined neither.[107] Because of the synonymous use, it is likely that a narrower interpretation of financial stability was adopted.

Limiting the scope of a financial stability definition to what is considered to be ‘the financial system’ and specifically to ‘financial institutions’ based on the type of institution that they are (such as ‘banks’), however, does not reflect modern financial realities. Before the GFC, commercial banks were treated as a special class of institution because they are subject to failures, and are vulnerable to so-called ‘runs’ on banks.[108] During the GFC, however, it became clear that runs causing financial instability were ‘not unique to commercial banks’[109] and it was clear that ‘any intermediary that is subject to maturity mismatch (ie using short-term funding to acquire longer-term assets) can be subject to runs and panics’,[110] including for example so-called ‘shadow’ banks (which include money market mutual funds and securities firms).[111] After the GFC a broader interpretation of financial stability appears to be more reflective of modern realities.

[106] See Chapter 4 below.

[107] Financial System Inquiry, Murray Inquiry Final Report (n 12).

[108] Allen, ‘What is “financial stability” (n 20) 945.

[109] Ibid. Allen refers to Gary Gorton and Andrew Metrick, ‘Regulating the shadow banking system’ (Paper on Economic Activities No 2, Brookings Institute, 2010) <https://www.brookings.edu/bpea-articles/regulating-the-shadow-banking-system-with-comments-and-discussion/>, and to the discussion on the threats that even medium-sized shadow banking entities can pose to financial stability.

[110] Allen, ‘What is “financial stability” (n 20) 945. See also Gorton and Metrick (n 109) 298-9.

[111] Ibid.

2 *A Broad Scope*

Because it has an important social impact, financial stability is also sometimes conceived of more broadly, reflecting its broader public policy goal.[112] Financial stability can also be interpreted broadly because it can have ‘a measurable effect on economic performance (real activity or the rate of inflation)’.[113] Financial stability is important because of its close links with the health of the real economy, and because of the social costs of economic contractions.[114] Financial *in*stability has the effect that ‘innocent bystanders get hurt’.[115] Accordingly, under a broad definition, financial stability is not limited to the financial system and financial institutions, but encompasses a wider range of institutions and extends beyond the financial system, to (sometimes) the entire economy.[116]

A broader definition of financial stability can therefore be justified, and a definition of financial stability should therefore make it clear that persons who are not directly connected to the financial institutions will also be affected by financial instability.[117] A definition that reflects the public policy aspect of financial stability would then demonstrate that[118]

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[112] On public policy see Andrew Crockett, ‘Why is Financial Stability a Goal of Public Policy?’ (1997) 82(4) *Economic Review Federal Reserve Bank of Kansas City* 5 (‘Why is financial stability a goal of public policy?’).

[113] Crockett (n 3) 532. That is the case even though that measurement is not always easy to determine.

[114] Allen, ‘What is “financial stability” (n 20) 946; See also Crockett (n 3), referenced by Allen; See also Janet L Yellen, ‘A Painfully Slow Recovery for America’s Workers: Causes, Implications, and the Federal Reserve’s Response’ (Speech, A Trans-Atlantic Agenda for Shared Prosperity Conference, 11 February 2013) <http://www.federalreserve.gov/newsevents/speech/yellen20130211a.htm>.

[115] Allen, ‘What is “financial stability”’ (n 20) 947; Yellen (n 114).

[116] A broad definition reflects the importance of the link between the financial system and the broader economy that makes financial stability such an important public policy goal. See Allen, ‘What is “financial stability”’ (n 20) 946.

[117] See Allen, ‘What is “financial stability”’ (n 20) 947. See also Hilary J Allen,‘A New Philosophy For Financial Stability Regulation’ (2013) 45(1) *Loyola University Chicago Law Journal* 173, 183.

[118] Allen, ‘What is “financial stability”’ (n 20) 947.

financial stability is concerned with the externalities of financial system failure suffered by persons, not because of their relationships with financial institutions, but as a result of the broad economic contractions that flow from financial crises.

As financial *in*stability extends beyond the financial system into the broader economy, and has a negative effect in the real economy,[119] policymakers and governments may therefore adopt a broader definition of financial stability including political purposes.

Although a broad definition may be attractive because it reflects the undeniable public policy implications of financial stability, from a regulatory perspective it presents difficulties. It results in there being almost no distinction between the financial system and the economy as a whole, and financial stability simply becomes equated to macroeconomic stability.[120] In a very broad definition, the unique role of financial institutions and the financial sector, and the specific importance of financial regulation, are disregarded. Fundamentally, the key issue that financial stability is concerned with cannot be disregarded in the definition, and that is 'the ability of financial institutions to cause negative externalities for consumers and taxpayers in a way that non-financial institutions generally do not'.[121]

Further, an overly broad definition of financial stability would result in financial stability regulation 'swallowing up the entire economy',[122] and non-financial institutions may also have to be made subject to forms of financial regulation, including prudential regulation. There should be some 'demarcating line between

[119] See Crockett (n 3) 531.

[120] Allen, 'What is "financial stability"' (n 20) 944. Allen cites Alan S Blinder, 'It's Broke, Let's Fix It: Rethinking Financial Regulation' (2010) 6(4) *International Journal of Central Banking* 277, 278-79.

[121] Allen, 'What is "financial stability"' (n 20) 944.

[122] Ibid.

institutions that populate the financial system, and the broader economy'[123] even if it is not clear where to draw that line.[124]

A broad definition can also result in regulatory difficulties for the regulator itself. A very broad definition will likely use mostly theoretical, hardly measurable concepts. This will have an adverse effect on the clarity and transparency of financial stability as a policy objective.[125] It will also be difficult to put such a definition into practical, operational use.[126] It may also create difficulties for a regulator with a national focus if the ambit of financial stability involves broad cross-border considerations. Ultimately, a broad definition can adversely affect the clarity and transparency of financial stability as a policy objective and hinder working out an operational version of the definition, which could be used practically by the central bank. [127]

D. Methodological Difficulties in Creating a Definition of Financial Stability

In addition to its inherent nature and scope, methodological difficulties also make the concept 'financial stability' elusive.

[123] Ibid 945.

[124] Ibid.

[125] Smaga (n 89) 14-15.

[126] Ibid.

[127] Ibid.

1 *Defining Financial Stability by its Opposite: Instability*

Financial stability is often defined by reference to the opposite – financial *in*stability[128] or 'avoiding financial crises'[129] and examples of *in*stability, as the latter is more easily recognisable.[130]

(a) A Range of Different Interpretations of Financial Instability

Using financial instability as a point of departure however does not lead to a generally recognized or accepted definition of financial stability as there are still different views as to what financial instability is.[131] For example, financial instability has been described in terms of the financial system being fragile, and not able to withstand 'normal' shocks.[132] It has also been described as the financial system being unable to do its job of channelling funds towards productive investment opportunities because of shocks interfering with information flows.[133] It has also been described as a situation in which the means

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[128] Crockett notes that '[m]uch writing on the subject of monetary and financial stability has been from the perspective of the causes and consequences of *instability'*: Crockett (n 3) 531.

[129] Schinasi, 'Responsibility of Central Banks' (n 100) 4. See Allen and Wood, 'Defining and achieving financial stability' (n 5) 5, 11.

[130] Crockett notes that this is not unlike the process in medicine, where pathology helps to understand physiology: 'In finance, as in medicine, pathology is a powerful tool for understanding physiology': Crockett (n 3) 531.

[131] Different views reflect different theoretical underpinnings and/or different historical perspectives.

[132] For example, Borio and Drehmann, both senior economists at the BIS, describe financial instability as 'a situation in which normal-sized shocks to the financial system are sufficient to produce financial distress; it is therefore a situation in which the financial system is "fragile"': Claudio Borio and Mathias Drehmann, 'Towards an Operational Framework for Financial Stability: "Fuzzy" Measurement and Its Consequences' (Working Paper No 284, Bank for International Settlements Monetary and Economic Department, 11 June 2009) <https://www.bis.org/publ/work284.pdf>.

[133] Mishkin in 1999 when considering financial instability focussed in particular on how the key function of the financial system is the 'channeling *(sic)* funds to those individuals or firms that have productive investment opportunities'. He noted that '[i]f the financial system does not perform this role well, then the economy cannot operate efficiently and economic growth will be hampered'. Mishkin also defined financial stability by its opposite, financial instability. The role of the financial system in performing the core functions of 'finance' and investment is central to Mishkin's definition: Mishkin, 'Global Financial Instability' (n 56) 3-4. He notes that '[f]ocusing on

of payment are not available at any price,[134] or where both the means of payment and investment opportunities are not available.[135] More fundamentally, financial instability has also been described as economic impairment through fluctuations in asset prices, or when intermediaries are unable to meet contractual obligations.[136] These different approaches evidence a wide range of possible interpretations or emphasis.

(b) Problems Associated with Using Financial Instability as a Starting Point for the Definition

Defining financial stability using financial instability as a starting point or guide is neither very helpful nor ideal.[137] Treating financial stability as meaning the

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information problems leads to a definition of financial instability: Financial instability occurs when shocks to the financial system interfere with information flows so that the financial system can no longer do its job of channeling funds to those with productive investment opportunities. Indeed, if the financial instability is severe enough, it can lead to almost a complete breakdown in the functioning of financial markets, a situation which is then classified as a financial crisis': at 6. See also Anatolyevna and Ramilevna (n 20) 856, citing Mishkin, 'Global Financial Instability' (n 56) 3.

[134] See for example the work of Allen and Wood. William Allen is an economist and former central banker; Geoffrey Wood is a professor of economics. Allen and Wood, 'Defining and achieving financial stability' (n 5) 6.

[135] Ibid 7. Allen and Wood note that the financial system will be stable 'if there is efficient allocation of savings to investment opportunities'. This is also the approach of Anna Schwartz. She defines a financial crisis with reference to some of the key elements that also appear in definitions of financial instability. 'A financial crisis is fuelled by fears that the means of payment will be unobtainable at any price and, in a fractional reserve banking system, leads to a scramble for high-powered money. It is precipitated by actions of the public that suddenly squeeze the reserves of the banking system…': Anna J Schwartz, 'Real and Pseudo-Financial Crises', in Anna J Schwarz (ed), *Money in Historical Perspective* (University of Chicago Press, 1987) 271, 277. E Philip Davis provides a similarly broad definition. He describes a financial crisis as 'a major collapse of the financial system, entailing [the] inability to provide payments services or to allocate credit to productive investment opportunities': Anatolyevna and Ramilevna (n 20) 856-7, citing E Davis, 'A Typology of Financial Instability' (2001) 2 *Oesterreichische National Bank Financial Stability Report* 92.

[136] Crockett (n 3) 532. In his opinion, financial instability is 'a situation in which economic performance is potentially impaired by fluctuations in the prices of financial assets or in the ability of financial intermediaries to meet their contractual obligations': See also Vlahović (n 21) 22.

[137] The problems that result from defining financial stability by virtue of its opposite, financial instability, has been pointed out more than 20 years ago by a former RBA Assistant Governor (Financial System): J F Laker, 'Monitoring Financial System Stability' [1999] (October) *Reserve Bank of Australia Bulletin* 1. Although in some other areas of law the definition of a concept by

absence of financial instability, is at best a starting point and not sufficient on its own,[138] for the following reasons.

Firstly, financial instability is often associated with *a specific financial crisis*. Accordingly, a definition of financial stability that is based on that specific example of financial instability will be too narrow and overly situation-specific. For example, if a run on a bank by depositors were a definitive characteristic, then the definition of financial stability would or could be 'the absence of bank-runs by depositors'. Such a definition would however have been too narrow to encapsulate the circumstances of the GFC.[139] It would ironically mean that there would have been financial stability by definition before the collapse of Lehman Brothers at the start of the GFC – that was not the case.[140]

Secondly, *risk avoidance* could become the *dominant objective* of financial stability regulation, if the pursuit of financial stability equates to the avoidance of financial instability.[141] Regulators may for example have to move against rapid economic growth in a particular area of the economy, if it could potentially create financial instability. That may undermine normal economic growth and may even be unnecessary.

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virtue of its opposite can be helpful (for example it is easier to define good faith by virtue of the absence of bad faith), that is not always the case with the definition of financial stability.

[138] Ibid 2.

[139] In the GFC, financial institutions failed as a consequence of financial instability, but the ensuing credit crunch caused significant financial instability even in the absence of failed institutions. Government bail-outs (or government facilitated bail-outs) prevented some institutional failures.

[140] Even though Lehman Brothers collapsed because of underlying or latent weaknesses and so-called 'amplification mechanisms' (the seeds of financial instability), those only really became apparent when Lehman Brothers failed. See Allen, 'What is "financial stability"' (n 20) 942.

[141] If policy objectives were simply geared at avoiding financial instability, then policy decisions, analyses, and analytical frameworks could become biased, and both private and social benefits of finance could be sacrificed. See Schinasi, 'Defining Financial Stability' (n 40).

One of the key disadvantages of limiting a definition of financial stability to the absence of financial instability is that it limits the perception of financial stability 'strictly to the lack of [a] financial crisis'.[142] Not every disruption is a financial crisis, because 'asset bubbles can build up and systemic risk can accumulate [even] in the absence of visible signs of … [a] crisis'.[143] If avoiding financial instability were however a general policy objective, economic growth may be detrimentally affected.[144] One of the key social and private benefits of finance – the creation of economic growth – can thereby be lost.

Thirdly, defining financial stability from the perspective of financial instability creates *difficulties for the financial stability regulator*. A definition needs clarity, and '[d]efining "financial stability" with sufficient clarity to guide actions and create a structure for accountability is difficult'.[145] Basing a definition of financial stability on what is construed to be financial instability, may unintentionally focus only on some of the *causes* of financial instability, rather than the concept itself, and may not provide a definition of sufficient generality or clarity.

(c) Advantages of Not Basing a Definition on Financial Instability

Not basing the definition on financial instability has advantages. Such an approach would not limit the concept of financial stability to a single quantitative indicator,[146] as for example the existence of a specific event of instability. It would also be forward-looking,[147] and would not necessarily be influenced by the most recent financial crisis. Lastly, it would recognize that aiming for financial stability

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142 Smaga (n 89) 14-15.

143 Ibid.

144 See Schinasi, 'Defining Financial Stability' (n 40) 3.

145 Ibid.

146 Schinasi, 'Defining Financial Stability' (n 40) 11.

147 Ibid.

will likely involve a trade-off between resilience and efficiency, meaning that at times, systems may be efficient (eg lead to growth) through certain failures (ie a lack of resilience). At other times, resilience should be prioritised over efficiency.

2 *Describing Rather Than Defining Financial Stability*

Providing a description rather than a definition has some practical benefits. The concept is not ring-fenced, but there is still guidance as to whether there is financial stability or not. Buiter suggests four dimensions of financial stability that can be highlighted in a description: 'the prevention and/or mitigation of asset and credit booms',[148] the 'prevention and/or mitigation of funding liquidity crises for systemically important financial institutions (SIFIs) and for the sovereign',[149] the prevention and/or mitigation of market liquidity crises involving markets for systemically important financial instruments,[150] and the prevention and/or mitigation of solvency crises for SIFIs.[151]

Although defining financial stability by using financial instability as a starting point is common and practical, it is not necessarily the best way of defining financial stability. Such definitions are seldom completely objective and ahistoric. The potential influences on definitions of financial stability will now be analysed.

3 *Difficulties Measuring and Modelling Financial Stability*

One way of defining financial stability could be through economic models or mathematical formulae. For example, under the inflation-targeting model, the

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148 Willem H Buiter, 'The Role of Central Banks in Financial Stability: How Has it Changed?' (Discussion Paper No 8780, Centre for Economic Policy Research, January 2012) <https://papers.ssrn.com/sol3/papers.cfm?abstract_id=1988710>.

149 Ibid.

150 Ibid 2.

151 Ibid 1-2. Buiter, a well-known banker and economist, asks: '[F]inancial stability: what is it?' but then does not formulate a definition. Instead, Buiter points to four dimensions of financial stability, thereby adopting a more descriptive approach.

'measure' of successful monetary policy operations is whether the annualised rate of inflation as defined remained within the targeted bands. Although financial stability modelling is not yet fully developed as a discipline, the notion of 'stability' involves discretion, and mathematical and/or numerical terms may be less ideal than descriptive options for legislative purposes.

In any event, quantification of financial stability is difficult. Jeanneau points out that[152]

> even if some elements were quantifiable, multiple trade-offs would nevertheless be faced by policy makers in the absence of a straightforward method for (eg) setting off … Still, some quantification could be useful, wherever possible.

Ultimately, compliance with the financial stability mandate may not be a quantifiable matter but should be judged qualitatively. The problem with financial stability is that (unlike monetary policy) it is 'messy',[153] and financial instability can arise from a range of different, and often unforeseen causes. Financial stability can be influenced by a large number of disparate known (and unknown) factors including bank liquidity, availability of credit, payment systems, consumer protection, even the tax system.[154] The tools of financial stability are wide-ranging, and financial stability can be improved or damaged by a very wide range of (sometimes surprising) issues.[155]

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[152] Ibid.

[153] Luci Ellis, 'Financial Stability and the Banking Sector' (Speech, Sydney Banking and Financial Stability Conference, 12 July 2016) <https://www.rba.gov.au/speeches/2016/sp-so-2016-07-12.html>.

[154] See Luci Ellis, 'Macroprudential Policy: What Have We Learned?' (Presentation, Bank of England Roundtable for Heads of Financial Stability) 16 <https://www.rba.gov.au/information/foi/disclosure-log/pdf/131413.pdf>.

[155] See John Simon, 'Ten Years of Research – What Have We Learnt Since the Financial Crisis?' (Speech, Economic Society of Australia (QLD) and Griffith University Symposium, 7 March 2019) <https://www.rba.gov.au/speeches/2019/sp-so-2019-03-07.html>.

4 *Difficulties Creating Neutral and Objective Definitions*

In principle, definitions, including financial stability definitions, are not entirely objective, a-temporal and ahistoric.[156] They reflect external influences of their time of creation, including the political and intellectual climate. That raises some fundamental difficulties.

Firstly, definitions reflect the times in which they are created. Conceptions of financial stability have changed over time, and definitions of financial stability (and revised definitions of financial stability) can reflect the causes and/or characteristics of the latest financial crisis. That may make it harder to hold regulators accountable if the definition does not fit the current circumstances. Further, if a definition is not neutral, the situation may arise where the criteria of stability inherent in a definition of financial stability may be met, so there may be stability in theory, but in fact there may not be actual financial stability.

The GFC for example had an important influence on perceptions of financial stability. Before the GFC financial instability was effectively equated to instability in the banking system, frequently occasioned by runs on bank and bank failures. Definitions of financial stability before and after the GFC reflect the influence of these events. The RBA's definitions demonstrate similar historical changes. For example, in 1999, the RBA defined financial stability as:[157]

> … in broad terms, … the avoidance of disruptions to the financial system that are likely to cause significant costs to real output.[158]

The post-GFC description of financial stability provided by the RBA on its website (a more detailed version compared to the one quoted above in Part II A 1 above),

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[156] All definitions will likely contain some measure of subjectivity reflective of the subjective circumstances of the author and their historic time.

[157] See Laker (n 137).

[158] See also Crockett, 'Why is financial stability a goal of public policy?' (n 112); See C Kent and G Debelle, 'Trends in the Australian Banking System: Implications for Financial System Stability and Monetary Policy' (Discussion Paper No 1999-05, Reserve Bank of Australia, March 1999) <https://www.rba.gov.au/publications/rdp/1999/pdf/rdp1999-05.pdf>.

references characteristics of the GFC that were shown to have an important effect on financial stability. The extended description post-GFC description reads as follows:[159]

> A stable financial system is one in which financial intermediaries, markets and market infrastructure facilitate the smooth flow of funds between savers and investors and, by doing so, help promote growth in economic activity. Conversely, financial instability is a material disruption to this intermediation process with potentially damaging implications for the real economy. From this perspective, the safeguarding of financial stability can be seen to be a forward-looking task – one that seeks to identify vulnerabilities within the financial system and, where possible, take mitigating action. Some of these vulnerabilities have a macroeconomic dimension, such as changes in the condition of household and corporate sector balance sheets, and developments in credit and asset markets, all of which have the potential to affect the level and distribution of financial risk within the economy. Other vulnerabilities relate to the way in which financial intermediaries and financial market participants price and manage their various risks. In addition, a resilient financial system is one in which there are well developed crisis management arrangements for handling distressed financial institutions in such a way that public confidence in the financial system will not be undermined.

Post-GFC indicators in this definition of financial stability include:

- an emphasis on a smooth flow of funds – in the GFC the inability to obtain and the unwillingness to provide credit in the interbank market created the costly credit crunch. This approach to financial stability differs from the earlier focus on the failure of institutions and the creation of systemic risk;
- an enlargement of the perceived risks to financial stability to include a large array of vulnerabilities, which are not limited to the liquidity or solvency of financial institutions only;
- an acknowledgement of the potentially destabilising effects of the mis-pricing of risk – reminiscent of the problems experienced during the GFC

[159] Reserve Bank of Australia, ‘About Financial Stability’ (Web Page, 2019) <https://www.rba.gov.au/fin-stability/about.html>.

with the inaccurate valuation of complex financial products by credit rating agencies; and

- a reference to the availability of crisis management. After the GFC, for example, 'living wills' and individual resolution plans were developed for the unwinding of large complex institutions, as one of the methods of resisting moral hazard arising from organisations that are too big to fail (TBTF) and that relied on and expected public financial assistance.[160]

These characteristics demonstrate how a definition of financial stability can be influenced by the time in which it is created and by the understanding of financial stability at that time.

Secondly, apart from evidencing temporal influences, definitions of financial stability can also reflect specific underlying economic theories. For example, a monetarist approach will likely emphasise the link between monetary conditions and financial stability. In monetary economics 'an excess demand for money which the central bank in its capacity as lender of last resort had an obligation to relieve'[161] was viewed as 'a central feature of financial crises'.[162]

Thirdly, definitions are often also subjective and contextual. For example, central bank definitions appear to be generally narrower than government definitions of financial stability.[163] Further, although definitions of financial stability display similarities, there are also differences in emphasis, and differences indicative of the specific approach of the author of the definition.[164] Different definitions can

[160] See further Chapter 3.

[161] See David Laidler, 'Financial Stability, Monetarism and the Wicksell Connection' (Working Paper No 2007-3, Economic Policy Research Institute, 2007) <https://ir.lib.uwo.ca/cgi/viewcontent.cgi?referer=https://www.google.com/&httpsredir=1&article=1041&context=economicsepri_wp>. Laidler references differences between monetary economics and Wicksellian economics.

[162] Ibid.

[163] Smaga (n 89) 15-17. Central banks do not appear to focus very much on the 'crisis' element.

[164] See Smaga (n 89).

reflect the subjectivity of the unique characteristics of national financial systems; globalization and liberalization of financial markets have not removed all national differences.[165] It may be impossible to formulate a single universally accepted definition because of national differences, and in view of the fact that different views may be taken on what constitutes a financial crisis (ie definitions demonstrate specific temporal and other biases).[166]

Finally, financial stability is multi-dimensional, and different definitions emphasise different dimensions.[167] These characteristics of financial stability definitions have important practical and regulatory implications, particularly for the accountability of institutions charged with the protection of financial stability.

IV Conclusion

This chapter has demonstrated how financial stability is an elusive concept. It is therefore not straightforward to make 'financial stability' the objective of a regulatory agency. There are methodological difficulties in determining what such an objective entails, and the exact nature and scope of financial stability can vary. Economics is also still grappling with the notion of financial stability, and therefore financial stability cannot be easily measured. Further, financial stability can be interpreted narrowly or broadly. In any event, financial stability may even be something of a misnomer, given that in principle both the concepts of 'finance' and 'stability' presuppose and require instability, thereby creating difficulties when financial stability is included in the mandate of a regulatory agency such as a central bank.

[165] Ibid, 14-15.

[166] This conclusion is based on an analysis of the work of Smaga.

[167] As referred to by Serge Jeanneau, 'Financial Stability Objectives and Arrangements – What's New?' in M S Mohanty (ed) *The Role of Central Banks in Macroeconomic and Financial Stability* (BIS Papers, No 76, February 2014) 48 <https://www.bis.org/publ/bppdf/bispap76.pdf>.

The definitional difficulties cannot be ignored from a regulatory perspective, as:[168]

> "financial stability" alone as an objective leaves wide open the important questions of how much stability is desired, in what elements of financial system behaviour it is desired, and at what expense with respect to other policy concerns.

Defining financial stability therefore matters from a regulatory point of view. When there is a 'heightened need for accountability in financial stability actions', clear objectives play a 'special role' in accountability.[169] Defining what is meant by the term financial stability may be one of the key issues when setting objectives for financial stability for a regulator. A definition of financial stability is also important for effective governance and accountability mechanisms for the RBA. At the most basic level, what the RBA is required to do, and whether it has achieved those objectives, require clarity. The fact that the concept is uncertain makes it a difficult object of a regulatory mandate and objective.

[168] Ibid 47-8. Although there are some definitional difficulties in relation to monetary policy, these have largely been overcome by the inflation targeting model.

[169] See Bank for International Settlements, *Central Bank Governance and Financial Stability* (Report, May 2011) <http://www.bis.org/publ/othp14.pdf> ('Ingves Report').

CHAPTER 3

Central Banks and Financial Stability Responsibilities after the GFC

Bagehot 's principal message is that the first task of a central bank during a financial panic is to end the panic.[1]

In times of crisis, a central bank should lend freely against good collateral at high rates.[2]

As the lender of last resort to the financial system – the economic equivalent of the US Cavalry – central banks invariably find themselves at the scene of financial disasters.[3]

I. Introduction

The analysis of the unique nature of central banks in this chapter demonstrates how the existing characteristics and roles of central banks as institutions impact on their roles in financial stability, and on the regulation of that role.[4] Mandating

[1] Richard G Anderson, 'Bagehot on the Financial Crises of 1825...and 2008' (2009) 7 *Economic Synopses* 1.

[2] This is a paraphrase of Bagehot's formula. Vincent Bignon, Marc Flandreau and Stefano Ugolini, 'Bagehot for Beginners: The Making of Lender of Last Resort Operations in the Mid-Nineteenth Century' (2012) 65(2) *Economic History Review* 580.

[3] Paul Tucker, *Unelected Power: The Quest for Legitimacy in Central Banking and the Regulatory State* (Princeton University Press, 2018), 7.

[4] This chapter reflects research that was also conducted and published before and during the candidature for this PhD, in particular the following publications: John H Farrar and Louise Parsons, 'Financial Stability After the Global Financial Crisis: Globalisation, Nationalism and the Potential Demise of a Rules-Based Order' in John H Farrar, Bee Chen Goh and Vai Io Lo (eds), *Scholarship, Practice and Education in Comparative Law: A Festschrift in Honour of Mary Hiscock* (Springer, forthcoming); Louise Parsons, 'Domestic Regulatory Architecture for the

a central bank with financial stability is complex. The experiences and lessons of the GFC, however, have largely cemented the view that central banks *are* – alternatively *should be* – responsible for financial stability, notwithstanding the challenges identified.[5]

Part II A of this chapter deals with the sui generis nature of central banks that is rooted in their history. Part II B examines how the unique nature of central banks is influenced by the fact that they are statutory bodies and operate subject to a mandate or charter, as agents of government (or perhaps as trustees or guardians[6]) with important public policy objectives. Nevertheless, central banks are generally intended to be independent and free from political influence. They characteristically have wide discretion and powers, extending beyond banking and monetary policy. Further, central banks can make financial and/or economic policy that can affect the economy of a whole country. The democratic deficit of their powers has accordingly been critiqued, particularly in respect of monetary policy and their role as LOLR (see Part II B 2). The LOLR function is arguably the most significant financial stability tool of central banks, and that ability, combined with central banks' unique expertise and system-wide view, make central banks well-suited to play a lead role in financial stability.

Protection of Financial Stability after the GFC: Global Order or Disorder', in Leon Wolff and Danielle Ireland-Piper (eds), *Global Governance and Regulation: Order and Disorder in the 21st Century* (Routledge, 2018) 147; Louise Parsons, 'Regulating Australia's Financial Stability in the National Interest' in John H Farrar, Mary Hiscock, and Vai Io Lo (eds), *Australia's Trade, Investment and Security in the Asian Century* (World Scientific, 2015) 251; Louise Parsons, 'Developments in Central Banking after the GFC: Central Banks, the State, Globalisation and the GFC' in John H Farrar and David G Mayes (eds), *Globalisation, the Global Financial Crisis, and the State* (Edward Elgar, 2013) 218; John H Farrar and Louise Parsons, 'Globalisation, the GFC and Paradigm Shift' (2013) 32(12) *Banking & Financial Services Policy Report* 14; John H Farrar and Louise Parsons, 'Globalisation, the Global Financial Crisis and the Reinvention of the State' (2012) 24(2) *Singapore Academy of Law Journal* 367. It also builds on the research for an earlier publication: John H Farrar, Louise Parsons and Pieter I Joubert, 'The Development of an Appropriate Regulatory Response to the Global Financial Crisis' (2009) 21(3) *Bond Law Review* 1.

[5] See Louise Parsons, 'Developments in Central Banking after the GFC: Central Banks, the State, Globalisation and the GFC' in John H Farrar and David G Mayes (eds), *Globalisation, the Global Financial Crisis, and the State* (Edward Elgar, 2013) 218 ('Developments in Central Banking').

[6] See Tucker (n 3) Chapter 4.

Part III analyses the historical importance of the GFC in cementing the role of central banks in financial stability. It does so by considering the role of central banks during and after the GFC (Part III A), in particular the addition (or accentuation) of a financial stability mandate (Part III B).

These characteristics of central banks raise particular challenges for their roles in financial stability: they are uniquely independent but have public policy objectives; they are currency and monetary policy authorities; they are regulatory agents; they are also banks (Part III B). Their independence flows from their monetary policy and currency issuing obligations, but the high level of independence enjoyed generally by central banks may conflict with financial stability obligations.

This chapter provides important background and context for the analysis of the RBA as a central bank with a financial stability responsibility that is undertaken in Chapters 4 and 5.

II. Central Banks are Unique Institutions

Central banks are unique institutions. In brief, they act as agents of government, but also as the banker of banks, and (with the exception of central banks in economic unions such as the European Union) there is only one central bank per country. They are uniquely powerful entities, 'as guardians of monetary stability (and financial stability) and dictate price levels, influencing the level of risk-taking in the economy'.[7] Monetary policy decisions, as well as many other central bank functions,[8] impact everyone in the country. Some key characteristics related to this thesis are discussed below.

[7] Charles Goodhart and Rosa María Lastra, *Central Bank Accountability and Judicial Review* (Policy Note No 32, May 2018) 3 <https://www.suerf.org/policynotes/2585/central-bank-accountability-and-judicial-review/html>.

[8] Such as the issuing of notes and coin and ensuring the availability of physical currency, as well as the domestic and international value of the currency.

A. Central Banks are Sui Generis Institutions

Central banks are sui generis institutions. Their unique nature is derived from their history, origin and roles.

1 *The Nature of a Central Bank: Origin, History and Roles*

Central banks were not originally expressly created to ensure financial stability. The first central banks were created to fund the government of the day.[9] For example, the Swedish Riksbank, the earliest central bank, was created in 1668 as a joint stock bank. It was authorised to lend funds to the government and also to act as a clearing house for commerce.[10] The BOE was created in 1694 for the purchase of government debt.[11] As these early central banks engaged in banking activities and held deposits of other banks, they became bankers for banks, facilitating transactions between the different banks. These central banks had large reserves, operated 'extensive networks of correspondent banks',[12] and had become 'the repository for most banks in the banking system'.[13] It was a natural

[9] Michael Bordo, 'A Brief History of Central Banks', *Federal Reserve Bank of Cleveland* (Economic Commentary, 7 January 2012) <https://www.clevelandfed.org/newsroom-and-events/publications/economic-commentary/economic-commentary-archives/2007-economic-commentaries/ec-20071201-a-brief-history-of-central-banks.aspx>.

[10] Central banks have also at times been responsible for providing loans to governments to fund government projects, and even war. Some have secondary responsibilities such as maintaining full employment. See Tomas Otahal, 'Rent-seeking Origins of Central Banks: The Case of the Federal Reserve System' (Working Paper in Business and Economics No 8/2011, Model University in Brno, 2011) 1 <http://ideas.repec.org/p/men/wpaper/08_2011.html>; See also Bordo (n 9); See Forrest Capie, Charles Goodhart and Norbert Schnadt, 'The Development of Central Banking' in Forrest Capie, Stanley Fischer, Charles Goodhart, Norbert Schnadt (eds), *The Future of Central Banking: The Tercentenary Symposium of the Bank of England* (Cambridge University Press, 2012) 1 <http://eprints.lse.ac.uk/39606/1/The_development_of_central_banking_%28LSERO%29.pdf>. See also Rosa M Lastra (ed), *International Financial and Monetary Law* (Oxford, 2nd ed, 2015) 50-51.

[11] Bordo (n 9); See also David Kynaston, 'Till Time's Last Sand: A History of the Bank of England 1694-2013' (Bloomsbury, 2017).

[12] Bordo (n 9).

[13] Ibid.

development for them to become lenders of last resort in a crisis.[14] As providing liquidity assistance to banks preserves financial stability, it can be said that central banks in fact *always* had a role in financial stability, even if that role was not expressly part of the central bank's charter.[15]

The role of LOLR further developed in the 1800s, and the now-famous formulation of William Bagehot – that central banks should lend freely to banks with liquidity crises against sound collateral and at a high interest rate – have assisted in avoiding banking crises.[16]

At the turn of the twentieth century, the focus in central banking shifted to maintaining the money supply in accordance with the amount of gold reserves, a form of price stability.[17] In 1913, for example, the United States created the Federal Reserve Bank, ending an era of banking crises in the so-called 'free banking era'.[18]

The shift to 'modern' central banking came in the middle of the twentieth century. Mid-twentieth century central banking was characterised by considerations of inflation and unemployment, and an increase in central bank independence. For example, the *Federal Reserve Act*[19] secured the independence of the Federal Reserve in 1951,[20] and the RBA was created as an independent central bank in 1959.[21] Central bank independence also became very closely linked with the

[14] Ibid.

[15] See Tucker (n 3) Chapter 20.

[16] Bordo (n 9).

[17] Ibid.

[18] Ibid.

[19] *Federal Reserve Act of 1913*, 12 USC

[20] Bordo (n 9).

[21] *Reserve Bank Act 1959* (Cth).

importance of monetary policy in the battle against inflation in the later part of the twentieth century.[22]

Apart from conducting monetary policy, central banks also act as LOLR[23] to financial institutions in liquidity crises, discussed further below. Central banks have often also been the banker to government and it is by definition the banker to other (commercial) banks.[24] Central banks fulfil many other functions as well. Typical central bank functions also include providing and overseeing payment systems,[25] issuing notes and coin, holding foreign reserves, and publishing financial stability reviews. Some central banks are also the microprudential supervisor and are responsible for bank supervision.

Central banks have an important role in crisis management and crisis prevention. They have 'traditionally focused on treating financial crises',[26] with the 'main objective during a financial crisis … to contain the damage and limit the impact on the real economy'.[27] From that perspective, then, central banks have in some way been involved in preventing financial instability.

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[22] See Mario Draghi, 'Central Bank Independence' (Lecture, Lamfalussy Lecture National Bank of Belgium, 5 October 2018).

[23] See Paul Tucker, 'The Lender of Last Resort and Modern Central Banking: Principles and Reconstruction' (Paper, BIS Papers No 79, 2014); Bank for International Settlements, 'Re-thinking the Lender of Last Resort' (BIS Papers No 79, September 2014) 10. It's an important function but the role of lender of last resort could be modernised, as intimated in these sources. See also Lawrence Schembri, 'Stress Prevention: Central Banks and Financial Stability' (Speech, Bank of Canada, International Monetary Fund, Centre for International Governance Innovation and Peterson Institute for International Economics Workshop, 6 May 2016).

[24] See Bank for International Settlements, *Issues in the Governance of Central Banks* (Report, May 2009) 19 <http://www.bis.org/publ/othp04.pdf>; See Otahal (n 10) 1.

[25] Bank for International Settlements, *Central Bank Oversight of Payment and Settlement Systems* (Report, May 2005) <https://www.bis.org/cpmi/publ/d68.pdf>. Payment systems responsibilities were new additions to the task list of central banks and reflect technological advancements and innovations in payments systems.

[26] Vittorio Corbo, 'Financial Stability in a Crisis: What is the Role of the Central Bank?' (BIS Paper No 51, Bank for International Settlements, March 2010), 27.

[27] Ibid.

2 *Central Banks are Mandated Institutions*

Central banks act on government authority, as agents for government with (mostly) a formal mandate. The government provides a central bank with its powers and objectives through its regulatory framework. Central banks are often 'mandated' or 'chartered' regulatory agencies and are therefore somewhat unique. They have both specific and formal obligations but are generally also independent from government.

Not all responsibilities of government agencies are 'mandates' and not all tasks central banks perform are referred to as 'mandates'. For example, it is not customary to refer to central banks as having a 'mandate' for payment system regulation, or a 'mandate' to issue currency.[28] The monetary policy role of the central bank is however generally referred to as a 'mandate', and it is often considered to be the defining or key central bank 'mandate'. Any additional or new 'mandate', such as a financial stability mandate, will impact on existing mandates, and vice versa.

The concepts 'charter' and 'mandate' have not received much academic consideration, even though they are frequently used academically, professionally and in the media to describe the way in which governments have allocated responsibilities to central banks.[29]

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[28] The note printing function is more likely to be referred to as a 'monopoly'. Even though the central bank may be responsible for money in circulation, the actual design and issue of domestic currency is likely to be subject to the approval of government.

[29] For example, in an article about the RBA entitled 'Our Charter, Core Functions and Values', the word 'charter' is only used in the heading of the piece and is not subjected to any further direct examination: 'Our Charter, Core Functions and Values', *Reserve Bank of Australia*, (Web Page, 2015) <https://www.rba.gov.au/publications/annual-reports/rba/2015/our-charter-core-functions-and-values.html>.

(a) Mandates and Charters in General

A 'charter' can be described as an instrument granted by a sovereign or legislative power that establishes a body politic (such as the United Nations (UN)) or another organization, and/or that grants rights, liberties or powers to citizens or members of a group. It can also refer to an instrument of incorporation (eg of a municipality), or another formal written document that creates an organisational structure, and prescribes its powers, privileges and duties (eg a university or corporation).[30]

Being established by a charter is traditionally a prestigious way of incorporation because it carries the stamp of the sovereign. For example, throughout history, just over 1,000 charters have been granted by the British monarch, with the BOE being one of the earliest recipients of a charter.[31] The BOE originally existed under a 'charter'[32] and still refers to its 'charter' on its website.

In Australia, the *RBA Act* does not expressly provide a 'charter' or 'mandate' to the RBA, but the RBA's 'charter' is generally considered to be contained in s 10(2).[33] The RBA makes reference to its 'charter' in its publications and on its website[34] even though it never had a charter of the same ilk as the BOE's

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[30] See generally Bryan A Garner and Henry Campbell Black, *Black's Law Dictionary* (Thomson Reuters, 10th ed, 2014) 284. The essential characteristics based on this and other descriptions seem to be that the charter is granted in writing by a sovereign and creates, authorises and empowers an entity with rights and privileges.

[31] Privy Council Office, 'Chartered Bodies' *Privy Council Office* (Web Page) <https://privycouncil.independent.gov.uk/royal-charters/chartered-bodies/>.

[32] See *Bank of England Act 1694* 6 Wm & M 1.

[33] 'Our Role', *Reserve Bank of Australia* (Web Page) <https://www.rba.gov.au/about-rba/our-role.html>.

[34] See for example Reserve Bank of Australia, (n 33).

charter.[35] A charter is often used in relation to banks - some modern commercial banks in the US are 'chartered' banks.[36]

The meaning and effect of a mandate is similar to that of a charter and the terms are used interchangeably and synonymously. A mandate can be described as a written command given by a principal to an agent, in which the agent is requested and authorised to act in a certain manner.[37] A mandate can also be an official order, and sometimes allows the mandated agent to not only act on behalf of the principal but also act independently.[38]

Both the words charter and mandate refer to the granting of significant authorities and powers to the central bank by the state. They are therefore also both related to the concept of agency and central banks have been seen to be independent agencies.[39]

It is observed that a mandate/charter can fulfil (at least) two functions:

- It can *authorise* or *empower* the agent to take certain actions; and/or
- It can *compel* or *command* the agent to take certain actions.

It therefore can provide both the '*may*' and '*must*' of the agent's actions, or either one of the two. Not all mandates spell out whether the agent is merely empowered to take certain actions at its discretion, or whether the agent is also compelled to take those actions, leaving the agent no discretion. Importantly, in both senses it likely means that the agent is constrained to acting within the parameters of the mandate/charter.

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[35] See Privy Council Office (n 31). Neither the RBA nor its predecessor, the Commonwealth Bank, was established by a charter under the authority of the British monarch. Rather, both were established purely by the Australian Parliament. It's interesting to note that some banks operating in Australia did in fact have a Royal Charter.

[36] See 'How Can I Start a Bank?' *Board of Governors of the Federal Reserve System* (Web Page, 2 August 2013) <https://www.federalreserve.gov/faqs/banking_12779.htm>.

[37] Garner and Black (n 30) 1105. The term comes from Roman and Civil Law.

[38] Ibid. These seem to be the key characteristics based on a range of descriptions.

[39] See Tucker (n 3) 11. Tucker however considers that the true role of a central bank approaches that of trustee or guardian, more so than that of an agent.

The nature of the central bank's mandate/charter is fundamentally informed by the fact that it is granted by the state. Central banks are usually creatures of statute, as their mandates/charters are provided by the government/state through legislation.[40] A central bank mandate/charter typically includes a goal that needs to be pursued and provides the authority to do so.[41] It still provides the central bank with considerable independence and freedom to set the parameters within which it operates. There can of course be some constraints and not all central banks are equally independent.[42]

Irrespective of whether a central bank's mandate/charter merely empowers or also compels, it effectively allows the central bank to make and implement public policy, giving central banks considerable freedom and independence.

(b) Relationship between Mandates/Charters and Central Bank Independence

The concept of a mandate/charter is fundamental to central bank independence, and central bank independence is closely linked to it having a mandate/charter. Having a mandate implies that the central bank has the authority to make decisions independently,[43] and it essentially gives the central bank freedom,

[40] 'Given that central banks are created by government legislation and derive their powers from such legislation, they cannot be completely separate from the government': Bernie W Fraser, 'Central Bank Independence: What Does It Mean?' (Speech, SEANZA Central Banking Course, 23 November 1994) <https://www.rba.gov.au/speeches/1994/sp-gov-231194.html>.

[41] '[G]ive central banks a charter which includes a strong commitment to price stability, and the freedom to pursue it. This does involve the government in setting the goals, but that is the way it should be: central banks cannot expect to determine the goals they should pursue, but they should have adequate scope to pursue the goals that have been set': Ibid.

[42] There is a very large body of literature on central bank independence and the measuring of central bank independence. See for example Alex Cukierman, 'Central Bank Independence and Monetary Policy-Making Institutions: Past, Present and Future' in David Mayes and Geoffrey E Wood (eds), *Designing Central Banks* (Routledge, 2009) 68.

[43] '[C]entral banks with multiple goals have more independence, because they have extra dimensions on which they must make decisions': Fraser (n 40) 4.

albeit within certain parameters. Independence can be seen to be the consequence of being provided with a mandate, and even to some extent a prerequisite of fulfilling that mandate. Central banks are generally intended to be politically independent from government and to not be subject to the direct control of government and its political motives. Central banks are therefore mandated to fulfil public functions for the benefit of a state or nation and despite being granted independence by the state to fulfil that mandate, are still subject to some direction and control by the government. (The independence of central banks is analysed further in Part II B below).

The significant independence of central banks that arises predominantly from the monetary policy function (and historically also from the money printing function) means that they cannot be classified simply as a typical 'agent', because in some instances they are free to create the parameters of their powers.[44] Even though there are some limits on central bank mandates, which may either be expressed in the relevant statute or may be imposed through other forms of regulation such as the inflation-targeting model, the extent of a central bank's independence may exceed that of a regular 'mandated agent'. That means that the nature of the role played by central banks could approach that of trustee or even guardian.[45]

(c) Implications of the Relationship between Central Bank Mandates/Charters and Central Bank Independence

Clarity in the mandate/charter given to a central bank is important because the mandate/charter is the instrument of delegation used by government. The actions of central banks can be judged by the extent to which they comply with their mandate, and their credibility can be affected if their compliance is found to be wanting.[46] For example, the Federal Reserve was heavily criticised in the GFC

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[44] See Tucker (n 3) 73, and on independent agencies generally.

[45] Ibid, for example at 81, 449.

[46] See generally Tucker (n 3). See also Alan S Blinder, 'Central Bank Credibility: Why Do We Care?' How Do We Build It? (Working Paper No 7161, National Bureau for Economic Research, June 1999) <https://www.nber.org/papers/w7161.pdf>.

for acting as LOLR for insolvent (rather than just illiquid) institutions.[47] A central bank's mandate/charter should therefore be seen as both a sword and a shield.

The scope or ambit of the mandate should be clear as it defines the parameters of the agency's responsibilities. Central bank independence allows the central bank considerable discretion. 'Central bank discretion (a key component of independence) is [however] the freedom to act *within* a legal framework'.[48] The *scope or ambit* of the mandate is relevant in relation to the *type* of actions as well as the *specific functional area* (for example, in monetary policy, the mandate given will determine whether the central bank may set the inflation targets/goals, and choose the instruments with which to achieve it, or whether it may just choose the relevant instruments). If the mandate is intended to *compel* certain actions, it should not merely be phrased as authorising certain actions, and vice versa.

Although mandates/charters are by virtue of their technical nature and history formal concepts, mandates/charters are sometimes treated in an informal manner. Central bank mandates are for example sometimes said to have changed, evolved or grown, even when there has been no change in the formal or legal mandate.[49] For example, in the early 1990s, 'the greater reliance on market-based policies (rather than controls) in Australia … significantly enhanced the degree of independence of the Reserve Bank, without any change in the

[47] Levy Economics Institute, 'The Lender of Last Resort: A Critical Analysis of the Federal Reserve's Unprecedented Intervention After 2007' (Report, Levy Economics Institute, April 2013) <http://www.levyinstitute.org/pubs/rpr_4_13.pdf>; See also James B Stewart, 'Solvency, Lost in the Fog at the Fed' *New York Times* (online, 7 November 2014) <https://www.nytimes.com/2014/11/08/business/the-feds-ambiguous-definition-of-solvency.html>.

[48] Goodhart and Lastra (n 7) 4 (emphasis added).

[49] This sort of language was common after the GFC. See for example Gill Marcus, 'The Changing Mandates of Central Banks – The Challenges for Domestic Policy' (Speech, Gordon Institute of Business Science, 30 May 2012); See Charles A E Goodhart, 'The Changing Role of Central Banks' (Working Paper No 326, Bank for International Settlements, November 2010), <http://www.bis.org/publ/work326.pdf>; See Dimitris N Chorafas, *The Changing Role of Central Banks* (Palgrave Macmillan, 2013). Another example is the RBA's mandate for financial stability that is referred to as a mandate, but is in fact not a classic legal mandate.

Bank's charter'.[50] This demonstrates the extent to which legal and non-legal conceptions of a mandate can differ. Legal conceptions of a mandate are that they are formal and will require express granting and explicit changing. Non-legal conceptions entail a simple granting of authority that is fluid and adaptable. If non-legal conceptions of a mandate prevail, the legal underpinning of an actual mandate can be diminished to the extent that it can be worthless. The need for a formal mandate will be discussed in Chapters 8 and 9 of this thesis.

3 *Central Banks are Regulatory Agencies*

Central banks are not typical regulators.[51] 'Regulators' are generally understood to be formal government-authorised bodies capable of making legally binding regulations that affect the conduct of others.[52] Regulators are generally statutory bodies empowered to issue delegated legislation/regulation, and exist in various industries. Regulators therefore have the ability to affect the conduct of others through legally binding regulations, but also through other means.

In Australia, the financial regulators are APRA and ASIC, and the RBA is included as the third government financial regulator.[53] All three – APRA, ASIC and the RBA – issue formal regulations. The RBA can issue regulations in relation to the payments system,[54] but the RBA can also influence the behaviour of market participants through other means, including the publication of the financial stability review. In countries where the central bank is also responsible for microprudential supervision and bank supervision, the central bank will perform

[50] See Fraser, (n 40).

[51] The role of the RBA has however been described as 'essentially regulatory in nature', although it is also a bank: Sheelagh McCracken, John Stumbles, Greg Tolhurst and Olivia Dixon, *Everett and McCracken's Banking and Financial Institutions Law* (Lawbook, 9th ed, 2017) 30-1.

[52] APRA and ASIC are typical regulators in that they are authorized to make regulations.

[53] Ibid, 20.

[54] *Payment Systems (Regulation) Act 1998* (Cth).

some classic 'regulatory' functions through the issuing of prudential regulation. That is not the case in Australia.

4 *Central Banks are Banks*

Central banks are, however, also banks, and can for example accept deposits and lend money. Their combined nature of being both a regulatory agent and a bank puts them in a special position.[55] Commercial banks hold bank accounts at central banks (for example the exchange settlement accounts in Australia),[56] and 'settlement' of payments only occur once the relevant amount has been transferred in the bank's accounts held by the central bank.[57] Central banks can also operate bank accounts and have often served as banker to government including government departments.[58] Effectively monetary policy is implemented through the banking functions in that the central bank can raise or lower the interest that it charges commercial banks. Arrangements can also exist for liquidity arrangements to facilitate real time gross settlement (RTGS) through payment systems operated by a central bank.[59] The role of the central bank as banker therefore is important for its financial stability role as well as for its role of providing liquidity – this function is related to the next point.

[55] Because of this dual nature central banks need a special accountability regime: Goodhart and Lastra (n 7).

[56] Reserve Bank of Australia, 'Net Settlement in Payments Systems' (Media Release, 1 March 1999) <https://www.rba.gov.au/media-releases/1999/mr-99-02-role.html>.

[57] 'Final and irrevocable settlement is achieved by the simultaneous crediting and debiting of Exchange Settlement Accounts (ESAs) held at the Reserve Bank of Australia': 'About RITS', *Reserve Bank of Australia* (Web Page) <https://www.rba.gov.au/payments-and-infrastructure/rits/about.html>; See also Reserve Bank of Australia, 'Net Settlement in Payments Systems' (Media Release, 1 March 1999) <https://www.rba.gov.au/media-releases/1999/mr-99-02-role.html>.

[58] For example, the RBA is a banker to government: 'About the RBA', Reserve Bank of Australia (Web Page) <https://www.rba.gov.au/about-rba/>.

[59] For example, at the South African Reserve Bank the national payment system involves an agreed 'repo' system with participants, and at the RBA, the RITS system allows for the provision of liquidity to banks with exchange settlement accounts.

5 *Central Banks are Lenders of Last Resort*

The so-called LOLR function of central banks[60] is typically used when a financial institution/bank experiences illiquid circumstances and there is a risk of failure with potential systemic consequences.[61] This role therefore typically comes to the fore in the face of a potential financial crisis. The classic Bagehot formula, that central banks should lend freely to institutions that have liquidity problems (but are still solvent) against high interest rates, is the foundation of the central bank's role as LOLR.[62]

The LOLR function is of critical importance, but the central bank has a discretion whether or not to provide LOLR assistance. The extent to which a central bank is entitled to make LOLR decisions on its own is indicative of its independence.[63] The ability of the central bank to use its balance sheet in order to provide LOLR assistance is unique,[64] and although it is an example of the 'banking' function of central banks, it also goes much further. Through the LOLR function central banks effectively become '[d]elegated managers of the consolidated state balance sheet'.[65] Any losses sustained by central banks when providing

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[60] For in-depth contemporary analysis of this function, see Bank for International Settlements, 'Re-thinking the Lender of Last Resort' (BIS Papers No 79, September 2014) 10. See also Lastra (n 10) 45-51.

[61] See for example Vicente Jakas, '*The Credit Crunch: Revisiting the Problem of Systemic Risk as a Strong Case for the Lender of Last Resort'* in Greg N Gregoriou (ed), *The Banking Crisis Handbook* (CRC Press, 2009). For an explanation of systemic risk see: London School of Economics and Political Science (LSE), 'What is Systemic Risk?' (YouTube, 17 February 2015) <https://www.youtube.com/watch?v=UzW195qWHYg>.

[62] The LOLR role is also referred to as emergency liquidity assistance (ELA). It has also been seen to be a macro-prudential action: Lastra (n 10) 49.

[63] This independence has far-reaching consequences. A decision not to provide LOLR can lead to a financial crisis with dire consequences for a whole country. Similarly, a decision to provide LOLR assistance can prevent widespread losses, but it can also place an undesirable burden on the public purse.

[64] See Goodhart (n 49).

[65] Paul Tucker, 'How can Central Banks Deliver Credible Commitment and be "Emergency Institutions"?' (Speech, Hoover Institution Conference, 21 May 2015): 'Net losses flow to the central treasury in the form of reduced seigniorage income, entailing either higher taxes or lower spending in the longer run (and conversely for net profits)'.

emergency liquidity assistance can affect the state's balance sheet, because the government guarantees the central bank, and unrecovered LOLR funds can also deplete any surplus income that the central bank would normally have paid over to the state.[66] Ultimately, therefore, if the central bank is unable to recoup any of the funds provided as LOLR, the loss will be borne directly or indirectly by the taxpayers.[67] The central bank therefore effectively has a fiscal role.[68]

The LOLR is also a key reason why central banks are/should be responsible for financial stability: providing emergency liquidity promotes financial stability by counteracting systemic risk.[69]

6 *Central Banks are Monetary Authorities*

Modern central banks are primarily responsible for monetary policy.[70] Central banks[71] set the interest rate at which the central bank is prepared to lend to commercial banks, thereby generally influencing interest rates in the country.[72] Lifting interest rates usually has a cooling effect on economic activity; lowering interest rates normally stimulates economic activity.[73] Central banks' interest rate

[66] Ibid.

[67] Central banks generally pay over surpluses made from their operations to the government. Any losses sustained through LOLR activities may reduce the amounts paid over to the government. The government may also be required to provide funding to the central bank as it operates under an implied/express government guarantee.

[68] This is one of the concerns that Tucker and others have about the powers of unelected officials to bind the nation's fiscal assets.

[69] See Masaaki Shirakawa, 'Future of Central Banks and Central Banking' (Speech, International Conference, 26 May 2010).

[70] Bank for International Settlements, *Issues in the Governance of Central Banks* (Report, May 2009) <http://www.bis.org/publ/othp04.pdf> 17. Lastra notes that 'monetary policy' is often undefined: Lastra (n 10) 37-8.

[71] Often through a monetary policy committee.

[72] See generally about RITS and standing facilities: 'Standing Facilities', Reserve Bank of Australia (Web Page, 1 June 2017) <https://www.rba.gov.au/mkt-operations/resources/tech-notes/standing-facilities.html>.

[73] Increasing interest rates generally increase the price of goods and may curb spending; lowering interest rates generally lower prices and increase spending. In that way the supply and demand economic cycle is influenced. In periods of high inflation, interest rates may be lifted to

decisions impact prices, inflation and economic conditions. Monetary policy is concerned with price stability, both in relation to the internal (domestic) and external (international) value of the currency. In particular, domestic currency instability is linked to inflation, which was a serious problem in the second half of the twentieth century.[74] Central banks earned considerable prestige and respect as a consequence of their effective fight against inflation in the late twentieth century.[75]

An important development in the conduct of monetary policy came through the inflation targeting model, originally developed in New Zealand. In this model, the optimal range of inflation is set by the government, and the central bank then is required to maintain national inflation levels within those bands.[76] Some measure of inflation is necessary to ensure economic growth, but high levels of inflation have a negative impact on the economy.

The link between central bank independence and central bank monetary policy is important and is discussed in the next section on central bank independence.

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force a lowering of prices; in periods of low inflation, interest rates may be lowered to stimulate economic activity.

[74] On the so-called 'Great Inflation' of the 1970s and 1980s, see John Singleton, *Central Banking in the Twentieth Century* (Cambridge University Press, 2011).

[75] See Claudio Borio and Pierre L Siklos, 'Central bank Credibility Before and After the Crisis' (Working Paper No. 21710, National Bureau of Economic Research, July 2016); See Michael Bordo and Pierre L Siklos, 'Central-bank Credibility, Reputation and Inflation Targeting in Historical Perspective' (VOX CEPR Policy Portal, 12 December 2014) <https://voxeu.org/article/central-bank-credibility-reputation-and-inflation-targeting-historical-perspective>.

[76] 'Inflation targeting is a monetary-policy strategy that was introduced in New Zealand in 1990, has been very successful, and as of 2007 had been adopted by more than 20 industrialized and non-industrialized countries. It is characterized by (a) an announced numerical inflation target, (b) an implementation of monetary policy that gives a major role to an inflation forecast and has been called 'inflation-forecast targeting', and (c) a high degree of transparency and accountability': Lars E O Svensson, 'Inflation Targeting', in Steven N Durlauf and Lawrence E Blume (eds), *Monetary Economics* (Palgrave Macmillan, 2010) 127, 127.

B. Central Bank Independence, Monetary Policy and the So-called Democratic Deficit

Central bank independence falls into a special category of independence that is not shared by other regulators. Central bank independence has at times been equated to that enjoyed by the judiciary[77] and even the military.[78] In order to achieve their objectives, central banks have to be independent both from politicians and from the market stakeholders affected by their regulation/direction.[79] The broad discretion of an independent central bank will however impact on the way in which it may perform a financial stability mandate. Central bank independence depends on political will, is determined by the government and reflects the relationship between the state and the central bank. Central bank independence was initially justified because the potential for political influence over money printing or money creation and lending to government was considered to be too dangerous to entrust to a politically motivated entity.[80] People were more likely to trust a reputable third party like a central bank rather than the sovereign/government, for example when money was raised for the purposes of the sovereign, such as war.[81] Modern central bank independence still involves trust, although it's no longer an issue, for example, of whether the government will repay loans.[82] Trust issues for central banks now relate to citizens being confident that the central bank will act in the interest of the national

[77] See Tucker (n 3) 566.

[78] Ibid.

[79] See Tucker (n 3). Not all central banks are of course equally independent – the nuances of independence will be discussed below.

[80] See Fraser (n 40) on the danger of entrusting government with the issue of paper money and of conflicts of interest between politics and commerce.

[81] See Michael D Bordo, Øyvind Eitrheim, Marc Flandreau, and Jan F Qvigstad (eds), *Central Banks at a Crossroads: What Can We Learn from History?* (Cambridge University Press, 2016) 24. Paul Tucker also emphasizes the need for the credibility and legitimacy of central banks in view of their 'unelected power': See generally Tucker (n 3) but in particular Part IV on power.

[82] That was the case when central banks were used to raise money on behalf of the sovereign/government.

economy when conducting monetary policy and when performing its central banking tasks. The potential for political influence over monetary policy and the potential to use monetary policy for political gain justifies central bank independence.[83] In essence, it is thought that ‘an independent, expert body not bound up in the electoral cycle would do a better job than politicians in conducting monetary policy’.[84] Accordingly, central banks are provided with a mandate/charter which grants authority to act independently.

1 *Increased Central Bank Independence: A Recent Consequence of the Monetary Policy Function*

The level of central bank independence has changed over time, and the significant level of independence alluded to above that most central banks currently enjoy arose in the late 20th century, when it was demonstrated that increased independence correlated favourably with reduced inflation.[85]

In the earlier part of the 20th century, governments reduced the independence of central banks as a consequence of their perceived failures following the Great Depression and the collapse of the gold standard.[86] The gold standard and central bank independence had become associated with deflation and unemployment, and central banks were criticised for policy errors and a lack of clarity in their theoretical foundations.[87] Governments consequently resumed

[83] ‘Keynes expressed his thoughts on central bank independence while testifying before the 1913 Royal Commission into an Indian central bank. The ideal central bank, he said, “would combine ultimate government responsibility with a high degree of day-to-day independence for the authorities of the bank”. He added that it would be desirable “to preserve unimpaired authority in the executive officers of the bank, whose duty it would be to take a broad and not always commercial view of policy”’: Fraser (n 40) 1, quoting David Ricardo in a paper on the establishment of a national bank from 1824.

[84] Bernie Fraser, ‘Reserve Bank Independence’ (Speech, National Press Club, 15 August 1996) <https://www.rba.gov.au/speeches/1996/sp-gov-150896.html>.

[85] Ibid.

[86] Goodhart (n 49) 2; Bordo et al (n 81) 69-70.

[87] See John Singleton, ‘The Winds of Change for Central Banks’ (2010) 20(3) *Central Banking* 23; See Parsons, ‘Developments in Central Banking’ (n 5).

control over monetary policy.[88] The result was a decline in central bank independence after the Great Depression and the Second World War, and the creation of inter alia the IMF as a way to protect financial stability.[89]

The German central bank, the Bundesbank, however, became the model for central bank independence.[90] It was an exception to post-Depression central banks[91] in being largely independent from government. It was a very successful central bank and the Deutsch Mark become the most stable currency.
When inflation became a worldwide problem in the mid-1970s, central banks shifted their focus to ensuring price stability, and over time it became generally accepted that central bank independence was required for effective monetary policy operations.[92] Independence from the political pressures of government was necessary to implement monetary policy for the common good.[93] Politicians or government departments may serve predominantly political agendas, whereas independent central banks may be more inclined 'to subordinate other goals, such as growth and employment, to the fight against inflation'.[94] Empirical research confirmed the benefits of central bank independence in the fight against inflation.[95] In fact '[e]conomic theory suggests that [central bank independence], coupled with an explicit mandate for maintaining price stability, offers an

[88] See Goodhart (n 86); See Parsons, 'Developments in Central Banking' (n 5).

[89] See Harold James, 'Central Banks: Between Internationalisation and Domestic Political Control' (Working Paper No 327, Bank for International Settlements, November 2010) <http://www.bis.org/publ/work327.pdf>; See Parsons, 'Developments in Central Banking' (n 5).

[90] See James (n 89), 12; See Parsons, 'Developments in Central Banking' (n 5).

[91] Ibid.

[92] See Alexandre Lamfalussy, 'Keynote Speech' (Speech, Bank for International Settlements Annual Conference, 24−25 June 2010)>; See Parsons, 'Developments in Central Banking' (n 5).

[93] See John B Goodman, 'The Politics of Central Bank Independence' (1991) 23(3) *Comparative Politics* 329, 329; See Parsons, 'Developments in Central Banking' (n 5).

[94] See Goodman (n 93) 329.

[95] Ibid.

institutional device for realising the social benefits associated with law and stable inflation rates'.[96]

In the mid-1990s, more central banks became independent, demonstrating the political commitment to price stability.[97] It constituted a 'quiet revolution'[98] and a 'quantum upward jump',[99] and contrasted with the preceding 40 years which was characterised by little, if any, reform in central banking.[100] For example, in 1997 the BOE became operationally independent from government, even though there was no formal legislative change.[101] Central banks in other countries, including developing countries, also became more independent.[102] The issue is what impact this independence will have on the financial stability function.

2 *The Democratic Deficit*

The consequence of central bank independence is that unelected officials perform important public functions with a high level of independence. It amounts to 'delegating responsibility to un-elected technocrats'.[103] This has led to criticism of central banks and their independence. Over the past 10 to 20 years, central

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[96] Wolfram Berger and Friedrich Kissmer, 'Central Bank Independence and Financial Stability: A Tale of Perfect Harmony?' (2013) 31 *European Journal of Political Economy* 109, 109.

[97] See Sylvester C W Eijffinger and Jakob De Haan, 'The Political Economy of Central-Bank Independence' (Special Paper No 19, Princeton Studies in International Economics, 1996) 1; See Parsons, 'Developments in Central Banking' (n 5).

[98] See Alan S Blinder, *The Quiet Revolution: Central Banking Goes Modern* (Yale University Press, 2004).

[99] Cukierman (n 42) 70.

[100] See Parsons, 'Developments in Central Banking' (n 5).

[101] Cukierman (n 42) 74; Goodhart (n 86) 5.

[102] For example, the independence of the South African Reserve Bank was enshrined in the new South African Constitution in 1994.

[103] Mark Beeson and Stephen Bell, 'Independent Central Banking and the Democratic Deficit: The Reserve Bank of Australia and the Politics of Ambiguity', *UQ eSpace* (Web Page, 1 January 2004) 1 <https://espace.library.uq.edu.au/view/UQ:10019>. See also Annelise Riles, *Financial Citizenship: Experts, Publics, and the Politics of Central Banking* (Cornell University Press, 2018), Chapter 2.

banks have become more transparent in their operations, because transparency and accountability are seen as important measures of addressing the democratic deficit, but they are still seen as secretive institutions.[104]

The democratic deficit has important consequences for a financial stability mandate. Financial stability policy in the hands of a central bank may be more difficult for the government/state to direct (compared to, for example, the inflation-targeting model that directs monetary policy at least to some extent), and therefore financial stability policy may lie within the purview of non-democratically appointed officials.

3 *Different Forms of Independence*[105]

The form and degree of central bank independence vary. There is a large and well-researched body of literature about the different degrees of independence of central banks, but a detailed discussion of that literature is beyond the scope of this thesis.[106] The following key characteristics of central bank independence are however relevant for purposes of a financial stability role of central banks:

1. Central banks have a *double dimension* of independence – they are both independent from government and from the financial markets.[107] They

[104] See Riles (n 103).

[105] See also Frans Van Dijk, 'Independence and Autonomy: The Parallel Worlds of Courts and Public Agencies', *Blog of the Montaigne Centre for Rule of Law and Administration of Justice* (Blog Post, 11 December 2018) <http://blog.montaignecentre.com/index.php/1265/independence-and-autonomy-the-parallel-worlds-of-courts-and-public-agencies/>. Van Dijk, referring to the work of Koen Verhoest, also compares central banks in the EU to courts. He considers managerial autonomy, policy autonomy, structural autonomy, financial autonomy, legal autonomy and interventional autonomy.

[106] Much of this literature was produced and inspired by Alex Cukierman, and it involved the use of economic models to determine the degree of independence of central banks, using various indicia of independence, such as the appointment of the governor, duration of the governor's service, role of government representatives in the decision-making of the central bank and so forth. See for example Alex Cukierman, Steven B Webb, and Bilin Neyapti, 'Measuring the Independence of Central Banks and Its Effect on Policy Outcomes' (1992) 6(3) *World Bank Economic Review* 353.

[107] See Goodhart and Lastra, (n 7).

operate in the public interest: they do not operate in the political interest of governments, or in the private profit interest of market players;[108]

2. Central banks are *accountably independent* – that means that their accountability is part and parcel of their independence.[109] Transparency and accountability are the pillars of central bank independence[110] (See also Chapters 6 and 7);

3. There are *degrees of independence*, and independence is not necessarily absolute.[111] The independence of a central bank lies somewhere on a continuum from it being totally independent to only marginally independent. Degrees of independence have been measured by academics such as Alex Cukierman.[112] For example, the Australian RBA is considered to be moderately independent because of the important role that government representatives play in some of the RBA's activities, and for the strong hand of government in the appointment of the governor and other high-ranking officials and board members;

4. Even if a central bank is classified as 'independent', there may be a difference between its *legal* independence and *factual* independence; [113]

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[108] Ibid.

[109] Ibid.

[110] See Florin Cornel Dumiter, 'Central Bank Independence, Transparency and Accountability Indexes: A Survey' (2014) 7(1) *Timisoara Journal of Economics and Business* 35.

[111] Goodhart and Lastra, (n 7).

[112] See for example Alex Cukierman, 'Central Bank Independence and Monetary Policy-Making Institutions: Past, Present and Future' in David Mayes and Geoffrey E Wood (eds), *Designing Central Banks* (Routledge, 2009) 68.

[113] Legal independence refers to the legal guarantee or protection of central bank independence, often found in its founding legislation, or at times a fundamental constitution, as is the case in South Africa. Factual independence denotes real independence in practice.

5. Depending on the extent of independence that a government wishes the central bank to have, the central bank can be *goal independent*, or *instrument independent*, or both; and

6. The *'inflation-targeting'* model of monetary policy, originally implemented by the Reserve Bank of New Zealand and since adopted by some 20 jurisdictions, regulates the relationship between the state and central bank by granting the central bank effectively only instrument independence. The government sets the inflation target between certain margins, and the central bank has discretion to choose the monetary policy instruments to achieve those targets.[114] The central bank is accountable to Parliament in respect of meeting the inflation target through periodic addresses by the central bank governor.

It is not clear whether the current level of central bank independence is also appropriate for a financial stability responsibility.

C. Central Bank Governor: A Special and Significant role

The unique and significant role of the Governor of a central bank contributes to central bank's unique nature. The Governor is the leader and figurehead of the organisation and their personal characteristics are highly significant. Central bank governors hold great personal esteem and markets react to their appointment, dismissal or retirement.[115] Their role has no private or public sector equivalents and it is unlike that of the CEO of a commercial/retail/investment bank, in that the role is generally unconstrained by a board of directors, and it is also unlike that

[114] The central bank's choice of instruments may be constrained by statute or otherwise: See Eijffinger and De Haan (n 97) 2-3;See also Goodhart (n 86), 5; See also Parsons, 'Developments in Central Banking' (n 5).

[115] See Christoph Moser and Axel Dreher, 'Do Markets Care about Central Bank Governor Changes? Evidence from Emerging Markets' (2010) 42(8) *Journal of Money, Credit and Banking* 1589; Frédéric Lebaron and Aykiz Dogan, 'Do Central Bankers' Biographies Matter?' (2016) 10(2) *Sociologica* 1.

of a minister in charge of a state department, who is part of cabinet. Despite the fact that central bank governors are required to act independently in accordance with the independent nature of the central bank as an organisation, central bank governors may still in some instances be appointed by politicians exercising political power. A recent example is the appointment of Jeremy Powell by President Trump to replace Janet Yellen as chairperson of the Federal Reserve.[116]

The individual characteristics of the central bank Governor are significant, and this person is appointed in accordance with processes provided for in the founding legislation of the central bank.

Notwithstanding the importance of central bank governor, there is relatively little academic literature on their roles.[117] The special role of the RBA's Governor is analysed in Chapters 6 – 8, and the importance of the personal characteristics and even personality of a Governor is also discussed in Chapter 6.

In conclusion, the sui generis nature of central banks both facilitate but also complicate the role of a central bank as financial stability regulator. The democratic deficit that flows from independence also impacts the financial stability responsibility because a closer relationship with government may be more appropriate.

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[116] Although Mr Powell is arguably less academically qualified than Dr Yellen to lead the Fed and Dr Yellen had a stellar track record at the Fed, Mr Powell is a Republican, and Dr Yellen a Democrat. See 'New Fed Chair Jerome Powell was the Best Choice… for Trump', *The Guardian* (online, 6 November 2017) <https://www.theguardian.com/business/2017/nov/05/jerome-powell-boring-choice-fed-chairman-interesting-times>.

[117] See for example: Moser and Dreher (n 115); Guillermo Vuletin and Ling Zhu, 'Replacing a "Disobedient" Central Bank Governor with a "Docile" One: A Novel Measure of Central Bank Independence and Its Effect on Inflation' (2011) 43(6) *Journal of Money, Credit and Banking* 1185; Walter A de Wet, 'Thinking like a Governor: Central Banking under an Inflation Target' (2003) 71(4) *South African Journal of Economics* 792; Berthold Herrendorf and Ben Lockwood, 'Rogoff's "Conservative" Central Banker Restored' (1997) 29(4) *Journal of Money, Credit, and Banking* 476.

It is not only the general characteristics of central banks that impact their financial stability responsibility. The GFC has also resulted in changed perceptions of the roles and responsibilities of central banks in financial stability. The GFC and its impact on central banks will be discussed next.

III. The GFC and its Effect on the Roles and Responsibilities of Central Banks

The GFC was a momentous historical event that significantly impacted central banks, because of the role that they played in both the unfolding and resolution of the crisis, and also in the role that central banks have subsequently been required to play in financial stability. The GFC was also an important event that should (and did) inform the actions of governments when creating an appropriate regulatory framework for the financial stability regulator.

A. GFC – A Costly Crisis of Financial Stability

1 *An International Crisis of Financial Stability*

The GFC was a protracted crisis, and its disruptive effects were global in their reach, traversing all layers of society. It fundamentally affected companies, industries and the personal lives of many people all over the world.[118] The GFC followed the Great Moderation, and was largely not foreseen.[119] It is not just the fact that a major crisis was not foreseen in general, but that the very regulators

[118] See Kevin Rudd, 'The Global Financial Crisis' (February 2009) *The Monthly* <https://www.themonthly.com.au/issue/2009/february/1319602475/kevin-rudd/global-financial-crisis>.

[119] Some economists like Prof Raghuram Rajan saw the possibility of a financial crisis. Bernanke however critically misjudged the impact of the problems experienced in the subprime mortgage market when he concluded: 'At this juncture, however, the impact on the broader economy and financial markets of the problems in the subprime market seems likely to be contained': Ben S Bernanke, 'The Economic Outlook' (Testimony, Joint Economic Committee, US Congress, 28 March 2007) <https://www.federalreserve.gov/newsevents/testimony/bernanke20070328a.htm>.

and institutions that were expected to prevent instability missed the warning signs of the crisis. Blinder summarised the impact of the unusual crisis well:[120]

> Nobody thought this might happen. Things can go wrong. But the number of things that have gone wrong, and the ferocity with which they have gone wrong I think was beyond the imagination of almost everyone.

What started as a crisis in the subprime mortgage market in certain parts of the US mortgage market, spiralled quickly into a fully-fledged credit crunch, in which financial institutions not only refused providing credit to each other, but failed, or almost failed. Multiple causes of the GFC have been identified in key studies,[121] but generally the circumstances that brought about the GFC include: [122]

- deficiencies in lending standards and practices in the USA and the 'bubble' in the subprime mortgage market,
- the complexities and opacity of sophisticated securitised products, for example collateralised debt obligations (CDOs) and financial conglomerates,[123]
- flawed credit-rating practices and inaccurate asset valuation by credit-rating agencies,

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[120] Remarks by Alan Blinder during a radio interview on US Public Broadcasting Service, 9 January 2009, and cited by David Gruen, 'Reflections on the Global Financial Crisis' (Speech, Sydney Institute, 16 June 2009) <https://static.treasury.gov.au/uploads/sites/1/2017/06/Sydney_Institute_Address.pdf>.

[121] See eg High Level Group on Financial Supervision in the EU, *Report* (Report, 25 February 2009) <https://www.esrb.europa.eu/shared/pdf/de_larosiere_report_en.pdf?351e1b35ec1ca5e855d2e465383a311f> (De Larosière Report); Financial Crisis Inquiry Commission, *The Financial Crisis: Final Report of the National Commission on the Causes of the Financial and Economic Crisis in the United States* (Inquiry Report, January 2011) <http://fcic-static.law.stanford.edu/cdn_media/fcic-reports/fcic_final_report_full.pdf>.

[122] See John H Farrar and Louise Parsons, 'Globalisation, the GFC and Paradigm Shift' (2013) 32(12) *Banking & Financial Services Policy Report* 14; John H Farrar and Louise Parsons, 'Globalisation, the Global Financial Crisis and the Reinvention of the State' (2012) 24(2) *Singapore Academy of Law Journal* 367; John H Farrar, Louise Parsons and Pieter I Joubert, 'The Development of an Appropriate Regulatory Response to the Global Financial Crisis' (2009) 21(3) *Bond Law Review* 1.

[123] 'In conclusion, it is clear that the systemic phase of the current global financial crisis was triggered by the failure of large complex global financial conglomerates': Douglas W Arner and Joseph J Norton, 'Building a Framework to Address Failure of Complex Global Financial Institutions' (2009) 39(1) *Hong Kong Law Journal* 95, 127.

- flawed remuneration incentives,[124] especially for mortgage brokers and bank sales personnel and managers;
- high levels of leveraging supported by doubtful assets,[125]
- the presence of assets of dubious or unknown value (subprime mortgages) in securities; and
- globalisation and the internationalisation of finance that contributed to the rapid spread of the crisis: what started in the United States in some localised neighbourhoods spread across the globe, and eventually virtually no country was unaffected.[126]

Enormous losses were sustained during the GFC. One author called it a two trillion dollar crisis.[127] The fiscal cost of the GFC (referred to as the Great Recession by some) is said to have exceeded that of the Great Depression.[128] In 2017, the level of output in the US was still 13% below pre-crisis output. In the UK, the losses are estimated to have been 16% of GDP, and 'are [proportionately] larger than in the US and indeed larger than those that followed the Great Depression'.[129] In the UK and EU, the opportunity costs for citizens have been the highest for at least a century.[130] In fact, 'the banking sector entered a zone of

[124] Gruen for example refers to 'perverse incentives in financial markets – too much pay for short-term returns, and not enough downside for losses': Gruen (n 120).

[125] Ibid.

[126] See also Charles Goodhart, 'The Background to the 2007 Financial Crisis' (2008) 4(4) *International Economics and Economic Policy* 331.

[127] Charles R R Morris, *The Two Trillion Dollar Meltdown* (Public Affairs, 2008). For a summary of the cost, see also Barak Orbach, 'Regulation: Why and How the State Regulates' (Foundation Press, 2013), 11-3. See also International Monetary Fund, *World Economic Outlook* (Report, September 2015) <https://www.imf.org/en/Publications/WEO/Issues/2016/12/31/Adjusting-to-Lower-Commodity-Prices>.

[128] Andrew G Haldane, 'Rethinking Financial Stability' (Speech, Rethinking Macroeconomic Policy IV Conference, 12 October 2017).

[129] Ibid.

[130] Ibid.

several years of negative performance'.[131] The real economy was caught in a 'liquidity spiral that became a dangerous threat to the smooth functioning of the most vital and crucial segment of the financial system until then – the banking sector, and this resulted in a high amount of non-performing loans'.[132] More than ten years after the start of the GFC, its negative impact is still being felt in some places in the world.[133]

2 *The Onset of the GFC and the Roles of Central Banks*

The GFC presented a crisis particularly for central banks, because it arose in their backyards and, as it were, played out in their front yards.[134] Central banks did not foresee the GFC, and the manner in which the crisis progressed was also not foreseen.[135] Central banks took much of the credit for the Great Moderation, because the favourable conditions during that time were attributed to a decline in inflation volatility. Managing and reducing inflation had been one of the key objectives of central banks.[136] The GFC however brought the Great Moderation to an abrupt end.[137]

Central banks were both blamed for the onset of the GFC but also praised for their efforts in resolving the GFC.[138] There was evidence of some extraordinary

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[131] Ana Vlahović, 'Challenges to the Implementation of a New Framework for Safeguarding Financial Stability' (2014) 3(3) *Journal of Central Banking Theory and Practice* 19, 20.

[132] Ibid, 20-1.

[133] Malcolm Edye, 'Reflections on the Financial Crisis' (Speech, CFO Summit, 16 March 2014) <http://www.rba.gov.au/speeches/2014/sp-ag-160314.html>; See Parsons, 'Developments in Central Banking' (n 5).

[134] Central banks were criticised for their roles in the GFC and suggestions were made for improvements in their operations. See Kara M Westercamp, 'A Crack in the Façade and the Whole Building Came Tumbling Down: A Critical Examination of the Central Banks' Response to the Subprime Mortgage Loan Crisis and Global Financial Market Turmoil' (2009) 18(1) *Transnational Law and Contemporary Problems* 197.

[135] See Parsons, 'Developments in Central Banking' (n 5).

[136] See Ben Bernanke, 'The Great Moderation' (Speech, Eastern Economic Association, 20 February 2004).

[137] See Gruen (n 120).

[138] See Tucker (n 3) 2.

central banking actions (many of these were actions by the Federal Reserve), including:

- acting as LOLR on a large scale for illiquid institutions – and perhaps, in some cases, insolvent institutions (there has been some criticism of for example the Federal Reserve exceeding its mandate); [139]
- extending the LOLR assistance to institutions beyond those that would normally qualify for LOLR assistance;[140]
- substantially increasing their balance sheets;[141]
- using novel ways to alleviate the credit crunch;[142]
- negotiating with commercial banks to shore up other banks through takeovers;[143]
- reducing interest rates to extraordinary low levels to encourage lending;
- collaborating across international borders for example to reduce interest rates;[144]
- relinquishing the appearance of independence through joint public appearances with government representatives;[145] and

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[139] Ibid.

[140] For example AIG, an insurer, and car manufacturer Chrysler.

[141] See Guy Debelle, 'Lessons and Questions from the GFC' (Speech, Australian Business Economists Annual Dinner, 6 December 2018) 5 <https://www.rba.gov.au/speeches/2018/pdf/sp-dg-2018-12-06.pdf>. Debelle notes: 'The re-intermediation by central banks mitigated the withdrawal of intermediation by the banking sector. A part of that increase in the balance sheet addressed the large counterparty risk aversion. Central banks were willing to stand between institutions that were unwilling to deal with each other, as well as accommodate the rapid increase in demand for liquidity. That large increase in central bank balance sheets mitigated the large contraction in the financial sector, which goes a long way to explaining why it has still yet to lead to a marked rise in inflation, despite this being foreshadowed by a number of commentators over the past decade'.

[142] Ibid 6.

[143] Henry M Paulson, *On the Brink: Inside the Race to Stop the Collapse of the Global Financial System* (Business Plus, 2010) Chapter 9.

[144] Ashley Seager and Kathryn Hopkins, 'Another Day of Global Market Turmoil Despite Rate Cut Action', *The Guardian* (online, 9 October 2008) <https://www.theguardian.com/business/2008/oct/08/interestrates.banking>.

[145] The case of Ben Bernanke and Hank Paulson is particularly interesting. Sometimes Tim Geithner also joined the other two in public appearances.

- acquiring assets that could be potentially valueless through the schemes to purge toxic assets from the balance sheets of banks.[146]

Central banks play the role of first responder or ‘firefighter’ during a crisis and the GFC was no exception. Their actions were praised, but also criticised. An important development during the GFC as to the perceived role of central banks is that central banks should play a lead role in financial stability, and that they should focus more on their financial stability mandate (see discussion below.)

3 *Australia in the GFC*

Australia escaped some of the worst effects of the GFC but was not unaffected.[147] Early in the GFC, then Prime Minister Kevin Rudd reassured the Australian public that Australia was ‘better positioned than practically every other country in the world to see its way through this crisis’ because of its strong banks, regulators and budget surplus.[148] The Australian government provided fiscal stimulus quickly and effectively.[149] A government guarantee on wholesale debts and

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[146] ‘TARP Programs’, *United States Department of the Treasury* (Web Page, 15 November 2015) <https://www.treasury.gov/initiatives/financial-stability/tarp-programs/Pages/default.aspx>.

[147] See Michael Priestley, *Australia, China and the Global Financial Crisis*, (Parliamentary Library Briefing Book, 12 October 2010) <https://www.aph.gov.au/About_Parliament/Parliamentary_Departments/Parliamentary_Library/pubs/BriefingBook43p/australiachinagfc>, Chapter 2 Key Financial Developments Since the Wallis Inquiry; See also Alison Lui, *Financial Stability and Prudential Regulation: A Comparative Approach to the UK. US, Canada, Australia and Germany* (Routledge, 2017) Chapter 4.

[148] Kevin Rudd, ‘{Untitled interview}’ (Interview at Press Conference, Prime Minister's Courtyard, Parliament House, Canberra, 12 October 2008).

[149] ‘Rudd Unveils $10.4b Stimulus Plan’, *Sydney Morning Herald* (online, 14 October 2008) <https://www.smh.com.au/business/rudd-unveils-104b-stimulus-plan-20081014-50a6.html>. See also Guy Debelle, ‘Lessons and Questions from the GFC’ (Speech, Australian Business Economists Annual Dinner, 6 December 2018) <https://www.rba.gov.au/speeches/2018/pdf/sp-dg-2018-12-06.pdf>: ‘Fiscal stimulus in Australia in my view was absolutely necessary and was a critical factor behind Australia's good economic outcomes. While one can argue about the exact nature of the implementation, the fact that it was designed to take effect quickly was vital in the circumstances: “go hard, go early, go to households” as Ken Henry put it’ (footnotes omitted). Further, Michael Priestley, in a report to Federal Parliament, concluded: ‘Australia’s strong economic performance during the GFC can be attributed to the Government’s stimulus measures, a sound and liquid banking system and not least China’s robust demand for energy and minerals imported from Australia’: Priestley (n 147).

deposits was also provided on 12 October 2008.[150] In Australia there was no need for any government bailout of banks.

Part of the Australian success can be attributed to the actual events of the GFC. In that respect Australia was somewhat lucky,[151] but Australia also benefited from China's strong growth at the time and Australia's trade links to China.[152] Australian banks however made less use of opaque securitised products, and banks were well-regulated. The Twin Peaks regulatory system has since been praised for being an effective regulatory structure for microprudential and conduct regulation.[153] The Australian banks were also less exposed to issues relating to poor asset quality.[154] Further, Australia did not have the same level of counterparty uncertainty because of similar structures in Australian banks.[155] Australia's well-regulated financial system therefore received significant praise.[156]

4 *GFC Lessons*

The relevant 'lessons' that can be identified as resulting from the GFC and that are relevant to the Australian central bank as financial stability regulator, are:[157]

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150 Debelle (n 149) 8.

151 Ibid 7.

152 Ibid.

153 Andrew Schmulow, 'Financial Regulation: Is Australia's 'Twin Peaks' Model a Successful Export?', *Interpreter* (Blog Post, 1 March 2016) <https://www.lowyinstitute.org/the-interpreter/financial-regulation-australias-twin-peaks-model-successful-export>.

154 Debelle (n 149) 9.

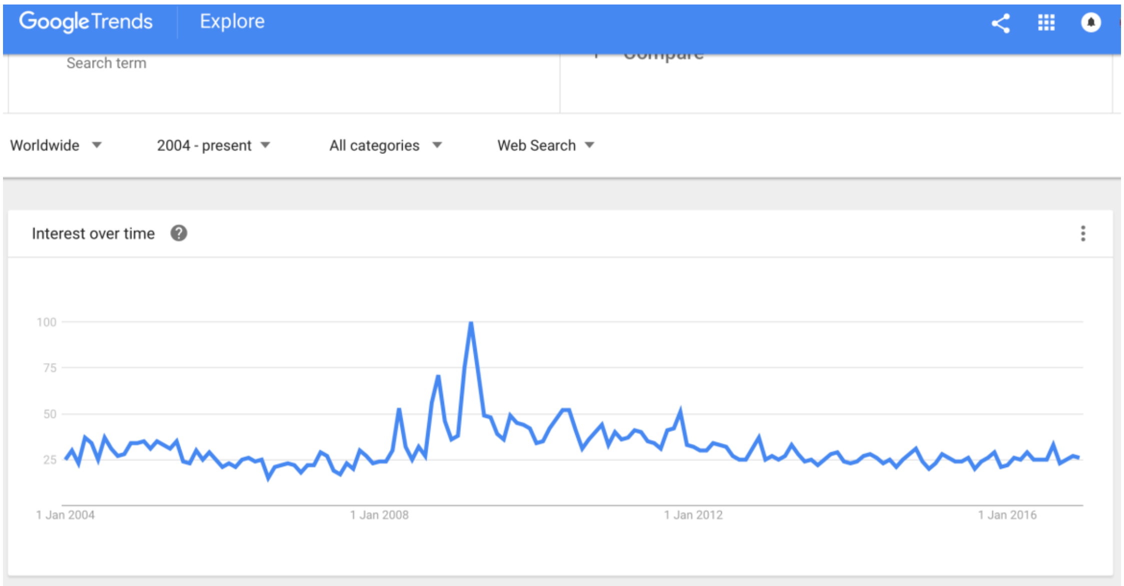
155 Ibid 8.

156 See for example Financial Services Institute of Australasia (Finsia), *Navigating Reform: Australia and the Global Financial Crisis* (Report, October 2009) <https://www.finsia.com/docs/default-source/industry-reports-financial-system-inquiry/navigating-reform--australia-and-the-global-financial-crisis.pdf?sfvrsn=4>.

157 A full list of all the lessons from the GFC are beyond the scope of this thesis, as many of the lessons relate not to the regulation of regulators, but to the regulation implemented by regulators.

1. *Financial stability as a concept gained significant prominence and importance*: Financial stability as a concept assumed new prominence world-wide during and after the GFC.[158] The events and fall-out of the GFC led governments and central banks worldwide to take significant steps to restore (some) financial stability. There was a proliferation of discussion of financial stability and the need to secure financial stability by policy makers, market leaders and academics. 'Financial stability' became the buzzword in the GFC[159], as evidenced, inter alia, by its popularity as a search term on Google (see figure 3.1).

Image 3.1 Interest in the term 'financial stability' since 2004



Screenshot taken by the author of the prevalence of the term financial stability on Google.

[158] 'When the north-Atlantic financial crisis erupted in August 2007, the economics profession in the advanced economies and some central bankers rediscovered financial stability': Willem H Buiter, 'The Role of Central Banks in Financial Stability: How Has it Changed?' (Discussion Paper No 8780, Centre for Economic Policy Research, January 2012) 1 <https://papers.ssrn.com/sol3/papers.cfm?abstract_id=1988710>. See also Lastra (n 10) 39.

[159] See Hilary J Allen, 'What is "Financial Stability"? The Need for Some Common Language in International Financial Regulation' (2014) 45(4) *Georgetown Journal of International Law* 929.

2. *Financial stability is a public good and a national priority*: There is agreement that insufficient emphasis had been placed on financial stability before the GFC. In fact, 'achieving and preserving financial stability has now become a key policy objective in our societies',[160] and financial stability has come to be regarded as 'not only a national but an international public good'.[161] The importance of financial stability is generally accepted. If there is financial instability, 'innocent bystanders get hurt'.[162] Accordingly a system-wide approach is needed for the regulation of financial stability, nationally and internationally.

3. *Regulation is important*: An important lesson from the GFC was that the financial markets are not entirely 'self-stabilising' under certain conditions,[163] and that they 'do not self-stabilise at any socially acceptable cost'.[164] Alan Greenspan also noted that contrary to his earlier views, it was shown that self-interest of commercial enterprises was not sufficient to safeguard broader interests.[165] The following solution has been proposed:[166]

> The answer is not to repress financial markets. Rather, it is to recognise that markets need rules, constraints and careful monitoring so that market failures are less frequent and less costly. And that the rules, constraints and monitoring exercises need a macroprudential approach – that is, one that tries to capture not only individual risks but system-wide risks.

160 Peter Praet, 'The (Changing) Role of Central Banks in Financial Stability Policies' (Speech, Annual Internal Banking Conference, 10 November 2011).

161 Charles B Blankart and Erik R Fasten, 'Financial Crisis Resolution – The State as a Lender of Last Resort?' (2009) 29(3) *Economic Affairs* 47, 50.

162 Allen (n 159), 946.

163 Vlahović (n 131) 27.

164 Ibid.

165 Alan Beattie and James Politi, '"I Made a Mistake," Admits Greenspan', *Financial Times* (online, 24 October 2008) <https://www.ft.com/content/aee9e3a2-a11f-11dd-82fd-000077b07658>.

166 Jaime Caruana, 'Systemic Risk: How to Deal with It' (Paper, Bank for International Settlements, 12 February 2010) <https://www.bis.org/publ/othp08.htm>.

4. *Central banks should play the lead role in financial stability*: One of the key lessons of the GFC was that central banks should play a key role in financial stability.

5. *A macro-prudential focus is important*: The GFC highlighted the so-called ‘fallacy of composition’, namely the assumption that the individual resilience of financial institutions would also ensure the resilience of the financial system as a whole. Empirical data and the events of the GFC showed that systemic risk cannot be mitigated by the resilience of individual firms alone.[167] The GFC highlighted that regulators needed to focus more broadly than on specific sectors in isolation and needed to consider macroeconomic issues and macroprudential policy. ‘Out of this intellectual vacuum, a new framework for regulation has been born – macroprudential regulation’.[168]

6. *A systemic approach is required*. Similarly, the importance of preventing systemic risk[169] on a global level became evident, and this realisation led to the eventual introduction of specific regulatory regimes for so-called SIFIs[170] and gSIFIs.[171] The manner in which systemic risk is avoided is

[167] See Haldane (n 128); See also Andrew Crockett, ‘The Theory and Practice of Financial Stability’ (1996) 144(4) *De Economist* 531.

[168] Haldane (n 128).

[169] The concept of systemic risk is not new and was an important consideration long before the GFC. The Group of Ten in January 2001 defined it as follows: ‘Systemic risk is the risk that an event will trigger a loss of economic value or confidence in, and attendant increases in uncertainty about, a substantial portion of the financial system that is serious enough to quite probably have significant adverse effects on the real economy. … The adverse real economic effects from systemic problems are generally seen as arising from disruptions to the payment system, to credit flows, and from the destruction of asset values’: Group of Ten, *Consolidation of the Financial Sector* (Report, 30 January 2001) <https://www.bis.org/publ/gten05.htm>.

[170] Systemically Important Financial Institutions.

[171] Globally Systemically Important Financial Institutions.

through a macroprudential perspective, and the need for a macroprudential regulator was born out of the GFC:[172]

> In summary, the market failures associated with fire-sale externalities and behavioural tendencies which can drive short-termism provide a strong case for a macroprudential regulator with an objective of preserving the dynamic resilience of the financial system, both among banks and, prospectively, among non-banks.

What the appropriate instruments and tools are for macroprudential policy, is however not clear: [173]

> There is no settled, practical approach to defining the breadth of objectives of a macroprudential regime. … Nor, in the main, is there any settled approach to defining the appropriate set of macroprudential instruments.

7. *A focus on macroprudential policy is required*: 'The global financial crisis has highlighted the costs of systemic instability at both the national and global level, as well as the need for dedicated macro-prudential policies to achieve financial stability'.[174]

5 *Post GFC Regulatory Responses*

The following regulatory responses are however particularly relevant to the examination of the regulatory framework of the RBA for financial stability in this thesis.[175]

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[172] Haldane (n 128).

[173] Ibid.

[174] Sean Hagan and Ross Leckow, 'The Role of Law in Preserving Financial Stability', *IMF Blog* (Blog Post, 1 July 2016) <https://blogs.imf.org/2016/07/01/the-role-of-law-in-preserving-financial-stability/>.

[175] For an early account of the regulatory responses, see Farrar, Parsons and Joubert (n 122). A full account of the regulatory response to the GFC is beyond the scope of this thesis.

(a) International Responses

Internationally the regulatory response was coordinated through the FSB. The most significant regulatory changes subsequent to the GFC were in relation to liquidity, capital and resolution regimes for distressed financial institutions.[176] Special resolution arrangements have been created for SIFIs and gSIFIs.[177] Stress-testing has been widely adopted, and in some jurisdictions the concept of a 'living will' or predetermined resolution strategy for complex institutions have been devised.[178] The IMF and FSB perform peer reviews of member countries, and report on the financial stability frameworks in each country against pre-determined criteria.[179]

In some countries, such as the UK, the USA and South Africa, legislative change was implemented in respect of the roles, powers and functions of the financial stability regulator. In 2009, the BOE was given a legislative mandate for financial stability;[180] in 2010 the Federal Reserve was tasked with financial stability through the creation of the Financial Stability Oversight Committee (FSOC).[181] In 2017, the South African Reserve Bank (SARB) was provided with an express

[176] See Reserve Bank of Australia, Submission to the Australian Government, *Financial System Inquiry* (March 2014), Part 3; See also Kevin Davis, 'Financial Regulation after the GFC' (Speech, Melbourne Institute of Applied Economic and Social Research Forums, 8 and 10 September 2009) <https://kevindavis.com.au/secondpages/presentations/MIAESR%20talk%20-%20Sept09%20-%20Financial%20Regulation%20after%20the%20GFC.pdf>.

[177] See the standards adopted by the FSB members: Financial Stability Board, *Key Attributes of Effective Resolution Regimes for Financial Institutions* (Standards, 15 October 2014) <http://www.fsb.org/wp-content/uploads/r_141015.pdf>.

[178] See for example David H Carpenter, *"Living Wills": The Legal Regime for Constructing Resolution Plans for Certain Financial Institutions* (Report, 4 December 2014) <https://fas.org/sgp/crs/misc/R43801.pdf>.

[179] See Financial Stability Board, *FSB Framework for Strengthening Adherence to International Standards* (Standards, 9 January 2010) <http://www.fsb.org/wp-content/uploads/r_100109a.pdf>.

[180] See *Bank of England Act 1998* UK, Part 1A Financial Stability.

[181] Under the *Dodd−Frank Wall Street Reform and Consumer Protection Act*, 12 USC (2010), the Financial Stability Oversight Council (FSOC) was established as a federal body.

financial stability mandate.[182] In the EU, changes were also implemented after the GFC and for example the European Systemic Risk Board (ESRB) was created on the recommendations of the De Larosière report and as a direct response to the GFC.[183] 'In pursuit of its macroprudential mandate, the ESRB monitors and assesses systemic risks and, where appropriate, issues warnings and recommendations'.[184]

(b) Australian Response

In Australia, the Australian Government and the RBA confirmed the RBA's responsibility for financial stability in the 2010 version of the Joint Statement on the Conduct of Monetary Policy, jointly issued by the Treasurer and the Governor of the RBA.[185] This is a non-statutory public document of some significance (even if not legally binding).[186] In this document, the RBA's responsibility for financial stability was characterised as a 'long-standing' obligation.[187] There were no statutory changes to the regulatory framework of the financial stability regulators in Australia after the GFC.

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182 See Corlia van Heerden and Gerda van Niekerk, 'Twin Peaks in South Africa: A New Role for the Central Bank' (2017) 11(4) *Law and Financial Markets Review* 157.

183 'Mission & Establishment', *European Systemic Risk Board* (Web Page) <https://www.esrb.europa.eu/about/background/html/index.en.html>.

184 Ibid.

185 'Financial stability is a longstanding responsibility of the Reserve Bank and its Board, and was reconfirmed at the time of significant changes made to Australia's financial regulatory structure in July 1998. … The Reserve Bank Board oversees the Bank's work on financial system stability. Without compromising the price stability objective, the Reserve Bank seeks to use its powers where appropriate to promote the stability of the Australian financial system. It does this in several ways, …': The Treasurer and the Governor of the Reserve Bank, *Statement on the Conduct of Monetary Policy* (Statement, 30 September 2010) <http://www.rba.gov.au/monetary-policy/framework/stmt-conduct-mp-5-30092010.html>.

186 See further Chapters 4 and 5.

187 Although the RBA had been publishing financial stability reviews as separate publications since 2004, and although the Wallis Inquiry Report also confirmed the role of the RBA in financial stability, the RBA's role in financial stability has not been codified or legislated. See Chapters 4 and 5.

B. *Financial Stability as a Key Central Bank Objective after the GFC*

Financial stability and the role of central banks in financial stability became more important during and after the GFC.[188] It is not entirely settled whether central banks should be responsible for financial stability, given that their main focus is price stability (monetary policy), and may require an accompanying responsibility for systemic regulation (prudential supervision of financial institutions).[189] Not all central banks are also microprudential supervisors.

1 *Financial Stability: An Existing or Desirable Central Bank Responsibility*

The role of central banks in financial stability has been studied and analysed by central bankers, politicians, and academics. Some hold the view that central banks are responsible for financial stability simply by being central banks.[190] Financial stability is widely seen as 'one of the key tenets of a central bank's functions'.[191] Others consider that central banks *should* be responsible for financial stability, if they are not already.[192] For some, financial stability is the

[188] See Peter J N Sinclair, 'Central Banks and Financial Stability' (2000) 40(4) *Bank of England Quarterly Bulletin* 377

[189] Cukierman (n 42) 31. Rosa M Lastra and Luis Garicano argued in 201 that central banks are best placed for macroprudential supervision: Lastra (n 10) 48.

[190] That central banks should be responsible for financial stability, see for example Group of Thirty, *Financial Reform: A Framework for Financial Stability* (Report, 15 January 2009) 1-2 <https://group30.org/images/uploads/publications/G30_FinancialReformFrameworkFinStability.pdf; See also Rebecca Hicks, 'A Potential New Role for Central Banks: A Comparison of Expert Proposals for Reform, Developments in Banking and Financial Law' (2009) 28 *Review of Banking and Financial Law* 448; See Charles A E Goodhart, *The Regulatory Response to the Financial Crisis* (Edward Elgar, 2009).

[191] Alison Lui, *Financial Stability and Prudential Regulation: A Comparative Approach to the UK. US, Canada, Australia and Germany* (Routledge, 2017) 3. According to the BIS, 90 per cent of central banks consider they have a financial stability responsibility: ibid.

[192] In addition to sources cited in n 190, see for example Masaaki Shirakawa, 'Future of Central Banks and Central Banking' (Speech, International Conference, 26 May 2010); See Bank for International Settlements, *Central Bank Governance and Financial Stability* (Report, May 2011) <http://www.bis.org/publ/othp14.pdf> ('Ingves Report'); Praet noted that the so-called 'Jackson Hole consensus', in terms whereof central banks had a minimal direct role to play in financial stability but did so by maintaining price stability and minimising the effects of bubbles, had broken down: Peter Praet, 'The (Changing) Role of Central Banks in Financial Stability Policies'

consequence of price stability, and therefore central banks can be said to have two objectives – price stability and financial stability.[193] However, achieving price stability does not automatically ensure macroeconomic stability.[194] Nevertheless, central banks may assume (explicitly or implicitly) responsibility for financial stability in support of their monetary policy mandate because monetary policy cannot be effective in the absence of financial stability. Financial stability can therefore be seen as an implied obligation of central banks.[195]

Financial stability objectives do not only attach to central banks' monetary policy obligations, but also their LOLR function, and on that basis central banks can be said to have an established responsibility for financial stability. Providing emergency liquidity assistance can promote or secure financial system stability and can prevent or counteract the systemic risk that can be caused by a failing financial institution.[196]

Further, some expressed the view that the importance of a central bank's responsibility for financial stability outweighs its monetary policy obligations. Goodhart, for example, always maintained that monetary policy (ie price stability) was the first and core purpose of a central bank.[197] Other functions, such as the LOLR function, would be secondary. However, Goodhart changed his view, arguing that financial stability is the key function,[198] and that monetary policy could be outsourced to a specialist committee, or even government

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(Speech, Annual Internal Banking Conference, 10 November 2011). See further Parsons, 'Developments in Central Banking' (n 5) 235-238.

[193] Goodhart (n 86) 1; Cukierman, (n 42) 69.

[194] See Shirakawa (n 69).

[195] See Parsons, 'Developments in Central Banking' (n 5).

[196] See Shirakawa (n 69).

[197] Charles A E Goodhart, *The Regulatory Response to the Financial Crisis* (Edward Elgar, 2009) 35.

[198] Goodhart (n 86)19.

department.[199] He emphasised that only the central bank through the use of its balance sheet could enhance financial stability.[200]

Central banks may not have the microprudential tools required to influence the activities and behaviour of regulated institutions, but central banks have the following 'tools' that can be used positively for financial stability:

1. *Expertise, knowledge, research and analysis*: Central banks have the advantage of operating well-respected research departments, which places them in a superior position for executing a financial stability responsibility;

2. *Central banks are well-suited for a macroprudential focus*: Macroprudential policies are time-sensitive policies, often requiring pro-cyclical action, something for which central banks are well-suited;[201]

3. *Monetary policy* can contribute to financial stability;

4. *The central bank balance sheet and the ability to act as LOLR* is a key financial stability tool;

5. *Payment systems* have the potential to create financial stability difficulties, for example through Central Counterparties (CCPs), and central banks that have supervisory powers over the payment system and CCPs can control risks that could have systemic consequences;

6. *Many central banks already publish financial stability reviews*. This and other communications are key tools in procuring financial stability. The

[199] Ibid 5.

[200] Ibid 19.

[201] See Nellie Liang, 'Rethinking Financial Stability and Macroprudential Policy', *Up Front* (Blog Post, 4 December 2017) <https://www.brookings.edu/blog/up-front/2017/12/04/rethinking-financial-stability-and-macroprudential-policy/>.

prestige within which central banks are generally held enhance the effectiveness of central bank communication; and

7. *Communication*: Central banks use influence and persuasion to impact economic behaviour. The forms of communication used by central banks include formal, published communication, but also informal communication in meetings with various stakeholders, as well as moral suasion.

The RBA also uses these tools.

2 *The Challenges and Effects of a Financial Stability Mandate*

(a) Microprudential Regulation and Supervision

Allocating a responsibility for financial stability to one regulatory authority requires consideration of the regulator responsible for prudential regulation and bank supervision. Difficulties can arise if the central bank is the financial stability regulator but not also the microprudential supervisor. For example, the communication and information problems experienced between the BOE and the Financial Services Authority (FSA) in the UK at the time of the problems of Northern Rock Bank at the start of the GFC have led to a reintegration of the bank supervision function into the central bank in 2009.[202] The UK, US and South Africa have adopted the so-called integrated model after the GFC.[203]

Involvement in macro-prudential matters would however expose central banks to the political economy: [204]

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[202] See Julia Black, 'The Credit Crisis and the Constitution' in Dawn Oliver, Tony Prosser and Richard Rawlings (eds), *The Regulatory State: Constitutional Implications* (Oxford University Press, 2010) 92, 124; See also David G Mayes, 'The Role of Central Banks in Financial Supervision and Regulation' (2009) 29(3) *Economic Affairs* 40, 40.

[203] Mayes (n 202) 40; See also Chapters 5 and 8.

[204] Haldane (n 128).

> It has probably also contributed to some people questioning the appropriate scope of central banking, its degree of independence from the political process and from wider society and appropriate accountability mechanisms.

(b) The Importance of Central Bank Independence, Monetary Policy and Concerns about the Democratic Deficit

The extent to which government should be involved in financial stability decisions is important but is ultimately a political question. It is not clear whether the same level of independence – that is the level that is appropriate for monetary policy – is also appropriate for financial stability. Arguably it is not, as financial stability policy has a broader fiscal impact. Inherently, financial stability issues are much more unpredictable in both their cause and in their solution. The GFC is an excellent example, where financial instability was the consequence not of institutions failing because of liquidity problems and a classic 'run on the bank', but because of a spiralling credit crunch. The financial instruments that were intended to spread risk in a positive way, also did so negatively.[205] Instead of providing liquidity in the normal manner, central banks had to provide intermediation to alleviate the credit crunch.[206]

Furthermore, as the LOLR function can directly impact taxpayers, the level of independence required by a central bank acting as LOLR may differ from the current high level of independence that central banks enjoy. Current regulatory frameworks do not always provide for financial stability actions.

The central bank's democratic deficit can be even further exaggerated through an additional financial stability responsibility, especially if it includes a responsibility for microprudential supervision. As Paul Tucker cautions in his

[205] That was the impact of complex securitized instruments such as CDOs.

[206] See Debelle (n 149) 5; See Gruen (n 120).

recent book, such a powerful central bank would sit well outside democratic tolerances for decision-making by unelected officials.[207]

IV. Conclusion

The current roles, nature and regulatory set-up of central banks make a financial stability role for central banks complex – including from a legal and regulatory perspective. Central banks are sui generis institutions, operate as independent mandated regulatory agents and conduct monetary policy – arguably the most significant role among the many important roles of central banks. Central banks are also well-placed to regulate and ensure financial stability, not least because of their ability to act as LOLR, but also through monetary policy, payment systems regulation and their unique aptitude for macroprudential policy. Central bank expertise, prestige and research capabilities are important contributors to their effectiveness in the role of financial stability regulator.

The unique nature and roles of a central bank, whilst making them ideal for a role in financial stability, also makes it complex to provide a central bank with a financial stability mandate. There are however no easy or clear answers as to how a financial stability responsibility would fit in with, and would affect and be affected by, the central bank's other responsibilities. The two most contentious issues are microprudential supervision and central bank independence. The important role that central banks play with monetary policy has important consequences for a financial stability responsibility, not least because of the way in which modern central banks behave and are regulated. Importantly, their current levels of independence derive predominantly from their monetary policy obligations, and independence has come to define modern central banks. As there are larger public policy issues involved with financial stability, the existing levels of central bank independence may not be appropriate. Furthermore, it is not clear what type of governance and accountability arrangements would

[207] See generally Tucker (n 3).

adequately balance out the independence of a central bank that is both responsible for financial stability and monetary policy.[208]

[208] Tucker has expressed some concerns in this regard: Ibid.

CHAPTER 4

The RBA's Responsibility for Financial Stability: An Informal Mandate

It is well-established that every statutory power and discretion is limited by the subject matter, scope and purpose of the statute under which it is conferred.[1]

[A] man with a genius for legislation … [is] rare in the history of the world.[2]

I Introduction

This chapter and the next analyse the regulatory framework and nature of the RBA's financial stability mandate.

It is somewhat surprising that the mandate of the RBA for a goal as important as financial stability is 'informal and decentralised'.[3] Those words – 'informal' and 'decentralised' - were used by the Murray Inquiry to describe the institutional

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[1] *R v Secretary for State for the Home Department; Ex parte Simms* [2000] 2 AC 115, 131, as cited by Chief Justice Robert French, 'Statutory Interpretation and Rationality in Administrative Law: National Lecture on Administrative Law 2015' (2015) 82 *Australian Institute of Administrative Law Forum* 1.

[2] Henry David Thoreau, 'Civil Disobedience' (Web Page) <https://legacy.earlham.edu/~peters/writing/disobey.htm>.

[3] 'Australia has long adopted what could be called a 'macro-prudential' approach to supervision under the rubric of financial stability. Yet, Australia's institutional structure is relatively informal and decentralised. The Reserve Bank of Australia (RBA) and APRA each have responsibility for financial stability. However, most macro-prudential tools can only be deployed by APRA. This places a strong premium on cooperation between the two agencies': Commonwealth, *Financial System Inquiry* (Final Report, November 2014) 233 <http://fsi.gov.au/files/2014/12/FSI_Final_Report_Consolidated20141210.pdf> (Murray Inquiry Final Report).

structure of the Australian financial stability mandate.[4] An informal mandate for financial stability is also surprising because one may have expected that the significance that financial stability assumed during the GFC may have been reflected in subsequent legislation. Also surprising is the confidence with which the Australian government and Australian financial regulators confirm that the RBA does indeed have a financial stability mandate.

In brief, the responsibility of the RBA for financial stability is *informal*, in that it is not an express, legislated responsibility. Rather, the responsibility for financial stability can (at best) be implied in the RBA's founding legislation. The responsibility has become a de facto or customary responsibility and is rooted in the history of the RBA. The execution of the financial stability responsibility further relies on non-legislative and non-binding agreements between the RBA and other regulators to cooperate and collaborate in the pursuit of financial stability. In short, the RBA's general and overarching responsibility for financial stability has no hard law origin and is based on soft law.

The responsibility for financial stability in Australia is further *decentralised***.** The responsibility for financial stability is shared between the RBA, APRA and the CFR. Ultimate responsibility is said to lie with the RBA, but the RBA is not exclusively responsible for financial stability. In fact, APRA has a significant number of financial stability tools, and the CFR influences the RBA's fulfilment of its financial stability mandate.

This chapter analyses how the responsibility of the RBA for financial stability is *informal*. In Chapter 5 the *decentralised* nature of the responsibility will be analysed. Although the regulatory framework of the RBA and other regulators and bodies involved will be discussed in historical perspective, the focus will be on the current regulatory architecture of the RBA (and on the other financial regulators only to the extent relevant).

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[4] The Murray Inquiry Final Report (n 3) 233.

Part II of this Chapter starts with an analysis of the RBA's legislative framework for financial stability and the express and implied statutory mandate for financial stability. It analyses any possible hard law origins of the RBA's financial stability mandate. Part III analyses the soft law origins of the RBA's financial stability mandate, and the extent to which the RBA's mandate is de facto and historical. It also identifies express but non-legal sources (or confirmations) of the RBA's financial stability mandate. This chapter concludes that there is a preponderance of soft law in the regulatory framework of the RBA's financial stability responsibility.

II Hard Law: The Use of Hard Law to Create the RBA's Responsibility for Financial Stability

In stark contrast to the Murray Inquiry's description of the financial stability mandate as 'informal', the RBA and APRA have described the regulatory framework for financial stability in Australia as 'clear and established'. This characterisation was made in an important document, namely the background document for the IMF FSAP team for the Australian country peer review.[5] The RBA and APRA noted: [6]

> Australia's financial stability policy framework involves *clear mandates* for financial stability distributed across several agencies, with the Council of Financial Regulators (CFR) playing a central coordinating role. The prudential elements of that framework rest with APRA, with analytical support from the RBA.

In fact, the RBA does not have a formal legislated mandate for financial stability, and no clear mandate, as will be shown below. The RBA only has a limited

[5] Reserve Bank of Australia and Australian Prudential Regulation Authority, 'Macroprudential Analysis and Policy in the Australian Financial Stability Framework', *Australian Prudential Regulation Authority* (Web Page, September 2012) <https://www.apra.gov.au/macroprudential-analysis-and-policy-australian-financial-stability-framework>. This document – originally prepared as background for the IMF FSAP team in early 2012 – sets out the tools and practices of these two agencies that are designed to support financial stability from a system-wide perspective. The Australian authorities view macroprudential policy as subsumed within the broader and more comprehensive financial stability policy framework.

[6] Ibid (emphasis added).

express legislated mandate for financial stability in relation to the payments system. Similarly, APRA's legislated 'mandate' in respect of financial stability is also not a clear mandate. Financial stability is not a statutory stand-alone objective. APRA's mandate is limited to *considering* financial system stability when balancing APRA's objectives of 'financial safety and efficiency, competition, contestability and competitive neutrality' of the entities it regulates, when performing and exercising its functions and powers.[7] As will be analysed below in this chapter, there is no statutory, overarching, financial stability obligation for the RBA that can be construed to be a broad and 'clear' mandate for financial stability.[8] The analysis classifies the different 'sources' of the RBA's financial stability mandate as different manifestations of 'hard law' and 'soft law'.

A. Hard Law Versus Soft Law – Introductory Comments

Hard law – or black letter law - is generally construed to be law or regulations that are legally binding, and legally enforceable by a central government authority.[9] Typical hard law instruments are parliamentary legislation and regulation promulgated under a legislative authority. Hard law is typically certain, formal, and has the highest level of democratic legitimacy.[10]

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[7] *Australian Prudential Regulation Authority Act 1998* (Cth) s 8(2).

[8] This thesis focuses on the mandate of the RBA, but as the mandate is shared, the mandate of the APRA is also considered.

[9] 'In legal terms "hard law" refers to rules that can be enforced by state sanctions, be they civil, criminal or administrative': Arie Freiberg, *Regulation in Australia* (Federation Press, 2017), 210.

[10] The best example of hard law is statute or formal regulation passed under a statute: Ibid.

Soft law - or ‘grey-letter law’[11] - gives rise to hortatory obligations but can still regulate and influence conduct in a strong and powerful manner.[12] The term soft law has been used to denote agreements, principles and declarations that are not legally binding. Soft law is considered to be quasi-legal instruments with no or weaker binding legal force.[13] Soft law includes ‘the range of rules, instruments and standards’ that influence compliance, but ‘which do not form part of explicit government regulations’.[14] Soft law has also been described as consisting of ‘rules issued by public or private bodies that do not comply with procedural formalities necessary to give the rules a specific legal status’.[15]

Although soft law instruments feature predominantly in the international sphere,[16] there are also many national examples.[17] For example in administrative law, a

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[11] This phrase was used by the Commonwealth Interdepartmental Committee: Commonwealth Interdepartmental Committee on Quasi-regulation, *Grey-Letter Law* (Report, December 1997) IX <https://www.pc.gov.au/research/supporting/grey-letter-law/greyletterlaw.pdf>. The Committee described black-letter law as ‘explicit government regulation’. In its report, ‘the term “quasi-regulation” refers to the range of rules, instruments and standards where government influences businesses to comply, but which does not form part of explicit government regulations. Quasi-regulation can take many forms such as codes of practice, advisory notes, guidelines, and rules of conduct, issued by either non-government or government bodies. In the context of a regulatory spectrum, quasi- regulation might be considered as “grey-letter law”’.

[12] In some instances, soft law can be more effective and important than hard law.

[13] J Paul Lomio, Henrik Spang-Hanssen and George D Wilson, *Legal Research Methods in a Modern World: A Coursebook* (Djoef, 2011).

[14] See Freiberg (n 9) 210.

[15] Rolf H Weber, ‘Overcoming the Hard Law/Soft Law Dichotomy in Times of Financial Crises’ (2012) 1(1) *Journal of Governance and Regulation* 8 11.

[16] See John Kirton, Marina Larionova and Paolo Savona (eds), *Making Global Economic Governance Effective: Hard and Soft Law Institutions in a Crowded World* (Routledge, 2010). Examples of international soft law instruments include for example those of the Financial Action Task Force (FATF), Basel III, the G20 Communiqués and publications from International Organization of Securities Commissions (IOSCO); See also Rolf H Weber, ‘Overcoming the Hard Law/Soft Law Dichotomy in Times of Financial Crises’ (2012) 1(1) *Journal of Governance and Regulation* 8; See also Chris Brummer, ‘Why Soft Law Dominates International Finance – And Not Trade’ (2010) 13(3) *Journal of International Economic Law* 623; See also European Center for Constitutional and Human Rights E V, ‘Term: Hard Law / Soft Law’, *European Center for Constitutional and Human Rights E V* (Web Page) <https://www.ecchr.eu/en/glossary/hard-law-soft-law/>.

[17] See Robin Creyke, ‘”Soft Law” and Administrative Law: A New Challenge’ (2010) 61 *Australian Institute of Administrative Law Forum* 15 <http://www.aial.org.au/aial-forum/volume-61-2010>; See also Robin Creyke and John McMillan, 'Soft Law v Hard Law' in Linda Pearson, Carol Harlow and Michael Taggart (eds), *Administrative Law in a Changing State: Essays in*

range of documents such as internal departmental guidelines, practice manuals, and codes of conduct play an important role.[18] In the context of financial stability, soft law includes, for example, memoranda of understanding, government documents and formal statements by the Australian government and the RBA.[19] Soft law can be very effective as a regulatory tool.[20] It however lacks some democratic credibility.

B. Limited Hard Law Mandate for Financial Stability Relating to the Payments System Only

This analysis starts with the hard law sources of the RBA's mandate.

The RBA currently is responsible for financial stability in two areas:

1. it has an overarching and *general* responsibility for financial stability, and
2. it has a narrow, limited express responsibility for financial stability in relation to the *payments system*.[21]

However, only the latter of these is reflected in legislation. The first is implied; the latter is express. A limited express financial stability mandate in relation to the

Honour of Mark Aronson (Hart Publishing, 2008) 377. The use of soft law in the regulatory framework of financial regulators in Australia has been analysed in Andrew Godwin and Ian Ramsay, 'Twin Peaks: The Legal and Regulatory Anatomy of Australia's System of Financial Regulation' (Working Paper No 074/2015, Centre for International Finance and Regulation, August 2015) <https://apo.org.au/sites/default/files/resource-files/2015/08/apo-nid67377-1188281.pdf>.

[18] Eight categories of soft law have been identified namely procedural rules, interpretive guides, instructions to officials, prescriptive/evidential rules, commendatory rules, voluntary codes, rules of practice, management or operation, and consultative devices and administrative pronouncements: See Robin Creyke, (n 16) 15.

[19] These are identified and discussed below.

[20] See Ellis Ferran and Kern Alexander, 'Can Soft Law Bodies be Effective? The Special Case of the European Systemic Risk Board' (2010) 35(6) *European Law Review* 751; See also Arie Freiberg, *Regulation in Australia* (Federation Press, 2017) 205.

[21] The phrase 'financial system stability' appears in *Reserve Bank Act 1959* (Cth) s 10B(3)(b)(iii). As the Payment System Board is also directed to consider the greatest advantage of Australia, there is also an implied obligation of financial stability overall in the payment systems obligations: Ibid s 10B(3)(a).

payment system has been introduced into the *RBA Act* in 1998, but the *RBA Act* does not expressly confer any overarching general responsibility for financial stability on the RBA.

The *RBA Act* – the RBA's enabling legislation – contains three references to financial stability,[22] but all three relate to the RBA's role as the payments system regulator. In fact, the charter of the RBA (or more specifically, of the Reserve Bank Board[23]), which is contained in s 10(2) of the *RBA Act*[24] is a key source of the RBA's roles and responsibilities, powers and obligations, does not make any express mention of a financial stability responsibility. Although the financial stability obligations in relation to the payments system may at first glance appear to be broad obligations (particularly because the phrase 'overall stability of the financial system' is used twice[25]), they are in fact limited and narrow obligations, and cannot be interpreted to extend to a broader obligation of financial stability as will be demonstrated below. The financial stability obligations in relation to the payments system are now considered in more detail.

1 ***Express Statutory Financial Stability Obligations in Relation to the Payments System***

Two of the three references to financial stability in the *RBA Act* appear in s 10B and the third is in s 25.

[22] Ibid ss10, 25.

[23] The RBA has two boards, the Reserve Bank Board, and the Payment Systems Board, each with its own objectives and responsibilities.

[24] *Reserve Bank Act 1959* (Cth) s 10(2).

[25] Ibid s 10B(3)(b)(iii), s10B(3)(c).

(a) Section 10 RBA Act

The RBA, through the Payments System Board, is responsible for the stability of the financial system within certain parameters and in a particular context. Section 10B(3) of the *RBA Act* sets out the 'charter' of the Payments System Board of the RBA,[26] with objectives that are broadly similar to those of the Reserve Bank Board set out in s 10(2), but for the noticeable difference that s 10B(3) includes express references to financial stability. The Payment Systems 'charter', as s 10B(3) is sometimes referred to, states that the Payments System Board needs to consider 'overall financial system stability'.[27] Notwithstanding the phrase 'overall stability of the financial system' used in this section, this is not an obligation for overarching financial stability for the following reasons.

Section 10B(3) includes two references to the 'overall stability of the financial system', and states:[28]

> It is the duty of the Payments System Board to ensure, within the limits of its powers, that:
>
> a. the Bank's payments system policy is directed to the greatest advantage of the people of Australia; and
> b. the powers of the Bank under the Payment Systems (Regulation) Act 1998 and the Payment Systems and Netting Act 1998 are exercised in a way that, in the Board's opinion, will best contribute to:
>   i controlling risk in the financial system;
>   ii promoting the efficiency of payments system; and
>   iii promoting competition in the market for payment services, consistent with the *overall stability of the financial system*; and

[26] Ibid s 10B(3)

[27] Ibid s 10B(3).

[28] Ibid s10B (emphasis added).

c. the powers and functions of the Bank under Part 7.3 of the Corporations Act 2001 are exercised in a way that, in the Board's opinion, will best contribute to the *overall stability of the financial system*.

When considering the text of the legislation within its context and purpose,[29] it is clear that this section does not confer a general responsibility for financial stability in a broad sense on the RBA. In the absence of definitions in the *RBA Act* of the phrases ‘financial stability’, ‘stability of the financial system’ or ‘financial system’, or of the individual words in those phrases, the context becomes more important in interpreting the legislation. In the context (particularly that of ss 10B(3)(b)—(c)), it is clear that financial stability here refers merely to financial stability directly linked to the effective functioning of the payments system.[30]

Further, this interpretation is also supported by the historical context. The Payments System Board and the powers for the RBA in relation to the payments system were created following the Wallis Inquiry in light of, inter alia, concerns about the impact of new technologies in payments systems.[31] Failure of a financial institution to settle – a failure that can be caused by a problem in the payments system – entails a potential financial stability risk, and was of concern at the time the legislation was passed.[32] It is worth noting that the RITS payment

[29] General principles of statutory interpretation, namely giving consideration to the words or text of the legislation, within their context and purpose, will be adopted. See Chief Justice Robert French, ‘What Were They Thinking? Statutory Interpretation and Parliamentary Intention’ (Sir Frank Kitto Lecture, University of New England, 23 September 2011) <http://www.hcourt.gov.au/assets/publications/speeches/current-justices/frenchcj/frenchcj23sep11.pdf>.

[30] Read in context and especially in light of the introductory words in s 10B(3)b, the term ‘financial system stability’ in s 10B3(iv) refers to financial stability directly linked to the effective functioning of the payment system.

[31] The creation of the Payments System Board coincided with potential risks associated with a dramatic increase in technological developments in payment systems.

[32] The payments system is ‘the infrastructure which facilitates the several million payments made each day in Australia, that is, the mechanics of how individuals, businesses and governments are enabled to meet their monetary obligations to others’: Explanatory Memorandum, *Payments Systems (Regulation) Bill 1998*, introduced on 26 March 1998, House of Representatives.

system,[33] Australia's first RTGS system, was introduced in 1998, around the same time that the Payments System Board in the RBA was created and the payments system regulatory obligations given to the RBA. RITS, the RTGS that was intended to dramatically reduce the risk of payment failures between the banks, is an important example of technological advancements at the time of the promulgation of the legislation. Because of the highly sensitive nature of payment settlements, regulation of the system has always been of paramount importance. It was emphasised in the explanatory memorandum[34] to the RBA amendment legislation in 1998 (an amendment to include the payments system regulatory obligations for the RBA) that '[a] safe and reliable payments system is also essential for the smooth functioning of a country's economy',[35] and is important for the general functioning of the Australian economy.[36] In summary, the focus was on (1) the payments system's safety and integrity, (2) its efficiency, (3) competition among service providers, and (4) the manner in which the RBA used its powers in relation to the payments system. It is with reference to the last two of these objectives that the legislation expressly requires the RBA to consider financial stability. Financial stability can become an issue with competition in the payments system (see s 10B(3)(b)(iii)), as for example the introduction of new players into the payments systems market can create a risk that could lead to payments system – and potentially financial system – instability.

Similarly, in s 10B(3)(c) of the *RBA Act*, which requires the RBA to exercise its powers and functions under Part 7.3 of the *Corporations Act 2001* (Cth) in a way

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[33] See 'About RITS', *Reserve Bank of Australia* (Web Page) <https://www.rba.gov.au/payments-and-infrastructure/rits/about.html>.

[34] Explanatory Memorandum *Payments Systems (Regulation) Bill 1998*, (n 32).

[35] Ibid.

[36] The reason is that '[t]he risks, which are of particular interest to those responsible for managing the national payments system, come from exposures between institutions' participation in the payments clearing and settlement process. These risks would crystallise *(sic)* if an institution were unable to meet its settlement obligations to other participants in the payments system': Explanatory Memorandum *Payments Systems (Regulation) Bill 1998* (n 32). Further, reforms were necessary after the Wallis Commission for 'the enhancement of the safety and integrity of the system', and 'to improve the efficiency with which payments instructions are handled and funds made available, and to promote greater competitive equity among service providers'.

that will 'best contribute to the overall stability of the financial system',[37] the express responsibility for the stability of the financial system is a limited responsibility. It is limited to the context of potential instability in the system created by clearance and settlement services providers. Although the responsible Minister issues licences to clearing and settlement services providers, the RBA has limited regulatory influence under Part 7.3 of the *Corporations Act 2001* (Cth).[38] The RBA may in its discretion[39] set standards[40] for licensed service providers,[41] in consultation with clearance and settlement service providers and ASIC,[42] and may revoke the standards in consultation with ASIC.[43] Considerations of financial system stability in this context are therefore very narrow.[44] The Central Counterparty (CCP) Standards regulate the conduct of central counterparties that generally reduce risk in the system, and play an important role in financial stability in the payments system. The standards are aimed at ensuring that there is stability in the payments system. The Securities Settlement Facilities (SSF) Regulations for securities settlement facilities are intended to ensure that the licencees properly identify and control risks that are associated with the operation of the securities settlement facilities and that SSFs conduct their affairs in accordance with the SSF Standards so as to promote overall stability of the financial system. The SSF Standards also do not define

[37] *Reserve Bank Act 1959* (Cth) s10B(3)(c).

[38] *Corporations Act 2001* (Cth) Part 7.3 and ss 820A, 820B, 820C. Applications are made to the Minister who may also place conditions on a licence, and vary or cancel licences.

[39] The RBA has discretionary powers ('may'): *Corporations Act 2001* (Cth), 827D(1).

[40] There are two sets of standards, namely the Financial Stability Standards for Central Counterparties (CCP Standards) and the Financial Stability Standards for Securities Settlement Facilities (SSF Standards): See 'Financial Stability Standards for Central Counterparties December 2012', *Reserve Bank of Australia* (Web Page, December 2012) <https://www.rba.gov.au/payments-and-infrastructure/financial-market-infrastructure/clearing-and-settlement-facilities/standards/central-counterparties/2012/>.

[41] *Corporations Act 2001* (Cth), s 827D.

[42] Ibid ss 827D(3), 827D(6).

[43] Ibid s 827D(8).

[44] When considering the focus and content of these standards, it is clear that the express legislative responsibility of the RBA for financial stability in this regard also focuses on a narrow conception of financial stability.

‘financial system’ nor do they contain a definition of ‘financial system stability’ or any synonymous term.

In conclusion, s 10 of the *RBA Act* therefore, firstly, does not contain an express mandate for financial stability in a broad and general sense, but limits the financial stability responsibility to the payments system. Secondly, the obligations in relation to financial stability in s 10 of the *RBA Act* are limited to making financial stability a consideration and not a clear goal/objective in itself.

(b) Section 25 RBA Act

The third express reference to ‘financial stability’ in the *RBA Act* is in s 25M(1)(d). Section 25M requires the RBA’s Payments System Board to provide an annual report to the Minister of Finance in relation to standards determined under s 827D of the *Corporations Act 2001* for operators of clearing and settlement systems.[45] The considerations of financial stability relevant to this section are considerations that relate to the clearing and settlement industry, part of Australia’s payments system. In this context there is also no broad overarching mandate for considerations of financial stability, and considerations of financial stability are limited to potential financial instability that can ensue as a result of problems in the clearing and settlement industry.

An ancillary obligation exists in s 827D of the *Corporations Act 2001*. It empowers the RBA to set financial stability standards. Under the *Corporations Act 2001*, both the RBA and ASIC have various powers relating to licensing, standard-setting and direction over providers of clearing and settlement facilities.[46]

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[45] *Reserve Bank Act 1959* (Cth) s 25M(1). The Payment Systems Board must provide an annual report to the Minister.

[46] *Corporations Act 2001* (Cth) s 821-7. ‘The *Corporations Act 2001* includes as an objective “the reduction of systemic risk and the provision of fair and effective services by clearing and settlement facilities”. To support this objective, the Act … gives the RBA the power to set financial stability standards, and gives both the RBA and ASIC various powers … The two agencies agreed on an MOU in 2002, detailing the processes and information-sharing arrangements they would follow in pursuit of these joint responsibilities’: Reserve Bank of Australia and Australian Prudential Regulation Authority (n 5).

Section 25 of the RBA Act therefore also does not give a clear and express mandate for general financial stability to the RBA. In fact, the strongest legislated 'mandate' for financial stability is simply to balance financial stability considerations with other objectives,[47] and is not a direct stand-alone goal.

2 *An Implied Statutory Mandate for Financial Stability in the RBA Act: A Mandate that Attaches to the Nature of a 'Central Bank', its Policies and Broad Public Obligations*

Although there is no express specific mandate for financial stability, the RBA's general mandate to act as a central bank has on occasion been interpreted to imply a mandate for financial stability.

It can be argued that the RBA's responsibility for financial stability is *implied* in the *RBA Act*, and that a responsibility for financial stability forms part of its 'monetary and banking policy'[48] or simply part of its role as a central bank. Alternatively, or additionally, it can be argued that the RBA's role in financial stability has become binding as an entrenched *de facto* role, one that was always part of the responsibilities of the central bank, albeit not expressly identified as such. The implied mandate will be examined after a brief summary of the RBA's general express legal mandate/charter. Other sources that confirm the RBA's financial stability mandate – but that cannot legally create a mandate – will be examined as part of the RBA's de facto financial stability role in Part III below.

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[47] Regarding competition, 'the strongest legislated mandate … is simply to 'balance' it with other objectives while promoting financial system stability': See Productivity Commission, *Competition in the Australian Financial System: Overview and Recommendations* (Inquiry Report No 89, 29 June 2018) <https://www.pc.gov.au/inquiries/completed/financial-system/report/financial-system-overview.pdf>.

[48] *Reserve Bank Act 1959* (Cth) s 8A(2).

(a) The RBA's General Express Statutory Mandate or Charter

No express responsibility for financial stability was incorporated into either the mandate of the RBA in the *RBA Act* when the RBA was first created as a central bank under that name in 1959, or in the 1901 charter of its predecessor, the Commonwealth Bank, the first Australian central bank.

The mandate of the RBA in the *RBA Act* is included in s 10(2)[49] and is also referred to as its 'charter'. In terms of s 10(2) the RBA (through the Reserve Bank Board) has the duty to: [50]

> ensure that the monetary and banking policy of the Bank is directed to the greatest advantage of the people of Australia and that the powers of the Bank … are exercised in such a manner as, in the opinion of the Reserve Bank Board, will best contribute to:
>
> a. the stability of the currency of Australia;
>
> b. the maintenance of full employment in Australia; and
>
> c. the economic prosperity and welfare of the people of Australia.

The 'monetary and banking policy' referred to in s 10 forms part of the express obligations of the RBA pursuant to s 8A(2) of the *RBA Act*,[51] which states that '[t]he Reserve Bank Board is responsible for the Bank's monetary and banking policy'.

Although its charter does not contain an express legislative requirement for the RBA to promote financial stability, the RBA has been considered to have a 'longstanding responsibility' to maintain the stability of the Australian financial

[49] Ibid s 10(2).

[50] Ibid s 10(2); See for example also, 'Our Charter, Core Functions and Values', *Reserve Bank of Australia*, (Web Page, 2015) <https://www.rba.gov.au/publications/annual-reports/rba/2015/our-charter-core-functions-and-values.html>.

[51] *Reserve Bank Act 1959* (Cth) s 8A2.

system.[52] This has for example been confirmed by the RBA and APRA in the document provided to the IMF for the Australian Country peer review. They noted:[53]

> Given the serious damage to employment and economic prosperity that can occur in times of financial instability, the [RBA] Act has long been interpreted to *imply* a mandate to pursue financial stability.

The general responsibility of the RBA for financial stability is endorsed by the Australian government. The Australian government has at times even referred to having actively provided this mandate to the RBA, albeit not through legislation.[54] This position has also been echoed by the RBA. For example, Dr Luci Ellis of the RBA has stated publicly in Sydney in 2016[55] that the RBA considers the statements made by the Treasurer during the Second Reading Speech of the *APRA Act* in Parliament in 1998 to be the legal source of the RBA's mandate for financial stability (this point will be returned to later).

Statements by both the Australian government and the RBA regarding the RBA's mandate for financial stability however intimate a level of formality in mandating that does not in fact exist, as the manner in which the Australian government has provided a financial stability responsibility to the RBA is decidedly informal/non-legal, and there's no formal legal mandate. (The informal origins of the mandate are dealt with in more detail below). Further, the content of the RBA's financial stability responsibility has not been clarified. The general responsibility for

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[52] See for example, The Treasurer and the Governor of the Reserve Bank, *Statement on the Conduct of Monetary Policy* (Statement, 30 September 2010) <http://www.rba.gov.au/monetary-policy/framework/stmt-conduct-mp-5-30092010.html>.

[53] Reserve Bank of Australia and Australian Prudential Regulation Authority (n 5); See also Reserve Bank of Australia and Australian Prudential Regulation Authority, *Macroprudential Analysis and Policy in the Australian Financial Stability Framework* (Report, September 2012) <https://www.rba.gov.au/fin-stability/resources/2012-09-map-aus-fsf/pdf/2012-09-map-aus-fsf.pdf> (emphasis added).

[54] See below.

[55] Luci Ellis, 'Financial Stability and the Banking Sector' (Speech, Sydney Banking and Financial Stability Conference, 12 July 2016) <https://www.rba.gov.au/speeches/2016/sp-so-2016-07-12.html>. This point was made during the delivery of her speech at a conference which the author attended.

financial stability is therefore at best the product of soft law, and is a non-legal, non-binding, customary, de facto and/or implied responsibility.[56]

Before moving to the discussion of the financial stability mandate as an implied mandate, it should be noted that a creature of statute (such as the RBA) is legally bound by the authorities granted to it by its founding statute. Its amount of legal 'wiggle room' is probably small. Failure to comply with its statutory obligations can have consequences of varying significance for the institution concerned.[57] Therefore, although it could be argued that an implied responsibility for financial stability exists under the *RBA Act*, such arguments are only moderately convincing because a very liberal interpretation of the statute would have to be taken to find that such a unique and specific responsibility has in fact been implied. This view was also expressed in the Murray Inquiry, namely that 'the RBA takes its mandate to promote financial stability *as implied* under the Reserve Bank Act 1959'.[58] Financial stability is also explicitly included in the Statement on the Conduct of Monetary Policy[59] agreed between the Treasurer and the Governor of the RBA, most recently in October 2013. The possible implied statutory mandate for financial stability is now discussed.

[56] 'This implicit goal has been made more explicit by successive governments. In 1998, the then Treasurer explicitly referred to financial stability being the regulatory focus for the RBA, in the Second Reading Speech in support of the *APRA Act*. More recently, in 2010 the RBA and the Government recorded their common understanding of the RBA's longstanding responsibility for financial system stability, as part of the periodically updated Statement on the Conduct of Monetary Policy': See Reserve Bank of Australia and Australian Prudential Regulation Authority (n 5).

[57] The potential consequences are discussed in Chapter 7. They range from minor (potentially a proverbial slap on the wrist), to more serious, including termination of employment of key officials including the Governor.

[58] See Reserve Bank of Australia and Australian Prudential Regulation Authority (n 5) (emphasis added).

[59] The first such statement was made in 1996. The Treasurer and the Governor (designate) of the Reserve Bank, *Statement on the Conduct of Monetary Policy* (Statement, 14 August 1996) <https://www.rba.gov.au/monetary-policy/framework/stmt-conduct-mp-1-14081996.html>.

(b) An Implied General Statutory Mandate for Financial Stability?

There are *four possible reasons* why a responsibility for financial stability could be said to be implied in the *RBA Act*. These are examined below, including the inherent difficulties in each of the four arguments.

(i) Central Banks as Institutions are Generally Responsible for Financial Stability: The RBA as a Central Bank

The first possible argument is that the RBA is a central bank and as such is responsible for financial stability because financial stability is considered by many to be a central bank responsibility (see Chapter 2). Central banks traditionally have broad general powers, and in the opinion of at least some experts, an automatic responsibility for financial stability.[60]

The RBA was clearly established expressly as a central bank under the *RBA Act*:[61]

> **26 Reserve Bank to act as a central bank**
>
> The Reserve Bank:
>
> (a) is the central bank of Australia;
>
> (b) shall carry on business as a central bank; and
>
> (c) subject to this Act and to the Banking Act 1959 shall not carry on business otherwise than as a central bank.

The fact that the RBA would be a central bank – and a central bank only – was the key reason for the introduction of the 1959 legislation to create the RBA as separate from the Commonwealth Bank which was the central bank up to that point. This shift in the Commonwealth Bank's focus was important, and it was a

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[60] For example, Claudio Borio and Gianni Toniolo, 'One Hundred and Thirty Years of Central Bank Cooperation: A BIS perspective' (Working Paper No 197, Bank for International Settlements Monetary and Economic Department, February 2006) <https://www.bis.org/publ/work197.pdf>, Charles A E Goodhart, 'The Changing Role of Central Banks' (Working Paper No 326, Bank for International Settlements, November 2010), <http://www.bis.org/publ/work326.pdf>, Alex Cukierman, 'Central Bank Independence and Monetary Policy-Making Institutions: Past, Present and Future' in David Mayes and Geoffrey E Wood (eds), *Designing Central Banks* (Routledge, 2009) 68.

[61] *Reserve Bank Act 1959* (Cth) s 26.

vigorously debated topic in Parliament, resulting in the draft legislation having to be resubmitted a number of times.[62] Some of the contentious issues included the changes proposed to the Commonwealth Bank, which, since its inception in 1910, conducted both central banking and commercial banking functions, and the impact of those changes on the Commonwealth Bank and other banks. The role and impact of a central bank divorced from the Commonwealth Bank were not generally acceptable to members of Parliament.[63] However, the *RBA Act* was ultimately passed and the RBA was created as a central bank – and only a central bank – in 1959.

In the Second Reading speech of the Reserve Bank Bill in 1959, the then Treasurer, the Hon Harold Holt, made no mention of financial stability, and emphasised the creation of an independent central bank without any commercial banking functions.[64] The purpose of the Reserve Bank Bill 1959 (Cth) was simply to establish a central bank:[65]

> The Reserve Bank Bill is related to the first of these main purposes - namely, the establishment of the Reserve Bank of Australia as the central bank for the

[62] See Commonwealth, *Parliamentary Debates*, House of Representatives, 26 February 1959, 375-378 (Harold Holt) (Second reading speech).

[63] See the debate in the House of Representatives: Parliamentary Debate, following second reading speech, Reserve Bank Bill 1959, Commonwealth, *Parliamentary Debates*, House of Representatives, 10 March 1959, 440–468; Parliamentary Debate, Commonwealth, *Parliamentary Debates*, House of Representatives, 11 March 1959, 485–540.

[64] In the second reading speech the various tasks/obligations of the RBA were listed as follows: 'Like the Commonwealth Bank it will control the note issue and it will also have important responsibilities under the Banking Act. These will include administration of the statutory reserve deposit provisions, exchange control, acquisition and sale of gold, protection of depositors in other banks, determination of advance policy to be followed by trading banks and savings banks and, subject to the approval of the Treasurer, the regulation of bank interest rates. Except for the substitution of statutory reserve deposits for the present special accounts, these are all functions now discharged by the Commonwealth Bank and, with some changes of detail which I shall discuss in the Banking Bill, the duties and powers of the Reserve Bank in relation to them will be the same as those of the Commonwealth Bank': See Harold Holt (n 62) 378. In addition, the RBA also took on the function of the 'Rural Credits Department': at 376.

[65] See Holt (n 62) 376. See also Frank Decker and Sheelagh McCracken, 'Central Banking in Australia and New Zealand: Historical Foundations and Modern Legislative Frameworks' in Peter Conti-Brown and Rosa María Lastra (eds), *Research Handbook on Central Banking* (Edward Elgar, 2018) 245, 266. Decker and McCracken point out that the term 'central bank' is not defined.

> Australian monetary and banking system and as an institution that will not be directly associated with the conduct of retail banking business.

Financial stability is currently widely considered to be a central bank function, as set out above in Chapter 3, and the role of the RBA as a central bank in financial stability is further discussed as part of a de facto mandate below [Part III]. It can therefore be implied that as central banks are now also perceived to be responsible for financial stability, the RBA may also be perceived to be responsible for financial stability, even though that role was not envisaged at the time of its creation.

(ii) Financial Stability is Inherent in the Broad Goals and Objectives of the RBA's Express Charter

The second argument that could be made in favour of an implied mandate for financial stability under the general mandate of the RBA in the *RBA Act*, is that the broad goals and objectives of the RBA's charter allow for the RBA to pursue financial stability. In fact, financial stability could be said to be inherent in the broad goals and objectives of the RBA's express charter. The pursuit of financial stability can be seen as a way to achieve 'the greatest advantage of the people of Australia'[66] and ensure the 'economic prosperity and welfare of the people of Australia'.[67] In fact, the RBA and APRA noted:[68]

> [g]iven the serious damage to employment and economic prosperity that can occur in times of financial instability, the [RBA] Act has long been interpreted to imply a mandate to pursue financial stability.

[66] *Reserve Bank Act 1959* (Cth) s 10(2).

[67] Ibid.

[68] See Reserve Bank of Australia and Australian Prudential Regulation Authority (n 5).

At the time of the passing of the Reserve Bank Bill 1959 as well as the Commonwealth Bank Bill 1959,[69] consideration was specifically given to the 'stability' and 'stable development' of the Australian economy.[70] Although these expressions used by the then Treasurer may not fully encompass what is currently understood under the term 'financial stability', they do reflect the broader possible consideration of the concept of financial stability (as discussed in Chapter 2 above).

Nevertheless, even if the references to the welfare of the Australian economy in the RBA's charter are to be interpreted as references that are effectively synonymous with 'financial stability', the charter still does not give the RBA any direct responsibility for financial stability. Instead, financial stability (or the economic welfare of Australia) is merely *a consideration*, albeit an important one, in the conduct of the responsibilities of the RBA, and *not an objective in itself*. There is no direct 'mandate' for financial stability: the *RBA Act* merely requires that the monetary and banking policy should be implemented and that the powers of the RBA should be exercised in a manner that would promote welfare (including financial stability). Welfare (including financial stability) operates as a check or brake on other powers, not as a separate goal or objective.

It is also important to consider that the reference to the RBA's powers in this context refers to the powers provided to the RBA as general powers in the *RBA Act*. These powers are necessary for the RBA to fulfil its functions and give effect to the purposes of the *RBA Act* (although the purposes of the RBA and the *RBA Act* have not been clearly defined or set out in the *RBA Act*). Although the RBA's enumerated powers set out in s 8 of the *RBA Act* are a non-exclusive list, they are nevertheless quite specific (and by implication limited) powers:[71]

[69] Commonwealth, *Bills Digest* (Senate Official Hansard No 16 of 1959, 15 April 1959) <https://parlinfo.aph.gov.au/parlInfo/search/display/display.w3p;query=Id%3A%22hansard80%2Fhansards80%2F1959-04-15%2F0046%22;src1=sm1 > (Commonwealth Bank Bill 1959).

[70] See Holt (n 62) 378.

[71] *Reserve Bank Act 1959* (Cth) s 8.

Section 8 General powers

The Bank has such powers as are necessary for the purposes of this Act and any other Act conferring functions on the Bank and, in particular, and in addition to any other powers conferred on it by this Act and such other Acts, has power:

(a) to receive money on deposit;

(b) to borrow money;

(c) to lend money;

(d) to buy, sell, discount and re-discount bills of exchange, promissory notes and treasury bills;

(e) to buy and sell securities issued by the Commonwealth and other securities;

(f) to buy, sell and otherwise deal in foreign currency, specie, gold and other precious metals;

(g) to establish credits and give guarantees;

(h) to issue bills and drafts and effect transfers of money;

(i) to underwrite loans; and

(j) to do anything incidental to any of its powers.

The RBA's powers do not include any express powers in relation to financial stability, although the RBA could conceivably impact financial stability in the fulfilment of any and/or all of its tasks. Notwithstanding the broad characterisation of the powers of the RBA in s 8, the powers of the RBA should be interpreted reasonably to be limited to powers 'necessary' for particular purposes, so as to avoid an interpretation that gives the RBA virtually unlimited powers. Such a reasonable or more limited interpretation is now in line with the requirements of the *Public Governance, Performance and Accountability Act 2013* (Cth) (*PGPA Act*), including in particular s 26 of the *PGPA Act*, which requires officials to act with 'proper purpose'.[72] Ultimately, as per the 1959 Second Reading speech of

[72] Under the *Public Governance, Performance and Accountability Act 2013* (Cth) s 26 the RBA officials are obliged to act honestly, in good faith and for a proper purpose.

the Reserve Bank Bill,[73] the Reserve Bank Board had to ensure that the RBA stayed within the powers given to it.

The *RBA Act* also limits the powers of the RBA by allowing for the government to override the policy of the RBA. This reassurance was emphasised to Parliament during the Second Reading Speech. Then Treasurer, the Hon Harold Holt stated:[74]

> The duty is laid upon the board, as it is now laid upon the Commonwealth Bank, to ensure *within the limits of its powers* that the monetary and banking policy of the bank is directed to the greatest advantage of the people of Australia, and that *the powers of the bank are used to promote the stability of the currency, the maintenance of full employment and the economic prosperity and welfare of the people of Australia*. There are also provisions, similar to those in the present act, which require the board to *keep the Government informed* regarding the monetary and banking policy of the bank and, in the event of a difference of opinion between the board and the Government on that policy, *give the Government an ultimate power* to determine the policy of the bank. Under the board, the Governor will manage the bank. He will, as I have said, continue to be chairman of the board.

Lastly, even though it is clear that the powers of the RBA were to be interpreted broadly, broad powers are not unlimited powers, and finding implied powers and implied mandates in legislation should as a matter of principle be a conservative endeavour.

(iii) Financial Stability Is a Consequence of Monetary Policy

An argument could also be made that a mandate for financial stability can be implied through the responsibility of the RBA for monetary policy. Although the charter in s 10(2) of the *RBA Act* does not contain an express monetary policy mandate or specific operational responsibilities, it refers broadly to the ‘monetary

[73] See Holt (n 62) 377.

[74] Ibid (emphasis added).

and banking policy' of the RBA – a reference likely intended to encompass all the tasks and functions of the RBA as a central bank,[75] and reasonably interpreted to have that meaning. In terms of s 8A(2)[76] too, '[t]he Reserve Bank Board is responsible for the Bank's monetary and banking policy'. These references are probably not broad enough to encompass financial stability, although there are some experts who consider financial stability to be a fundamental requirement and consequence of monetary policy.[77] Before the GFC, for example, there was a widely held view that monetary stability also equalled financial stability. In the 1970s and 1980s, when inflation threatened domestic economies, effective monetary policy (that maintained the domestic and international value of the currency) certainly contributed to financial stability. Financial stability can be or is a consequence of monetary stability, and financial stability can potentially be seen as the ultimate goal of monetary policy. On that basis a responsibility for financial stability may be considered to be implied in the RBA's charter.[78] Given the significantly different considerations of financial stability policy compared to monetary policy, however, this conclusion is open to criticism.

(iv) Financial Stability Is a Consequence of the RBA's Banking Policy

Arguments that a financial stability mandate can be implied through the references to the RBA's 'banking policy' in the *RBA Act* are somewhat persuasive. In 1959, the RBA was responsible for the oversight and supervision of banks and financial institutions – that role was only removed from the RBA in 1998 with the creation of APRA. To the extent, however, that the RBA's role as

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[75] See generally Holt (n 62) 375-378.

[76] *Reserve Bank Act 1959* (Cth) s 8A2.

[77] See for example William Dudley, 'Why Financial Stability is a Necessary Prerequisite for an Effective Monetary Policy' (Speech, Andrew Crockett Memorial Lecture, Bank for International Settlements 23 June 2013) <https://www.newyorkfed.org/newsevents/speeches/2013/dud130624.html>.

[78] See for example Thomas C Baxter, 'Financial Stability: The Role of the Federal Reserve System' (Speech, Future of Banking Regulation and Supervision in the EU Conference, 15 November 2013) <http://www.newyorkfed.org/newsevents/speeches/2013/bax131120.html>.

lender of last resort to distressed financial institutions could form part of the 'banking policy' of the RBA, financial stability could be argued to be implied as a responsibility of the RBA. It should however be noted that the role of the central bank as LOLR is a very limited part of the overall pursuit of financial stability, and an obligation on the RBA to conduct its banking policy for the benefit of the Australian people does not lead to the conclusion that there is in fact an implied mandate for financial stability in a broad sense on the RBA.

In conclusion, the RBA's mandate for financial stability has a very limited basis in hard law, in the absence of an express mandate for an overarching responsibility for financial stability. The express statutory obligations in relation to financial stability do not equate to a general 'mandate for financial stability'. The RBA's 'general financial stability mandate' would at best have to be implied from other statutory obligations. The other sources of the RBA's mandate for financial stability are soft law sources. These will be discussed below.

III The Soft Law Origins of the RBA's Financial Stability Mandate

In addition to the argument that a mandate for financial stability can be implied into the statutory role of the RBA as a central bank per se, it can be argued that, through its role since its first inception, the Australian central bank has always contributed to financial stability. Its role in financial stability has therefore become a de facto role in financial stability: the implied mandate effectively equates to a de facto mandate. In this section, the other soft law origins of the RBA's financial stability mandate are discussed that contribute to the de facto mandate. Responsibilities of regulators can also arise from non-legally binding sources, even though the legal nature and consequences of such responsibilities are different.

The potential soft law origins of the RBA's financial stability responsibility include statements by the Australian government (eg in Parliament and in semi-formal public documents), statements by the RBA itself (including on its public website, public documents, and in collaboration with the Treasurer in semi-formal public documents), and undertakings given through memoranda of understanding with other financial regulators. These other potential soft law sources of a financial stability mandate are analysed below.

A *A De Facto Historical Responsibility for Financial Stability*

As noted above (See Chapter 3 and Part II B 2 above) a compelling argument can be made that central banking per se has a positive effect on financial stability, and in this vein, then, it can be argued that the Australian central bank has in fact always had a responsibility for financial stability since its inception. For the de facto mandate to have been historically part of the functions of the Australian central bank since its inception, the concept of financial stability needs to be construed broadly.[79]

Even though the RBA has never had an express or explicit legislative mandate for safeguarding financial stability in an overarching manner, both the RBA and its predecessor, the Commonwealth Bank, have always directly or indirectly (intentionally or incidentally), contributed to the promotion of financial stability in Australia. Financial stability was achieved as a consequence of fulfilling the central bank's other or general functions. The RBA and the Commonwealth Bank have therefore always been involved – in one way or another – in promoting and/or protecting financial stability.

This conclusion can be reached even though a possible mandate of the Australian central bank for financial stability did not expressly form part of the discussion in Parliament during the Second Reading Speech debates when the relevant enabling legislation was tabled and discussed in the House of

[79] See Chapter 2 for a discussion of the narrow versus broad interpretation of financial stability.

Representatives and the Senate in 1910 (for the creation of the Commonwealth Bank) or in 1959 (for the creation of the RBA).

Even though there was no express (or determinable) legislative intent in 1910 or 1959 to make the Australian central bank responsible for financial stability, by the time of the Wallis Inquiry in 1997 it was well recognised that the RBA indeed contributed to financial stability, and financial stability had almost imperceptibly become a 'central bank function', albeit an unarticulated function. Nevertheless, the recommendation by the Wallis Inquiry in 1998 that the RBA should '*retain* its responsibility for financial stability'[80] is indicative of the fact that financial stability was at that time a perceived established function of the RBA, potentially from the very first time that the RBA or its predecessor acted as a central bank. Given the rising importance of financial stability as a concept in the 1990s, this reference by the Wallis Inquiry may simply be a reflection of economic thought at the time.

Historically, however, an overarching and general consideration of financial stability evolved over time, starting with the predecessor of the RBA, the Commonwealth Bank. The RBA's role in financial stability is therefore deeply rooted in its history.

1 *History of the Creation of the First Australian Central Bank and its Role in and Responsibility for Financial Stability – the Commonwealth Bank and its De Facto Mandate for Financial Stability*

The role that the RBA and its predecessor, the Commonwealth Bank, played in financial stability can be traced back to the time of the creation of the

[80] The Wallis Commission recommended (in Recommendation 56) that the RBA should remain responsible for system stability. It noted that the RBA was best placed 'to ensure the stability of the financial system and to manage systemic risks' in consultation with Treasury and other regulators. Recommendation 60 was that the RBA should retain the responsibility for liquidity management to preserve stability. Recommendation 62 was that the payment systems board should implement payments systems efficiency objectives: See Commonwealth, *Financial System Inquiry* (Final Report, March 1997) <https://static.treasury.gov.au/uploads/sites/1/2018/07/01-fsi-fr-Prelim.pdf> (Wallis Inquiry Final Report).

Commonwealth Bank, from which time it developed into a de facto mandate for financial stability.[81]

(a) The Commonwealth Bank of 1911 – Financial Stability Through Safe Banking Services and Stability in the Banking Sector

(i) A Federally Guaranteed Bank – a Safer Commercial Bank

In 1911, following a number of bank crises in Australia and the inevitable public toll of those crises,[82] the Australian government passed legislation to create the Commonwealth Bank as a government-owned people's bank[83] with the purpose of providing safer and cheaper banking services to the Australian public. At the time of its creation, the Commonwealth Bank was empowered to conduct savings as well as general (trading) bank business and was the only bank to be involved in these two traditionally separate business areas. The Commonwealth Bank was however not a true 'central bank' at this time,[84] but rather only a commercial bank with a government guarantee.[85] The Commonwealth Bank was intended to benefit the Australian public by not only being more secure, but also by providing

[81] For a history of the Commonwealth Bank see: 'Our History', *Commonwealth Bank of Australia* (Web Page, 2019) <https://www.commbank.com.au/about-us/our-company/history.html>.

[82] See generally Chay Fisher and Christopher Kent, 'Two Depressions, One Banking Collapse' (Research Discussion Paper No 1999-06, Reserve Bank of Australia, June 1999) <https://www.rba.gov.au/publications/rdp/1999/pdf/rdp1999-06.pdf>.

[83] The governing Australian Labor Party, under the leadership of Tim Fischer, introduced the first Bill to establish the Commonwealth Bank in 1911. The Commonwealth Bank started operating in 1912. See Commonwealth Bank of Australia (n 81); See also 'A Brief History', *Reserve Bank of Australia* (Web Page) <https://www.rba.gov.au/about-rba/history/>.

[84] Selwyn Cornish, *The Evolution of Central Banking in Australia* (Reserve Bank of Australia, 2010) 3. See also Stephen Bell, *Australia's Money Mandarins: The Reserve Bank and the Politics of Money* (Cambridge University Press, 2004) 8. The Commonwealth Bank performed (limited) central banking functions.

[85] The Commonwealth Bank broadly contributed to financial stability. As it had a federal government guarantee, it would not experience a traditional 'run' on a bank, and would therefore not create systemic risk.

financial services more cheaply than the privately owned banks.[86] It functioned as a commercial bank to the public, but also as banker to government, under a federal government guarantee. No other bank had that privilege.[87]

The way in which the Commonwealth Bank was regulated in terms of its statutory framework laid the groundwork for its ultimate evolution as a full service central bank and financial stability regulatory agency, in large part due to its original government guarantee.[88] The provision of safer banking services backed by a government guarantee contributed to financial stability, and the creation of the Commonwealth Bank by the Australian Government contributed to financial stability. Creating a stable commercial bank that was protected from liquidity problems and where, as a consequence, depositor funds would be safe, was an important step in counteracting financial instability. While the stability of a single institution does not guarantee broad-spectrum financial stability, the instability of a single institution can create financial instability on a broader scale and lead to systemic risk.[89] Consequently, although the stability of the Commonwealth Bank could not safeguard the entire financial system, as a stable bank it would unlikely create systemic risk and thereby not put the financial system at risk.[90]

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[86] Cornish (n 84) 2.

[87] See Commonwealth Bank of Australia (n 81). It however also did not have the right to issue its own notes: Frank Decker and Sheelagh McCracken, 'Central Banking in Australia and New Zealand: Historical Foundations and Modern Legislative Frameworks' in Peter Conti-Brown and Rosa María Lastra (eds), *Research Handbook on Central Banking* (Edward Elgar, 2018) 245, 251.

[88] In relation to the role of a government guarantee, see Franklin Allen, Elena Carletti, Itay Goldstein, and Agnese Leonello, 'Government Guarantees and Financial Stability' (Working Paper Series No 2032, European Central Bank, February 2017) <https://www.ecb.europa.eu/pub/pdf/scpwps/ecbwp2032.en.pdf>.

[89] In relation to systemic risk, see Garry J Schinasi, 'Defining Financial Stability' (Working Paper No 04/187, IMF International Capital Markets Department, October 2004) <https://www.imf.org/external/pubs/ft/wp/2004/wp04187.pdf>. A single failed institution can create systemic risk if through its failure other institutions may also fail.

[90] This conclusion is supported by comparing the impact and activities of the Commonwealth Bank with the working definition of financial stability (see Chapter 2).

When the original functions of the Commonwealth Bank were expanded, its role in safeguarding financial stability was also consequently enlarged, as will be seen below.

(ii) Lender to Banks: The Federal Guarantee Creates Stability and Develops the LOLR Function

The Commonwealth Bank soon developed informally into a 'banker to banks', because of the security provided by the government guarantee,[91] and the deposit security it offered attracted both private and institutional customers. In 1924 legislation was passed by the Australian government formalising the role of the Commonwealth Bank as 'banker to banks'. This legislation expanded the Commonwealth Bank's role and thereby increased the effect that the Commonwealth Bank had on the financial system, by introducing a safety net for banks that faced liquidity problems through the Commonwealth Bank's lender of last resort function. The Commonwealth Bank's role in financial stability was thereby augmented, as the availability of emergency liquidity from the central bank has always been an important financial safety net.[92] In this respect too, the Commonwealth Bank therefore promoted the safeguarding of financial stability by preventing bank failures through possible emergency liquidity assistance.

(b) The Development of the Commonwealth Bank into a True Central Bank

During World War 1 (1914 – 1918) (WW1) the Commonwealth Bank already performed what can be considered to be key central banking functions. It performed the role of banker to government and assumed the role of manager of government debt at the end of WW1, even though at that time it was still primarily

[91] 'Our History', *Commonwealth Bank of Australia* (Web Page, 2019) <https://www.commbank.com.au/about-us/our-company/history.html>.

[92] See Chapter 2.

a savings and trading bank.[93] The Commonwealth Bank also assisted with marketing arrangements for Australia's export products.[94] At that point in time, however, the main central banking role of the Commonwealth Bank was still the provision of support to the private banking system.[95]

After the end of WW1, the Commonwealth Bank continued to develop as a central bank and contributed to financial stability through the undertaking of typical central banking functions, such as:

1. *Issuing of Australian bank notes* - In 1924, the Commonwealth Bank, still a commercial bank in essence, was given control over the issue of Australian banknotes,[96] a function previously performed by the Treasury.[97] The Commonwealth Bank's involvement came through the creation of the Australian Notes Board,[98] an independent body administered by a separate department of the Commonwealth Bank and chaired by the Governor of the Commonwealth Bank.[99] (Whilst centralized notes issue is perhaps in the 21st century is no longer an important component of financial stability, the need for a reliable production of currency and the efficient provision of payment mechanisms nevertheless contribute to financial stability. Control over the notes issue can therefore be included in the list of central banking functions that contribute to financial stability);

2. *Inter-bank settlement* - As banker to banks, the Commonwealth Bank settled transactions between banks. The efficient settlement of inter-bank

[93] Cornish (n 84) 8.

[94] Ibid, 3.

[95] Bell (n 84) 8.

[96] Ibid 9.

[97] See 'The Commonwealth Bank and the Note Issue: 1920 - 1960', *Reserve Bank of Australia Museum* (Web Page) <https://museum.rba.gov.au/displays/commbank-and-note-issue/>.

[98] Ibid; See also 'History of Banknotes', *Reserve Bank of Australia Banknotes* (Web Page) <https://banknotes.rba.gov.au/australias-banknotes/history/>.

[99] See Reserve Bank of Australia, (n 98).

debt is an important component of financial stability as the inability of one bank to settle payment obligations to other banks, especially when sizeable payment obligations are involved, has the potential to create systemic risk.[100] This practice is continued by the RBA, including through the exchange settlement accounts (ESAs);

3. *Regulator of banks and holder of bank reserves/capital* - As from 1932, the Commonwealth Bank developed into the regulator of banks by implementing a 'range of controls'[101] over the banking system, such as over policy and interest rates. Private banks were also required to hold funds with the Commonwealth Bank in designated accounts.[102] One of the goals of the regulation of commercial banks was the prevention of bank failures, and through this regulatory function, the Commonwealth Bank contributed to financial stability. (The RBA is no longer the bank supervisor, but that function was expressly provided to APRA subsequent to the Wallis Inquiry);

4. *Exchange rate control and control over Australian gold reserves* - In 1932 the Commonwealth Bank was also tasked[103] with the management of the exchange rate of the Australian currency after the abolition of the gold standard.[104] This function complemented the role that the Commonwealth

[100] A failure to settle by one institution can create systemic risk if other institutions as a consequence are also unable to settle. Prior to the implementation of real-time gross settlement in the 1990s, settlement was always delayed by a few days in most cases, creating an inherent stability risk: See Committee on Payment and Settlement Systems, 'Payment, Clearing and Settlement Systems in Australia' in Committee on Payment and Settlement Systems, *Payment, Clearing and Settlement Systems in the CPSS Countries* (Bank for International Settlements, 2011) 1 <https://www.bis.org/cpmi/publ/d97.pdf>. 'This process serves to reduce the demand upon the relevant banks' liquidity and permits participants to maintain a lower level of funds in their ES accounts'. Tyree et al note that '[a]uto-offset automatically searches for bilateral offsetting transactions between banks to allow for simultaneous settlement' thereby reducing risk': Alan Tyree, P M Weaver and W S Weerasooria, *Weerasooria's Banking Law and the Financial System in Australia* (LexisNexis, 6th ed, 2006) 76.

[101] Reserve Bank of Australia (n 83).

[102] Ibid.

[103] Ibid.

[104] Bell (n 84) 9.

Bank had since 1929, namely the control of gold in Australia.[105] Currency stability broadly contributes to financial stability.[106] Even though the gold standard no longer exists and the Australian dollar has a floating exchange rate, the RBA is still involved in the external value of the Australian dollar through monetary policy;[107] and

5. *Being independent and asserting independence*[108] - At this early stage in the history of the Australian central bank just after WW1, the Commonwealth Bank acted in a manner that has subsequently been considered to be typical of a central bank, when it asserted its independence through refusing to support the government's fiscal stimulus plans in the late 1930s.[109] These steps, however, ultimately led to a revision of the 'independence' sections in the legislation governing the Commonwealth Bank. (The RBA is currently a moderately independent central bank, and its independence has been accepted and endorsed by subsequent governments).[110]

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[105] Ibid. The Commonwealth Bank was also tasked with control over the gold as from1929, another typically central banking function.

[106] By performing this responsibility, the Commonwealth Bank also contributed to financial stability.

[107] See 'The Exchange Rate and the Reserve Bank's Role in the Foreign Exchange Market', *Reserve Bank of Australia* (Web Page, January 2018) <https://www.rba.gov.au/mkt-operations/ex-rate-rba-role-fx-mkt.html>.

[108] For the past three decades, especially since the late 1980s, there has been wide-ranging acceptance that central banks should be independent from government. See Guy Debelle, 'Lessons and Questions from the GFC' (Speech, Australian Business Economists Annual Dinner, 6 December 2018) <https://www.rba.gov.au/speeches/2018/pdf/sp-dg-2018-12-06.pdf>; See also Donato Masciandaro and Davide Romelli, 'Ups and Downs of Central Bank Independence from the Great Inflation to the Great Recession: Theory, Institutions and Empirics' (2015) 22(3) *Financial History Review* 259.

[109] See David Gruen and Colin Clark, 'What Have We Learnt? The Great Depression in Australia from the Perspective of Today' (Annual Colin Clark Memorial Lecture, Brisbane, 11 November 2009) <http://archive.treasury.gov.au/documents/1689/PDF/03_Colin_Clark_speech.pdf>.

[110] See for example the various Statements on the Conduct of Monetary Policy; See also Bernie W Fraser, 'Central Bank Independence: What Does It Mean?' (Speech, SEANZA Central Banking Course, 23 November 1994) <https://www.rba.gov.au/speeches/1994/sp-gov-231194.html>; Bernie W Fraser, 'Reserve Bank Independence' (Speech, National Press Club, 15 August 1996) <https://www.rba.gov.au/speeches/1996/sp-gov-150896.html>. Bell points out

2 *The Establishment of the Reserve Bank of Australia Formally as a Central Bank – with a Focus on Monetary Policy and Bank Supervision*

The RBA as an institution started operating as the central bank of Australia on 14 January 1960, subsequent to its creation by the *RBA Act* (promulgated in 1959), as noted above. Essentially the Commonwealth Bank was split in two.[111] The central banking functions of the Commonwealth Bank were transferred to the RBA, and the commercial bank and savings bank functions of the Commonwealth Bank became the responsibilities and business focus of the Commonwealth Bank of Australia (CBA).[112] The CBA no longer had a government guarantee. The *RBA Act* however included the same 'policy charter' as that of its predecessor,[113] the board was virtually identical to that of the Commonwealth Bank, and it was headed by the same Governor.

(a) The 'Charter' of the RBA – Still Unchanged

The 'policy charter' or 'mandate' of the RBA is, as noted above, contained in s 10(2) of the *RBA Act*. It tasks the RBA through the Reserve Bank Board[114] to essentially direct its monetary and banking policy for the benefit of the people of Australia.[115] The RBA's charter in s 10(2) of the *RBA Act* has remained

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that the RBA moved from an 'instrument' to an 'actor': See Matthew Smith, 'From Instrument to Actor: The Changing Role of the RBA', *Australian Review of Public Affairs* (Web Page, 21 February 2005) <http://www.australianreview.net/digest/2005/02/smith.html>, reviewing Stephen Bell, *Australia's Money Mandarins: The Reserve Bank and the Politics of Money* (Cambridge University Press, 2004).

[111] The central banking roles transferred to the Reserve Bank of Australia while the commercial banking activities remained with the Commonwealth Bank of Australia.

[112] See Reserve Bank of Australia (n 83).

[113] See Glenn Stevens, 'Address to the Reserve Bank of Australia's 50th Anniversary Gala Dinner' (Speech, Anniversary Gala Dinner, 8 February 2010).

[114] In terms of *Reserve Bank Act 1959* (Cth) s 8A(2) '[t]he Reserve Bank Board is responsible for the Bank's monetary and banking policy'.

[115] Under its charter (s 10(2) *Reserve Bank Act 1959* (Cth), the RBA has the duty to:

unchanged since 1959, and the RBA's responsibility for or role in the safeguarding of financial stability has (as noted above) been recognised as a long-standing obligation by the RBA itself and by others, even though there is no exact date on which the responsibility can be pinpointed as 'originating', or having been recognised or labelled as such.

In the years between 1960 and 1998, the conduct of monetary policy was a priority, given the problems of inflation and currency fluctuations experienced worldwide at that time. In the 1990s the notion of financial stability, as a separate consideration or objective, increased in importance. Before 1998, the RBA was also the supervisor of banks, and therefore responsible for the microprudential regulation and supervision of banks in Australia. Financial stability as a concept was in the early 1990s often closely linked to stability in the banking sector, and financial instability was equated with bank runs. These developments in the history of the RBA were commensurate with developments in central banks elsewhere in the world.[116] When the responsibility for bank supervision was removed from the RBA in 1998 and placed with APRA, some responsibilities that can be categorised as financial stability responsibilities and are related to prudential supervision also shifted away from the RBA to APRA.

Nevertheless, the intention of the Australian government appears to have been that the RBA would remain responsible for financial stability. The comments by the then Treasurer, the Hon Mr Peter Costello, during the second reading speech of the Australian Prudential Regulation Authority Bill to the effect that the RBA remains responsible for financial stability, is testament to that fact[117] (see further

> 'ensure that the monetary and banking policy of the Bank is directed to the greatest advantage of the people of Australia and that the powers of the Bank … are exercised in such a manner as, in the opinion of the Reserve Bank Board, will best contribute to:
> a. the stability of the currency of Australia;
> b. the maintenance of full employment in Australia; and
> c. the economic prosperity and welfare of the people of Australia'.

[116] See Peter J N Sinclair, 'Central Banks and Financial Stability' (2000) 40(4) *Bank of England Quarterly Bulletin* 377.

[117] 'There are three fundamental regulatory objectives for government intervention in the financial system. The first is the maintenance of financial stability, including through ensuring a safe and reliable payments system. This goal, which has close links with the price stability

Part III 2). It is evident that at this stage what constituted financial stability was no more than a very narrow interpretation, and it was not limited to the prevention of failures of banks/financial institutions. This was evident from the second reading speech too and was also linked to stability in the payment system.[118]

A focus on the safeguarding of financial stability as a separate or specific central bank function developed in the 1990s among central banks internationally, and saw the establishment of financial stability departments, and the publication of financial stability reviews[119] by a number of central banks. That was also the case with the RBA – the first stand-alone Australian Financial Stability Review was published by the RBA in March 2004. Prior to that the RBA had commented on financial stability in its other official publications.[120]

(b) The RBA's Monetary Policy and Financial Stability

After its creation in 1959, the RBA was nevertheless continuously, and always at least to some extent, involved in the safeguarding of financial stability in Australia, predominantly through the conduct of monetary policy and (until 1998) prudential supervision. There was also an underlying presumption at that time that the successful conduct of monetary policy will also result in financial stability – ie that a stable currency combined with low inflation and low interest rates will result in stability in financial institutions. It was the view that these prerequisites would

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objective of monetary policy, is to be the regulatory focus of the Reserve Bank of Australia': Commonwealth, *Parliamentary Debates*, House of Representatives, 26 March 1998, 1649 (Peter Costello, Treasurer) (Second reading speech Australian Prudential Regulation Authority Bill).

118 Ibid.

119 See, for example, Caroline Bradley, 'Changing Perceptions of Systemic Risk in Financial Regulation' in Pablo Iglesias-Rodriguez, Anna Triandafyllidou, and Ruby Gropas (eds), *After the Financial Crisis: Shifting Legal, Economic and Political Paradigms* (Palgrave Macmillan, 2016) 75, 89.

120 The 1999 Annual Report of the RBA is a good example, as it followed the introduction of the new structures in the government regulators: See Reserve Bank of Australia, *1999 Report and Financial Statements* (Annual Report, 3 August 1999) 26-28 <https://www.rba.gov.au/publications/annual-reports/rba/1999/pdf/1999-report.pdf>.

create the type of stable conditions envisaged by financial stability (as per the working definition adopted in this thesis).[121] The RBA, as supervisor and regulator of banks (until 1998) as well as the LOLR, also focussed on the stability of individual financial institutions and the potential impact of possible liquidity problems on the overall banking system in Australia.[122]

B *Express but Non-legally Binding Official Statements Confirming the Financial Stability Responsibility of the RBA*

Certain express statements by the Australian government that the RBA is responsible for financial stability have been relied upon (by the RBA and the government) when referring to the 'mandate' of the RBA for financial stability. In addition, some undertakings given by the RBA itself have been relied upon as support for (or evidence of) the RBA's financial stability mandate.

1 *The APRA Act Second Reading Speech 1998*

As noted above, Dr Luci Ellis acknowledged reliance on statements made by the Hon Mr Peter Costello, the then Treasurer, in the Second Reading Speech of the Australian Prudential Regulation Authority Bill before Parliament in 1998, as evidence of the mandate of the RBA for financial stability.[123] The RBA and APRA

[121] In the 1980s and 1990s the prevailing view was that low/stable inflation and stable exchange rates would result in financial stability: See John Taylor, 'The Great Inflation, The Great Disinflation, and Policies for Future Price Stability' (Conference Paper, Reserve Bank of Australia Conference, 1992) <https://www.rba.gov.au/publications/confs/1992/taylor.html>.

[122] 'The Bank's strong view was that bank supervision should remain in the central bank because there were major synergies between monetary policy, financial system stability and bank supervision': Reserve Bank of Australia, *Report and Financial Statements 1997* (Annual Report, 30 June 1997) 27 <https://www.rba.gov.au/publications/annual-reports/rba/1997/pdf/1997-report.pdf>.

[123] Ellis (n 55). 'Financial Stability and the Banking Sector' (Speech, Sydney Banking and Financial Stability Conference, 12 July 2016) <https://www.rba.gov.au/speeches/2016/sp-so-2016-07-12.html>.

too have confirmed that the comments by Mr Costello should be interpreted in that manner.[124] Mr Costello stated:[125]

> The *first [objective] is the maintenance of financial stability*, including through ensuring a safe and reliable payments system. This goal, which has close links with the price stability objective of monetary policy, is to be the regulatory focus of the Reserve Bank of Australia.

Notwithstanding the government's express intention that the RBA should be responsible for financial stability, the *RBA Act* was left unchanged at that stage, and has remained unchanged since.

Legally, the reliance on Mr Costello's second reading speech is problematic. Firstly, the legislation under discussion was the *APRA Act*, not the *RBA Act*. In terms of traditional statutory interpretation principles,[126] the second reading speech of a different piece of legislation has very little, if any, bearing on the interpretation of the actual legislation that is being interpreted, unless the two pieces of legislation were considered by Parliament simultaneously. At the time of the second reading speech of the *APRA Act,* the *RBA Act* had already been in force for almost 40 years, and was intended to be left unchanged. At most Mr Costello's statement can be seen to be a corroboration of a general view held at that time that the RBA was responsible for financial stability – although such responsibility was not an express legislated mandate.

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[124] See Reserve Bank of Australia and Australian Prudential Regulation Authority (n 5).

[125] Government intervention in the financial system is justified for the maintenance of financial stability, to provide specialised regulation for 'conduct, disclosure and dispute resolution', and for 'prudential supervision of those parts of the financial system which require more intense regulation for safety and stability reasons': Costello (n 117).

[126] 'The [statutory interpretation] approach now ascendant in Australia has been labelled 'literal in total context': it explains statutory interpretation in terms of the attribution of meaning to the words of a statutory text in the totality of the 'context' in which the statutory text was enacted': Stephen Gageler, 'Common Law Statutes and Judicial Legislation: Statutory Interpretation as a Common Law Process' (2011) 37(2) *Monash University Law Review* 1, 1. Although Gageler cautioned against a pedantic, semantic and mechanical approach to statutory interpretation, and against making 'a fortress out of the dictionary', there is doubt that the second reading speech of a specific piece of legislation (the *APRA Act 1998*) can be a reliable interpretive tool for another piece of legislation that passed through parliament approximately 40 years earlier (the *RBA Act 1959*).

2 *The Statement on the Conduct of Monetary Policy 2010*

In 1996, the Government and the RBA jointly issued a public statement, entitled 'Statement on the Conduct of Monetary Policy'.[127] The purpose of this statement was to formalise the inflation-targeting model of monetary policy that was adopted in 1996.[128] A revised Statement on the Conduct of Monetary Policy was issued in 2010, after the Federal election,[129] including for the first time an express reference to financial stability. The government, through the Treasurer, and the RBA, through the Governor as Chairperson of the RBA Board, in this document again demonstrated the informality of the allocation of a financial stability responsibility to the RBA when they jointly stated that[130]

> [f]inancial stability is a longstanding responsibility of the Reserve Bank and its Board, and was reconfirmed at the time of significant changes made to Australia's financial regulatory structure in July 1998.

This was the first occasion on which the Statement on the Conduct of Monetary Policy included a statement on the financial stability responsibility. It may not be entirely coincidental that at the time of the 2010 Statement financial stability was prominently in the public spotlight in the aftermath of the GFC.[131] In some

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[127] The Treasurer and the Governor (designate) of the Reserve Bank, *Statement on the Conduct of Monetary Policy* (Statement, 14 August 1996) <https://www.rba.gov.au/monetary-policy/framework/stmt-conduct-mp-1-14081996.html>. This was the first such statement: See 'Agreement on Framework for Monetary Policy', *Reserve Bank of Australia* (Web Page) <https://www.rba.gov.au/monetary-policy/framework/>.

[128] 'This statement records the common understanding of the Governor (designate) of the Reserve Bank and the Government on key aspects of Australia's monetary policy framework. It is designed to clarify respective roles and responsibilities': The Treasurer and the Governor (designate) of the Reserve Bank (n 127). See also Frank Decker and Sheelagh McCracken, 'Central Banking in Australia and New Zealand: Historical Foundations and Modern Legislative Frameworks' in Peter Conti-Brown and Rosa María Lastra (eds), *Research Handbook on Central Banking* (Edward Elgar, 2018) 245, 257.

[129] The Treasurer and the Governor of the Reserve Bank, *Statement on the Conduct of Monetary Policy* (Statement, 30 September 2010) <http://www.rba.gov.au/monetary-policy/framework/stmt-conduct-mp-5-30092010.html>. The statements issued in 2003, 2006 and 2007 differ very little from the original 1996 statement.

[130] Ibid.

[131] See Chapter 2.

respects, it can be seen as the first direct, formal or official confirmation of the RBA's financial stability mandate.

As a document, the 2010 Statement is however an odd choice for such a broadly public and official (but not legally-formal) statement by the government (and the RBA) as to the RBA's responsibility for financial stability. The peculiarities include:

1. that the reference is inserted after years of the Statement on the Conduct of Monetary Policy not referring to financial stability, although (presumably) during all those years the RBA was responsible for financial stability; and

2. that, if the statement is to be interpreted as a formal confirmation of responsibility, the provision of that financial stability responsibility comes in a document, that
   (a) is a 'statement' not a 'directive',
   (b) deals with monetary policy;
   (c) is issued and signed by the party conferring the responsibility *and* the party receiving the responsibility. Typically, the provision of a mandate by government to a statutory body is done in a top-down manner, not a collaborative manner, and the RBA is not in a legal position to be required to 'accept' or 'reject' the responsibilities given to it as a government agent; and
   (d) confirms an existing mandate and can therefore not be construed as the first granting of a mandate. Typically a mandating process is prospective not retrospective.

In the 2010 Statement on the Conduct of Monetary Policy, the Australian government and the RBA also set out part of the history of the RBA's financial stability responsibility. It is noted that '[t]he stability of the financial system is critical to a stable macroeconomic environment'.[132] It also reaffirmed the longstanding nature of the RBA's responsibility in this regard and that it had preceded the reallocation of responsibilities to APRA in 1998.

Perhaps the predominant purpose of this Statement on the Conduct of Monetary Policy was however political in nature, and it had a placatory or reassuring role for the Australian public in the turmoil of the GFC. This conclusion is borne out by the comment included in the Statement to the effect that the Treasurer supports the financial stability arrangements set out in the Statement, and that these had 'served Australia well during the recent international crisis period',[133] referring to the GFC. The reference to the RBA's financial stability responsibility has been repeated in all subsequent Statements on the Conduct of Monetary Policy.

The subsequent two Statements on the Conduct of Monetary Policy (issued in 2013 and 2016) provide a more abbreviated and matter-of-fact reflection of the responsibility of the RBA and exclude a reference to the 1998 legislative changes:[134]

> The Reserve Bank promotes the stability of the Australian financial system through managing and providing liquidity to the system, and chairing the Council of Financial Regulators (comprising the Reserve Bank, Australian Prudential Regulation Authority, the Australian Securities and Investments Commission and the Treasury).

There is also a perceptible difference in the descriptions of the role of the RBA in financial stability between the 2010, and 2013 and 2016 Statements, reflecting a

[132] Ibid.

[133] The Treasurer and the Governor of the Reserve Bank (n 129).

[134] See The Treasurer and the Governor of the Reserve Bank, S*tatement on the Conduct of Monetary Policy* (Statement, 19 September 2013) <https://www.rba.gov.au/monetary-policy/framework/stmt-conduct-mp-6-24102013.html>; The Treasurer and the Governor of the Reserve Bank, *Statement on the Conduct of Monetary Policy* (Statement, 19 September 2016) <https://www.rba.gov.au/monetary-policy/framework/stmt-conduct-mp-7-2016-09-19.html>.

stronger role for the RBA in financial stability as from 2013. In 2010, the role of the RBA was described as follows:[135]

> The Reserve Bank Board oversees the Bank's work on financial system stability. Without compromising the price stability objective, the Reserve Bank seeks to use its powers where appropriate to promote the stability of the Australian financial system. It does this in several ways, including through its central position in the financial system and its role in managing and providing liquidity to the system, and through its chairmanship of the Council of Financial Regulators, comprising the Reserve Bank, APRA, the Australian Securities and Investments Commission and Treasury.

In 2013 and 2016, the role is described as follows, and includes a role in financial system policy for the RBA:[136]

> The Reserve Bank promotes the stability of the Australian financial system through managing and providing liquidity to the system, and chairing the Council of Financial Regulators (comprising the Reserve Bank, Australian Prudential Regulation Authority, the Australian Securities and Investments Commission and the Treasury). … In addition, the Governor and the Reserve Bank will continue to participate, where appropriate, in the development of financial system policy, including any substantial Government reviews, or international reviews, of the financial system itself.

This analysis of the Statements on the Conduct of Monetary Policy therefore also reflects the increasing importance of the RBA's financial stability responsibilities.[137] The Statements are however not a hard law source of the financial stability responsibilities, but can be construed to have persuasive power

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[135] The Treasurer and the Governor of the Reserve Bank (n 129).

[136] See the 2013 and 2016 Statements on the Conduct of Financial Stability: The Treasurer and the Governor of the Reserve Bank (n 134) and The Treasurer and the Governor of the Reserve Bank (n 134).

[137] Ibid. See also concern expressed about the effect of the focus on financial stability and its effect on inflation and wages: Stephen Kirchner, 'The RBA's Shift to Worrying About Financial Stability Could be Hurting Australian Wages', *The Conversation* (online, 16 May 2018) <https://theconversation.com/the-rbas-shift-to-worrying-about-financial-stability-could-be-hurting-australian-wages-96714>.

as soft law. It would be difficult for either the RBA or the Government to deny what has been publicly confirmed in these Statements.

3 *Memoranda of Understanding with Other Regulatory Agencies*

A further soft law source of the RBA's financial stability mandate is the framework of memoranda of understanding that underpins the operation of the CFR. The RBA has entered into a number of memoranda of understanding with the other financial regulators to regulate their interaction as members of the CFR. These memoranda of understanding reflect the role of the RBA in financial stability. These are further discussed in Chapter 5.

There are a number of problems with these MOUs operating as soft law origins of the RBA's financial stability responsibility. A public role – such as the overarching responsibility for financial stability – cannot (or should not) simply be assumed by agreement between regulators in a parliamentary democracy. Similarly, an agreement in the form of an MOU between a regulator, such as the RBA, and a government representative such as Treasury, confirming the responsibility of the RBA for financial stability, does not constitute a legally binding mandate. Not only is Treasury a branch of the executive, and not part of the legislature, but a memorandum of understanding per se is not a binding agreement.

The content of the MOUs is nevertheless important to develop an understanding of the RBA's de facto mandate. In the 1998 MOU between the RBA and APRA (the 'RBA-APRA MOU'), their different roles in financial stability are set out as follows:[138]

> 2. The responsibilities of the RBA and APRA for promoting financial stability are largely complementary.

[138] *Memorandum of Understanding between the Reserve Bank of Australia and the Australian Prudential Regulation Authority*, signed 12 October 1998 (Memorandum of Understanding) <https://www.apra.gov.au/sites/default/files/MoU-RBA-Reserve-Bank-of-Australia.PDF> (emphasis added).

> 3. The RBA's role is focused on the objectives of monetary policy, *overall financial system stability* and regulation of the payments system. It has no obligation to protect the interests of bank depositors and will not supervise any individual financial institutions. The RBA does, however, have discretion to provide *emergency liquidity support* to the financial system.
>
> 4. APRA is responsible for the prudential supervision of banks, life and general insurance companies and superannuation funds. Supervision of building societies, credit unions and friendly societies will transfer to APRA from State jurisdictions at a later date. APRA has powers to act decisively in the interests of depositors or policy holders and fund members if a supervised institution is in difficulty.

In the 2002 MOU between the RBA and ASIC (the 'RBA-ASIC MOU') the different responsibilities of the RBA and ASIC in relation to stability standards are clarified.[139] This MOU, referencing in particular the RBA's responsibility in terms of financial stability standards under the *Corporations Act*, does not confirm the RBA's overarching responsibility for financial stability.

In the more recent 2008 MOU between the RBA, APRA, ASIC and Treasury on Financial Distress Management[140] entered into during the GFC (the 'Financial Distress Management MOU'), the overarching responsibility of the RBA for financial stability is confirmed:[141]

> The RBA has primary responsibility for the maintenance of *overall financial system stability*, including stability of the payments system, and for providing liquidity support to the financial system or to individual financial institutions where appropriate.

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[139] *Memorandum of Understanding between the Australian Securities and Investments Commission and the Reserve Bank of Australia*, signed 18 March 2002 (Memorandum of Understanding) <https://download.asic.gov.au/media/1340888/MOU-ASICandRBA.pdf>. The MOU lists the various responsibilities of the parties in relation to financial stability standards and compliance monitoring, also under the *Corporations Act 2001* (Cth).

[140] *Memorandum of Understanding on Financial Distress Management between the Members of the Council of Financial Regulators*, signed 18 September 2008 (Memorandum of Understanding) <https://www.cfr.gov.au/financial-institutions/crisis-management-arrangements/pdf/mou-financial-distress-management.pdf>.

[141] Ibid (emphasis added).

The criticism of the RBA-APRA MOU as an example of soft law founding the mandate of the RBA is also applicable to the Financial Distress Management MOU. The addition of the Treasury as a party to this MOU does not change the circumstances. In fact, it is clear from the words used in the MOU that the role of Treasury is not that of legislative government ie Parliament – Treasury acts as a member of the executive branch of the Australian government only.[142]

The relevance of the MOUs as soft law for purposes of this discussion is mainly that they confirm the de facto mandate of the RBA for financial stability. MOUs are soft law, but they are perhaps the 'most binding' form of undertaking that can be given by one government regulator to another. A formal binding contract with legally enforceable obligations and remedies and that could potentially give rise to litigation in the event of breach is not appropriate in the context, as no such legal consequences could reasonably be intended. Nevertheless, from an operational point of view, the employees of the regulators may be expected to comply with their undertakings in the MOU, and it is an important 'quasi-legal' document. However, notwithstanding the effectiveness of an MOU in regulating relationships among regulators, it cannot create any broader public roles that would normally lie in the purview of Parliament to assign to regulators.

[142] See for example the following statements in the MOU regarding financial distress management: 'The Treasury provides advice to the Government on policy and possible reforms that promote a sound financial system, including on financial distress management arrangements. The Treasury has responsibility for advising the Government on matters relating to the exercise of the Treasurer's powers, and on the broader economic and fiscal implications of developments that pose a threat to the stability of the financial system': *Memorandum of Understanding on Financial Distress Management between the Members of the Council of Financial Regulators*, signed 18 September 2008 (Memorandum of Understanding) <https://www.cfr.gov.au/financial-institutions/crisis-management-arrangements/pdf/mou-financial-distress-management.pdf>.

4 *Other General Statements and Confirmations by the RBA of its De Facto Responsibility for Financial Stability*

General confirmations of the RBA's financial stability role can be found in other soft law sources, including significant RBA publications that are nevertheless not legal documents.

The first of these are the RBA's statements on the RBA website – a detailed and key source of information about the RBA. The RBA states on its website that '[m]aintaining the stability of the financial system is a longstanding responsibility of the Reserve Bank'.[143] The RBA also has a financial stability department.[144]

A second important document is the financial stability review. Although the RBA published overviews of its assessment of financial stability in Australia in its Annual Reports,[145] the first stand-alone Financial Stability Review was published by the RBA in March 2004.[146] In this document the RBA again confirms its 'long-

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[143] 'Financial Stability', *Reserve Bank of Australia* (Web Page) <https://www.rba.gov.au/fin-stability/>.

[144] 'Organisational Structure', *Reserve Bank of Australia* (Web Page) <https://www.rba.gov.au/about-rba/structure/organisational.html>.

[145] See Reserve Bank of Australia, *Financial Stability Review* (Review, March 2004) 1 <https://www.rba.gov.au/publications/fsr/2004/mar/pdf/0304.pdf> (Foreword): 'As part of its longstanding responsibility for the stability of the Australian financial system, the Reserve Bank has periodically outlined its assessment of the state of the financial system, including in its Annual Report. This *Financial Stability Review* is the first occasion on which a more detailed assessment has been published in a stand-alone publication – a practice that will be continued half-yearly from now on'. In its Annual Report of 1998, the RBA included a chapter on 'Surveillance of the Financial System' and confirmed that financial stability was a perpetual responsibility of the RBA: See Reserve Bank of Australia, *1998 Report and Financial Statements* (Annual Report, 30 June 1998) 6-23 <https://www.rba.gov.au/publications/annual-reports/rba/1998/pdf/1998-report.pdf>. In the 1999 Annual Report, the RBA noted: '[The financial stability] mandate was reconfirmed by the Government when it introduced landmark changes to Australia's financial regulatory structure, which came into effect from 1 July 1998': Reserve Bank of Australia, *1999 Report and Financial Statements* (Annual Report, 3 August 1999) 26 <https://www.rba.gov.au/publications/annual-reports/rba/1999/pdf/1999-report.pdf>. This is most likely a reference to the statements of Mr Costello in the Second Reading Speech of the *APRA Act*.

[146] Reserve Bank of Australia, *Financial Stability Review* (Review, March 2004) <https://www.rba.gov.au/publications/fsr/2004/mar/pdf/0304.pdf>.

standing' responsibility in respect of financial stability, and announces its decision to publish financial stability reviews separately as from that date on a bi-annual basis.[147] The publication of financial stability reviews was a new trend in the 1990s and early 2000s, and many central banks started publishing financial stability reviews. What this demonstrates is that through the publication of separate financial stability reviews, financial stability was thrown into 'sharper relief'[148] compared to the RBA's other functions. The financial stability reviews were, right from the first edition, longer than the sections devoted specifically to financial stability issues in the earlier RBA Annual Reports.

The significance of these confirmations of the RBA's responsibility is that they all serve to reinforce the de facto nature of the RBA's mandate for financial stability.

V. Conclusion

This chapter demonstrated that the RBA's mandate for financial stability has not been conferred in a formal legal manner. Instead, the RBA's mandate for financial stability is a de facto mandate that derives mostly from soft law instruments. The only express statutory responsibility for financial stability of the RBA is in relation to the payments system. Although the *RBA Act* does make reference to 'financial stability' and 'financial system stability', there is no clear, concrete, legislated and overarching mandate for financial stability in the RBA's enabling legislation and these references are only directives to the RBA to consider the financial stability implications of its payment systems responsibilities. The RBA's legislative

[147] Ibid 1. The chapter 'Surveillance of the Financial System' was retained in the RBA's Annual Reports and changed to 'Financial System Stability' in 2000: Reserve Bank of Australia, *Reserve Bank of Australia: Annual Report 2000* (Report, 3 August 2000) <https://www.rba.gov.au/publications/annual-reports/rba/2000/pdf/2000-report.pdf>.

[148] 'In publishing the Financial Stability Review, the Reserve Bank has joined a growing number of central banks that are addressing their stability mandates through publishing a formal report. … In Australia's case, the supervision of individual financial institutions was transferred to the Australian Prudential Regulation Authority (APRA) in 1998, with the Reserve Bank maintaining its responsibility for the overall stability of the financial system': Reserve Bank of Australia, *Financial Stability Review* (Review, March 2004) 1 <https://www.rba.gov.au/publications/fsr/2004/mar/pdf/0304.pdf>.

financial stability mandate is at best implied generally from the enabling legislation, or from its nature as a central bank, but the most important sources of the mandate – or confirmations of the mandate – are contained in informal documents and statements, ie soft law. As will be discussed in Chapters 5 — 9, the informality of the mandate, as well as the fact that it is also shared between the RBA and other regulatory agencies, have negative implications for the governance and accountability of the RBA. The consequences of the uncertainty and uneasiness in the RBA's mandate for financial stability which result from both its informal nature and its decentralised nature will be analysed below (see Chapters 5 — 9 below).

CHAPTER 5

The Regulatory Responsibility for Financial Stability in Australia: A Shared and Decentralized Responsibility

The institutional responsibility in the financial system for supporting competition is loosely shared across APRA, the RBA, ASIC and the ACCC. In a system where all are somewhat responsible, it is inevitable that (at important times) none are.[1]

I Introduction

The financial stability responsibility in Australia is both an informal and a decentralised and shared responsibility. This chapter analyses how the financial stability responsibility of the RBA is shared between the RBA and other regulators. Part II provides an overview of the financial stability regulators in Australia, as well as the regulatory architecture of each, but with an emphasis on the RBA. Part III analyses the different roles of the different regulators, including the Twin Peaks regulatory design, much of which is a legacy of the Wallis Inquiry. Part IV evaluates the decentralised and shared elements of the financial stability responsibility and assesses the need for collaboration and communication between regulators. The chapter concludes that the shared responsibility as a whole is also characterised by informality, and as none of the regulatory authorities has an express legislative overall responsibility for financial stability, there is uncertainty. The involvement of different regulators also directly impacts the RBA's responsibility for financial stability.

[1] Productivity Commission, *Competition in the Australian Financial System: Overview and Draft Recommendations* (Draft Report, 29 January 2018) 2 <https://www.pc.gov.au/inquiries/completed/financial-system/draft/financial-system-draft-overview.pdf>.

II Overview of the Regulatory Structure of the Australian Regulators involved in Financial Stability

In order to assess the role and responsibility of the RBA for financial stability, it is necessary to consider the entire regulatory framework of Australian regulators involved in financial stability. The components of a 'regulatory framework' for financial stability for purposes of this discussion include the regulatory architecture of the agencies/institutions, their structures, forms, functions, obligations, powers, and tools, as well as the interactions between regulators. The regulatory framework therefore encompasses how the different regulatory agencies have been structured in order to perform this task, what the functions of each of the regulatory agencies are, and how the different regulatory agencies collaborate and cooperate. The structural regulatory framework in Australia for example determines that the RBA as central bank is responsible for financial stability overall, although APRA, an entirely separate regulator, is responsible for prudential supervision. This division is a relevant consideration as in other countries the prudential supervision is often structurally integrated into the central bank.[2]

A *Informal and Decentralised Regulation: Some Preliminary Comments about who the Responsible Parties are and the Content of their Responsibilities*

As noted above, the regulation of financial stability adopted by the Australian government has been described by the Murray Inquiry as being 'relatively informal and decentralised'.[3] This is an apt description, as it is 'informal' in the sense that the responsibilities of the regulators have not been comprehensively spelled out in legislation or any other formal clear documentation, and it is

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[2] See Chapter 8 for common practices in the G20 countries.

[3] Commonwealth, *Financial System Inquiry* (Final Report, November 2014) <http://fsi.gov.au/files/2014/12/FSI_Final_Report_Consolidated20141210.pdf> (Murray Inquiry Final Report) See Chapter 5.

'decentralised' in the sense that the main responsibilities for financial stability are shared between the RBA and other regulatory agencies. As noted in Chapter 4, the Australian government through the Treasurer, and the RBA through the Governor, demonstrated the informality of the allocation of the financial stability responsibility in the 2010 Statement on the Conduct of Monetary Policy, when they jointly stated that financial stability was a longstanding responsibility of the RBA, and reconfirmed in July 1988.[4] Although this statement demonstrates the informality of the financial stability responsibility, it does not reflect the fact that the responsibility is decentralised or shared between the RBA and the APRA, but intimates that it is a responsibility of the *RBA only*. Apart from APRA and the RBA, the CFR also has an important role in financial stability. The Charter of the CFR confirms the decentralised nature of the financial stability responsibility in Australia and includes the CFR as a third responsible party that has a role in the promotion of financial stability in Australia. Its Charter states that one of its two ultimate objectives is to 'promote stability of the Australian financial system'.[5] (Both the RBA and APRA are members of the CFR, and the RBA's Financial Stability Reviews are only published after reading at the CFR.[6])

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[4] The Treasurer and the Governor of the Reserve Bank, *Statement on the Conduct of Monetary Policy* (Statement, 30 September 2010) <http://www.rba.gov.au/monetary-policy/framework/stmt-conduct-mp-5-30092010.html>.

[5] The present version of the Charter of the Council of Financial Regulators, which reflects the changes brought about by the collapse of HIH Insurance, was adopted on 13 January 2004. It notes that: 'The Council of Financial Regulators (CFR) aims to facilitate cooperation and collaboration between the Reserve Bank of Australia, the Australian Prudential Regulation Authority (APRA), the Australian Securities and Investments Commission and The Treasury. Its ultimate objectives are to contribute to the efficiency and effectiveness of regulation and to promote stability of the Australian financial system. The CFR provides a forum for: identifying important issues and trends in the financial system, including those that may impinge upon overall financial stability; ensuring the existence of appropriate coordination arrangements for responding to actual or potential instances of financial instability, and helping to resolve any issues where members' responsibilities overlap; and harmonising regulatory and reporting requirements, paying close attention to the need to keep regulatory costs to a minimum': Council of Financial Regulators, 'Charter', *Council of Financial Regulators* (Web Page) <https://www.cfr.gov.au/about/charter.html>; See also 'History', *Council of Financial Regulators* (Web Page) <https://www.cfr.gov.au/about/history.html>.

[6] Reserve Bank of Australia and Australian Prudential Regulation Authority, *Macroprudential Analysis and Policy in the Australian Financial Stability Framework* (Report, September 2012) <https://www.rba.gov.au/fin-stability/resources/2012-09-map-aus-fsf/pdf/2012-09-map-aus-fsf.pdf>.

From these preliminary statements and comments, it is apparent that there is also informality in the decentralisation of financial stability responsibilities, and a lack of legal clarity in the allocation of responsibilities for financial stability in the structural regulation in Australia. Despite this evident lack of clarity, the regulatory framework for financial stability in Australia has been described as 'clear and established' by the RBA and APRA in their background document for the IMF FSAP team for the Australian country peer review:[7]

> Australia's financial stability policy framework involves *clear mandates* for financial stability distributed across several agencies, with the Council of Financial Regulators (CFR) playing a central coordinating role. The prudential elements of that framework rest with APRA, with analytical support from the RBA.

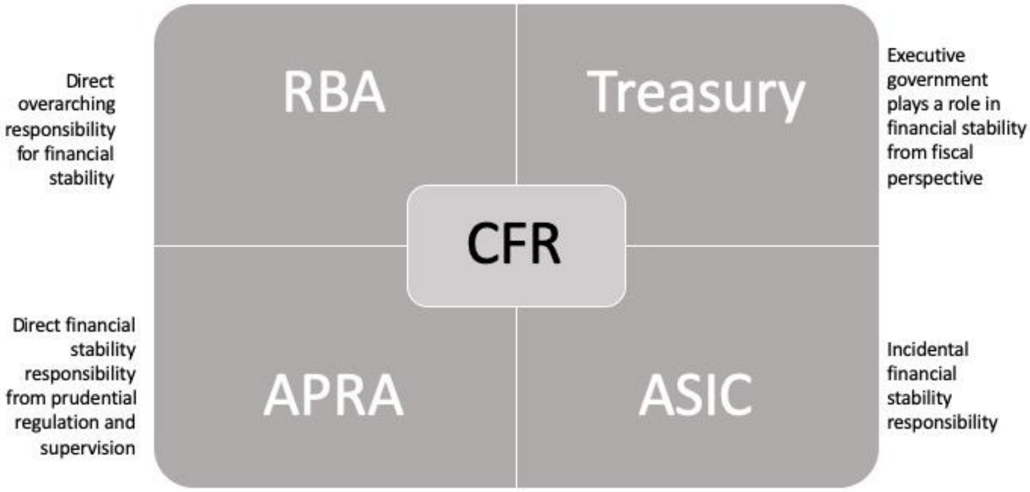
This chapter analyses and critiques the decentralised nature of the financial stability responsibility, and the lack of 'clear mandates'.

B *The Regulatory Agencies Involved in Financial Stability: An Introductory Overview of the Australian Regulatory Framework and Architecture*

This section provides a brief overview of the financial stability regulatory architecture in respect of the role of the different regulators. The purpose of this overview is to give a snapshot of the key roles of each of the role players to contextualise the more detailed discussion of each individual regulator in Part III below. Notwithstanding the RBA's overarching responsibility for financial stability, the CFR plays a central role in this shared and decentralised responsibility (see figure 5.1 below).

[7] Ibid (emphasis added): 'This document – originally prepared as background for the IMF FSAP team in early 2012 – sets out the tools and practices of these two agencies that are designed to support financial stability from a system-wide perspective. The Australian authorities view macroprudential policy as subsumed within the broader and more comprehensive financial stability policy framework'.

Figure 5.1 Division of responsibility for financial stability between the CFR Members and the CFR



This figure shows the membership and roles of the CFR.

The regulatory architecture for financial stability in Australia comprises three key role-players, namely the RBA, APRA (the two key government regulatory agencies), and the CFR. The regulatory framework however also includes the Australian government, in particular Parliament and Treasury, and to a lesser extent, ASIC. The Australian government creates and empowers the government regulators through their founding legislation. The Treasurer and the Treasury fulfil certain specific functions together with the government financial regulators and collaborate with the financial regulators and regulatory bodies/agencies. Importantly, the Australian government and Parliament represent the Australian people and their interest. The summary below provides a snapshot that is elaborated upon later.

1. *The RBA*: As part of its overarching responsibility for financial stability, the RBA plays an important role, including through the publication of research on financial stability. The RBA also plays a lead role in the CFR by chairing the CFR, providing administrative support to the CFR, and reporting the findings and recommendations of the CFR in the RBA’s Financial Stability Reviews.

2. *APRA*: APRA is a statutory body created by the *APRA Act*, which includes an express albeit limited mandate for financial stability in s 8(2).[8] As prudential regulator of financial institutions, APRA plays an important role in the implementation of prudential policy and microprudential supervision. The object of microprudential supervision is, at least indirectly, financial stability. Prudently managed financial institutions are less likely to fail, and therefore systemic risk, or knock-on effects as a consequence of the failure of a single financial institution, are less likely to occur.[9]

3. *The CFR*: The CFR is not a statutory body and has no legal personality, but nevertheless plays a key role in financial stability in Australia as it is the forum for the facilitation of collaboration and cooperation of the financial stability regulators.[10] The CFR is an Inter-Agency Committee (IAC)[11] and was created following the Wallis Inquiry. It adopted a charter in January 2004 and operates through a series of MOUs entered into by and between the various members of the CFR. The members are, as noted above, the RBA, APRA, ASIC and Treasury, and it is chaired by and administratively supported by the RBA.

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[8] The *Australian Prudential Regulation Authority Act* 1998 (Cth) s 8(2) requires the following: 'In performing and exercising its functions and powers, APRA is to balance the objectives of financial safety and efficiency, competition, contestability and competitive neutrality and, in balancing these objectives, is to promote financial system stability in Australia'.

[9] For example, the requirements of the Basel III Accord increased the requirements for Tier 1 and Tier 2 capital after the GFC, so as to create stronger banks and increase financial stability: See Basel Committee on Banking Supervision, *High-level Summary of Basel III Reforms*', *Bank for International Settlements* (Note, December 2017) <https://www.bis.org/bcbs/publ/d424_hlsummary.pdf>.

[10] The CFR is important. 'Agencies coordinate their actions through the Council of Financial Regulators, a body that demonstrated its worth, if any demonstration was needed, through the global financial crisis': David Gruen, 'Towards an Efficient and Stable Financial System' (Speech, CEDA State of the Nation 2014, 23 June 2014) <https://treasury.gov.au/speech/towards-an-efficient-and-stable-financial-system/>.

[11] For a discussion of interaction and coordination between agencies, see Erland Walter Nier, 'Financial Stability Frameworks and the Role of Central Banks: Lessons from the Crisis' (Working Paper No 09/70, International Monetary Fund, April 2009) <https://www.imf.org/external/pubs/ft/wp/2009/wp0970.pdf>.

4. *Treasury*: Treasury functions as the executive arm of the Australian government and represents government and public interest in its dealings with the government financial regulators/agencies. Treasury is represented on the CFR and is required to be consulted by the regulatory agencies in various tasks. The Treasury is also involved in financial regulation by providing policy advice to the government.[12] The Minister has the legal power to give policy direction to APRA and ASIC, although this power has not been used in the case of APRA and has only been used once in the case of ASIC.[13]

5. *ASIC*: ASIC has no financial stability mandate, and there is indeed nothing in the *Australian Securities and Investments Commission Act 2001* (Cth) (*ASIC Act*) that suggests that it does.[14] ASIC nevertheless undoubtedly plays a vital supporting role because of its role in market supervision. It is also expressly responsible for payment system stability, for which it derives powers from the *Corporations Act*. ASIC is also a member of the CFR.

6. *Other regulators*: Other regulators include the Australian Competition and Consumer Commission (ACCC) responsible for promoting competition and fair trade in the marketplace, and the Australian Transaction Reports and Analysis Centre (AUSTRAC), a financial intelligence unit (FIU) responsible for combating money laundering and terrorism financing (AML/CFT).

The manner in which the Australian government has decentralised the responsibility for financial stability to the different regulatory agencies/bodies in Australia can be summarised as follows:

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[12] ‘Policy Topics’, *Australian Government The Treasury* (Web Page) <https://treasury.gov.au/policy-topics/>.

[13] See Joanna Bird, ‘Regulating the Regulators: Accountability of Australian Regulators’ (2011) 35(3) *Melbourne University Law Review* 739.

[14] See Reserve Bank of Australia and Australian Prudential Regulation Authority (n 6).

Table 5.1 Summary of Australian government regulators in financial stability

Regulatory agency/ Institution	Structural characteristics of the institution/ regulatory agency/ body	Specific identifiable financial stability responsibility	Legal or other origin of the financial stability responsibility (hard/soft law)
RBA	Statutory body with independent legal personality	Overarching responsibility for financial stability	No express legal mandate, but an implied or de facto mandate. Lack of formal mandate in hard law supplemented by soft law that confirms rather than creates the mandate.
		Chairing role of the CFR; provision of administrative support to the CFR; reporting of the findings and recommendations of the CFR in Financial Stability Reviews published as the RBA.	Charter of the CFR (soft law)
		Payment system Stability	Express legal mandate in the *RBA Act* Express powers in the *Corporations Act* (hard law)
APRA	Statutory body with independent legal personality	Financial stability is the objective of its prudential regulation (avoiding financial instability in individual firms)	Express legal mandate provided in the *APRA Act* (limited scope) (hard law)

ASIC	Statutory body with independent legal personality	Payment system Stability No express financial stability mandate Considered not to have a financial stability mandate	Express powers in the *Corporations Act* (limited scope) (hard law)
		Other financial stability obligations (indirect)	*ASIC Act* (hard law but implied/indirect)
CFR	Committee created by MOU and usage	Promotion of Financial stability	Indirectly created (soft law) Came into existence through MOUs of which the Government is a member Informal, supported by a Charter adopted by members and intra-member MOUs
Treasury	Government department, not independent	Consultative duties of regulators with Treasury captured in legislation	Part of executive arm of federal government

III Analysis of the Decentralised Financial Stability Responsibility in Australia

This Part sets out and analyses the roles of the different Australian financial regulators in financial stability in more detail.

A *The RBA's Financial Stability Role as Envisaged by the Wallis Inquiry*

As demonstrated in Chapter 4, despite the absence of an express legislative mandate for financial stability, the RBA is generally considered to be the key regulatory agency responsible for financial stability.

Throughout its history Australia's central bank improved financial stability as a consequence of its operations. The financial stability 'mandate' in its present conceptualisation was more formally identified at the time of the Wallis Inquiry. The Wallis Inquiry recommended that the three key functions of the RBA were to be:

- monetary policy,
- systemic stability and
- payment systems regulation.[15]

The Australian Government mostly accepted the recommendations of the Wallis Inquiry in this regard,[16] and a suite of legislation was passed to implement the Twin Peaks regulatory model, create APRA and incorporate the payment systems regulation function into the RBA. No amendment was however made to the *RBA Act* in respect of the responsibility for financial stability.

The role of the RBA in the 'financial system stability' was however confirmed by the Australian government in a statement by the then Treasurer, the Hon Mr Peter Costello, on 2 September 1997.[17] He announced that:[18]

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[15] Commonwealth, *Financial System Inquiry* (Final Report, March 1997) 25 <https://static.treasury.gov.au/uploads/sites/1/2018/07/01-fsi-fr-Prelim.pdf> (Wallis Inquiry Final Report). See figure 5.2 below.

[16] The Government's Response to the Wallis Inquiry was made in the House of Representatives by the Treasurer, The Hon Peter Costello MP on 2 September 1997: Peter Costello, 'Australian Financial System Reform' (Press Release No 102, The Treasury, 2 September 1997) <http://fsi.treasury.gov.au/content/PublicInformation/PressReleases/PR020997.asp>.

[17] Ibid.

[18] Ibid (emphasis added).

> The Government has decided:
>
> first, that the Reserve Bank of Australia will be strengthened and its role focused on the objectives of monetary policy, *overall financial system stability* and regulation of the payments system. As part of this, a new Payments System Board will be appointed within the Reserve Bank with stronger regulatory powers to ensure safety, greater competition and efficiency in the payments system.

It is necessary to comment briefly on the phrase 'systemic stability' in this context. From the wording of the Wallis Inquiry it is clear that the concept 'systemic stability' mostly related to the use by the RBA of its LOLR function, from the perspective that typically 'systemic *in*stability' was usually created by bank illiquidity and failure. The Wallis Inquiry's use of the phrase 'systemic stability' seems to carry the same meaning as that of financial stability in the working definition.

The wording used by the Wallis Inquiry demonstrates that financial stability was considered to be a general and overarching responsibility of the RBA. Although this responsibility was ill-defined and not incorporated expressly in the *RBA Act*, it appears to have been generally accepted by the Wallis Inquiry, the Australian government and the RBA that it was the case. The Wallis Inquiry further recommended that financial stability should be conducted 'in consultation as necessary with the Treasurer and other financial sector regulatory authorities'.[19] As monetary policy is not conducted in consultation with government or other regulators, the role of the RBA in financial stability was conceived to be on a different level of independence compared to the monetary policy function of the RBA. There is no evidence that this implied difference in role received any express consideration at the time, and there is no evidence that consideration was given to the potential impact on the independence of the RBA. The

[19] The Wallis Inquiry recommended in Recommendation 56 that the RBA should 'remain responsible for system stability' as 'the central bank is best placed to ensure the stability of the financial system and to manage systemic risks'. There should however be 'consultation as necessary with the Treasurer and other financial sector regulatory authorities': The Wallis Inquiry Final Report (n 15) 21.

establishment of the CFR gave effect to the recommendation of the Wallis Inquiry that financial stability issues required consultation.[20]

The contribution of the RBA to financial stability was viewed to be (predominantly) the provision of LOLR assistance to banks. Changing the banks' perception that LOLR assistance would be virtually guaranteed in the event of the illiquidity and/or failure of a bank if the RBA was also the prudential supervisor, was an important consideration for the Wallis Inquiry. That was one of the key reasons why APRA was created,[21] ie the reduction of potential moral hazard. In particular, the Wallis Inquiry stated: [22]

> …while the central bank may still provide *support to maintain financial stability*, there is no implied or automatic guarantee of any financial institution or its promises in the event of insolvency.

The Wallis Inquiry however noted that financial instability could arise as a consequence of 'a wide variety of sources',[23] and that it should therefore be 'addressed by the monetary authorities'.[24] This was the motivation why 'the systemic stability of the financial system should remain the responsibility of the central bank'.[25] The RBA was to retain its role as LOLR, and the Wallis Inquiry was of the view that such assistance should only be available to financial institutions that had ESAs with the RBA.[26] The Wallis Inquiry also emphasised

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[20] It was recommended that the CFR be retained for sharing and cooperation: Ibid 28.

[21] The government accepted the Wallis Inquiry's recommendation to remove prudential supervision from the RBA to avoid the supervised banks expecting a virtual guarantee of government assistance through the LOLR function, in the event of illiquidity.

[22] See the introductory overview: The Wallis Inquiry Final Report (n 15) 21 *(emphasis added).*

[23] Ibid 23.

[24] Ibid.

[25] Ibid.

[26] 'The RBA should continue to have powers as a lender of last resort to those financial corporations operating ESAs with it. However, the RBA should cease to have explicit responsibilities for the protection of bank depositors and should act instead in the national interest only': Ibid.

the importance of the effective and proper functioning of the payment systems for stability.

About this time (ie in the late 1990s, early 2000s), the RBA contributed to the safeguarding of financial stability in Australia – directly and/or indirectly through:

1. its ability to use its balance sheet to assist banks with liquidity problems – ie the *LOLR functions* (it was anticipated that by removing the bank supervisory functions from the RBA that the risk of moral hazard of financial institutions and banks[27] would be reduced and that there would be no or less reliance on the ability of the RBA to provide bailout funds by supervised financial institutions);

2. its role in *macro-prudential analysis*;

3. the *conduct of monetary policy* – it was generally considered that financial stability would flow from monetary stability (ie that the stable value of the currency and low inflation would result in financial stability); and

4. oversight, regulation and strengthening of the *payments system*.

The RBA still fulfils those roles and they can be said to be the key roles that the RBA plays in financial stability.[28]

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[27] Sheelagh McCracken, John Stumbles, Greg Tolhurst and Olivia Dixon, *Everett and McCracken's Banking and Financial Institutions Law* (Lawbook, 9th ed, 2017) 18-9.

[28] See also Reserve Bank of Australia, *1999 Report and Financial Statements* (Annual Report, 3 August 1999) 26-7 <https://www.rba.gov.au/publications/annual-reports/rba/1999/pdf/1999-report.pdf> for a discussion of what foundations of financial stability (including low inflation, stability in financial institutions, and the smooth functioning financial markets).

B *The Introduction of Twin Peaks, the Creation of APRA and APRA's Role in Financial Stability*

The Wallis Inquiry of 1996 is an important milestone in the history of the RBA and other financial regulators in Australia. The purpose of the inquiry was to take stock of the results of the financial deregulation of the Australian financial system and consider likely further changes in the financial system, specifically the effect of developments in technology.[29] In particular the Inquiry's mission stated that:[30]

> Recommendations will be made on the nature of the regulatory arrangements that will best ensure an efficient, responsive, competitive and flexible financial system to underpin stronger economic performance, consistent with financial stability, prudence, integrity and fairness.

From the mission statement of the Wallis Inquiry it is clear that financial stability was perhaps not the key focus, but still an important consideration, even in the absence of a definition in the Terms of Reference of what financial stability entailed. It can be concluded that at this time the concept of 'financial stability' generally focussed on the avoidance of potential systemic risk through liquidity problems in banks.

One of the main achievements of the Wallis Inquiry was the subsequent introduction by the Australian government of the now much-admired Twin Peaks regulatory system.[31] Following the implementation of the recommendations of the

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[29] The Wallis Inquiry was established in June 1996 to perform 'a stocktake of the results arising from the financial deregulation of the Australian financial system since the early 1980s … and … technological development'. It had to make recommendations for 'regulatory arrangements that will best ensure an efficient, responsive, competitive and flexible financial system to underpin stronger economic performance, consistent with financial stability, prudence, integrity and fairness': The Wallis Inquiry Final Report (n 15) 5. The Terms of Reference were included as Annexure A in the final report: at 707 – 9.

[30] Ibid (emphasis added).

[31] Andrew Schmulow, 'Financial Regulation: Is Australia's 'Twin Peaks' Model a Successful Export?', *Interpreter* (Blog Post, 1 March 2016) <https://www.lowyinstitute.org/the-interpreter/financial-regulation-australias-twin-peaks-model-successful-export> ('"Twin Peaks" Model a Successful Export?').

Wallis Inquiry, APRA was created as the prudential regulator of all financial institutions and the supervisor of banks.[32] The removal of the prudential supervision of banks from the RBA was an important component of the creation of the Twin Peaks system of regulation in Australia. ASIC was created as the regulator responsible for market supervision and consumer protection.[33] Generally the 'macroprudential supervisor' would be responsible for the safeguarding of financial stability. In Australia, however, there has not been a designated macroprudential supervisor, and the role of the APRA has been described as 'microprudential supervision with a macroprudential focus'.[34] Both the RBA and APRA are however of the view that the RBA retained a 'macroprudential analysis' function[35] subsequent to the Wallis Inquiry changes. This role has not been formalised in legislation.

The basic structure and allocated roles between the RBA, APRA and ASIC in the Twin Peaks system were devised by the Wallis Inquiry and are depicted in the figure below.

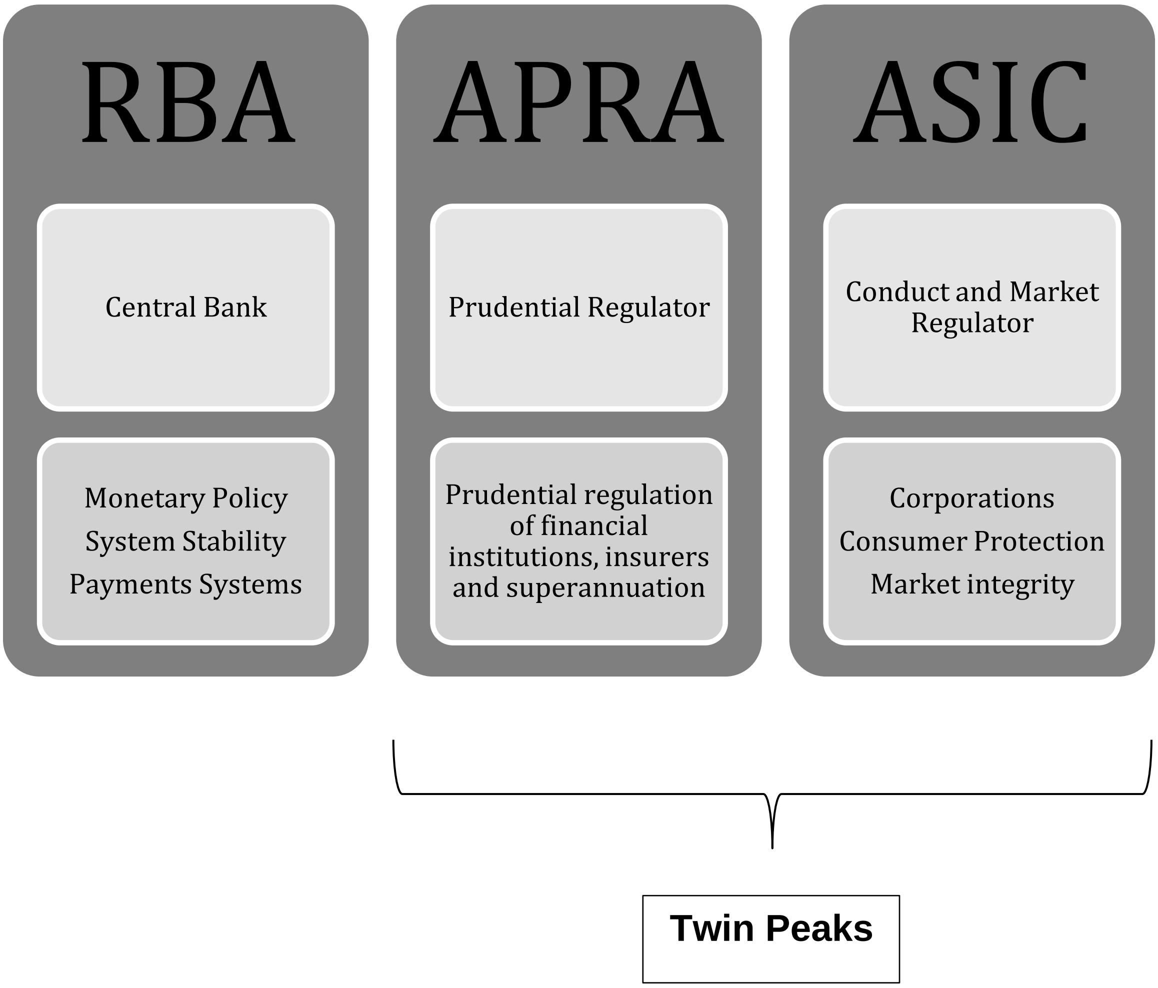
[32] Since the introduction of the Australian Government's Financial Claims Scheme (depositor protection) the imperative for the separation of lender of last resort and bank supervisor has also diminished in significance. For an overview of the deposit guarantee scheme, see 'Financial Claims Scheme', *Australian Prudential Regulation Authority* (Web Page) <https://www.fcs.gov.au>.

[33] For a discussion of Twin Peaks, see Andrew Godwin and Ian Ramsay, 'Twin Peaks: The Legal and Regulatory Anatomy of Australia's System of Financial Regulation' (Working Paper No 074/2015, Centre for International Finance and Regulation, August 2015) <https://apo.org.au/sites/default/files/resource-files/2015/08/apo-nid67377-1188281.pdf>; See Andrew Schmulow, 'Twin Peaks: A Theoretical Analysis' (Working Paper No 64/2015, Centre for International Finance and Regulation, 2015) <https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2625331>; See also Schmulow, '"Twin Peaks" Model a Successful Export?' (n 31).

[34] See Reserve Bank of Australia and Australian Prudential Regulation Authority (n 6).

[35] Ibid.

Figure 5.2 Twin Peaks regulatory framework



This figure shows the Twin Peaks regulatory architecture.

C *The Role of APRA in Financial Stability*

APRA was created in 1998 following the Wallis Inquiry, pursuant to the *APRA Act*. The primary role of APRA is prudential regulation of financial institutions. APRA 'is required to promote financial system stability in Australia while balancing its objectives of financial safety and efficiency, competition, contestability and competitive neutrality'.[36] APRA has a very large regulatory

[36] Ibid, in particular the section on 'Mandates'. Note also that APRA describes its mandate as follows on its website and in its 2017-2018 Annual Report: 'Our mandate is to protect the

purview, and is responsible for the prudential regulation and supervision of the banking, insurance and superannuation industries.[37]

1 *Role in Financial Stability*

The responsibility of APRA for financial stability is set out in s 8(2) of the *APRA Act*.[38] APRA is required to 'pursue financial stability considerations in concert with its other goals'.[39] In 2006, legislative reform was implemented that gave APRA an express mandate for financial system stability. This amendment was in line with amendments to the regulatory framework in New Zealand, and it was aimed (as far as could be established) at promoting cooperation between Australia and New Zealand. Each regulatory agency is meant to support and consult the other. The provision of an express mandate to APRA for financial stability was significant as previously it was the responsibility of the RBA only.

Section 8(2) of the *APRA Act* states:

> In performing and exercising its functions and powers, APRA is to balance the objectives of financial safety and efficiency, competition, contestability and competitive neutrality and, in balancing these objectives, is to promote financial system stability in Australia.

This section uses the phrase 'financial system stability', continuing the terminological confusion evident in the *RBA Act.* Although there is no helpful commentary available on how the phrase is to be interpreted, it appears to have

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Australian community by establishing and enforcing prudential standards and practices designed to ensure that, under all reasonable circumstances, financial promises made by institutions we supervise are met within a stable, efficient and competitive financial system': Australian Prudential Regulation Authority, *17/18 Annual Report* (Report, 28 September 2018) 3 <https://www.apra.gov.au/sites/default/files/2017-18_apra_annual_report.pdf>; See also 'APRA's Mandate, Vision and Values', *Australian Prudential Regulation Authority* (Web Page, 2019) <https://www.apra.gov.au/apras-madate-visions-and-values>; See also 'About APRA', *Australian Prudential Regulation Authority* (Web Page, 2019) <https://www.apra.gov.au/about-apra>.

[38] *Australian Prudential Regulation Authority Act 1998* (Cth) s 8(2).

[39] Ibid. See also Reserve Bank of Australia and Australian Prudential Regulation Authority (n 6).

been considered to be synonymous with financial stability. APRA's duty for financial stability was also reinforced by the Treasurer's 2007 Statement of Expectations for APRA which notes that prudential regulation is aimed at reducing market failure through limiting 'the systemic risks associated with breaches of financial promises'.[40] The Statement of Expectations is a soft law instrument that supplements the *APRA Act*.

Cooperation between the RBA and APRA is essential, and arrangements are encapsulated in the RBA-APRA MOU signed in 1998.[41] This document includes 'some of the specifics of the modes of cooperation and procedures for information sharing'.[42] There is no express legal obligation to share information and cooperate.

2 *Regulatory Roles and Powers*[43]

As prudential regulator, APRA is responsible for the framework of prudential regulation for the banking, finance, insurance and superannuation sectors. It implements Australia's adaptation of the Basel III framework.[44] APRA is also the microprudential supervisor, a role in which it adopts a risk-based approach.[45]

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[40] See Reserve Bank of Australia and Australian Prudential Regulation Authority (n 6), in particular the section on Mandates.

[41] Ibid.

[42] Ibid. See also *Memorandum of Understanding between the Reserve Bank of Australia and the Australian Prudential Regulation Authority*, signed 12 October 1998 (Memorandum of Understanding) <https://www.apra.gov.au/sites/default/files/MoU-RBA-Reserve-Bank-of-Australia.PDF> ('RBA-APRA MOU').

[43] For a restatement of the government's view of APRA's responsibilities for prudential regulation, the administration of the Financial Claims Scheme and the need to balance the objectives of financial safety and efficiency, competition, contestability and competitive neutrality, see Australian Government, 'Statement of Expectations 2018', *Australian Prudential Regulation Authority* (Web Page, 2018) <https://www.apra.gov.au/statement-expectations-2018>.

[44] See 'International Assessments', *Australian Prudential Regulation Authority* (Web Page, 2019) <https://www.apra.gov.au/international-assessments>.

[45] Australian Prudential Regulation Authority, *17/18 Annual Report* (Report, 28 September 2018) 3 <https://www.apra.gov.au/sites/default/files/2017-18_apra_annual_report.pdf>.

APRA further administers the Financial Claims Scheme, providing depositor protection in the event of the failure of a financial institution.[46]

3 *Contribution to Financial Stability*

As the prudential regulator, and by ensuring the financial safety of individual institutions, APRA contributes to overall financial stability by preventing systemic risk.[47] One of the key recent policy priorities of APRA was the implementation of 'unquestionably strong' capital ratios for banks,[48] with a view to enhancing the safety of the Australian financial system. APRA has also recently been tasked with implementing the Banking Executive Accountability Regime (BEAR),[49] aimed at avoiding the negative consequences of compensation and accountability regimes for bank executives as was highlighted during the GFC.

APRA also has significant crisis management/response powers, which have been strengthened recently. Although the LOLR powers lie with the RBA, APRA can and should take steps to minimise the negative consequences of a liquidity crisis suffered by one of its supervised entities.[50] Nevertheless, APRA has publicly stated that it does not pursue a situation where there is no failure on the part of any financial institution.[51] By implication, the overall financial stability

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[46] 'About APRA', *Australian Prudential Regulation Authority* (Web Page, 2019) <https://www.apra.gov.au/about-apra>.

[47] Ibid.

[48] See Australian Government, Statement of Expectations 2018 (n 43).

[49] *Treasury Laws Amendment (Banking Executive Accountability and Related Measures) Act 2018* (Cth).

[50] APRA is expected to act swiftly and effectively to resolve a crisis and to reduce consumer, financial system and economic distress: Australian Government, Statement of Expectations 2018 (n 43).

[51] APRA nevertheless does not 'pursue a zero failure objective': Australian Prudential Regulation Authority, 'Statement of Intent – September 2018', *Australian Prudential Regulation Authority* (Web Page, September 2018) <https://www.apra.gov.au/statement-intent-september-2018>.

considerations remain those of the RBA, and the RBA is primarily responsible for systemic stability.

4 *Relationship Between APRA and the Australian Government*

APRA's relationship with the government is not just regulated by the *APRA Act*, but also by the government's Statement of Expectations, such as the 2018 Statement. In its Statement of Intent that responds to the Statement of Expectations, APRA sets out its understanding of and undertakings in relation to its relationship with government. The details of these are beyond the scope of this thesis.

D *The Role of ASIC in Financial Stability*

ASIC is established and regulated by the *ASIC Act* and is Australia's corporate, markets and financial services regulator[52] but also performs a large number of functions under the *Corporations Act 2001* (Cth). ASIC is also subject to a Statement of Expectations issued by the Treasurer and has issued a Statement of Intent in response.[53]

The *ASIC Act* requires ASIC to: [54]

- maintain, facilitate and improve the performance of the financial system and entities in it;

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[52] 'Our Role', *Australian Securities and Investments Commission* (Web Page, 1 February 2019) <http://www.asic.gov.au/asic/asic.nsf/byheadline/Our+role?openDocument>.

[53] Commonwealth, 'Statement of Expectations – Australian Securities and Investments Commission April 2018', *Australian Securities and Investments Commission* (Web Page, 26 September 2018) <https://asic.gov.au/about-asic/what-we-do/our-role/statements-of-expectations-and-intent/statement-of-expectations-australian-securities-and-investments-commission-april-2018/>; 'ASIC's Statement of Intent', *Australian Securities and Investments Commission* (Web Page, 26 September 2018) <https://asic.gov.au/about-asic/what-we-do/our-role/statements-of-expectations-and-intent/asic-s-statement-of-intent/>.

[54] Ibid; *Australian Securities and Investments Commission Act 2001* (Cth) s 1(2).

- promote confident and informed participation by investors and consumers in the financial system;
- administer the law effectively and with minimal procedural requirements;
- enforce and give effect to the law;
- receive, process and store, efficiently and quickly, information that is given to ASIC; and
- make information about companies and other bodies available to the public as soon as practicable.

Although it is an independent regulatory agency, it falls under the portfolio of the Minister of Finance.

1 *Role in Financial Stability*

According to the IMF 2012 Country Report on financial stability in Australia, ASIC is a ‘highly regarded enforcer of market regulation’.[55] It plays an important role in securing financial stability by, for example, regulating the conduct of business supervision for companies such as insurance companies.[56] It also sets capital requirements, large exposure rules, and reporting requirements for Australian financial services licence holders.[57]

2 *Regulatory Roles and Powers*

ASIC has regulatory authority over ‘Australian companies, financial markets, financial services organisations and professionals who deal and advise in investments, superannuation, insurance, deposit taking and credit’.[58] It has three

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[55] International Monetary Fund, *Australia: Financial System Stability Assessment* (Report No 12/308, November 2012) 6 <https://www.imf.org/external/pubs/ft/scr/2012/cr12308.pdf>.

[56] Ibid. The IMF suggested certain improvements that should be made by ASIC: at 7.

[57] Ibid.

[58] Australian Securities and Investments Commission (n 52).

broad regulatory roles. It firstly acts as the *consumer credit regulator*. ASIC issues licences and regulates individuals and businesses (including banks, credit unions, finance companies, finance brokers, mortgage brokers and the like) involved in consumer credit activities,[59] and enforces standards set out in the *National Consumer Credit Protection Act 2009* (Cth).[60] Secondly, ASIC is the *markets regulator*. ASIC monitors compliance of authorized financial markets with their legal obligations aimed at operating fair, orderly and transparent markets.[61] Apart from advising the Minister about authorizing new markets, it has also been responsible for 'supervision of trading on Australia's domestic licensed equity, derivatives and futures markets'[62] since 1 August 2010. Thirdly, ASIC is the *financial services regulator*. ASIC licences and monitors financial services businesses to ensure that they operate efficiently, honestly and fairly. These businesses typically deal in superannuation, managed funds, shares and company securities, derivatives, and insurance.[63]

According to ASIC, its strategic priorities are:[64]

1. Ensuring *confident and informed investors and financial consumers* through education, by increasing responsible investment decisions by investors, by holding gatekeepers to account and studying consumer behaviour;

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[59] Ibid.

[60] Ibid.

[61] Ibid.

[62] Ibid.

[63] Ibid.

[64] Ibid.

2. Establishing *fair and efficient financial markets* through ASIC's role in market supervision and competition, and corporate governance; and

3. Providing an *efficient registration and licensing regime***.**

The significance of ASIC's overall role in financial stability in Australia is evident from the description given by ASIC of its importance in the 2007 Statement of Intent published in response to the government's Statement of Expectations. ASIC stated:[65]

> ASIC recognises the importance for the economy as a whole of effectively delivering on [its] these responsibilities. Corporations play an important role in the economy, and ASIC's role is to provide reliable, efficient infrastructure for their formation and operation. ASIC's role as a conduct and disclosure regulator in capital markets and financial products and services is vital for the confident and informed participation of investors and consumers in the financial system, and for maintaining Australian markets' reputation for integrity. An example is the priority we have announced on our work in the retail market for financial products and services.

The most recent Statement of Intent of 2018 has a broadly similar gist, and specifically confirms that ASIC's 'vision is for a fair, strong and efficient financial system for all Australians'.[66]

3 *Contribution to Financial Stability*

ASIC makes an important contribution to financial stability in relation to the payments system. Problems in the payments system can create risk for the entire financial system if there are difficulties with the settlement of large payment obligations. In conjunction with the RBA, ASIC is responsible for taking regulatory

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[65] ASIC's Statement of Intent', *Australian Securities and Investments Commission* (Web Page, 26 June 2007) <https://download.asic.gov.au/media/1321681/ASIC_Statement_of_Intent.pdf>.

[66] 'ASIC's Statement of Intent', *Australian Securities and Investments Commission* (Web Page, 26 September 2018) <https://asic.gov.au/about-asic/what-we-do/our-role/statements-of-expectations-and-intent/asic-s-statement-of-intent/>.

actions to minimise systemic risk in clearing and settlement systems.[67] In terms of the *Corporations Act,* ASIC has as an objective 'the reduction of systemic risk and the provision of fair and effective services by clearing and settlement facilities'.[68] The RBA's powers to set financial stability standards support this objective. Under the *Corporations Act* both ASIC and the RBA have powers over the licensing of, setting of standards for, and provision of directions to such facilities.[69] In particular, the directions power of ASIC under s 823E to holders of clearing and settlement facility licences contribute to the reduction of systemic risk.[70] The MOU between the RBA and ASIC set out their agreement in relation to these joint responsibilities.[71]

ASIC contributes indirectly to financial stability through its market conduct, disclosure and financial services regulation. ASIC's Strategic Framework however is not directly focussed on systemic stability but rather on the following strategic priorities or outcomes:[72]

- Confident and informed investors and financial consumers
- Fair and efficient financial markets; and
- Efficient registration and licensing.

ASIC's contribution to financial stability is therefore indirect.

[67] Reserve Bank of Australia and Australian Prudential Regulation Authority (n 6) 2.

[68] *Corporations Act 2001* (Cth) Chapter 7.

[69] See Reserve Bank of Australia and Australian Prudential Regulation Authority (n 6) 3.

[70] Ibid. When giving such directions, ASIC is required to consult with the RBA.

[71] *Memorandum of Understanding between the Australian Securities and Investments Commission and the Reserve Bank of Australia*, signed 18 March 2002 (Memorandum of Understanding) <https://download.asic.gov.au/media/1340888/MOU-ASICandRBA.pdf>; See also Reserve Bank of Australia and Australian Prudential Regulation Authority (n 6) 3.

[72] 'Strategic Framework', *Australian Securities and Investments Commission* (Web Page, 15 August 2017) <https://asic.gov.au/strategic-framework>.

E *The Role of Other Regulators in Financial Stability*

Other regulators include the ACCC, responsible for promoting competition and fair trade in the market place, and AUSTRAC, an FIU responsible for anti-money laundering and combating the financing of terrorism.[73] Their direct roles in financial stability are small.

F *The Creation of the CFR and its Role in Financial Stability*

The CFR, as an IAC, has as its current members the RBA, APRA, ASIC as well as the Treasury. This type of committee is found in many countries and often has financial stability objectives and tasks.[74] Quite often such an IAC exists even in countries where the central bank has an express mandate for financial stability, although there may be some differences between the mandates of the central banks and the IACs.[75]

The CFR was established in 1998 with the implementation of the recommendations of the Wallis Inquiry. It replaced the Council of Financial Supervisors, which had been tasked with facilitating coordination and communication between the financial regulators at that time, being the RBA, the Insurance and Superannuation Commission, the Australian Securities

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[73] International Monetary Fund, *Australia: Financial System Stability Assessment* (Report No 12/308, November 2012) <https://www.imf.org/external/pubs/ft/scr/2012/cr12308.pdf>, a country report.

[74] The focus of the CFS is on financial stability: See Serge Jeanneau, 'Financial Stability Objectives and Arrangements – What's New?' in M S Mohanty (ed) *The Role of Central Banks in Macroeconomic and Financial Stability* (BIS Papers, No 76, February 2014) 54-5 <https://www.bis.org/publ/bppdf/bispap76.pdf>. In some countries, IACs were created after the GFC. In some the governor of the central bank is also the chair of the IAC, but not in all of them. See also 'Council of Financial Regulators', *Reserve Bank of Australia* (Web Page) <https://www.rba.gov.au/fin-stability/reg-framework/cfr.html>.

[75] See Jeanneau (n 74) 55.

Commission and the Australian Financial Institutions Commission.[76] The Council of Financial Supervisors existed from 1992 to (February) 1998.[77]

1 *Background – the Wallis Inquiry*

The CFR was seen by the Wallis Inquiry as 'the collaborative dimension of the regulatory agencies' activities'.[78] Accordingly, the CFR was created as an inter-agency body with a view to ensure cooperation and collaboration between its member agencies. The Wallis Inquiry did not envisage the CFR as a separate body, but considered that its strength would come from the commitment of its members to co-operate closely.[79] The need for closer collaboration and coordination of the financial regulators was identified by the report of the Royal Commission into the collapse of HIH Insurance in 2001.[80]

The first members of the CFR were the RBA, APRA, and ASIC; the Australian Treasury became a member in June 2003.[81] The reason for the inclusion of the Treasury was 'to ensure that coordination among the principal financial regulatory agencies with an interest in financial stability would continue at the highest level'.[82] This timing also coincided with the introduction of new governance arrangements for APRA, with its board being replaced by 'a three-member executive group'.[83] This changed membership reflects the need for government

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76 'History', *Council of Financial Regulators* (Web Page) <https://www.cfr.gov.au/about/history.html>.

77 Ibid.

78 Ibid.

79 Council of Financial Regulators, *Annual Report 1998* (Report, 1998) <https://www.rba.gov.au/publications/annual-reports/cfr/1998/pdf/1998.pdf>.

80 *Royal Commission into the Failure of HIH Insurance* (Final Report, 4 April 2003) (HIH Royal Commission).

81 Council of Financial Regulators, 'History' (n 76).

82 Ibid.

83 Ibid.

to be involved in financial stability matters. According to the CFR, since the expansion of its membership in 2003, there has been a heavy focus on financial stability in its discussions and deliberations. It has considered both domestic and international issues of financial stability,[84] and 'the adequacy of Australia's financial regulatory architecture in dealing with potential threats to financial stability'.[85] The three examples cited by the CFR relating to its investigations into financial stability are all in connection with the Financial Claims Scheme, implemented during the GFC and continued in a revised form after the GFC.[86]

Although they are not members of the CFR, the ACCC, AUSTRAC and the Australian Taxation Office (ATO) can attend meetings of the CFR as necessary.[87]

2 *Lack of Institutional Character*

As noted above, the Wallis Commission did not see the need to constitute the CFR as a separate body,[88] but envisaged that its members would commit 'to cooperate closely'.[89] Given the importance of financial stability that necessitated the creation of the CFR in the first instance, it is surprising that the method of regulation of this pinnacle body does not include any formal organization, any formal mandate or similar hard law mechanisms. It is not an optimal way of

[84] Ibid.

[85] Ibid. No explanation is provided for what the Council means with this reference.

[86] Ibid. The examples cited include advice to the Government in November 2008 on a package of measures, including the introduction of a Financial Claims Scheme to protect depositors and policyholders in the event of a failure of an authorized deposit-taking institution and/or an insurer, assisting with the implementation of the Financial Claims Scheme as well as a Guarantee Scheme for Large Deposits and Wholesale Funding in the second half of 2008, and an assessment for the Government in 2010 on the structure of the Financial Claims Scheme post-GFC and advice on its implementation in 2011.

[87] 'The Inquiry does not see a need to expand the permanent membership of the CFR to include the Australian Competition and Consumer Commission (ACCC), the Australian Transaction Reports and Analysis Centre (AUSTRAC) or the Australian Taxation Office (ATO), as these agencies can already attend meetings as necessary': Murray Inquiry Final Report (n 3).

[88] Council of Financial Regulators, 'History' (n 76).

[89] Ibid.

structuring a body of this nature, as the entire regulatory framework is based in soft law, making the nature, tasks and role of this body discretionary and potentially open to the subjective views and possible whims of powerful personalities.[90]

3 *Charter of the CFR*

The CFR has evolved and has become somewhat formalised by for example adopting a charter[91] setting out its objectives. It however has no legal personality or obligations.[92] It is not a statutory body and has no regulatory functions that exist separately from those of its members.[93] The Governor of the RBA chairs the CFR.[94]

According to its charter, the ultimate objectives of the CFR are two-fold: [95]

- to contribute to the efficiency and effectiveness of regulation; and
- to promote stability of the Australian financial system.

There is however no legal compulsion on any of its members to participate, collaborate or cooperate in the CFR.[96]

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[90] The potential for personality to be disproportionately important as a regulatory mechanisms in the absence of other hard law mechanisms is discussed in Chapter 6.

[91] Ibid.

[92] Ibid.

[93] Reserve Bank of Australia and Australian Prudential Regulation Authority (n 6) 3.

[94] 'Organisation', *Council of Financial Regulators* (Web Page) <https://www.cfr.gov.au/about/organisation.html>.

[95] 'Charter', *Council of Financial Regulators* (Web Page) <https://www.cfr.gov.au/about/charter.html>.

[96] It is however not suggested that the CFR or any of its members have in any way acted with impropriety in the past.

4 *Contribution to Financial Stability*

The CFR describes its role as *contributing* to the efficiency and effectiveness of financial regulation and promoting the stability of the Australian financial system.[97] It appears however that the most important aspect of the role of the CFR is the protection of the stability of the financial sector. It fulfils its functions by providing a high-level forum of cooperation[98] for the member agencies. In this forum, members share 'information and views on financial sector conditions and risks, [discuss] regulatory reforms and, if the need arises, [coordinate] responses to potential threats to financial stability'.[99] Meetings are held more or less every two months,[100] and steps are taken to ensure 'appropriate coordination arrangements for responding to actual or potential instances of financial instability'.[101] It is also the forum for members to discuss conflicts that arise because of responsibility overlap.[102]

The RBA's Financial Stability Review is also tabled at the meetings of the CFR and only published thereafter. This practice was implemented shortly after a revision of the charter of the CFR in 2003 to, firstly, increase the focus on financial stability, and, secondly, to include the Treasury as a member.[103] The inclusion of the Commonwealth Treasury in the CFR indicates that the Australian government cannot reasonably be excluded from the regulatory framework of financial regulators in particular as it may relate to financial stability.

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[97] Ibid.

[98] Ibid.

[99] Ibid. It started its own website in 2013: Council of Financial Regulators, 'Launching the Council of Financial Regulators Website' (Media Release No 2013-01, 11 February 2013) <https://www.cfr.gov.au/news/2013/mr-13-01.html>.

[100] Reserve Bank of Australia and Australian Prudential Regulation Authority (n 6) 3-4.

[101] Ibid.

[102] Ibid.

[103] Reserve Bank of Australia, *Financial Stability Review* (Review, March 2004) <https://www.rba.gov.au/publications/fsr/2004/mar/pdf/0304.pdf> Foreword, 1.

The CFR describes its own functions as including sharing of information among members, the discussion of regulatory issues, and coordination of responses to potential threats to financial stability.[104] It also advises the Australian government on whether Australia's financial regulatory arrangements are adequate[105] and whether 'Australia's financial system architecture [is adequate] in light of ongoing developments'.[106] The CFR thereby contributes to the 'efficiency and effectiveness of financial regulation by providing a high-level forum for cooperation and collaboration among its members'.[107] It is seen as a flexible and low-cost approach to coordination.[108] Its value as 'an effective means of coordinating responses to potential threats to financial stability'[109] was demonstrated in the GFC.

5 *The MOUs between Different Regulators that are Members of the CFR: Interaction between Members and their Obligations*

The relationships between the regulators in the CFR are governed by a suite of memoranda of understandings. These have already been mentioned in Chapter 4. The MOUs confirm the lead role of the RBA in financial stability and also regulate the relationships between the different regulators. The result is that the relationships between the key financial regulators in Australia and the members of the CFR are regulated predominantly by soft law instruments. The significant interaction required between the regulatory agencies for purposes of financial stability, is not regulated in statute.

[104] Ibid.

[105] Ibid.

[106] Ibid.

[107] Ibid.

[108] Ibid.

[109] Ibid.

For ease of reference, the relevant MOUs and their main purposes and content are summarised in Table 5.2 below.

Table 5.2 List of Memoranda of Understanding

MOU	**Agencies involved**	**Date signed**	**Main purpose or content of the MOU**
RBA-APRA MOU	RBA and APRA	12 October 1998	Sets out a framework for cooperation aimed at promoting the stability of the Australian financial system.[110]
RBA-ASIC MOU	RBA and ASIC	20 March 2002	Entered into to '…assist each agency in the performance of its regulatory responsibilities under the Corporations Act 2001 in relation to clearing and settlement facilities … and to promote transparency, help prevent unnecessary duplication of effort and minimise the regulatory burden on licensed facilities'.[111]
APRA-Treasury MOU	APRA and The Treasury	Unknown	Sets out 'an agreed basis for policy and operational co-ordination between Treasury and APRA. The Memorandum is non-binding and each party reserves the right to vary its terms at any time, following consultation with the other party.'[112]

[110] *Memorandum of Understanding between the Reserve Bank of Australia and the Australian Prudential Regulation Authority*, signed 12 October 1998 (Memorandum of Understanding) <https://www.apra.gov.au/sites/default/files/MoU-RBA-Reserve-Bank-of-Australia.PDF> (first paragraph) ('RBA-APRA MOU').

[111] *Memorandum of Understanding between the Australian Securities and Investments Commission and the Reserve Bank of Australia*, signed 18 March 2002 (Memorandum of Understanding) <https://download.asic.gov.au/media/1340888/MOU-ASICandRBA.pdf> ('RBA-ASIC MOU').

[112] *Memorandum of Understanding between the Treasury and the Australian Prudential Regulation Authority* (Memorandum of Understanding)

APRA-ASIC MOU	APRA and ASIC	New version signed on 18 May 2010, replacing the MOU of 30 June 2004.	Sets out a framework for cooperation on matters 'in areas of common interest where cooperation is essential for the effective and efficient performance of their respective financial regulation functions.'[113]
Financial Distress Management MOU	APRA, ASIC, RBA and The Treasury	18 September 2008	Memorandum of Understanding of Financial Distress Management.[114]

In the RBA-APRA MOU, signed on 12 October 1998, the RBA's responsibility for financial stability is confirmed.[115] The purpose of this MOU, namely to set out the framework for cooperation between the two organisations in relation to the promotion of stability in the Australian financial system,[116] reflects the historical developments of the removal of the bank supervision function from the RBA after the Murray Inquiry, and the advent of Twin Peaks. Clause 3 of the MOU sets out the responsibilities in relation to financial stability of the RBA and the RBA's role: 'The RBA's role [in promoting financial stability] is focused on the objectives of monetary policy, *overall financial system stability* and regulation of the payments system'.[117] In similar vein, the role of the RBA as supporter of the 'financial system' rather than of individual banks, is also clarified in clause 12. The RBA is

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<https://www.apra.gov.au/sites/default/files/MoU-Treasury.pdf> (clause 1) ('APRA-Treasury MOU').

[113] *Memorandum of Understanding between the Australian Prudential Regulation Authority and the Australian Securities and Investments Commission*, signed 18 May 2010 (Memorandum of Understanding) <https://www.apra.gov.au/sites/default/files/ASIC-MoU.pdf> ('APRA-ASIC MOU') (clause 1.1).

[114] *Memorandum of Understanding on Financial Distress Management between the Members of the Council of Financial Regulators*, signed 18 September 2008 (Memorandum of Understanding) <https://www.cfr.gov.au/financial-institutions/crisis-management-arrangements/pdf/mou-financial-distress-management.pdf> ('Financial Distress Management MOU').

[115] RBA-APRA MOU: See the document as a whole, but in particular clauses 1, 2, 3, 11 and 12.

[116] Ibid clause 1.

[117] Ibid clause 3 (emphasis added).

responsible for establishing 'whether, and how, it might provide emergency liquidity support to the financial system. It does not see its balance sheet as available to support the solvency of an individual financial institution in difficulty'.[118] This MOU also sets out some of the specifics of the modes of cooperation and procedures for information sharing.[119]

The RBA-ASIC MOU of 2002 sets out the processes and information-sharing arrangements agreed upon in pursuit of their joint responsibilities.[120]

The Financial Distress Management MOU signed by all relevant regulators in 2008 expressly confirms that the RBA 'retains its responsibility for financial stability'.[121] In this MOU the role of the RBA in financial stability – or 'financial system stability', as it is referred to at times – is clarified. It is evident that there is an assumption that financial stability results from the role of the RBA as LOLR and also from its role in monetary policy and the payments system. This MOU also sets out clear principles and the roles of the members of the CFR in the event of circumstances of actual or potential financial instability and provides a non-exclusive list of three examples of such circumstances:[122]

- financial distress in an authorised deposit-taking institution (ADI), general insurer, life insurer or superannuation fund;
- disruption to financial markets; or
- interruptions to the smooth functioning of financial system infrastructure (including payment and settlement systems).

The Financial Distress Management MOU contains a number of obligations that the signatories have assumed simply by virtue of their signature to the MOU, and the obligations therefore arise from, or are confirmed in, soft law. These are

[118] Ibid clause 12.

[119] Reserve Bank of Australia and Australian Prudential Regulation Authority (n 6) 2.

[120] Ibid 3.

[121] See the Financial Distress Management MOU.

[122] Ibid clause 1.

however *key obligations* for Australia's financial stability. Nevertheless, as an instrument the MOU is not legally binding, and it is likely unenforceable against any of the signatories. It is very doubtful whether a member of the public would be able to enforce any of the obligations undertaken against any of the regulators. At the start of the MOU it states: [123]

> This Memorandum of Understanding (MOU) between the members of the Council of Financial Regulators (Council) sets out the objectives, principles and processes for dealing with stresses in the Australian financial system.
>
> The MOU identifies the responsibilities of each Council member and is intended to facilitate a coordinated response to stresses in the financial system.

The language used in this MOU also deserves comment. The signatories undertake to act in accordance with and assume responsibility for their *statutory* mandates,[124] although the 'mandates' of the regulators are, as demonstrated above, not always statutory, and not as clear as the language in the MOU may suggest. Further, notwithstanding the reference to the binding statutory mandates of each of the signatories to the MOU, the MOU nevertheless summarises and details the roles of each of the regulators as follows:[125]

> [t]he responsibilities of each member for dealing with stress in the financial system are as follows:
>
> - The RBA has primary responsibility for the maintenance of overall financial system stability, including stability of the payments system, and for providing liquidity support to the financial system or to individual financial institutions where appropriate.
> - APRA is responsible for the prudential supervision of banks, building societies, credit unions, life and general insurance companies, friendly societies and certain superannuation funds. In performing its functions to protect the interest of depositors, policyholders and fund members, APRA is required to balance the objectives of financial safety and efficiency, competition, contestability and competitive neutrality and, in balancing these

[123] Ibid.

[124] Ibid clause 2.

[125] Ibid.

objectives, is to promote financial system stability in Australia. APRA has failure management and enforcement powers to deal with a distressed institution and will be responsible for administering the Financial Claims Scheme (FCS).

- ASIC is responsible for monitoring, regulating and enforcing corporations and financial services laws, and for promoting market integrity and consumer protection across the financial services sector and the payments system.
- The Treasury provides advice to the Government on policy and possible reforms that promote a sound financial system, including on financial distress management arrangements. The Treasury has responsibility for advising the Government on matters relating to the exercise of the Treasurer's powers, and on the broader economic and fiscal implications of developments that pose a threat to the stability of the financial system.

As a regulatory mandate cannot be created by agreement between regulators, this MOU is not a formal source of a formal mandate. It demonstrates both the informal aspects and decentralised aspects of the financial stability mandate.

Two further important observations should be made in light of the above. Firstly, the fact that the MOU refers to the RBA as having ‘primary responsibility’ is important and reflects the generally accepted view that the RBA is responsible for financial stability in an overarching manner (see Chapter 4). Secondly, the MOU demonstrates the extent to which the Australian government is involved in financial stability. The role of the Treasury as advisor to the Australian government on policy and potential reforms reaffirms the government’s active role in financial stability and expressly acknowledges the importance of financial stability for the broader economy in Australia. It also reflects a different relationship of independence of the RBA in relation to financial stability.

The MOU however also extends beyond the mere regulation of the relationships between the different signatories but includes the principles for decisions and actions. The MOU confirms that the work in the CFR will be aimed at contributing ‘to the efficiency and effectiveness of regulation’ and will be geared ‘to promote stability of the Australian financial system'.[126] Even though an MOU is not formally binding in nature, the persuasive nature of the MOU means that it is likely that this non-binding document that establishes protocols and boundaries also fundamentally influences decision-making separate from the protocols and boundaries. It also addresses the substantive matters of financial stability. This document is however an example of a regulatory process where decision-making and regulation is ultimately left up to statutory and other bodies without a clear guideline from government that will hold the agencies accountable. It is essentially the signatories who determine how financial stability will be achieved, and although government is represented on the CFR, it does not control the process or outcomes. This situation does not accord with democratic principles or the rule of law. The role of MOUs as governance mechanisms is further addressed in Chapters 6 and 7.

IV Evaluation of the Decentralised and Shared Regulatory Framework for Financial Stability

The effect of a decentralised mandate is that a number of role-players share that mandate. The sharing of financial stability responsibilities create a number of difficulties. The RBA and APRA have responsibilities that *overlap* at least to some extent. Both the RBA and APRA prioritise the safety of the financial system, although APRA is the microprudential regulator and the only one with prudential regulatory tools. The RBA's tools include interest rates, payment systems regulation, the LOLR facility that can influence financial markets, as well as the dissemination of information and research. It has been noted that both APRA and the RBA conduct their tasks with a macroprudential focus, but in Australia there is no designated macroprudential regulator.[127]

[126] Ibid.

[127] For a discussion of the difference between macroprudence and macroprudential supervision, see Charles Littrell, 'What is the Difference Between Macro Prudence and Macroprudential Supervision?' (Speech, Annual Macquarie University Centre for Financial Risk, 1 July 2013) <https://australiancentre.com.au/wp-content/uploads/2016/04/D1P3-Macro-prudence-Charles-Littrell-APRA.pdf>.

When a mandate or responsibility is decentralised, it also means that the different responsibilities of regulators when combined, should make up the whole of the regulatory oversight. As the overarching goal of financial stability regulation in Australia has not been expressed (or perhaps even conceptualised) it is not possible to determine whether the sum of the parts make up the whole, and whether or not there are any *gaps*. In addition, when a regulatory responsibility is shared, the roles and responsibilities of each of the responsible entities should be clear, and the manner in which they should interact with other regulators should be clear as well. That is also not the case with the financial stability responsibility in Australia. Although the tasks of the different regulators have been described, and their interactions have been stipulated to some extent albeit through informal means, what the overarching financial stability mandate of the RBA entails, has not been clarified. There is accordingly a significant gap in the regulatory framework of financial stability regulation in Australia.

V Conclusion

This chapter demonstrated the extent to which the financial stability mandate in Australia is a decentralised and shared mandate. The financial stability regulatory responsibilities are shared between the RBA, APRA and the CFR (although other regulators such as ASIC and the Treasury also play a part). In particular, APRA has most of the tools that could be used for financial stability purposes – those being predominantly prudential tools. Coordination, cooperation and collaboration between regulators are therefore of the utmost importance, and the CFR has been created to fulfil that need, as well as the need to enhance communication between the regulators. However, the CFR itself is an informal arrangement, relying on MOUs for its operation, and all of its obligations as well as some of those of its members, are encapsulated in soft law instruments. This chapter has demonstrated how the MOUs do not sufficiently address the regulatory responsibilities of the regulators. The decentralised, shared and informal character of the financial stability responsibility leads to potential difficulties with overlaps, gaps, lack of interactions and an absence of an overarching goal. The RBA’s performance of its financial stability mandate is therefore fundamentally affected by the fact that it alone is not responsible for financial stability. This has important consequences for the governance and accountability of the RBA.

CHAPTER 6

Governance of the RBA as Financial Stability Regulator

In practice, law-makers have to understand the capabilities and propensities of regulatory agencies and design regulatory frameworks that make good use of them.[1]

… one first class man should be trusted and given ample powers. …[2]

I Introduction

Chapters 6 and 7 critically examine the governance and accountability arrangements of the RBA for financial stability. Chapter 6 deals with governance; Chapter 7 deals with accountability. Governance and accountability mechanisms can act as controls and drivers of the RBA in its financial stability responsibilities in the absence of an express statutory mandate for financial stability. Governance and accountability mechanisms can 'steer the flow of events and behaviour'.[3] Together these chapters argue that the governance and accountability regulatory regime of the RBA for financial stability is not optimal. The analysis conducted in these chapters are summarised in table form in Appendix 3.

This chapter commences with a discussion of the importance of governance, transparency and accountability for independent central banks (Part II). It describes a functional continuum of governance, transparency and

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[1] Malcolm K Sparrow, *The Regulatory Craft: Controlling Risks, Solving Problems, and Managing Compliance* (Brookings Institution Press, 2000) 6.

[2] Commonwealth, *Parliamentary Debates*, House of Representatives, 15 November 1911, 2644 (Andrew Fisher) 2645 (Second Reading Speech).

[3] Freiberg refers to governance mechanisms that are 'about steering the flow of events and behavior (sic)': Arie Freiberg, *Regulation in Australia* (Federation Press, 2017) 5, citing Braithwaite, Coglianese and Levi-Faur.

accountability mechanisms that drive and control the conduct of central banks. This chapter then focusses on three key governance mechanisms that can potentially control and drive the RBA in its financial stability responsibilities: the powers and mandate of the RBA as an agent of the Australian government (Part III), the functional relationship of the RBA with the state in relation to financial stability, in particular how the RBA has been created as an independent central bank and the role of government in its operations (Part IV); and the internal governance arrangements of the RBA that influence RBA decision-making (Part V A). In light of the relative ineffectiveness of the first two governance mechanisms, and the unusually significant role of the Governor (see Part V B), this chapter postulates that behavioural factors that have their root in the behavioural sciences can be ultimate drivers of the RBA's financial stability actions. In this chapter the role of 'personality' is examined. This chapter concludes that the governance mechanisms are not truly effective as controls or drivers of the RBA's financial stability responsibilities, and in light of the preponderance of soft law and non-legal controls and drivers, the principles of democratic rule-making and the adherence to the principles of the rule of law have not been supported.

II Governance, Transparency and Accountability: Essential for Independent Central Banks

A *Designing a Regulator for Financial Stability: An Independent Central Bank as a Regulatory Agency*

The regulatory framework that a government puts in place when making an independent central bank responsible for financial stability should reflect the government's objectives for the central bank, and the central bank's responsibilities. When effecting its 'architectural choices'[4] in creating a public policy regulator, the government should not only give general direction, but

[4] Paul Tucker, *Unelected Power: The Quest for Legitimacy in Central Banking and the Regulatory State* (Princeton University Press, 2018) 72.

should also include measures to ensure that the central bank executes its obligations and meets the objectives set. Accordingly, governance and accountability mechanisms in the regulatory framework should reinforce the regulatory goals, and because of central bank independence, should also be effective as drivers and controls of the central bank's actions.

Generally, in the context of central banks, governance, transparency and accountability have always been considered to be the counterweights and countermeasures of the central bank's independence.[5] As is reflected in an extensive body of literature, governance, transparency and accountability are the triumvirate of independent central banks, relating mostly to the independence of central banks as monetary policy authorities.[6] An in-depth discussion of this body of literature is beyond the scope of this thesis. The focus in this thesis is on governance and accountability as controls and drivers of the RBA's financial stability mandate.

Central bank independence has many benefits, but independence requires responsibility.[7] 'Democratic accountability for unelected officials and arm's

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[5] This point enjoys wide acceptance in the literature on central bank independence. For a recent commentary on the independence of the RBA, see Guy Debelle, 'Central Bank Independence in Retrospect' (Speech, Bank of England Independence: 20 Years On Conference, 28 September 2017) <https://www.rba.gov.au/speeches/2017/pdf/sp-dg-2017-09-28.pdf>; See also Ben S Bernanke, 'Central Bank Independence, Transparency, and Accountability' (Speech, Institute for Monetary and Economic Studies International Conference Bank of Japan, 26 May 2010) <https://www.federalreserve.gov/newsevents/speech/bernanke20100525a.pdf>.

[6] For a recent survey of indices measuring independence, accountability and transparency, see Florin Cornel Dumiter, 'Central Bank Independence, Transparency and Accountability Indexes: A Survey' (2014) 7(1) *Timisoara Journal of Economics and Business* 35; See also N Nergiz Dincer and Barry Eichengreen, 'Central Bank Transparency and Independence: Updates and New Measures' (Working Paper No 2013-21, 4 September 2013) 2 <http://dx.doi.org/10.2139/ssrn.2579544>.

[7] 'Central bank independence is widely advocated as a means of insulating monetary policy from short-term political pressures; it is seen as an efficient means of addressing the time-consistency problems that plague discretionary policy. …[Nevertheless] with independence … comes ... responsibility': Pierre L Siklos, 'Central Bank Transparency: Another Look' (2011) 18(10) *Applied Economics Letters* 929, 929.

length institutions necessitate behaviour that demonstrates sensitivity for the public's need to understand how policy is made'.[8] Debelle has noted:[9]

> [W]ith independence has come the accountability. The accountability is to the politicians and the population at large, not a small group of central banking aficionados, nor the financial markets.

The framework of governance and accountability mechanisms is important because the RBA is an independent central bank and regulatory agent of the Australian government, acting as agent, and perhaps even trustee[10] or guardian of the national financial stability responsibility on behalf of the Australian government. As an independent government agency, the RBA is therefore subject to a unique governance, transparency and accountability framework. The RBA differs from a typical government regulatory agency. Government regulatory agents usually form part of the executive branch of the government, are created through statutory authority to perform public functions, and are subject to oversight from the legislative branch (Parliament) and the judiciary through judicial review. The RBA's unique governance, transparency and accountability framework will be analysed in relation to the financial stability function.

B *Governance, Transparency and Accountability: A Regulatory Functional Continuum*

This thesis proposes that the three requirements of governance, transparency and accountability can be viewed from a regulatory perspective as being on an operational continuum:

Governance → Transparency → Accountability

[8] Dincer and Eichengreen (n 6), 2.

[9] Debelle (n 5) (footnotes omitted).

[10] This view about the role of the central bank in financial stability is espoused by Paul Tucker. Tucker (n 4).

This operational continuum also has a temporal layer and a functional layer:

Operational	Governance ←→ Transparency ←→ Accountability

Temporal	*Ex ante* ←→ Ex post facto

Functional	Prevention ←→ Disclosure ←→Explanation←→Justification ←→ Sanction
	PROACTIVE ←→ REACTIVE

Governance mechanisms are *proactive* measures that lie on one end of the continuum, ensuring that the regulatory agency, such as the RBA, acts in accordance with what is required of it. They aim at regulating organisational behaviour so as to prevent problems. They are about steering and/or guiding.[11] While the RBA's governance mechanisms focus on the sound operations of the RBA as a regulatory agency, the RBA demonstrates compliance by making its actions (including views and decisions) transparent. Transparency mechanisms give visibility to governance and the adherence to governance principles. Transparency allows both the organisation and others to consider whether the organisation is indeed doing what it is required to do.

Transparency is therefore the first step of, and part of, accountability, which lies at the opposite end of the operational continuum. Accountability overlaps to some extent with, and includes, transparency, in that at the lowest end of the spectrum of the range of accountability mechanisms, an organisation may simply be required to *disclose* certain matters (ie provide a factual account). Accountability a little higher up on the spectrum means that *explanations and justifications* are also provided in addition to a factual account. At the highest

[11] See Julia Black, *Legitimacy and the Competition for Regulatory Share* (Working Paper No 14/2009, LSE Law, Society and Economy, 2009) 4 <https://papers.ssrn.com/sol3/papers.cfm?abstract_id=1424654>. See also Freiberg, (n 3).

end of the scale of accountability, however, *consequences* for failure to comply are introduced (for example corrections or reversals of decisions) and at the most severe end of the scale, there may be *sanctions* and even *punitive* measures.[12] Accountability is therefore *reactive* in nature.[13]

The continuum is illustrated in the figure below.

Figure 6.1: The Continuum of Governance – Transparency – Accountability

Figure: 6.1
This figure reflects proactive and reactive arrangements/measures, and indicates preventative and sanctioning measures. Governance involves essentially 'ex ante' measures, whereas transparency is both ex tempore and ex post facto. Accountability is in essence ex post facto.

[12] See Julia Black, 'Constructing and Contesting Legitimacy and Accountability in Polycentric Regulatory Regimes' (2008) 2(2) Regulation & Governance 137, 150. Accountability involves 'informing, explaining and justifying'.

[13] Ibid, 150. The origin of the concept 'accountability' and of the requirement 'to account' is 'literally to give "a count"'.

Governance, transparency and accountability in relation to the RBA's actions in respect of financial stability will be discussed in more detail below.

C *Governance Mechanisms*

The manner in which an institution is governed is important in controlling its actions. Governance involves the structures, mechanisms and processes that are in place to ensure that the regulatory agency acts in the manner it is supposed to act in furtherance of its responsibilities. These include government and self-imposed mechanisms and processes as well as external influences, such as international 'best' practice and the market. Although engaging in governance involves reflection, self-evaluation and self-correction, it is essentially a *proactive* measure.[14] Good governance measures are adopted to ensure that the entity acts correctly and appropriately, and ultimately does not attract some sanction. Governance measures also function as a process-orientated safety net.

The governance mechanisms of the RBA originate from a wide number of sources, namely:

1. RBA-specific governance requirements directly or indirectly derived from the founding legislation of the RBA as a regulatory agency, namely its *mandate and powers*;

2. The *relationship of the RBA with the state*, in particular the level of operational *independence* of the RBA from government, and the extent

[14] The concept of governance focusses on how the entity operates. In this thesis, the word 'governance' is used to mean 'that large subset of governance that is about steering the flow of events and behavior (sic)': Freiberg, (n 3). It involves notions of control similar to that of the term in 'corporate governance': See John H Farrar, *Corporate Governance: Theories, Principles and Practice* (Oxford University Press, 3rd ed, 2008) 3. Governance has however also been described as 'the aspect of regulation whereby governments engage individuals and private or non-governmental organisation to achieve public policy objectives': Freiberg, at 5.

to which the Australian government has retained a measure of control over the RBA's operations and actions;

3. *Internal governance structures* of the RBA such as the *board* structure and the *role of the Governor* (these may be wholly or partially statutory in nature);

4. Other governance mechanisms linked to the fact that the RBA is a regulatory agency and/or a body corporate including *non-RBA specific measures* such as the *PGPA Act* (these may also be wholly or partially statutory in nature); and

5. Some *disclosure* (transparency) requirements that serve a governance functions (these may also be wholly or partially statutory in origin).

The most significant governance mechanisms will now be discussed in turn, being statutory powers and mandate, the relationship with government, and the internal governance of the RBA, in particular the role of the Governor.

III Powers and Mandate of the RBA as a Regulatory Agent of the Australian Government: Key Governance Mechanisms

The governance mechanisms discussed in this Part are proactive, ex ante measures that have the potential to control and drive the actions of the RBA. The first of these is the mandate of the RBA provided by the Australian government. This Part considers the RBA's informal and decentralised mandate from a governance perspective.

A *Governance of Agents of the State*

1 *Powers and Mandates of State Agents*

The first and most important aspect of the governance of a regulatory agent of the State created by statute are its statutory mandate including its powers.

The regulatory framework that forms part of the 'architectural design' for the RBA should take into consideration that the central bank will act as *agent* of the State. The essence of an agency relationship is that the agent's mandate is specifically defined, and that the agent is only authorised to act, and is only required to act, within the parameters of its mandate.[15] It may include some elements of the well-known command-and-control management framework,[16] to the extent that as a management framework it also reflects the principles of agency.[17] It sets out who should do what, within which parameters, and what the consequences of a failure to do so would be. This is also relevant to a creature of statute that acts for and on behalf of the government. In fact, 'the role of Government in a mandating relationship is that of a traditional command and control orientation that is defined through legislation and implemented

[15] G E Dal Pont, *Law of Agency* (LexisNexis, 3rd ed, 2014). There is no general definition of an agent. Sometimes, an 'agent' may not be an agent in the legal sense of the word, and at times agency is only part of the relationship (for example, a lawyer-client relationship can be contractual as well as one of agency: at 4. Definitions of an agent can be narrow or wide. At its broadest, an agent can be described as 'a person who has authority to act on behalf of a principal, either generally or in respect of some particular act or matter': at 5.

[16] The command and control management technique is typically used in the military, and is characterized by a 'top-down' hierarchical approach. Superiors instruct (command) subordinates on what to do, and then check (control) that subordinates have in fact performed the work. As a management technique it has been subject to critique, but it is still widely practiced. See John Seddon, *Freedom from Command and Control: A Better Way to Make the Work Work* (Manager, 2005).

[17] See however Black (n 12) 150. The command and control relationship is not always just a one-way relationship, but rather a dialectic relationship. The accountor also influences the accountee. When suggesting in this thesis that there should be greater clarity in the manner in which the RBA is regulated as a regulatory agency, the dialectic elements of the relationship are largely ignored for purposes of efficiency of discussion.

through agency regulation'.[18] Although command-and-control models of regulation have been demonstrated to be less effective in the regulation of regulatees such as banks and financial institutions,[19] a regulator, acting as the agent for government (such as the RBA), needs clear direction as to its goals, powers and objectives, and as it acts in the public interest, its performance should be controlled. The formal powers and mandate of the agent also grants it legitimacy. This principle therefore aligns with Australian democratic values and supports the rule of law.

The most important governance mechanisms are the statutory mechanisms. Statutory mechanisms carry the necessary democratic sanction of Parliamentary endorsement and are fundamental for the operation of principles of the rule of law. Statutory mechanisms would therefore provide the necessary level of legitimacy to the RBA.

The *RBA Act* creates the RBA, provides it with mandates and powers, and creates the internal governance structures and roles of the boards and relevant officials.[20] Although the RBA performs a public function and has reporting mechanisms that reflect its public role, it is also an independent body corporate. It therefore shares characteristics of private and public sector forms of governance.[21]

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[18] Christopher J Koliba, Jack W Meek, Asim Zia, and Russell W Mills, *Governance Networks in Public Administration and Public Policy* (Routledge, 2nd ed, 2018) 264, citing T Fox, H Ward and B Howard, *Public Sector Roles in Strengthening Corporate Social Responsibility: A Baseline Study* (World Bank, 2002) 3.

[19] See Deborah E Rupp and Cynthia A Williams, 'The Efficacy of Regulation as a Function of Psychological Fit: Reexamining the Hard Law/Soft Law Continuum' (2011) 12(2) *Theoretical Inquiries in Law* 581, 582-3. See also Figure 1.1 in Chapter 1 above. The level of regulation at which the command and control model does not work as well is between the regulatory agent and the regulated entities, for example between ASIC and the financial institutions.

[20] The *RBA Act* is supplemented by *Payment Systems (Regulation) Act 1998* (Cth).

[21] See Anona Armstrong, Xinting Jia and Vicky Totikidis, 'Parallels in Private and Public Sector Governance' (Conference Paper, GovNet Annual Conference on Contemporary Issues in Governance, 28–30 November 2005) <http://vuir.vu.edu.au/948/1/Parallels_in_Private_and_Public_Sector_Governance.pdf>.

2 *Mandate*

Independent regulatory agents such as the RBA can be effectively governed by a clear mandate that stipulates what the government expects of the relevant regulatory agent. The mandate or charter of a regulatory agent accordingly has particular regulatory significance when a government seeks to make an independent central bank responsible for financial stability. As was set out in Chapters 4 and 5, the RBA's mandate is however at best implied or de facto, and it is also decentralised and shared with APRA, the CFR and government. In essence, it is informal because it is based on unclear foundations and documents that are not legally binding, namely:

- a comment in a second reading speech of another piece of legislation, not the RBA Act;
- a joint statement by the Governor and the Treasurer in a Statement on the Conduct of Monetary Policy issued after the GFC;
- various other confirmations that the RBA is responsible for financial stability;
- MOUs between the RBA and other government regulatory agencies confirming that the RBA is responsible for financial stability;
- voluntary acts by the RBA including the creation of a financial stability department and the publication of a financial stability review;
- general central bank practice, and doing 'what central banks do' including possibly considering financial stability to form part of 'banking policy' (both unclear and undefined concepts); and
- history and tradition that included a financial stability role for the RBA that has been accepted both by the Australian government and the RBA.

(a) Regulatory Consequences of an Informal Mandate

There is no express formal legal mandate/obligation for financial stability in an overarching sense for the RBA, rather, the origin of the mandate lies in soft law. Accordingly, the Australian government has not utilised the most significant regulatory mechanism available. This has an important impact on the governance of the RBA.

The deficiencies relate to a lack of certainty and clarity as to:

1. The very *existence* of the RBA's financial stability responsibility (is the RBA responsible for financial stability and what does the responsibility entail?);

2. The *objective(s)* of the RBA's financial stability responsibility (what is the RBA required to achieve in relation to financial stability, especially in the absence of a numerical target as is the case with monetary policy?);

3. The *meaning* of 'financial stability' for purposes of this role of the RBA (whether financial stability is limited to the narrow financial system, ie mostly the payments system, or whether financial stability is considered broadly to encompass national economic welfare, or something in between);

4. The *scope* of the RBA's role in the financial stability responsibility (whether the RBA is responsible for overseeing, pursuing, protecting, furthering, or actually achieving financial stability); and

5. The *liability* of the RBA for actions and outcomes in relation to financial stability including those that are not in its control (whether the RBA can be held responsible for failures in achieving objectives that are not clear and are also shared).

A regulatory agent that performs functions outside of its mandate or does not execute its mandate loses legitimacy and credibility. Similarly, regulatory agencies taking on public responsibilities of their own accord or without proper government sanction can undermine the democratic process and rule of law principles.

3 ***Specific Statutory Powers***

An important measure of control over the RBA is by the state's grant of powers to the RBA, which are constrained under the *RBA Act*. Section 8 of the *RBA Act* provides a non-exclusive but nevertheless very specific list of general powers to the RBA.[22] The list of various general powers of the RBA[23] is expanded by *RBA Act* s 7(1)(j) which grants the RBA the power 'to do anything incidental to any of its powers'[24] and any other powers conferred by the *RBA Act*.[25] However, the RBA's powers are still expressly constrained to only 'such powers *as are necessary for the purposes of the Act*'.[26] Any acts by the RBA that have not been provided for under this section (and the sections incorporated by the introductory part of this section of the *RBA Act*) may therefore be considered to be ultra vires. The consequences of the RBA acting outside of its statutory powers are however not spelled out under the *RBA Act*. The limitation of powers of the RBA therefore does not provide a significant control or directive for its financial stability responsibilities.

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[22] Section 8 provides that the RBA has 'such powers as are necessary for the purposes of this Act and any other Act conferring functions on the [RBA] and, in particular, and in addition to any other powers conferred on it by this Act and such other Acts, has power:
(a) to receive money on deposit;
(b) to borrow money;
(c) to lend money;
(d) to buy, sell, discount and re-discount bills of exchange, promissory notes and treasury bills;
(e) to buy and sell securities issued by the Commonwealth and other securities;
(f) to buy, sell and otherwise deal in foreign currency, specie, gold and other precious metals;
(g) to establish credits and give guarantees;
(h) to issue bills and drafts and effect transfers of money;
(i) to underwrite loans; and
(j) to do anything incidental to any of its powers'.

[23] *Reserve Bank Act 1959* (Cth) s 8.

[24] Ibid s 8(j).

[25] Ibid s 8, General Powers: 'The Bank has such powers as are necessary for the purposes of this Act and any other Act conferring functions on the Bank and, in particular, and *in addition to any other powers conferred on it by this Act and such other Acts*, has power:…' (emphasis added).

[26] Ibid s 8 (emphasis added).

In addition to providing a clear mandate and powers, the government seeking to make an independent central bank responsible for financial stability should also impose governance and accountability obligations on that central bank as a regulatory agent[27] to support the financial stability responsibility, and control and drive its activities.

IV Governance of the RBA through the Relationship between the RBA and the State

The second governance mechanism is that of the independence of the RBA – ie its relationship with the state and the role that the state has in the RBA's role as financial stability regulator.

A *General Independence of the RBA and Operational Involvement of the Australian Government*

An important method of control by the Australian government over the RBA is through moderating its independence as a central bank: the RBA can be described as being only moderately independent.[28]

The RBA has been established as a separate body corporate under the leadership of its Governor,[29] and primarily because of its monetary policy function, it has a significant degree of independence compared to other regulatory agencies, such as APRA and ASIC. The RBA is not a government

[27] See the discussion of the importance but also potential negative consequences of accountability regimes on government regulators: See Joanna Bird, 'Regulating the Regulators: Accountability of Australian Regulators' (2011) 35(3) *Melbourne University Law Review* 739.

[28] For example, the 2002 legislative change can be interpreted to be a reduction in the level of independence of the RBA because the responsibility for the appointment of the Governor was transferred from the Governor-General to the Treasurer. The most independent central banks in the world are those that have been created most recently, such as those in the Kyrgyz Republic, Latvia, Hungary, Armenia, and Bosnia and Herzegovina: See Dincer and Eichengreen (n 6), 25, 29.

[29] *Reserve Bank Act 1959* (Cth) s 7(a).

department, and is considered to be a ‘corporate Commonwealth entity’[30] with separate legal personality, that can ‘act in its own right exercising certain legal rights such as entering into contracts and owning property’.[31] As a corporate Commonwealth entity the RBA is subject to the *PGPA Act 2013,*[32] which applies in a unique way to the corporate Commonwealth entities because of their different legal status.[33] The role of the *PGPA Act* is discussed below. The RBA has also implemented a code of conduct for its staff,[34] a form of self-governance.

When compared to other central banks, however, the RBA is a moderately independent central bank.[35] The RBA has no constitutional guarantee of independence and its enabling statute also does not expressly establish it as an independent central bank.[36] The RBA’s independence is provided by the fact that it is a body corporate[37] and not a government department. Also, the person who chairs of the RBA Board (ie the Governor) is not a government employee. The RBA Board is not fully controlled by government[38] but Governors and board members are government appointees. The decisions of

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30 Other examples of Commonwealth corporate entities are Airservices Australia and the Commonwealth Superannuation Association: See ‘Governance Structures in the Public Sector’, (Web Page, 21 December 2017) <https://www.finance.gov.au/resource-management/governance/overview/>.

31 Ibid.

32 *Public Governance, Performance and Accountability Act 2013* (Cth).

33 Ibid.

34 See for example ‘Code of Conduct for Reserve Bank Staff’, *Reserve Bank of Australia* (Web Page) <https://www.rba.gov.au/about-rba/our-policies/code-conduct-rba-staff.html>.

35 The case of the SARB is different. In terms of s 224 of the *Constitution of the Republic of South Africa 1996,* ‘the South African Reserve Bank, in pursuit of its primary object, must perform its functions independently and without fear, favour or prejudice, but there must be regular consultation between the Bank and the Cabinet member responsible for national financial matters’.

36 See *Reserve Bank Act 1959* (Cth).

37 Ibid s 7(a).

38 See *Reserve Bank Act 1959* (Cth).

the RBA Board are also not subject to government approval,[39] although there is input from a government representative on the RBA Board.

The RBA has instrument independence in relation to monetary policy, but not goal independence.[40] The inflation targeting policy entails that the government provides the RBA with an inflation goal that the RBA is expected to achieve, but it allows virtually complete instrument independence to the RBA.[41] This level of independence has existed since 1996, when the Australian government increased the RBA's independence in the conduct of monetary policy. The Australian government confirmed the Reserve Bank's independence to set the price of money, thereby relinquishing government control over interest rates, and allowed the RBA to decide on interest rates based on the national interest and not the political cycle.[42] This was an important political step but also aligned with economic theory of the time, namely that a more independent central bank was preferred for better inflation outcomes. At the time, the level of the RBA's independence was influenced by four key factors,[43] namely (1) the RBA had multiple objectives, (2) the inflation-target was flexible, (3) the RBA was required to consult with the Treasurer, and (4) there was a 'good board' that incorporated real world considerations along with the views of the RBA.[44]

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[39] Ibid.

[40] See Chapters 4 and 5 above. That means that the RBA has freedom to exercise its responsibility, but it must do so in line with government's goal of an efficient and stable financial system best able to support growth. 'This independence, and explicit government support for this independence, is critical to ensuring the effectiveness of our financial regulators': David Gruen, 'Towards an Efficient and Stable Financial System' (Speech, CEDA State of the Nation 2014, 23 June 2014) <https://treasury.gov.au/speech/towards-an-efficient-and-stable-financial-system/>.

[41] See Debelle (n 5).

[42] See Paul Kelly, 'The Howard Decade - Separating Fact From Fiction' (2008) 7 *New Critic* <http://www.ias.uwa.edu.au/new-critic/seven/howarddecade>. See also The Treasurer and the Governor (designate) of the Reserve Bank, *Statement on the Conduct of Monetary Policy* (Statement, 14 August 1996) <https://www.rba.gov.au/monetary-policy/framework/stmt-conduct-mp-1-14081996.html>. This was an important political move on the part of the Australian Government.

[43] Fraser (n 105).

[44] Ibid.

The role of the Australian government in the functioning of the RBA however tempers its independence significantly (the specifics of the government's involvement are discussed in relation to the RBA's internal governance structures below, as well as in the limitation of the RBA's powers). Some of the measures of control that the government has over the RBA are direct, such as in the appointment of key officials and the strong role of the government in the RBA's governance structures. In addition, government participates in decision-making at board level, including in monetary policy decisions because of the presence of a treasury official on the RBA Board. This is rather unique, and the RBA is the only central bank in the OECD with a government representative on the board.[45] It is not an ideal situation,[46] because independence of the central bank 'enhances the effectiveness and credibility of monetary policy'.[47] The RBA's moderately low level of independence is exacerbated by the fact that the government is also represented at the CFR by the Treasurer.[48]

The presence of the Secretary to the Department of the Treasury on the RBA Board means that the Australian government has a voice inside the RBA and at the highest level of the RBA as an organisation, on the board that ultimately has the biggest corporate and political influence. This presence overshadows the role of the government in relation to the Payments System Board, which

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[45] In the proposed Reserve Bank Amendment (Enhanced Independence) Bill 2008 (which was not adopted), it was pointed out that the RBA is the only central bank in the OECD with a treasury official on its governing board: See Commonwealth, *Bills Digest* (Digest No 97 of 2007–08, 20 March 2008) <https://www.aph.gov.au/Parliamentary_Business/Bills_Legislation/bd/bd0708/08bd097> (Reserve Bank Amendment (Enhanced Independence) Bill 2008).

[46] There is what has been referred to as 'a considerable body of economic literature' to that effect. See Commonwealth (n 45).

[47] Ibid. This point was reiterated when the proposed amendment to the *Reserve Bank of Australia Act 1959* was introduced.

[48] As of December 2018, the CFR publishes a statement following its meetings: Council of Financial Regulators, 'Quarterly Statement by the Council of Financial Regulators' (Media Release 2018-02, 13 December 2018) <https://www.cfr.gov.au/news/2018/mr-18-02.html>.

has a direct reporting obligation to the Minister of Finance in relation to the standards determined under s 827D of the *Corporations Act*.[49]

Through the presence of government representatives in meetings where operations decisions may be made, and through the presence of the Treasurer at the CFR, the government therefore has influence but not control over the operations of the RBA.

B *Government Influence over and Control of Policy*

The RBA's independence is also reduced by the ability of the Australian government to finally determine RBA policy,[50] through a statutory right to intervene in RBA policy.[51]

The general duty of the RBA to 'liaise' with government is included in s 13 of the *RBA Act*, and although the obligations under that section do not expressly compel consultation, the context of the section makes it clear that consultation is required. According to the RBA, '[i]n practice this is done in the regular, generally monthly meetings which the Governor and Deputy Governor have with the Treasurer, shortly after each meeting of the Reserve Bank Board'.[52] It is also mandatory for both RBA boards, namely the Reserve Bank Board and the Payments System Board, to inform the government of the policy of the RBA from time to time. Even though the duty to inform is mandatory, the content of the information to be provided and its frequency are however not regulated by statute.

[49] These reports should also include a discussion of developments in the clearing and settlement industry during that financial year.

[50] *Reserve Bank Act 1959* (Cth) s 11.

[51] Ibid.

[52] 'Reserve Bank Board', *Reserve Bank of Australia* (Web Page) <https://www.rba.gov.au/about-rba/boards/rba-board.html>.

The reasonably strong government influence seems to have the potential to affect the financial stability function of the RBA, but the RBA enjoys more independence on a policy level in financial stability than what it does in relation to monetary policy, because of the inflation-targeting model for monetary policy.

However, the RBA's independence in relation to financial stability – along with its other policy decisions – is affected by the fact that the Australian government may override the RBA's policy. Under s 11 of the *RBA Act*, the Australian government must be informed of RBA policy emanating from both boards, and under section 11(2) of the *RBA Act* the government has the right to question RBA policy, albeit only on the ground that RBA policy is not 'directed to the greatest advantage of the people of Australia'.[53] The *RBA Act* prescribes that in the event of a disagreement between the Treasurer and the RBA, the Treasurer and the relevant RBA Board should endeavour to reach agreement. If no agreement can be reached, the relevant Board is required to provide the Treasurer with a statement on the disputed issue. The matter is then finally determined by the Australian government,[54] albeit through the Governor-General. Under s 11(4) of the *RBA Act* the Treasurer may, on receipt of the statement by the RBA, 'submit a recommendation to the Governor-General, and the Governor-General, acting with the advice of the Federal Executive Council, may, by order, determine the policy to be adopted by the [RBA]'.[55] The RBA is compelled to implement the policy as directed, although the *RBA Act* limits the RBA's responsibility to acts that are within its powers.[56] The actions

[53] *Reserve Bank Act 1959* (Cth) s 11(2).

[54] Ibid s 11.

[55] Ibid s 11 (4).

[56] Under s 87, the RBA is protected against claims based on invalidity of its actions or transactions: 'The validity of an act or transaction of the Bank shall not be called in question in any legal proceedings on the ground that any provision of this Act has not been complied with'. Further, although the Commonwealth has guaranteed the debts of the RBA (s 77 Guarantee by Commonwealth), creditors are precluded from taking legal action against the Commonwealth: 'The Commonwealth is responsible for the payment of all moneys due by the Bank but nothing

of the Treasurer are open to Parliamentary scrutiny, as the Treasurer is required to inform both Houses of Parliament as to the order that was given in respect of the RBA's policy. In addition, a copy of the statement by the relevant RBA Board, as well as a statement by government in relation to the matter, must be provided to Parliament as well. As far as could be established, these powers have never been used.

The potential for policy override, however, remains a significant governance mechanism.

C *Regulatory Consequences of RBA's Moderate Independence*

The regulatory consequences of the government's operational involvement in the RBA's operations and policy formulation are overall moderate. Because of the presence of government representatives at operational level, government may at least to some extent influence central bank operations and policy formulation. The extent to which that would assist in the governance and accountability of the RBA for the financial stability responsibility, is however not clear, but the potential is there.

V Internal Governance Structures and the Role of the Governor

Internal governance mechanisms of the RBA as an institution are the third governance mechanisms analysed in this chapter – the role of the Governor is of particular importance.

in this section authorizes a creditor or other person claiming against the Bank to sue the Commonwealth in respect of his or her claim'.

A *Internal Governance Mechanisms in the RBA and the Role of the Governor*

In order to appreciate the governance impact of the role of the Governor, it is necessary to briefly sketch the internal governance structures of the RBA.

1 *Internal Governance: The Board(s) Structure of the RBA*

Internal governance mechanisms provide important measures of control and direction for an organisation. Decision-making in the RBA is characterised by its twin board structure.[57] The RBA Board is responsible for the RBA's monetary and banking policy, and the RBA's policy on all other matters, except for its payments system policy (*RBA Act* s 10).[58] The Payments System Board is responsible for the RBA's payments system policy (s 10B).[59] The relationship between the two boards is regulated by ss 8 and 10 of the *RBA Act.* Generally, the policy of the Reserve Bank Board prevails if policies are inconsistent, and disagreements between the boards are 'resolved as determined by the Governor',[60] who chairs both boards. The boards are discussed in more detail below.

The governance structure of the RBA can be depicted as in figure 6.2 below.[61]

[57] Ibid s 8A.

[58] Ibid s 8A(2). The RBA Board is constituted as provided for in Part III of the *Reserve Bank Act 1959* (Cth).

[59] Ibid s 8A(3).

[60] Ibid ss 8A(4), 10C(2), 10C(3).

[61] See Reserve Bank of Australia, *Reserve Bank of Australia: Annual Report 2018* (Report, 27 August 2018) <https://www.rba.gov.au/publications/annual-reports/rba/2018/pdf/2018-report.pdf>.

Figure 6.2: Governance Structure of the RBA

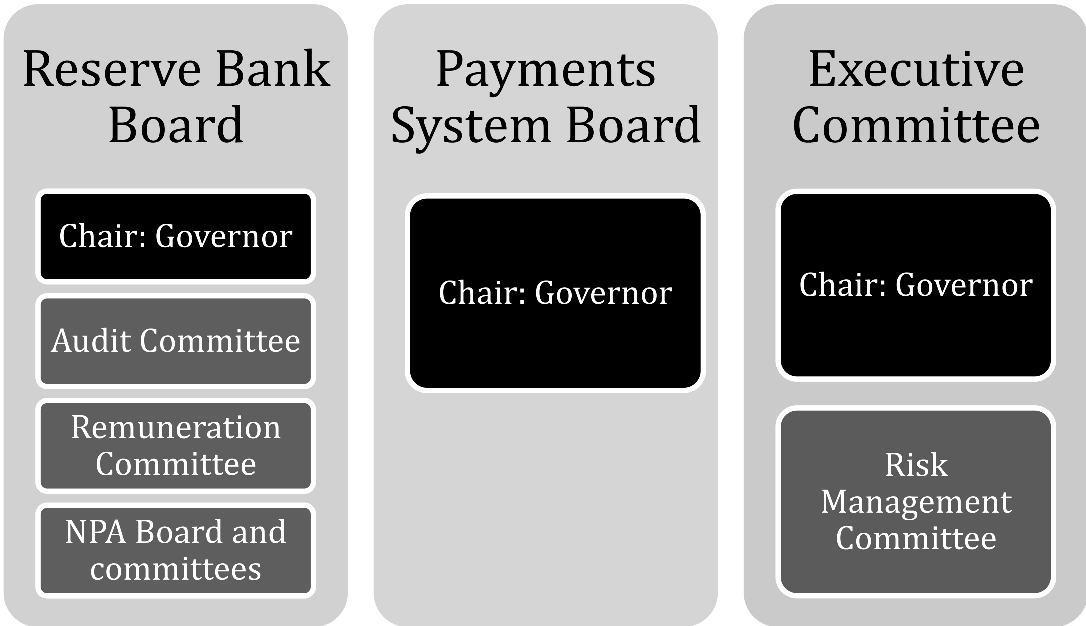

Figure 6.2: This figure reflects the information as provided by the RBA in its August 2018 Annual Report.

(a) The Reserve Bank Board

The role and constitution of the Reserve Bank Board is of particular importance, because apart from considering financial stability issues, the Reserve Bank Board also performs the role of the monetary policy committee. That is not always the case in other central banks. In monetary policy, a high level of independence is required (as discussed in Chapter 3).

The composition of the Reserve Bank Board reflects both independence and a strong government influence. One of the factors that enhance the independence of the RBA is the presence of non-RBA and non-government-affiliated persons on the Reserve Bank board.[62] Nevertheless, all board

[62] See 'Reserve Bank Board' (n 52).

members who are at the time of their appointment to the board an RBA official, hold their office 'during the pleasure of the Treasurer'.[63] The Treasurer appoints both the Governor and Deputy-Governor,[64] and they 'hold office subject to good behaviour',[65] but on terms and conditions determined by the Reserve Bank Board.[66] Effectively the Treasurer therefore can control the presence on the board of all nine members of the Reserve Bank Board: the Treasurer appoints six board members,[67] one board member is a subordinate of the Treasurer (the Secretary of the Department of the Treasury), and the Treasurer can terminate the appointment of the Governor and Deputy-Governor at the Treasurer's pleasure. The composition of the RBA Board is commensurate with the need for more government involvement in financial stability matters, although a strong government involvement and lower levels of independence are negatively indicated for the effective conduct of monetary policy.

There are however measures in place to protect the RBA's independence. Reserve Bank Board members may not be directors, officers or employees of ADIs,[68] and are required to make an oath or affirmation of allegiance and a declaration of secrecy on appointment to the Reserve Bank Board. These requirements reflect the public nature of the role they play as members of the Reserve Bank Board. In addition to the possibility of termination of their appointment by the Treasurer, the *RBA Act* contains a number of other directives as to when board members will cease to be board members.[69] Those circumstances are not relevant here.

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[63] *Reserve Bank Act 1959* (Cth) s 14(3).

[64] Ibid s 24(1).

[65] Ibid s 24(1)(c). Under s 25, a number of other reasons for the vacation of office are spelled out, including the bankruptcy of the Governor or Deputy-Governor.

[66] Ibid s 24A.

[67] Ibid s 14(1)(d).

[68] Ibid s 17(1).

[69] Ibid s 18.

Despite the presence of external persons that are not RBA employees on the Reserve Bank Board, the role of the Governor remains significant. The RBA Board is chaired by the Governor, with the Deputy Governor as the Deputy Chairperson,[70] and *ex officio* they have particular power and importance,[71] including a deliberative vote and casting vote.[72] The role of the Governor is discussed in more detail below.

The Reserve Bank Board has very broad powers and responsibilities that are however limited by the Payments System Board and the fact that the Reserve Bank Board is not directly involved in the day-to-day operations of the RBA. A non-statutory 'Executive Committee' is 'the key decision-making committee of the Reserve Bank for matters of a management and/or administrative nature'.[73] The RBA describes it as a management committee, with the role of assisting and supporting the Governor in performing their obligations in managing the RBA.[74] It is chaired by the Governor.[75] The Executive Committee functions to some extent like a management committee of a large corporation and the Reserve Bank Board relies on the Executive Committee for operational (management/administrative) matters.[76]

[70] Ibid s 20.

[71] Ibid s 21.

[72] Ibid s 21(5).

[73] Reserve Bank of Australia (n 61).

[74] Ibid.

[75] As expected in a management committee, the senior officials of the RBA attend the meetings of this committee, generally held weekly. Certain senior managers, such as the heads of the Audit, Information and Risk and Compliance departments and the General Counsel also attend these meetings in an advisory capacity: See Reserve Bank of Australia (n 61).

[76] Ibid. The fact that the Governor chairs both the Reserve Bank Board and the Executive Committee is different to the normal operation of a corporate Executive Committee and Board of Directors. The RBA also has a Risk Management Committee.

(b) The Payments System Board

The composition of the Payments System Board is also regulated by the *RBA Act*.[77] The Governor also chairs the Payments System Board.[78] A representative from APRA sits on the Payments System Board, but there is no Treasury representative on the Payments System Board.[79] Nevertheless, the hand of government is evident in the Payments System Board through the role of the Treasurer in appointing all board members to the Payments System Board other than the two RBA board members and the APRA board member.[80] Nevertheless, as chair, the Governor has important powers, including directing the times and places at which the Payments System Board will meet,[81] and if the Governor presides, they will have a deliberative and/or casting vote.[82] As is the case with the RBA Board, the Treasurer may terminate the appointment of members of the Payments System Board.[83] In the case of a conflict between a decision of the Payments System Board and Reserve Bank Board, the decision of the Reserve Bank Board prevails.

(c) Board Members (Including the Governor and Deputy-Governor)

Members of the RBA Board and the Payments System Board have specific statutory disclosure obligations relating to their material personal interests

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[77] See *Reserve Bank Act 1959* (Cth) Part IIIA.

[78] Ibid s 25C.

[79] Ibid s 25A.

[80] Ibid s 25B.

[81] Ibid s 25F.

[82] Ibid s 25F. Note that if the other RBA official appointed to the Payments System Board were to chair the meeting, they would have these powers.

[83] Ibid s 25L(3) and (4).

under the *RBA Act*.[84] Although these disclosure obligations do not directly regulate the actions of the RBA itself, they provide a measure of control over the acts of the RBA by preserving – at least to some extent – the independence and neutrality of the decision-makers in the RBA. These disclosures also protect the RBA's independence and the integrity of its decisions. It should be noted that even if a board member has declared 'a material personal interest' in a matter, the board member may still be present at a board meeting that considers the matter, and the board member may also vote on that matter.[85]

All RBA board members are effectively appointed by the Australian government, represented by the Treasurer.[86] A fairly recent attempt to increase the independence of board members failed when a Bill introduced to change the manner of appointments of board members was defeated in Parliament.[87] Although the Bill was defeated, it is important to note that the rationale behind it was to prevent a recurrence of the so-called Robert Gerard affair, where the then Treasurer, Mr Peter Costello, for political reasons, had intervened in the shortlisting and nomination process of a board member.[88] As no further attempts at increasing the independence of the RBA board members have been made since, an inference can be drawn that the political perspective in Australia is that the current balance of independence reflects the political will of government and desired level of control over the actions of the RBA.

The board structure of the RBA and in particular the role of the government in the boards, favour the conclusion that in the absence of an explicit and

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[84] The disclosure obligations of the RBA Board members are under ss 7B and 7C *Reserve Bank Act 1959* (Cth); those of the Payments System Board under s 7C.

[85] *Reserve Bank Act 1959* (Cth) ss 7B(1) and 7B(2).

[86] Ibid ss 14(1)(d) and 25B(3).

[87] The Bill was introduced on 20 March 2008. See Commonwealth, *Bills Digest* (Digest No 97 of 2007–08, 20 March 2008) <https://www.aph.gov.au/Parliamentary_Business/Bills_Legislation/bd/bd0708/08bd097> ('*Reserve Bank Amendment (Enhanced Independence) Bill 2008*').

[88] Ibid. Mr Robert Gerard was an influential donor of the Liberal Party, but was also being investigated by the Australian Tax Office.

prescriptive mandate for financial stability, interaction between board members (including the Governor) can control and direct the actions of the RBA. In the absence of strong legislative directives in relation to financial stability, the boards may be open to persuasive arguments from individual board members, most likely the Governor.

(d) Role of the Governor

The role of the Governor is quite extraordinary, and affects all aspects of the RBA's activities, including the financial stability role. As an individual, the Governor has a very high level of control over the RBA as an organisation, in a management and policy capacity, and there are few checks and balances on their role – unlike, for example, the checks and balances on the role of a CEO in a corporation that may be subject to the control of the board, or the role of a minister in a Government department, which may be controlled by the Prime Minister or Cabinet. The governor's role instead reflects the *presidential* model of governance, where the president holds the ultimate say, except in this instance, extraordinary powers are placed in the hands of an *unelected individual*.[89]

The importance of the person who holds the position of Governor cannot be overemphasized. In fact, in the 1911 Parliamentary discussion about the role of the central bank Governor, the Hon Andrew Fischer described the characteristics of a Governor as follows:[90]

> … one *first class* man should be trusted and given ample powers. … In some respects he will have an autocrat's position, and if we get the right man, I have no doubt that we are pursuing a right course in that regard. … With the safeguards regarding audit to which I have referred, we can place confidence

[89] Tucker expressed concerns about the power of 'unelected' central banks and their governors. See Tucker (n 4).

[90] Commonwealth, *Parliamentary Debates*, House of Representatives, 15 November 1911, 2644 (Andrew Fisher) 2645 (Second Reading Speech) (emphasis added).

> in the Governor. As his *honour, good name, and integrity* will be involved, he will have power to appoint and to dismiss employees of the bank as he chooses … We hope to have a *wise* man at the head of this institution …

Parliament was persuaded to place considerable faith in a particular individual who would be a trust-worthy and benevolent autocrat. While that model of governance may have been broadly acceptable at that time, corporate governance models have since changed. The Governor's statutory role has however effectively hardly changed since 1959, or, indeed, since 1911.

The Governor's powers are augmented by their chairing both the Reserve Bank Board as well as the Payments System Board. There is no higher governing board in the RBA overseeing the role of the Governor. The Governor can determine the timing and number of board meetings,[91] and undoubtedly the agenda. The role of the Governor outside of the RBA is also significant and contributes to their powers. Domestically, the Governor also chairs the meetings of the CFR. Internationally, the Governor represents Australia and attends the G20 and BIS meetings and the Plenary of the FSB.[92] The Governor is also (currently) a member of the Standing Committee on Assessment of Vulnerabilities of the FSB, in addition to occupying other significant international leadership roles.[93] The Governor also has important obligations and importance under the *PGPA Act* (see Part III C below). The Governor is the RBA's figurehead and main public face, and personally powerful.

The Governor's stature and powers are protected by their security of office. The Governor and Deputy Governor are both appointed by the Treasurer for

[91] See *Reserve Bank Act 1959* (Cth) s21(1)) which makes it clear that the Governor as Chairperson may direct the times and places of the meetings of the RBA Board; the RBA Board itself may also make such a determination. Pursuant to s21(5) *Reserve Bank Act 1959* (Cth) the Governor may have a deliberative or casting vote.

[92] The Governor is also Co-Chair of the Regional Consultative Group for Asia. The RBA's international involvement is detailed in the 2018 Annual Report. See Reserve Bank of Australia, (n 61).

[93] Ibid.

fixed terms, and they hold office unless otherwise determined by the Treasurer, and subject to the requirements of the *RBA Act*.[94] The Governor and Deputy Governor hold office for their full term unless they satisfy the requirements the *RBA Act* for termination of their appointment, ie become bankrupt, disabled, or behave with impropriety.[95]

The roles of the Governor and Deputy Governor and their relationship to government are important in respect of both the independence of the RBA, and how the RBA is governed and controlled by the government of the day. The extent to which the role of the Governor (and Deputy Governor) is controlled and/or influenced by the government, and in particular a Treasurer with political affiliations, may change the way in which the RBA itself is governed and controlled.

The formal relationship between the Governor and the Australian government is also of particular importance because of the significant influence and importance of the Governor. The need for the government to have some control over the appointment and termination of appointment of the Governor is important. This was an issue in 2007/8, as noted above, when a Bill to enhance the independence of the RBA was proposed by the governing Australian Labor Party but did not pass.[96] The objective of the Bill was to remove the Treasurer's right to terminate the employment of the Governor and Deputy Governor, and instead require both Houses of Parliament to make a recommendation for implementation by the Governor-General. Effectively this would revert to the statutory position before 2002, when appointments were subject to the approval of the Governor-General.[97] Although the Opposition was not against

[94] *Reserve Bank Act 1959* (Cth) Part III, dealing with the Reserve Bank Board and the Governor and Deputy Governor of the Bank.

[95] Ibid s 25(1)(c).

[96] *Reserve Bank Amendment (Enhanced Independence) Bill 2008*.

[97] These powers were passed to the Treasurer in 2002 through the *Financial Sector Legislation Amendment Act (No. 1) 2003* (Cth). The Treasurer was given the powers and functions of appointing and terminating the appointment of RBA Board members (ss 14 and 18), and appointing the Governor, Deputy Governor and members of the Payments System Board, and

increasing RBA independence, the Bill was defeated on the basis that it was impractical, and limited the grounds for termination of employment, ie it would reduce the level of control that the Government would have over the Governor. During Parliamentary Debate in the House of Representatives, the Hon Malcolm Turnbull, for the Liberal Party (in opposition at that time), pointed to the need for some measure of *control* over the acts of the Governor, highlighting that if the Governor were to act in a manner that is ‘corrupt, dishonest or reckless or which brings the [RBA] into disrepute or which brings [the] whole financial system into disrepute’,[98] there would be no power under the proposed legislative amendments to terminate the Governor’s employment.[99] Effectively, the final ‘hold’ that the Australian government has over the Governor is the risk of their loss of employment.[100] The control that Parliament has over the actions of the Governor and the RBA by virtue of the Governor’s appearances before Parliament, was also emphasised.[101] There was some support for more accountability by the RBA and an increase in the number of appearances by the Governor in Parliament.[102]

Some examples of central bankers’ improper behaviour suggest that concerns about the character and actions of a central bank governor are warranted, although such circumstances occur rarely. An example is Antonio Fazio, former

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also terminating their appointments. These powers were granted for the purposes of efficiency, but they did not provide safeguards for the acts of a potentially capricious treasurer: See *Reserve Bank Amendment (Enhanced Independence) Bill 2008.*

[98] Commonwealth, *Parliamentary Debates*, House of Representatives, 14 May 2008, 2769 (Malcolm Turnbull) (Second Reading Speech) 2771.

[99] Ibid.

[100] In any event, Turnbull argued, as the Governor-General would act on the advice of Government, the practical effect of the implementation of the Bill would not be much different.

[101] Turnbull also stated that the Opposition was in favour of increasing the number of times that the Governor was to appear before the House of Representatives Standing Committee on Economics thereby demonstrating a preference for more accountability by the RBA: Turnbull (n 98) 2772.

[102] It should be noted that the ‘control’ referred to here may exist in the potential for being criticised, embarrassed or sanctioned. Behavioural factors may therefore play a role here – the anticipation of disclosure and the potential of criticism, embarrassment and even sanction may play a proactive role in the governance of the RBA’s behaviour as well.

governor of the Bank of Italy, who although reluctant to leave his position, finally resigned in the face of alleged wrong doing. He was later convicted of market-rigging.[103] What is important in the case of Fazio is that it highlighted that it can sometimes be difficult to remove a governor from office.

The Governor plays a very significant role in the RBA, and to a large extent controls – or can control – the policies and practices of the RBA. Despite the measures of control over the Governor, there is still significant leeway for an RBA Governor to choose a direction which is against the public interest, perhaps because of political affiliations. For example, in the USA, political affiliations and the relationship between the then chairman of the Federal Reserve, Arthur Burns, and President Nixon were highly controversial.[104] In Australia, the independence of former RBA Governor Bernie Fraser was also questioned when then Prime Minister Paul Keating bragged that because of his relationship with Governor Fraser, Keating had the RBA 'in his pocket'.[105]

The personality and personal power of the Governor are therefore significant controlling and directive powers in the governance of the RBA.

[103] See Sara Rossi, 'Court Cuts Jail Sentence of Ex-Bank of Italy Boss', *Reuters* (online, 29 May 2012) <https://www.reuters.com/article/us-italy-banks-governor-idUSBRE84R0N020120528>. Malcolm Turnbull referred to this scandal in July 2005 pointing to 'allegations of corruption, nepotism and very poor policy by the Bank of Italy': Turnbull (n 98) 2771.

[104] See Doug French, 'Burns Diary Exposes the Myth of Fed Independence', *Mises Daily Articles* (Web Article, 27 December 2010) <https://mises.org/library/burns-diary-exposes-myth-fed-independence>; See also Burton A Abrams, 'How Richard Nixon Pressured Arthur Burns: Evidence from the Nixon Tapes' (2006) 20(4) *Journal of Economic Perspectives* 177.

[105] See Bernie W Fraser, 'Reserve Bank Independence' (Speech, National Press Club, 15 August 1996) <https://www.rba.gov.au/speeches/1996/sp-gov-150896.html>. Fraser disowned the comments: 'Much of the wind beneath the view that the Bank was 'political' flowed from Paul Keating's comment at a press conference in February 1989 that 'they do what I say', and from a more celebrated but harder to document comment at a supposedly private dinner in December 1990 that he had the Reserve Bank (among others) 'in his pocket'. I believe Mr Keating regretted being associated with those throwaway lines and, to my knowledge, he never repeated them'.

B *Governance by Personality? The Potential for Behavioural Factors to Play a Disproportionate Role in Governance*

1 *Behavioural Factors can play the Role of Governance Mechanisms*

What then compels, or controls, drives and steers the RBA to pursue a financial stability objective, and pursue it in a manner that meets the requirements of the Australian public? There is no clear statutory mandate for the RBA to do so, and the implied or de facto mandate is informal, decentralised and shared. The Australian government exerts some control over the RBA through curtailing the RBA's independence, and theoretically can alter RBA policy, but such a step would be reactive rather than proactive and therefore not a true governance mechanism. There are accordingly regulatory gaps in governance mechanisms for the RBA's financial stability responsibility.

In the absence of a clear hard law mandate for the RBA, and inadequate supplementary governance mechanisms acting as drivers and controls of RBA actions, behavioural factors potentially play a disproportionately important role in influencing the acts of the RBA. This thesis argues that behavioural factors (originating in the behavioural sciences such as psychology and sociology) could be unduly important in the regulation of the RBA's conduct in financial stability, and that ultimately it may be because of the personal power of the RBA Governor that the RBA pursues a financial stability objective.

Sociological and psychological factors have been recognised as drivers of human (and organisational) behaviour in a legal context by legal theorists,[106] for example to explain why laws are obeyed, or why certain acts are taken or avoided. A detailed discussion of this theory is beyond the scope of this

[106] See for example Tom R Tyler, *Why People Obey the Law* (Princeton University Press, 2006). Work by Christine Parker and John Braithwaite in relation to tax and competition compliance, and other scholars about compliance with environmental regulation, are further examples, but beyond the scope of this thesis.

thesis.[107] These behavioural factors are not inherently negative or positive, and apply to individuals, and individuals when acting for an institution or corporation.

Behavioural factors that can most likely play a role[108] in the case of the RBA's financial stability responsibility, are

1. the personal characteristics of individuals, in particular those of the Governor ('*personality*', as referred to this thesis) and

2. the pursuit of *prestige*.[109]

Assuming that the RBA is a model regulator, with the highest professional and ethical standards, employing the most competent, professional and ethical personnel (including the Governor and Deputy Governor), what compels the RBA to pursue financial stability as a goal?[110] The answer may be that strong personal qualities and leadership, in particular those of the Governor, gives effect to public policy goals, and leads the organisation (and the country) in the desired direction – that is the power of *personality*. As it is an *ex ante* factor, and operates proactively, it is therefore discussed with governance mechanisms in this chapter.

Alternatively, or additionally, the answer may be that the RBA as an organisation and its leaders and officers seek *prestige* and work to impress and

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[107] The focus of this thesis is on the gaps in the existing framework and the threats of behavioural factors, not behavioural governance factors per se.

[108] These factors can provide both the impetus for action, but can also put the brakes on action and are therefore both drivers and controls.

[109] In this regard, 'personality' refers to the individual characteristics and personal make-up of the relevant individual, in this case mostly the powerful Governor, and 'prestige' to the desire for and need to achieve and ensure respect and acclaim. It is in particular the person and personality of the Governor that matters, because of their unusual and important role.

[110] The answer, as discussed above, is not 'clear regulatory goals'. The answer also does not lie in 'clear regulatory responsibility'. There are no express regulatory objectives and the mandate is informal. There are also no clear government controls.

excel domestically and internationally. Seeking prestige and excellence would include the desire of the RBA's officials and the organisation to obtain favourable peer review and admiration, and to satisfy political and electorate expectations. It would also involve the avoidance of sanction and disgrace, and therefore will be discussed as an accountability mechanism in the next chapter. Some key drivers and controls of the RBA as financial stability regulator may be behavioural factors. The consequence is that principles of good governance, democracy, legitimacy of regulatory institutions in Australia and the rule of law will be undermined.

2 *The Personality and Person of the Governor*

The personality of the Governor as the leader of the RBA (encompassing for purposes of this discussion especially their personal characteristics and abilities) is generally important but becomes even more significant in light of a weak hard law framework.[111] Personality relates not only to worldview, background, political persuasion and philosophical beliefs, but also to the manner in which the individual is able to deal with (and use) power, peer pressure and persuasion. The potential for personality in this sense to play a very significant role is increased in the face of lesser hard law regulatory forces. Personality (and power) play a measurable role in the making of risk decisions[112] and policymaking.[113]

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[111] The focus in this discussion is specifically on the Governor, but it is acknowledged that the role of the Deputy Governor and other senior RBA officials can also be very influential.

[112] See for example G J Davies, G Kendall, E Soane, J Li, F Charnley and S J T Pollard, 'Regulators as 'Agents': Power and Personality in Risk Regulation and a Role for Agent-Based Simulation' (2010) 13(8) *Journal of Risk Research* 961; See also the modelling of the influence of personality: G J Davies, G Kendall, E Soane, J Li, S A Rocks, S R Jude and S J T Pollard, 'Regulators as Agents: Modelling Personality and Power as Evidence is Brokered to Support Decisions on Environmental Risk' (2014) 466-467 (January) *Science of the Total Environment* 74.

[113] James Basham and Aanor Roland, 'Policy-Making of the European Central Bank during the Crisis: Do Personalities Matter?' (Working Paper No 38/2014, Institute for International Political Economy Berlin, 2014) <https://www.econstor.eu/bitstream/10419/101312/1/790611287.pdf>.

The personality and personal characteristics of central bank governors are important considerations. Central bank governors may even be selected for their even-keel rationalist and moderate approaches to life, as generally central bank governors project an image of rational and dispassionate care.[114] That view is not held universally though. It has for example been said that: [115]

> [t]he problem with both independent courts and independent banks can be stated very simply: they may run amok. Constitutional scholars and central bankers not infrequently belong to extreme, sectarian and ideological schools of thought.

While there may be no evidence that any governor of the RBA fell into any of these extreme sectarian or ideological schools, the risk exists. In fact, recent political events in the world have demonstrated the extent to which populist views for example can succeed politically.[116]

Importantly, though, 'the literature has shown that the identity of central bank council members [including governors] has an important bearing on economic outcomes'.[117] Markets react to changes in central bank governor.[118] There is

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[114] Former RBA Governor Glenn Stevens was described by the then Treasurer, Wayne Swan, as a 'somewhat dour character, albeit with a wry sense of humour', and with 'a complex and interesting personality' evidenced by him being both 'quite a good jazz guitarist' and 'a pillar of his church': See Jessica Irvine, Vanda Carson and Ellie Harvey, 'Treat for Elite as Reserve Bank Celebrates', *Sydney Morning Herald* (online, 9 February 2010) <https://www.smh.com.au/business/treat-for-elite-as-reserve-bank-celebrates-20100208-nnc5.html>. See also Annelise Riles, 'The Secret Lives of Central Bankers', *The New York Times* (online, 20 October 2018) <https://www.nytimes.com/2018/10/20/opinion/sunday/fed-central-banks.html>. She notes that central bank governors are often aloof and rational, and as a group is not very diverse.

[115] See Jon Elster, 'Constitutional Courts and Central Banks: Suicide Prevention or Suicide Pact?' (1994) 3(3 – 4) *East European Constitutional Review* 66.

[116] The election of Donald Trump as President in the US is a prime example. See John H Farrar and Louise Parsons, 'Financial Stability After the Global Financial Crisis: Globalisation, Nationalism and the Potential Demise of a Rules-Based Order' in John H Farrar, Bee Chen Goh and Vai Io Lo (eds), *Scholarship, Practice and Education in Comparative Law: A Festschrift in Honour of Mary Hiscock* (Springer, forthcoming).

[117] Christoph Moser and Axel Dreher, 'Do Markets Care about Central Bank Governor Changes? Evidence from Emerging Markets' (2010) 42(8) *Journal of Money, Credit and Banking* 1589, 1590.

[118] Ibid.

also evidence that governments can undermine central bank independence by 'filling lead positions at central banks with individuals that are favourably predisposed towards the policies put forward by the Government'.[119] The personality and personal qualities of the Governor therefore matter.[120] Although governors are not the only policy-makers in central banks, they are the most important individuals. Central bank governors are also 'among the most important non-elected policy makers in modern democracies'.[121] Governors often have 'considerable freedom of maneuver (sic)'[122] because of central bank independence from government. Accordingly, 'the appointment of responsive governors and the removal of "hostile" ones becomes the main source of influence that elected officials can exert over monetary policy'.[123] In the case of the RBA, the role and responsibilities of the Governor are, as shown above, extensive and highly influential.

The biographies of central bankers matter as the views and economics background of the governor can affect decision-making in the institution.[124] For example, former Chairman of the Federal Reserve, Ben Bernanke, acknowledged the fundamental influence of discussions he had as a child with his grandmother about the Great Depression on his role as Chair of the Federal Reserve.[125] A recent study concluded that biographical elements of central

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[119] See Laurenz Ennser-Jedenastik, 'Party Politics and the Survival of Central Bank Governors' (2014) 53(3) *European Journal of Political Research* 500.

[120] See also Perry Mehrling, Laurence S Moss, Jocelyn Pixley and George S Tavlas, 'What If the Leader of the Central Bank Told Hilarious Jokes and Did Card Tricks? A Panel of Experts' (2007) 66(5) *American Journal of Economics and Sociology* 863.

[121] Ennser-Jedenastik (n 119) 515.

[122] Ibid.

[123] Ibid.

[124] See Frédéric Lebaron and Aukiz Dogan, 'Do Central Bankers' Biographies Matter?' (2016) 10(2) *Sociologica* 1.

[125] Ibid. See also John Simon, 'Ten Years of Research – What Have We Learnt Since the Financial Crisis?' (Speech, Economic Society of Australia (QLD) and Griffith University Symposium, 7 March 2019) <https://www.rba.gov.au/speeches/2019/sp-so-2019-03-07.html>.

bank council members including governors 'help to better understand, or at least suggest refined interpretations about the dynamics of position-takings inside councils, and consequently monetary and financial policies of the central banks'.[126] The biographies – and personal characteristics – of central bank officials and governors 'allow to analyze (sic) from a more concrete basis what is really at stake in this very particular multidimensional élite group, which is evolving over time'.[127] The broad political persuasion of the governor also matters and can affect their professional role.[128]

It is not just the extent to which personal characteristics may influence a Governor's policy-related decisions that matter. Personal characteristics such as the ability to negotiate, and use and/or resist the use of power, peer pressure and persuasion, will affect the way in which policy may be determined. The manner in which a Governor is able to interact with other important stakeholders, and in particular other important personalities on boards, committees and councils, may be determinative. This is particularly important in Australia, where the mandate for financial stability is decentralised. The personalities of others role players such as the Minister of Finance, Treasurer, and head of APRA are also important.[129]

One of the most significant tools in financial stability that the RBA has is *persuasion*. The Governor, and the RBA, may, for example, have to persuade APRA to take certain steps, if the RBA deems those steps necessary.[130] The

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[126] Lebaron and Dogan (n 124) 34.

[127] Ibid.

[128] An empirical analysis has for example shown that 'a governor's ties to a political party in Government or opposition have a statistically significant and substantively important impact on their odds of surviving in office': Ennser-Jedenastik (n 119) 515.

[129] The personalities and their effects on the roles of central bank governors are evident from their biographies. See for example the description of Mervyn King: Dan Conaghan, *The Bank: Inside the Bank of England* (Biteback Publishing, 2012) 1, 63-99; See also Ben Bernanke, *The Courage to Act: A Memoir on a Crisis and its Aftermath* (Norton, 2015).

[130] Ellis refers to the RBA's use of a metaphorical microphone and a megaphone. The role of the person in communication is however important. See Luci Ellis, 'Why Financial Stability Policy Matters, and What We Can Do About It' (Address, University of Adelaide, 4 June 2014) <https://www.rba.gov.au/speeches/2014/sp-so-fs-040614.html>.

RBA has to persuade the banks or the markets, to engage in practices that will benefit financial stability. In debates at the CFR, the personal power of the Governor may also play a role. Personality clashes could for example have an important impact, as can personal agendas, and where there are no guiding legal principles, it may come down to personalities and personal agendas. The Governor may use their personal power to influence decisions; or may succumb to powerplay by others at the CFR or on the RBA Board.

The role of personality in procuring the compliance by the RBA with the needs of government is important. It has been determined that ‘the best way to ensure compliance with regulatory regimes is by appealing to self-interest, defined as rational calculation of the magnitude of liability discounted by the probability of enforcement’.[131]

Although it has been demonstrated at the level of regulation of regulatees such as banks and financial institutions, that ‘hard law (required behaviors (sic), processes, or disclosure) is effective to induce compliance, but only up to the point where resistance and a defensive culture ensues’[132] the same is not necessarily true at the level of a regulator which is a government agent.

The key issue is, however, that where there is considerable fundamental fluidity in the legal framework of the RBA in relation to ‘who does what and how’, then the personality of the Governor may have a disproportionately significant role to play, and may even amount to one of the key tools of control and influence of the operations of the RBA.

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[131] Rupp and Williams (n 19) 583.

[132] It has nevertheless also been pointed out that soft law has ‘the potential to engage a broader range of human motivations, needs, emotions, and moral reasoning, and thus might more effectively encourage behaviors that optimize society's regulatory goals than do approaches that rely only on appeal to the instrumental considerations or self-interest of the regulated entity’: Ibid 585.

The issue is whether these should play a significant regulatory or governing role in the behaviour of a government regulatory agent, and what effect that may have on regulator legitimacy, democratic principles and the respect for the rule of law.

VI Conclusion

This chapter has demonstrated that the range of governance mechanisms that control and drive the RBA's financial stability function are not optimal. The fact that the RBA has an informal and decentralised mandate for financial stability lies at the heart of the issue, as the mandates and powers of a regulatory agency when acting as an agent of government are important. The RBA is further governed by its relationship with the government, notably through its design as an independent central bank. As summarised in Appendix 3, the governance mechanisms, together with the transparency and accountability mechanisms discussed in Chapter 7, ultimately form a long list of controls on and drivers of the RBA, *but* these are not truly effective as controls or drivers of the RBA's financial stability responsibilities. In light of predominantly soft law governance mechanisms, there is the possibility that behavioural factors, such as the role of personality, may play a disproportionately important role in the governance of the RBA, at the expense of legitimacy and general principles of democracy and the rule of law. The transparency and accountability mechanisms will be examined in Chapter 7.

CHAPTER 7

Accountability of the RBA as Financial Stability Regulator

… [A]ccountability. It is the very bedrock of central bank independence in a democratic society.[1]

[A] central bank cannot be accountable for everything.[2]

I Introduction

This chapter examines the accountability framework of the RBA in its financial stability responsibility. Part II considers the role of transparency mechanisms as controls and drivers of the RBA's actions, and concludes that few are significant as controls and drivers in the financial stability responsibility. It also demonstrates how the search for prestige is a further behavioural influence on the RBA. Part III considers how the need to justify its actions, and the possibility of sanction, could drive and control the RBA in its financial stability responsibility. It considers accountability through Parliamentary control (Part III A), control by the Executive (Part III B), and the possibility for control by the Judiciary (Part III C).

This chapter however concludes that the existing governance and accountability mechanisms, which feature a preponderance of soft law

[1] Guy Debelle, 'Central Bank Independence in Retrospect' (Speech, Bank of England Independence: 20 Years On Conference, 28 September 2017) <https://www.rba.gov.au/speeches/2017/pdf/sp-dg-2017-09-28.pdf>.

[2] Ian J Macfarlane, 'Monetary Policy and Financial Stability' (Speech, CEDA Annual Dinner, 16 November 2004) <https://www.rba.gov.au/publications/bulletin/2004/dec/pdf/bu-1204-1.pdf>.

mechanisms, are assessed as being ineffective governance and accountability mechanisms of the RBA, in light of its informal, decentralised and shared mandate for financial stability. The transparency and accountability mechanisms are also summarised in Appendix 3.

II Transparency Mechanisms

As described in Chapter 6, this thesis considers governance, transparency and accountability to be on a regulatory continuum. Transparency mechanisms are primarily accountability mechanisms, because of the ‘fear of disclosure’, or the ‘fear’ of the ‘disinfectant effect of sunlight’.[3] Prestige-seeking behaviour is therefore also a factor in relation to transparency and accountability. Transparency mechanisms can provide both contemporaneous visibility to actions of regulators (continuous or real time disclosure), and can also be provided after the fact (ex post facto), by reporting past actions or behaviours. Some disclosure could be for the purpose of justification, and potentially sanction. Some transparency mechanisms are statutory, although arguably some of the most powerful transparency mechanisms may come through involuntary press and public disclosures.

A *The Role of Disclosure in the Accountability of a Government Regulatory Agency*

Disclosure forms part of how a government regulatory agency gives account of its activities. Disclosure plays many different roles. The anticipation of disclosure through accountability mechanisms[4] that also require transparency

[3] See Luc Juillet and Éric Phélippeau, ‘Sunshine is said to be the best of disinfectants: Transparency as a Tool of Ethics Regulation in Canada and France’ (Conference Paper, International Research Society for Public Management, 14 April 2016) <https://irspm2016.exordo.com/files/papers/604/final_draft/IRSPM_Conflict_of_Interest_Juillet_Paper.pdf>. On its limitations, see however, Amitai Etzioni, ‘Is Transparency the Best Disinfectant?’ (2010) 18(4) *The Journal of Political Philosophy* 389.

[4] The ’usual set of accountability questions’ have been described as being ‘who, to whom, how, for what, in accordance with what standards, and with what effects’: Julia Black, ‘Constructing

can influence the behaviour of the RBA as a regulator: that is the regulatory purpose of transparency and accountability regimes.[5] Measures imposed to hold an organisation or person accountable can amount to measures of *control*,[6] because actions, rights and expectations of the accountor[7] can influence the behaviour, decisions and actions of the accountee[8] (in this case the RBA). Being *accountable* performs a regulatory or controlling function for *independent* regulatory agencies. The three principles – control, accountability and independence – are inextricably related in the case of a central bank such as the RBA.[9] In view of central banks' important roles and redistributive effects, accountability by central banks is of key importance,[10] and transparency and accountability therefore accompany central bank independence. The fact that a central bank will be accountable supports its legitimacy and credibility, and justifies its independence:[11]

> It is then in the continuing life of that entity that accountability becomes necessary to ensure legitimacy. An accountable central bank must give

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and Contesting Legitimacy and Accountability in Polycentric Regulatory Regimes' (2008) 2(2) *Regulation & Governance* 137, 138 ('Constructing and Contesting Legitimacy and Accountability').

[5] See for example Chapters 12 and 13 on compliance and enforcement and sanction as methods of regulation: Arie Freiberg, *Regulation in Australia* (Federation Press, 2017). See also the section on accountability: at 84-99.

[6] 'To be accountable is to agree to subject oneself to relationships of external scrutiny which can have consequences': Black, 'Constructing and Contesting Legitimacy and Accountability' (n 4) 150.

[7] The accountor is the entity to whom the account must be made.

[8] The accountee is the entity accounting for its actions.

[9] For a discussion of issues relating to accountability, including the involvement of the accountor and the cooperation by the accountee, see Julia Black, 'Calling Regulators to Account: Challenges, Capacities and Prospects' (Working Paper No 15/2012, London School of Economics and Political Science Law Department, 11 October 2012) <https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2160220> ('Calling Regulators to Account').

[10] Charles Goodhart and Rosa Maria Lastra, *Central Bank Accountability and Judicial Review* (Policy Note No 32, May 2018) <https://www.suerf.org/policynotes/2585/central-bank-accountability-and-judicial-review/html>.

[11] Ibid.

> account, explain and justify the actions or decisions taken, against criteria of some kind, and take responsibility for any fault or damage.

Central bank accountability is accordingly not simply an '*ex post*' factor of central bank governance, but rather inextricably linked to independence. It is not simply 'an "add-on" to justify independence'.[12] Rather, central banks are 'accountably independent',[13] and[14]

> [a]ccountability – *ex ante* and *ex post* – is a constitutive part of the design of an independent agency in a democratic system, whose aim is to bring back the central bank to the system of checks and balances, (*trias politica*) (sic).

Transparency is a first step in accountability,[15] as accountability inevitably involves a measure of disclosure. Transparency allows for actions to be observed; accountability *per se* requires explanation or justification, and often also the taking of responsibility for actions and/or suffering punitive measures.[16]

To be 'accountable' therefore includes the provision of an explanation and justification for actions taken.[17] It could also include the imposition of consequences if explanations and justifications do not satisfy the requirements of the accountor. In the case of the RBA, the Australian government and indirectly the Australian public are the ultimate accountors.[18]

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[12] Ibid.

[13] Ibid.

[14] Ibid (emphasis unaltered).

[15] It can be seen as the first step – the giving of account (ie making actions transparent). See Goodhart and Lastra (n 10).

[16] Ibid.

[17] See Black, 'Calling Regulators to Account' (n 9); See Bird (n 19).

[18] Black adds the 'consequences' component: Black, 'Calling Regulators to Account' (n 9).

Accountability accordingly has three components:[19]

1. *Disclosure (or transparency)* - the accounting entity merely *discloses* facts/acts/decisions or makes them transparent;

2. *Justification* - the accounting entity *explains and justifies* facts/acts/decisions etc; and

3. *Sanction (or consequences)* - the accounting entity *accepts responsibility* and/or is made to *suffer sanctions or punitive consequences* in the event that it has failed to comply with its obligations.

Accountability measures can also be categorised according to their different strengths:[20]

- *Weak* accountability measures relate to explanations and justification (the consequence of which may be negative publicity and some recommendations); and
- *Strong* accountability measures require the regulator to respond, for example by changing or reversing a decision, or to suffer the imposition of a penalty, such as removal from office, or a civil or criminal sanction.

Sanctions have both punitive and deterrent effects, and are therefore strong accountability tools; they most likely have the most significant influence on behaviour.

[19] This classification reflects the approaches of Goodhart, Lastra, Bird and Black. See: Goodhart and Lastra (n 10); See also Joanna Bird, 'Regulating the Regulators: Accountability of Australian Regulators' (2011) 35(3) *Melbourne University Law Review* 739.

[20] See, for example, Bird (n 19), 741, 743, 746.

B *Transparency*

Transparency has been described as a 'soft' form of accountability.[21] Disclosure is an important component of accountability, and in particular the *fear of disclosure* has an impact on the behaviour chosen by an institution. In fact,[22]

> [t]ransparency is seen as a key element of accountability in an era of central bank independence. As central banks have become more independent and freer to choose their tactics, transparency has come to be seen as a mechanism enabling the public to assess whether the actions of central bankers are consistent with their mandate.

The pressure for transparency has been described as being 'more intense' as the mandate of central banks 'extends beyond the pursuit of easily quantifiable, independently verifiable targets like the rate of inflation to encompass emergency lending, securities market intervention, and related financial operations'.[23] Financial stability could also be added to that list. Transparency involves the disclosure of actions and practices of the agency, and will ideally reflect that the agency is acting in accordance with requirements. Accordingly, transparency is a means by which central banks not only enhance their policy credibility but retain flexibility.[24]

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[21] See Frans Van Dijk, 'Independence and Autonomy: The Parallel Worlds of Courts and Public Agencies', *Blog of the Montaigne Centre for Rule of Law and Administration of Justice* (Blog Post, 11 December 2018) <http://blog.montaignecentre.com/index.php/1265/independence-and-autonomy-the-parallel-worlds-of-courts-and-public-agencies/>. In this regard, transparency has been likened to dialogue.

[22] N Nergiz Dincer and Barry Eichengreen, 'Central Bank Transparency and Independence: Updates and New Measures' (Working Paper No 2013-21, 4 September 2013) 2 <http://dx.doi.org/10.2139/ssrn.2579544>.

[23] Ibid 3.

[24] Ibid 3.

Various indices of central bank transparency have been created, the details of which are beyond the scope of this thesis, but it is worth noting that economic, political, operational, procedural and policy transparency elements play a role in these indices.[25] This thesis focusses on concrete transparency requirements that affect or may affect the behaviour of the RBA, and that can act as controls or drivers of the RBA in its financial stability role.

C *Overview of Transparency Requirements and Mechanisms*

The RBA is subject to many transparency requirements.

1 *General Transparency Mechanisms*

There is large number of mechanisms that require the RBA to be transparent and to disclosure its operations. These have diverse origins, but do not specifically support the financial stability mandate. It is beyond the scope of this thesis to discuss all transparency mechanisms in detail (see also Appendix 3 for a summary of the governance, transparency and accountability mechanisms of the RBA in table form).

(a) Regular/routine disclosures

The RBA makes a number of *routine/regular* but nevertheless important disclosures. Some of these reports are in response to statutory requirements;

[25] See Dincer and Eichengreen (n 22); In relation to central bank transparency, see also, for example, Christopher W Crowe and Ellen E Meade, 'Central Bank Independence and Transparency: Evolution and Effectiveness' (Working Paper No 08/119, International Monetary Fund, 1 May 2008) <https://www.imf.org/en/Publications/WP/Issues/2016/12/31/Central-Bank-Independence-and-Transparency-Evolution-and-Effectiveness-21903>; See B Laurens, M Arnone and J Segalotto (eds), *Central Bank Independence, Accountability, and Transparency : A Global Perspective* (Palgrave Macmillan, 2009); See further Rania Al-Mashat, Ales Bulir and N Nergiz Dinçer, *An Index for Transparency for Inflation-Targeting Central Banks: Application to the Czech National Bank* (International Monetary Fund, 2018).

others are self-imposed/voluntary disclosures and communications. As transparency is a way in which to enhance and enforce governance, the extent of transparency adopted by the RBA should be noted (see also Appendix 3):

1. *RBA publications/reports* include the Reserve Bank of Australia Annual Report, the Quarterly Bulletin, Financial Stability Report, Quarterly Statement on Monetary Policy, and the Payments System Board Annual Report. The Reserve Bank of Australia Annual Report is tabled before the Standing Committee on Economics in Parliament. Of particular importance is also the publication of minutes of the monetary policy committee meetings of the Reserve Bank Board;[26]

2. *Oral/written statements*: Speeches by governors are delivered in public and published on the RBA website; other oral/written statements include the RBA's Governor's address to Parliament in accordance with undertakings in the Statement on the Conduct of Monetary Policy, and Interest Rate Decisions (published)[27] as well as Statements on Monetary Policy[28];

3. *Discussions that involve transparency* include those at the CFR, in particular discussions of the RBA's draft Financial Stability Report before publication;

4. *Statutory transparency requirements* include reports under legislation such as the *PGPA Act*, and Anti-Money Laundering and Counter-Terrorism Financing legislation;

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[26] These minutes are published after the meeting on the first Tuesday of every month excluding January. The minutes have been publicly available since 3 October 2006. See 'Minutes', *Reserve Bank of Australia* (Web Page, 2018) <https://www.rba.gov.au/monetary-policy/rba-board-minutes/2018>.

[27] See 'Interest Rate Decisions 1990', *Reserve Bank of Australia* (Web Page, 1990) <https://www.rba.gov.au/monetary-policy/int-rate-decisions/1990/>.

[28] Ibid. These have been published since 1990.

5. *Audit reports*: Auditing is important because although the audited entity submits to the process, it does not create the audit report. The level of objectivity in this form of transparency is therefore higher. The fact that the RBA is required by statute to have an audit committee[29] further contributes to governance, because failures in governance mechanisms often have financial repercussions, and audit reports typically include potential legal exposures including existing and pending legal proceedings;

6. *Annual financial statements* provided to the Auditor-General: under s 7A(8) of the *RBA Act* and in accordance with s 42(1)(b) *PGPA Act*, the RBA is required to provide annual financial statements to the Auditor-General after approval by the Reserve Bank Board; and

7. *Miscellaneous disclosures* which include the RBA's Corporate plan, research publications, conference publications, and workshop notes.[30]

Of the various routine publications of the RBA, the financial stability review is the most relevant publication for the financial stability mandate. The RBA commenced publication of the financial stability review without any statutory or other compulsion, at a time when financial stability became an important topic in central banking circles.

(b) Ad hoc disclosures

The RBA also makes a number of *ad hoc or specific disclosures*. Some disclosures may be required in specific circumstances and unlike those listed

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[29] *Reserve Bank Act 1959* (Cth) s 7A(9).

[30] See 'Publications', *Reserve Bank of Australia* (Web Page) <https://www.rba.gov.au/publications/>.

above, are not routine acts by the RBA. Some of these disclosures are voluntary, or partly voluntary. These include submissions to law reform commissions and commissions of inquiry,[31] and information to the IMF and/or FSB in relation to country peer reviews.[32] Some information may be provided to international fora and meetings, such as for example the Basel Committee and BIS. In certain circumstances, the RBA may also engage with the press/media,[33] make press statements or answer questions in public forms such as at conferences.

Transparency is however sometimes *imposed* on the RBA. Apart from unavoidable scrutiny by the press, there is also general public commentary and academic scrutiny.[34] Although it is not a reflection of work performed by the RBA itself, the so-called RBA Shadow Board at the Australian National University's Centre for Applied Macroeconomic Analysis provides valuable critique and commentary.[35] FOI requests also fall into this category.[36] Unless the RBA can legally resist FOI requests, responses are compulsory. Further, questioning of the Governor by Parliament can also serve as an involuntary imposition of transparency. All of these disclosures can affect the standing or prestige of the RBA.

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[31] Ibid.

[32] Such as for example, Reserve Bank of Australia and Australian Prudential Regulation Authority, *Macroprudential Analysis and Policy in the Australian Financial Stability Framework* (Report, September 2012) <https://www.rba.gov.au/fin-stability/resources/2012-09-map-aus-fsf/pdf/2012-09-map-aus-fsf.pdf>.

[33] See 'Latest Media Releases', *Reserve Bank of Australia* (Web Page, 2019) <https://www.rba.gov.au/media-releases/>.

[34] The BIS also critiques central banks. See John Mauldin, 'The Bank Of Central Banks Reveals The Biggest Threat To The Global Financial System' Forbes, 20 July 2016) <https://www.forbes.com/sites/johnmauldin/2016/07/20/the-bank-of-central-banks-reveals-the-biggest-threat-to-the-global-financial-system/#311c7f011c3e>.

[35] 'CAMA RBA Shadow Board', *Centre for Applied Macroeconomic Analysis* (Web Page, 31 August 2017) <https://cama.crawford.anu.edu.au/rba-shadow-board>.

[36] See 'Freedom of Information: Disclosure Log', *Reserve Bank of Australia* (Web Page, 2019) <https://www.rba.gov.au/information/foi/disclosure-log/>.

2 *The Public Governance, Performance and Accountability Act 2013* **(Cth)** *and Related Obligations*

The RBA is required to comply with a host of financial, corporate or procedural governance requirements.[37] The key statutory governance mechanism that could have a controlling effect on the policy actions of the RBA is the *PGPA Act*. Although many of these can be categorised as governance requirements, they are dealt with in this chapter because of the significant reporting requirements under the *PGPA Act.* It is not always possible to strictly delineate between governance and transparency requirements and this is one such example. The *PGPA Act* and its effect on the RBA also demonstrate that it is not always possible to draw a clear line between governance, transparency and accountability on the continuum discussed in Chapter 6.

The *RBA Act* in s 7A[38] confirms the application of the *PGPA Act* to the RBA (subject to certain exceptions),[39] and regulates the interaction between the *RBA Act* and the *PGPA Act* in terms of the relationship between the disclosure obligations under the *RBA Act* and those under the *PGPA Act*. The details of these are not relevant for purposes of this thesis.

The obligations of the RBA under the *PGPA Act* are however important supplements to the *RBA Act*. The Governor is the accountable authority for the RBA under the *PGPA Act*.[40] As this is an individual role, the way in which the role is fulfilled will reflect the subjective characteristics of the incumbent.

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[37] These include governance requirements stemming for example from anti-money laundering and counter-terrorism financing obligations. See also Appendix 2.

[38] Under the *RBA Act* s 7A, the RBA is subject to the *Public Governance, Performance and Accountability Act 2013* (Cth), with the Governor as the accountable authority (s 7A(1)).

[39] The exceptions that the RBA is not required to comply with, are listed in *Reserve Bank Act 1959* (Cth) s 7A(2), and board members of both the RBA Board and the Payments System Board (with the exception of the Governor, Deputy Governor and RBA staff members) are not considered to be officials under the *Public Governance, Performance and Accountability Act 2013* (Cth) (see *Reserve Bank Act 1959* (Cth) s 7A(3) and (4)).

[40] *Reserve Bank Act 1959* (Cth) s 7A(1).

The key relevant obligations of the Governor as the 'accountable authority' under the *PGPA Act* are:

- To govern the RBA 'so as to promote proper use of public resources, achieve the purposes of the entity and promote the financial sustainability of the entity' (s 15(1));
- To 'establish appropriate systems of risk and control, including oversight in the agency, and an appropriate internal system of control' (s 16);
- To 'encourage officials to cooperate with others' (s 17);[41]
- To 'manage the risk of imposing requirements on others' (s 17); and
- To 'keep the relevant minister and Minister of Finance informed' (s 18) to the extent that the information is consistent with the enabling legislation of the RBA (s 17(4A)), and subject to confidentiality provisions'.

All officials (including the Governor, Deputy Governor and other employees of the RBA) are also required to perform their duties in accordance with the *PGPA Act*. In particular, officers have a duty of due care and diligence,[42] with the relevant standard being that of a reasonable person in the same position.[43] Officials are to act in good faith, for a proper purpose,[44] and may not improperly use their position.[45] Officials may not use information obtained during the course of their employment improperly and/or for their own advantage or to cause detriment to the Commonwealth of Australia,[46] and all potential conflicts of interest must be disclosed.[47]

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[41] It is not clear whether this cooperation is limited to other RBA employees, or also the other regulatory agencies such as APRA and ASIC.

[42] *Public Governance, Performance and Accountability Act 2013* (Cth) s 25.

[43] Ibid s 25(1)(a) and (b).

[44] Ibid s 26.

[45] Ibid s 27.

[46] Ibid s 28.

[47] Ibid s 29.

The RBA as a body corporate also has to comply with other requirements of the *PGPA Act*, which relate to good corporate governance, including budgeting,[48] record-keeping,[49] performance measurement,[50] and financial reporting.[51] It is evident that the *PGPA Act* imposes a significant number of governance and reporting (transparency) obligations on the RBA.

In addition to the impositions from the *PGPA Act*, the Department of Finance treats the RBA as a 'material entity' and a 'public financial corporation', and makes the RBA subject to Commonwealth Procurement Rules.[52] The RBA's employees are however not engaged under the *Public Service Act*.[53]

The public character of the RBA is therefore evident from the externally imposed transparency requirements. All of these requirements are however general in nature, and they do not specifically govern the RBA in its core policy functions, including in the financial stability function.

3 *Assessment*

What is evident from the discussion on transparency above, is that none of the measures of transparency specifically controls or directs the financial stability function. However, the mere fact that communication or disclosure is made – or will be made – serves as a form of control and regulation. In principle, it

48 Ibid s 36.

49 Ibid s 37.

50 Ibid s 38.

51 Ibid Part 2 Division 4. Please note that this list is not a complete list of all the obligations under the *Public Governance, Performance and Accountability Act 2013* (Cth).

52 See 'Flipchart of PGPA Act Commonwealth Entities and Companies (186)', *Australian Government Department of Finance* (Web Page, 28 August 2018) <https://www.finance.gov.au/sites/default/files/Flipchart_28%20August.pdf>.

53 Ibid.

influences behaviours and decisions before they are taken, and also influences behaviour after the communication or disclosure has elicited some response.

The transparency mechanisms discussed above are however assessed by this thesis as having on the whole low effectiveness as controls and drivers of the financial stability responsibility (see also Appendix 3).[54] They are mostly not specifically linked to the financial stability responsibility and do not compel or direct any actions in relation to financial stability.

It may be that the *fear or anticipation of disclosure* – whether that disclosure arises voluntarily or involuntarily, formally or informally, through routine transparency measures or imposed accountability obligations – has a more important ‘governing’ effect. The mere anticipation of disclosure has been identified as an important governing mechanism,[55] and without the anticipation of disclosure, some governing mechanisms would likely not be effective. Accordingly, to the extent that in some cases the RBA’s behaviour may be influenced because of transparency requirements and it could affect the prestige in which the institution is held by peers, markets, the regulatees, the State and the public, transparency mechanisms have moderate effectiveness also on the financial stability responsibility. The behavioural factor of prestige-seeking behaviour may however be the real control and driver of the RBA’s financial stability actions.

[54] The assessment of the effectiveness of regulatory mechanisms was done on the basis of how likely and how reliably that mechanisms would control and drive the RBA to perform its financial stability tasks. It was an overall contextual assessment. That accords broadly with the evaluation criteria of effectiveness described by Freiberg, namely whether the objective has been achieved. See also Freiberg (n 5) 479.

[55] The anxiety of discovery has been described as a powerful regulatory force. See Andrew Schmulow, ‘Constructively Tough? Neither Side Has Committed to Fully Adopting Perhaps the Most Important Recommendation of the Banking Royal Commission’, *The Conversation* (online, 18 April 2018) (for URL see Bibliography).

D *Governance by Prestige? The Potential Role of Prestige-seeking Behaviour*

The second behavioural factor that can play a disproportionate role in controlling and influencing the actions of the RBA is the search for prestige. As noted above, in this context the search for prestige is synonymous with an endeavour to achieve comparative excellence. Central banks covet respect and admiration because of the need for credibility in order to exert influence. Commanding the respect of the markets, those they supervise (the regulatees), those who have appointed them (politicians and indirectly the electorate), and those who are affected by their decisions (the general public/electorate), is a critical factor in the effective functioning of a central bank,[56] and contributes to credibility. Professional prestige is therefore sought domestically and internationally.[57]

There is also an important element of personal prestige involved for those at the helm of central banks. Considering the traditionally comparatively low remuneration packages of central bankers, it has been said that 'central bankers are paid almost entirely in prestige'.[58]

[56] Prestige is a key factor in moral suasion. It is the combination of power and prestige that enables central banks to use moral suasion in the markets: See Joseph Lucia, 'Moral Suasion – An Obscure Tool' (1976) 126(600) *Banker* 141. For a detailed discussion of the history of the search for prestige in central banking, see Claudio Borio and Gianni Toniolo, 'One Hundred and Thirty Years of Central Bank Cooperation: A BIS perspective' (Working Paper No 197, Bank for International Settlements Monetary and Economic Department, February 2006) <https://www.bis.org/publ/work197.pdf>. The search for prestige has also been viewed negatively as being contrary to an endeavour to honestly serve the public interest, but this view has not been accepted without criticism: See Eugenia Toma and Mark Toma, *Central Bankers, Bureaucratic Incentives, and Monetary Policy* (Kluwer, 1986); See also Myles S Wallace, 'Book Review: Central Bankers, Bureaucratic Incentives, and Monetary Policy' (1989) 55(3) *Southern Economic Journal* 806.

[57] Central bank salaries are traditionally below that of the central bankers' peers in the market, and the salary of the Governor of the RBA is very modest by market standards. Accordingly, the role of the Governor is emphasized as a role of personal service and personal esteem, rather than personal financial advancement: See for example Karen Maley, 'RBA Governor Glenn Stevens "Humbled" by Queen's Birthday Award', *Financial Review* (online, 12 June 2016) <https://www.afr.com/news/economy/rba-governor-glenn-stevens-humbled-by-queens-birthday-award-20160612-gphg26>.

[58] See Matthew O'Brien, 'How much is a good central banker worth?' *The Atlantic* (online, 19 April 2012) <https://www.theatlantic.com/business/archive/2012/04/how-much-is-a-good-central-banker-worth/256089/>: 'Ben Bernanke is making just $199,700 this year. That's not to

In the absence of a strong legal framework that directs and guides the operations of the RBA for financial stability, the RBA may, for example, engage in certain activities because these appear to be best practice internationally. In this regard, the actions of the RBA may be quite fundamentally influenced by how the RBA is reflected in analysis by the media, academics and politicians.[59]

'Prestige' and the search for prestige is an important regulatory tool. It is a way for the RBA to create and enhance its own credibility and legitimacy.[60]

III Accountability to the Australian State

The importance of accountability of central banks to both the political process and the general public is of critical importance.[61] A central bank has to be accountable 'to the politicians and the population at large'.[62] Central bank independence depends on accountability.[63] In order to be able to 'take independent decisions about the appropriate stance of monetary policy, a central bank has to appropriately justify them'.[64] In fact, '[a]n accountable

say that we need to pay central bankers more to attract the best ones. We don't. Economists *really* care about prestige'.

[59] After the GFC, the BOE in the UK was essentially motivated by blame-avoidance: See Harpal Hungin and Scott James, 'Central Bank Reform and the Politics of Blame Avoidance in the UK' (2019) 24(3) *New Political Economy* 334.

[60] See Black, 'Calling Regulators to Account' (n 9) 146-7. Regulators can work on constructing their own legitimacy. The form that the strategy will take can vary and will depend on the type of legitimacy sought, including cognitive and normative legitimacy: at 147. The importance of the 'legitimacy community' is also emphasised. Legitimacy is 'a critical element in motivating behavioral responses': at 148

[61] Debelle (n 1). See also Black, 'Constructing and Contesting Legitimacy and Accountability' (n 4) 137. She notes that accountability is 'a critical element in the construction and contestation of legitimacy claims by both regulators and legitimacy communities, as they are the means by which legitimacy communities seek to ensure that their legitimacy claims are met': at 149.

[62] Ibid.

[63] Ibid.

[64] Ibid.

central bank should be judged for the reasonableness of its actions, by Parliament, the executive, the competent courts of justice and the public.[65]

Accountability in relation to financial stability objectives is however complex, not just because of the nature of financial stability, but also in light of the fact that the financial stability responsibility in Australia is both informal and shared. Nevertheless, accountability in relation to financial stability objectives needs to be clear, and Goodhart and Lastra for example suggest that the criteria against which the central bank must account, should be set.[66]

Some of the ways in which the RBA is held accountable for its operations, acts and decisions through disclosure are already inherent in the different ways in which transparency of the RBA's actions is provided because some justification may already be included in the disclosure itself.

Additional accountability measures that fall into the categories of justification and sanction are discussed below. The structure of the analysis below broadly reflects the separation of powers principles in Australian constitutional law, focussing on parliamentary, executive and judicial control. These are also typical of accountability regimes in constitutional/liberal democratic states (parliamentary oversight, executive control and forms of judicial review).[67]

A *Accountability to Parliament and Parliamentary Control*

There are no direct sanctions or punitive measures that Parliament can take against the RBA as an institution, but by its powers to issue amendment legislation, Parliament holds the ultimate control over its statutory creations.

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[65] Rosa María Lastra, 'Accountability in the Context of EMU & EBU: Judicial Review of the ECB by the CJEU' (EBI Brexit Seminar, Brussels, 10 January 2018).

[66] Goodhart and Lastra (n 10).

[67] See Black, 'Constructing and Contesting Legitimacy and Accountability' (n 4) 138.

Parliament can legislate to change or revoke the RBA's independence. There is no legal reason why Parliament may not take whatever legislative steps it sees fit in order to introduce measures which would have the effect of sanctions. It can even dissolve or nationalise the RBA as an institution. However, as central banking as an economic model is virtually universally adopted in all nations in the world, it is rather unthinkable that a developed Western democracy such as Australia would resort to such as step. Parliament would likely be strongly influenced by international opinion and the practical need for a central bank in order for Australia to continue to participate in the international financial sphere.

It is however doubtful whether the prospect of legislative change removing central bank independence, or drastically changing the organisational structure and/or reporting lines of the RBA, or even dissolving the RBA as an organisation, would act as an effective *control* measure for the acts, decisions and policy choices of the RBA on a daily basis. In addition, legislative change of such a fundamental nature will probably only be implemented if significant damage had already been done,[68] and will likely *not* have a significant *deterrent* effect.[69] The potential for intervention by Parliament may therefore not directly assist with the regulation of the regulator and its conduct when it really matters and parliamentary control therefore has been assessed as having *very limited benefit* as a regulatory tool.

[68] It is likely that for example a complete abolition of the RBA or restructuring of the RBA as government department will be an extreme measure, a step that will only likely be taken if the status quo in relation to the RBA has become politically intolerable. It would however be a case of shutting the gate after the horse had bolted.

[69] The role of Parliament has been described as being 'largely confined to post hoc scrutineer': Julia Black, 'The Credit Crisis and the Constitution' in Dawn Oliver, Tony Prosser and Richard Rawlings (eds), *The Regulatory State: Constitutional Implications* (Oxford University Press, 2010) 92, 118.

B *Accountability to the Executive and Executive Control*

As discussed in Chapter 6, the Australian government has the power to override policy decisions by the RBA,[70] and in what could be construed to be a personal punitive measure, the Treasurer may terminate the employment of the Governor and/or Deputy Governor.[71] Executive control is therefore *personal* – the policy of the RBA may be overridden by government, which may diminish the professional standing of the Governor (and/or the RBA)), and the Governor and/or Deputy Governor may lose their jobs if they do not exhibit 'good behaviour', which will also reflect poorly on the Governor and/or Deputy Governor. These powers have never been used in Australia, and the government has not overridden policy or terminated the services of a Governor or Deputy Governor. It should be noted that this type of action can enliven both the behavioural factors of control – personality and prestige – as well.

The *possibility* of executive control may however have some deterrent effect. The actions and decisions of the Governor and/or Deputy Governor may however still be taken in the knowledge that the government may take actions that could personally and publicly discredit the Governor, Deputy Governor and/or the RBA. The protection of the reputation of both the institution and the relevant individuals may have an important governing effect. In this instance, *personal prestige* is an important factor.[72] Executive control therefore has *some or limited benefit* as a proactive regulatory tool, as the threat of a personal loss of income, reputation, status, respect and power in the event of a termination of employment, may control and regulate the behaviour of the RBA through the decisions and influence of the Governor.

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[70] *RBA Act* s 11.

[71] Ibid s24(1)(c) – the Governor and Deputy-Governor holds office subject to 'good behaviour'.

[72] For more on this point see the discussion of prestige above.

C *Judicial Control and Sanction*

Judicial control is effectively regulation through imposed liability. The extent of judicial control over the RBA in its central banking capacities, and in particular in the performance of the financial stability function, is however *likely limited*. (Judicial control in cases where the RBA acts as employer or a commercial contracting party is not relevant to this thesis and are disregarded for purposes of this discussion.)

1 *Civil Liability: Actions Brought by Individuals*

A compelling argument can be made that regulatory agencies may be legally liable (or should be legally liable) to those affected by the manner in which they perform (or fail to perform) their regulatory and supervisory tasks, and that they should be capable of being held liable in contract or tort.[73] However, the position in Australia is not finally settled.[74] Although the tort of misfeasance in public office exists in Australia and can (at least theoretically) be used to launch an action against a financial regulator, it has not yet been successfully argued by persons *not* directly supervised or regulated by the particular regulator against whom such a claim can be made.[75] Further, the scope of cases that

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[73] Giesen argues that supervisors are 'just not that special...': Ivo Giesen, 'Regulating Regulators Through Liability: The Case for Applying Normal Tort Rules to Supervisors' (2006) 2(1) *Utrecht Law Review* 8, 31. They do not deserve special consideration, especially in light of the fact that '[s]upervision and supervisory (or: regulatory) authorities are becoming increasingly important as a means of regulating all kinds of public and private enterprises and markets, including the market for (other) services': at 8. Giesen refers to instances where Dutch courts held a supervisor liable for supervisory negligence. See also (as cited by Giesen) M Tison, 'Do Not Attack the Watchdog! Banking Supervisor's Liability After Peter Paul' (2005) 42(3) *Common Market Law Review* 639. Central banks may also be vulnerable to suit by foreign governments or entities: See Harvard Law Review, 'Notes: Too Sovereign To be Sued' (2010) 124(2) *Harvard Law Review* 550.

[74] An example of a case brought by individuals against a regulator in Australia on the basis of misfeasance in office or alleged negligence because of allegedly poor supervision, is *Lock v Australian Securities and Investments Commission (ASIC)* (2016) 248 FCR 547. The action for misfeasance in office brought by investors against ASIC failed.

[75] See *Lock v Australian Securities and Investments Commission (ASIC)* (2016) 248 FCR 547; See also *Chapel Road Pty Ltd v Australian Securities and Investments Commission (ASIC) (No 10)* (2014) 307 ALR 428. Cases involving claims by regulated entities, for example banks, against the regulator, are not relevant to the issue at hand. At issue is whether third parties – ie

may lead to legal relief may be limited, as in Australia the High Court confirmed that the key issue is the state of mind of the official.[76]

In the UK, in the case of *Three Rivers District Council v Governor and Company of the Bank of England*,[77] the tort of misfeasance in public office was accepted as the basis for a claim against the BOE. The claim was brought by the Three Rivers District Council on the basis of a breach of EU law, alternatively on the basis of misfeasance in public office.[78] Although the matter was struck out and the case did not succeed, misfeasance in public office was acknowledged as a ground for an action against a regulator, in that case the BOE. In England, as in Australia, the tort requires proof of more than negligence:[79]

> The main concern in *Three Rivers* was to confine reasonable foreseeability or objective fault to negligence actions, and to insist that at the very least, misfeasance required that its defendants knew they were running the risk that their actions were illegal and harmful but recklessly went ahead anyway.

The *Three Rivers* case confirmed that although it may be hard to prove misfeasance in public office, because more than mere negligence is required, it is possible to bring such a claim against a central bank/supervisory authority.[80] The Australian position will likely be similar.

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the clients of regulated entities, or the public at large – can successfully bring an action against a regulator on the basis of misfeasance in public office. Aronson, points out that liability for misfeasance in public office can fail even if officers of the relevant institutions had acted beyond their powers, provided that their actions were still done in good faith: See Mark Aronson, 'Misfeasance in Public Office: A Very Peculiar Tort' (2011) 35(1) *Melbourne University Law Review* 1.

[76] See *Northern Territory of Australia v Mengel* (1995) 185 CLR 307 and *Sanders v Snell* (1998) 196 CLR 329.

[77] See *Three Rivers District Council v Governor and Company of the Bank of England (No 2)* [1996] 2 All ER 363 and *Three Rivers District Council v. Governor and Company of the Bank of England (No. 3)* [2000] 3 All ER 558. There were a number of cases of which these are the most relevant.

[78] See Johann J de Jager, 'Three Rivers District Council v Governor and Company of the Bank of England: A Red Flag or a Red Herring for Bank Supervisors in South Africa' (2001) 13(4) *South African Mercantile Law Journal* 531.

[79] Aronson (n 75) 5 (emphasis added).

[80] In the *Three Rivers* case, the plaintiff could not prove that the BOE had dishonestly granted authority to the bank to operate, and had not dishonestly failed to revoke the authorisation to

In the Netherlands, the nature and quality of the supervision by the Dutch Central Bank formed the basis of a successful action against the Dutch Central Bank in 2006, when the Dutch District Court ruled that the Financial Supervisory Authority (part of the Central Bank) had acted negligently.[81] Cases against other financial regulators/supervisors have for example been brought in France[82] and Italy.[83] It should be noted that some jurisdictions have indemnities that protect their regulators.

Although financial supervisory authorities have sometimes been held liable in other jurisdictions,[84] and an action against the RBA on the basis of misfeasance in public office or negligence cannot be entirely ruled out, issues such as standing and the high threshold that must be proven, will pose significant challenges. The value of judicial control in this regard will *not be an effective control* of the acts of the RBA as a financial stability regulator.

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operate: See De Jager (n 78) 539. See also R Dijkstra, 'Essays on Financial Supervisory Liability' (PhD Thesis, Tilburg University, 2015).

[81] See the case against the Insurance Supervisory Authority for a supervisory failure when Vie d'Or became bankrupt: See *Vie d'Or* (Supreme Court of Netherlands, LJN AW2077, C04/279HR, 13 October 2006); See Dijkstra (n 80); See also Giesen (n 73); See also Mads Andenas and Gudula Deipenbrock (eds), *Regulating and Supervising European Financial Markets: More Risks than Achievements* (Springer, 2016).

[82] In the case of Kechichian, the court initially held the regulator/State of France liable on the basis of the regular standards of negligence, although on appeal it was determined that a higher standard, that of gross negligence, had to be satisfied in order to establish liability: See Cour Administrative d'Appel [French Administrative Court of Appeal], 25 January 2000, Kechichian (unreported) and Conseil d'État [French Administrative Court], 30 November 2001 reported in Rec Lebon (Conseil d'Etat [French Administrative Court], 30 November 2001 reported in 2002 Juris-Classeur Periodique (the appeal case); See Dijkstra (n 80); See also Andenas and Deipenbrock (n 80); See further Giesen (n 73).

[83] See the judgement by the Italian Supreme Court against Consob, the public authority responsible for the regulation of the Italian securities market. The case was brought on the basis of the negligent vetting of a prospectus: See Corte di Cassazione [Supreme Court of Italy], 3132 of 2001, 3 March 2001: See also Dijkstra (n 80); See also Giesen (n 73).

[84] See Dijkstra (n 80).

2 *Civil Liability: Class Action Most Likely on the Basis of Negligence*

Although class actions are possible in Australia, it seems unlikely that a class action on a civil basis, for example on the basis of negligence, against the RBA or any of its officers in the course of performing their duties in relation to financial stability, will succeed.[85] The main legal hurdles will be whether the RBA owes a duty to individuals, what the content and standard of that duty is (especially in light of the fact that there is no express statutory mandate for financial stability), and the case would have to satisfy the 'necessary condition' test of causation if brought in negligence.[86] In any event, the RBA could potentially avoid or reduce liability through joinder of APRA, or even the government, because the financial stability mandate is decentralised. A further difficulty may lie in creating the requisite 'class' of plaintiffs.[87]

3 *Indemnity of the RBA and Indemnities for Officers*

Although some jurisdictions have provided their supervisory authorities and/or central banks with legal indemnity,[88] the RBA does not have a statutory indemnity. Technically, therefore, the RBA could be held liable and be required

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[85] In Ireland the High Court considered a challenge to the validity of an exercise of a statutory power by the Central Bank of Ireland. Although the challenge failed, and the Central Bank's actions were validated, this case is an example of legal and factual circumstances that lead to a central bank's actions being judicially reviewed and/or litigated. See *Purcell v Central Bank of Ireland & Ors* [2016] IEHC 514 (29 July 2016).

[86] The various state Civil Liability acts all impose a 'necessary condition' requirement for causation in tort.

[87] This was for example a problem when attempting to mount a class action against commercial financial institutions in Australia after the Hayne Commission. See Duncan Hughes, 'Major Class Action Against Banks Over Mortgage Lending Flops', *Financial Review* (online, 14 December 2018) <https://www.afr.com/real-estate/major-class-action-against-banks-over-mortgage-lending-flops-20181214-h19465>.

[88] See Ashraf Khan, 'Legal Protection: Liability and Immunity Arrangements of Central Banks and Financial Supervisors' (Working Paper No 18/176, International Monetary Fund, 2 August 2018) <https://www.imf.org/en/Publications/WP /Issues/2018/08/02/Legal-Protection-Liability-and-Immunity-Arrangements-of-Central-Banks-and-Financial-46086>.

to pay any amounts it may be ordered to pay by a court, or perform such action as it is ordered by a court to perform.

All board members of the RBA Board and the Payments System Board have however been personally indemnified by the RBA 'against liabilities incurred by reason of their appointment to the relevant board or by virtue of holding and discharging such office'.[89] These indemnities are in substance similar to s 27M of the now repealed *Commonwealth Authorities and Companies Act 1997*(Cth) (CAC Act). Directors are however not indemnified from the legal consequences of actions not taken in good faith.[90] As long as the officers therefore act in good faith, it is unlikely that they will be personally liable for any losses suffered.

In any event, although persons in 'public office' can be held liable for certain legal breaches,[91] there is no standard test, and no clear defences federally.[92] The problem is that in these cases a very high standard is applied, and actual knowledge of, for example a lack of power, is required to establish liability.[93] It is therefore likely that even in the absence of a formal statutory indemnity, the actions of the decision-makers in the RBA may not be guided by the wish to avoid legal action. In this sense, too, the extent to which judicial control of this nature can have an impact on the way in which the RBA acts, is assessed to be *limited.*

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[89] See Reserve Bank of Australia, *Reserve Bank of Australia: Annual Report 2018* (Report, 27 August 2018) <https://www.rba.gov.au/publications/annual-reports/rba/2018/pdf/2018-report.pdf>. Various indemnities had been provided to members in terms of the relevant legislation, including (as applicable) s 27M of the *Commonwealth Authorities and Companies Act 1997* (*CAC Act*), depending on the relevant time of appointment. Senior RBA staff have been indemnified from personal liability that may be incurred in the conduct of their duties at the RBA, depending on when the events occurred. The RBA has a policy on assistance to staff for legal proceedings.

[90] See s 27M of the now repealed *CAC Act* providing an indemnity for liability.

[91] For example, some fiduciary breaches. See Tina Cockburn, 'Personal Liability of Government Officers in Tort and Equity' in Bryan Horrigan (ed), *Government Law and Policy: Commercial Aspects* (Federation Press, 1998) 374, 374-389.

[92] See Alan Robertson, 'Liability of Public Officers' (2002) 34 *Australian Institute of Administrative Law Forum* 25.

[93] Ibid 29. See for example *Northern Territory of Australia v Mengel* (1995) 185 CLR 307.

4 *Justiciability of Central Bank Actions*

The general justiciability of central bank actions should also be considered, and whether actions by central banks – in particular when exercising a financial stability function – are justiciable, and whether in particular they can be the subject of judicial review. Notwithstanding the possibility of legal action against the RBA (or RBA officials) in tort or otherwise in the performance of its financial stability mandate, it is unlikely that the relevant actions in relation to financial stability of which a plaintiff may complain would constitute justiciable actions. In fact, the nature of the pursuit of financial stability may not give rise to a justiciable action at all. If that is the case – as will be argued below – it places the conduct of the RBA in relation to financial stability beyond the constraints of judicial power.

(a) Other Jurisdictions: Justiciability of Central Bank Acts/Omissions

In other jurisdictions, some actions of central banks related to their actions as supervisors or monetary policy authorities have been the subject of judicial review, notably after the GFC.[94]

One such example is the review of measures taken by the ECB during the GFC by the Court of Justice of the European Union (CJEU) in 2015 in the decision in *Peter Gauweiler and Others v Deutscher Bundestag*, Judgment of the Court (Grand Chamber) of 16 June 2015.[95] The ECB's powers inter alia to 'deploy unconventional monetary policy measures' were challenged in the German

[94] "Up until the global financial crisis, courts dealt sparsely with central banking actions and decisions': Lastra (n 65).

[95] See *Gauweiler v Deutscher Bundestag* (Court of Justice of the European Union, C-62/14, ECLI:EU:C:2015:400, 16 June 2015).

court, and then also referred to the CJEU.[96] The CJEU however has express power to do so under art 35 of the *Statute of the European System of Central Banks*, and what has been described as ‘a fairly consistent standard of judicial review’[97] has developed.

The 2015 *Gauweiler decision* by the CJEU, although it also involved issues of the supremacy of EU law, essentially considered the powers of the ECB,[98] and it is therefore relevant to this thesis. The Court held that the Outright Monetary Transactions programme adopted by the ECB was in fact compatible with the ECB monetary policy mandate.[99] The review of the *Gauweiler decision* involved ‘a close scrutiny of the purposes of a mandate or competence, a check whether the instruments deployed serve the mandate, and an analysis whether the effects are proportionate to the objectives’.[100] At the heart of the matter were the legal powers of the ECB. On 10 December 2018 the CJEU held that the ECB’s public sector purchase programme was legal and did not breach the German Constitution.[101] In its considerations of the manner in which the ECB acted, the CJEU placed significant emphasis on the ECB’s express mandate.

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[96] Ursula Knapp and Balazs Koranyi, ‘Germany’s Top Court Rejects Fresh Challenge to ECB Powers’, *Reuters* (online, 18 October 2017) <https://www.reuters.com/article/us-germany-ecb-court/germanys-top-court-rejects-fresh-challenge-to-ecb-powers-idUSKBN1CN0TH>.

[97] Lastra (n 65).

[98] See Federico Fabbrini, ‘The European Court of Justice, the European Central Bank, and the Supremacy of EU Law’ (2016) 23(1) *Maastricht Journal of European and Comparative Law* 3.

[99] For a brief discussion, see Goodhart and Lastra (n 10) 6.

[100] See Lastra (n 65); See also M Goldmann, ‘Adjudicating Economics? Central Bank Independence and the Appropriate Standard of Judicial Review’ (2014) 15(2) *German Law Journal* 265. The Pringle and Gauweiler decisions on the powers of the ECB are controversial decisions of the CJEU, and the CJEU has been criticised for making law: See Paul P Craig and Menelaos Markakis, ‘Gauweiler and the Legality of Outright Monetary Transactions’ (2016) 41(1) *European Law Review* 4; See also Lastra (n 65).

[101] *Weiss and Others* (Court of Justice of the European Union, C-493/17, ECLI:EU:C:2018:1000, 11 December 2018); See also Central Banking Newsdesk, ‘ECB Secondary Bond Purchases are Legal, European Court of Justice Says’, *Central Banking* (online, 11 December 2018) <https://www.centralbanking.com/central-banks/monetary-policy/3905671/ecb-secondary-bond-purchases-are-legal-european-court-of-justice-says>; See also Beatriz Rios, ‘EU Top Court Rules in Favor of Draghi’s Bond-Buying Programme’ (*sic*), *EURACTIV* (Web Page, 11 December 2018) <https://www.euractiv.com/section/economy-jobs/news/eu-top-court-rules-in-favor-of-draghis-bond-buying-programme/>.

The decision of the CJEU is therefore also important for this argument, especially in light of the fact that the RBA does not have an express mandate for financial stability.

The position in the United States is different to the position in the EU. In the US there is no mechanism for judicial review of the Federal Reserve's monetary policy decisions in court.[102] However, 'the Fed's actions and decisions concerning supervision, financial stability and payment systems are subject to judicial review'.[103] In 2015, for example, AIG won its case against the United States Government on the basis that the Federal Reserve Bank New York (FRBNY) had exceed its mandate, and that it had also not treated AIG fairly during the GFC in providing LOLR assistance.[104] '[T]he Court of Federal Claims held that the Federal Reserve Act did not authorize the FRBNY to acquire equity in AIG, and that the FRBNY's doing so effected an illegal exaction'.[105] In this case the Court closely examined the mandate of the FRBNY, and this case is therefore also pertinent to this discussion.

The approach to judicial review in the United Kingdom has been described as one in which issues are found to be justiciable, but that the degree and intensity of review is the main concern.[106] In the UK, the decisions of the BOE have in

[102] See Goodhart and Lastra (n 10); See Lastra (n 65).

[103] See Goodhart and Lastra (n 10).

[104] Starr International sued the Federal Reserve Bank of New York claiming that federal officials acted illegally when making a loan of $US85 billion to AIG (of which it was the largest shareholder), at an interest rate of 14 per cent and in exchange for an equity stake in Starr International of 80 per cent. The court held that the actions of the Federal Reserve Bank of New York had exceeded its mandate. Nevertheless, as without the government intervention AIG would likely have had to file for bankruptcy in any event, no damages were awarded: *Starr International Co v United States*, 121 Fed. Cl. 428 (2015); See also Harvard Law Review, 'Fifth Amendment – Illegal Exaction – Court of Federal Claims Holds that Government Acquisition of Equity Share in AIG Effected an Illegal Exaction – *Starr International Co. v United States*, 121 Fed. Cl. 428 (2015)' (2016) 129(3) *Harvard Law Review* 859.

[105] The Court of Federal Claims held that the Government acquisition of an equity share in AIG amounted to an illegal exaction. Harvard Law Review (n 104).

[106] See Dominic McGoldrick, 'The Boundaries of Justiciability' (2010) 59(4) *International and Comparative Law Quarterly* 981.

recent times been reviewed in court, for example in relation to the experiences with Northern Rock Bank at the onset of the GFC. The depositors at Northern Rock Bank who were not entirely covered by the £2000 deposit guarantee, orchestrated a 'run' on the bank after hearing rumours that the bank was failing and had requested emergency liquidity assistance from the BOE.[107] In the case of *SRM Global Master Fund LP v The Commissioners of HM Treasury [2009]* EWCA Civ 788, shareholders of the failed Northern Rock Bank sought compensation on the basis of failures by the BOE. The court was requested to examine the policy grounds on which LOLR assistance was rendered by the BOE. The claim was dismissed by the Court of Appeal on the basis that the assumptions adopted by the BOE were not 'manifestly without reasonable foundation'.[108] The argument also failed on causation and because some matters were of a policy nature.[109] The fact that the assumptions on which the LOLR regime was based, were matters of policy rather than fact, meant that they did not need to be subject to challenge in the valuation procedure itself.[110] Ultimately, the decision of the court focussed on process and legality, rather than the merits of the compensation, but it can still be said to have been a form of judicial review of the LOLR regime.[111]

The Supreme Court of India recently decided that a circular issued by the Reserve Bank of India (RBI) was ultra vires.[112] Action was commenced by corporations mostly in the power sector against the validity of a circular issued

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[107] Jon Cunliffe, 'Ten Years On: Lessons from Northern Rock' (Speech, Single Resolution Board Annual Conference, 29 September 2017) <https://www.bankofengland.co.uk/speech/2017/ten-years-on-lessons-from-northern-rock-speech-by-jon-cunliffe >.

[108] *SRM Global Master Fund Lp v Her Majesty's Treasury* [2009] EWCA Civ 788. See paragraphs 51 – 71 dealing with the 'manifestly without reasonable foundation' test.

[109] See Lastra (n 65).

[110] *SRM Global Master Fund Lp v Her Majesty's Treasury* [2009] EWCA Civ 788.

[111] Lastra (n 65).

[112] See 'Box A Risks in Non-bank Lending Sector in India' (Web Page, Reserve Bank of Australia, Financial Stability Review, April 2019) <https://www.rba.gov.au/publications/fsr/2019/apr/box-a.html>

by the RBI which tightened rules regarding stressed assets.[113] The Supreme Court reportedly held that the circular in question had overreached the RBI's mandate, in what has been described in the media as 'a serious blow to the bank's officials'.[114]

Although it is beyond the scope of this thesis to provide an overview of all jurisdictions, the examples cited above demonstrate that decisions of central banks may be reviewable in some jurisdictions, and that in those they may relate to the *scope of the powers or mandate* of the institutions. International approaches may inform Australian jurisprudence or be examples of what may happen in Australia.

(b) Judicial Review of the RBA[115]

Central bank experts Goodhart and Lastra have no doubt that the central bank's actions and decisions should be the subject of judicial review of administrative actions.[116] Judicial review considers the process of decision-

[113] The issue appears to be whether the actions were in conflict with statutory powers of the Reserve Bank of India, and it was anticipated that the court would not interfere with policy: FE Bureau, 'Supreme Court Hearing on RBI Circular Next Week, Experts Say Scrapping of Central Bank Diktat May Kill IBC', *Financial Express* (online, 10 November 2018) <https://www.financialexpress.com/industry/supreme-court-hearing-on-rbi-circular-next-week-experts-say-scrapping-of-central-bank-diktat-may-kill-ibc/1377573/>; See also Reserve Bank of India, 'Reserve Bank of India Clarifies' (Press Release 2018-2019/2213, 16 March 2019) <https://rbidocs.rbi.org.in/rdocs/PressRelease/PDFs/PR2213F21CBD0960A44446ABD6F7177506BF78.PDF>.

[114] Andy Mukherjee, 'India's Crony Capitalism Claims Another Victim' *Bloomberg Opinion,* (online, 3 April 2019) <https://www.bloomberg.com/opinion/articles/2019-04-03/india-s-crony-capitalism-claims-another-victim>.

[115] See Australian Law Reform Commission, *Traditional Rights and Freedoms — Encroachments by Commonwealth Laws* (Report No 129, 2 March 2016) <https://www.alrc.gov.au/publications/freedoms-alrc129> in particular Chapter 15 Judicial Review and Chapter 16 on immunity from liability for administrative action.

[116] Goodhart and Lastra consider that it is something that is 'beyond question': Goodhart and Lastra (n 10). See also Alon Harel, *Why Law Matters* (Oxford University Press, 2014) Chapter 6. Harel develops a rationale for judicial review based on the right to a hearing. Harel notes that '… the value of judicial review is grounded in the adjudicative process and not in the institutions of courts or the professional background of judges': at 224.

making, ie the legality of the decision-making, and not the merits of the decision.[117]

In Australia, the High Court (under s 75(v) of the *Constitution*) and the Federal Court (under s 39B(1) and (1A) *Judiciary Act)*[118] have broad powers of judicial review, but require an 'error of law'.[119] In *Plaintiff S157/2002 v Commonwealth* (2003),[120] in relation to matters 'in which a writ of mandamus or prohibition or an injunction is sought against an officer of the Commonwealth', Gleeson CJ affirmed that this provision 'secures a basic element of the rule of law':[121]

> The jurisdiction of the Court to require officers of the Commonwealth to act within the law cannot be taken away by Parliament. Within the limits of its legislative capacity, which are themselves set by the Constitution, Parliament may enact the law to which officers of the Commonwealth must conform. If the law imposes a duty, mandamus may issue to compel performance of that duty. If the law confers power or jurisdiction, prohibition may issue to prevent excess of power or jurisdiction. An injunction may issue to restrain unlawful behaviour. Parliament may create, and define, the duty, or the power, or the jurisdiction, and determine the content of the law to be obeyed. But it cannot deprive this Court of its constitutional jurisdiction to enforce the law so enacted.

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[117] See Robin Creyke, Matthew Groves, John McMillan and Mark Smyth, *Control of Government Action: Text, Cases and Commentary* (LexisNexis Butterworths, 5th ed, 2018), Chapter 16. Judicial review is about the validity or legality of a decision. See also Paul Hughes, Justin liver and Rachel Trindade, 'The Role of Courts and Tribunals in Providing Guidance to Regulators' (Conference Paper, ACCC Regulatory Conference, 24-25 July 2008), 4 and 5. The only considerations are 'whether the decision has been made for an improper purpose, whether the decision is one which no reasonable person would reach, whether there has been a denial of natural justice, or whether the decision maker has made an error of law or gone beyond power': at 5.

[118] *Judiciary Act 1903* (Cth).

[119] Garry Downes, 'Judicial Review' (Speech, Seminar for the College of Law Government & Administrative Law, 24 March 2011) <https://www.aat.gov.au/AAT/media/AAT/Files/Speeches%20and%20Papers/JudicialReviewMarch2011.pdf>.

[120] *Plaintiff S157/2002 v Commonwealth* (2003) 211 CLR 476.

[121] Ibid [5] (per Gleeson CJ). See Australian Law Reform Commission, (n 115) 418 and Chapter 15 Judicial Review.

There have been two cases involving judicial review of the actions of the RBA in Australia relating to the exercise of the RBA's powers in relation to payment systems. In the case of *Visa International Service Association v Reserve Bank of Australia (2003)*[122] (consolidated with a similar application by MasterCard), the Federal Court dismissed the application that credit cards did not fall within the ambit of payment systems and could not be designated as such by the RBA. Similarly, in *Australian Retailers Association v Reserve Bank of Australia (2005)*,[123] the Federal Court dismissed the application that the EFTPOS system could not be designated by the RBA under s 18 of the *Payment Systems (Regulation) Act 1998* (Cth) and that an access regime under s 12 could not be imposed. Both those cases recognise that judicial review of some actions of the RBA is possible.

However, judicial review is limited to essentially a process question. Tambarlin J in the Visa and Mastercard challenge to the powers of the RBA summarised the role and powers of the courts in relation to judicial review as follows:[124]

> On judicial review the Court does not reconsider the merits of the RBA decisions, but is confined to examining decisions sought to be challenged in order to determine whether the decision-maker complied with the required legal process for decision-making. That is to say that it is not for the Court to perform the function assigned to the RBA by the legislation. The Court on

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[122] *Visa International Service Association v Reserve Bank of Australia* (2003) 131 FCR 300. This case was consolidated with an application by MasterCard International Incorporated. The issue was described as follows by Tambarlin, J at [1]: 'Both applications are brought against the Reserve Bank of Australia ("RBA") to set aside five decisions of the Payment Systems Board ("the PSB") of the RBA made under the Payment Systems (Regulation) Act 1998 (Cth) ("the PSR Act"). The decisions are part of a regulatory regime imposed by the RBA on what are known as four-party credit card schemes in Australia. The schemes, the subject of the regulations, include issuers (which are financial institutions such as banks that issue credit cards and extend credit to their customers), cardholders (who are purchasers of goods and services from merchants and customers of the issuers), merchants (who accept credit cards and claim on issuers for payment and satisfaction for transactions between merchants and customers, for example, stores, utilities and airlines) and acquirers (financial institutions such as banks that "acquire" merchants' claims against issuers) which agree to pay the merchant under the credit card schemes'.

[123] *Australian Retailers Association v Reserve Bank of Australia* (2005) 148 FCR 446.

[124] *Visa International Service Association v Reserve Bank of Australia* (2003) 131 FCR 300, 8.

> review must not substitute its own conclusion for that of the decision-maker simply because it would have been minded to reach a different conclusion in circumstances where it was reasonably open to the decision-maker to reach that conclusion.

The Court confirmed that its focus 'is directed to the legality of the decision-making process taken by the RBA and that must be distinguished from a re-examination of the merits of the decisions made'.[125]

Further, the cases relating to the validity of a designation of a payment system under the relevant legislation were essentially about a question of the legal interpretation of an express power under the statute. Section 11(1) of the *Payment Systems Regulations Act (1998)* (Cth) expressly grants the RBA the power to designate a payment system, and what will constitute a payment system is defined under s 8. Similarly, what 'designation' entails is also described under the Act, for example in Divisions 2, 3 and 4, detailing access requirements and standards.[126]

Absent express financial stability powers in the RBA Act, the situation in relation to the RBA's financial stability functions will be different, and it is likely that judicial review will *not be possible*.

5 *A Fundamental Question: Is Judicial Review Restricted to Process, or is Policy Also Justiciable?*

What the judicial reviews in the different jurisdictions above appear to have in common is that the review was in relation to whether the central bank acted within its powers. That's ultimately a review of process – not policy: [127]

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[125] Ibid 10.

[126] *Payment Systems Regulations Act (1998)* (Cth), Divisions 2, 3 and 4.

[127] Goodhart and Lastra (n 10).

> Judicial review does not extend to the ‘content of the decision’ (the aim of the Court is not to supplant or replace the decision taken), but it does extend to the parameters and legal framework that surround such decision in order to determine whether or not the central bank mandate has been exceeded.[128]

The issue is whether the matter under review is one of procedural justice or redistributive justice:[129]

> … common law judiciaries avoid judicially reviewing Government functions with high-stakes macroeconomic consequences and tend to focus on issues of procedural justice or fairness rather than redistributive justice.

The international tendencies sketched above seem to be that although courts will mostly focus on process and legitimacy, it may be inevitable that matters of policy (political policy) may be presented for review. An exercise of public power is in principle justiciable,[130] although policymaking would not be. Just having a public power is not enough.[131]

What is ‘justiciable’, is however not always clear, but the term generally signifies an issue that is appropriate or fit for judicial determination,[132] and would normally exclude political questions.[133] In the case of the RBA, its broad

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[128] These comments are made specifically in relation to the national central banks in the EU, but the same principles apply to the RBA. For example, it is unlikely that an Australian court will second-guess a discretionary decision in relation to the amount of LOLR assistance provided, but may review the authority to do so in the first place: See Goodhart and Lastra (n 10).

[129] Ibid.

[130] ‘If it is an exercise of public power, then, subject to satisfaction of the subject matter principle, the exercise of power is likely to be justiciable’: See Amanda Sapienza, ‘Justiciability of Non-Statutory Executive Action: A Message for Immigration Policy Makers’ (2015) 79 *Australian Institute of Administrative Law Forum* <http://www.aial.org.au/aial-forum-articles/justiciability-of-non-statutory-executive-action-a-message-for-immigration-policy-makers>.

[131] ‘Of course, the power being public power will not alone render an exercise of non-statutory executive power justiciable’: Sapienza (n 130) 78.

[132] Anthony Mason, ‘The High Court as Gatekeeper’ (2000) 24(3) *Melbourne University Law Review* 784, 788.

[133] Ibid.

financial stability responsibility is essentially about the making of policy, and may therefore not be justiciable: [134]

> Central bank discretion is the freedom to act within a legal framework. Judicial review does not extend to the 'content of the decision' (the aim of the Court is not to supplant or replace the decision taken), but it does extend to the parameters and legal framework that surround such decision in order to determine whether or not the central bank mandate has been exceeded.

Although the HCA has not considered matters in relation to policy decisions taken by the RBA, there are six possible instances when matters may not be justiciable:[135]

1. typically *policy matters* that are debated and made by governments are not justiciable,[136] because of their political nature;[137]

2. matters that are not justiciable are matters for which there is 'a *lack of judicially discoverable and manageable standards* for resolving it',[138] or

3. where there is an 'impossibility of deciding without an *initial policy determination* of a kind clearly for nonjudicial discretion', [139] or

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[134] See Lastra (n 65); See Sapienza (n 130) who describes the justiciability of an issue as follows: '[A] crucial question for its justiciability is whether the subject matter of the dispute is one that is resolvable by an application of judicial power. That is, can the dispute be resolved by courts declaring the law and applying legal criteria? Was the exercise of power attended by "standards capable of being assessed legally"? If the answer to these questions is "no", then the exercise of non-statutory public power will not be justiciable': at 78.

[135] Mason considers there to be seven instances. He lists the following: Express textual or implied commitment to a non-judicial agency, the absence of legal criteria and standards, the need for initial policy determination, a resolution that involves a lack of respect because of the involvement of other branches of government, an unusual need for an unquestioning adherence to a political decision already made, and the potential embarrassment because of multifarious pronouncements by various departments on the one question: See Mason (n 132) 789-94.

[136] Ibid 792.

[137] Ibid.

[138] Ibid.

[139] Ibid 792.

4. where it would be impossible for a court to undertake an independent resolution of the matter without 'expressing a lack of respect due' to *other branches of government*;[140] or

5. where there is an 'unusual need for [an] unquestioning adherence to a *political decision* already made';[141] or

6. where there is a possibility of 'embarrassment from *multifarious pronouncements* by various departments on one question'. [142]

Some actions of the RBA may be justiciable, others not. Generally, the courts cannot review policy or policy implementation. In addition, central banks use discretion in the performance of their monetary policy and also financial stability obligations. It is practically impossible for a central bank to follow mechanically an algebraic formula that describes the policy rule.[143] Therefore, some of the financial stability actions (and monetary policy decisions) of the RBA may be non-justiciable because it involves discretion, much like decisions on international relations or national security, which are typically non-justiciable.[144] Similarly, there is an absence of legal criteria and standards.[145] Perhaps the critical argument against judicial review of policy actions by the RBA would be the fact that doing so would involve a measure of disrespect for other branches of government.[146] Under the *RBA Act*, there is provision for the government to intervene in RBA policy, as noted above.

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[140] Ibid 789.

[141] Ibid 794.

[142] Ibid.

[143] See John B Taylor, 'Discretion Versus Policy Rules in Practice' (1993) 39 *Carnegie-Rochester Conference Series on Public Policy* 195.

[144] See Mason (n 135).

[145] Ibid.

[146] Ibid 793-4, Item E.

Another complication is that in the event that actions of the RBA were to be subject to judicial review, the court would have to take into consideration the principles, objectives and considerations in the statute which the RBA as regulator was required to consider.[147] In the case of the RBA, considerations include 'the stability of the currency of Australia, the maintenance of full employment in Australia and the economic prosperity and welfare of the people of Australia'.[148] How an act by the RBA that could be both in furtherance of prosperity and welfare in some respects, but contrary to prosperity and welfare in others, can be the subject of judicial review, is not clear. Although the decisions taken by the RBA in relation to payments systems issues may be similar to the issues in *Re Michael*,[149] issues in relation to monetary policy and financial stability may be different. The meaning of economic terms poses additional hurdles to justiciability.[150]

On the other hand, some actions of the RBA and even some policy issues may be justiciable.[151] The hurdle in relation to financial stability, though, is the absence of a clear financial stability mandate.

The reason why justiciability of aspects of the financial stability responsibility is important, is because of the important links between justiciability and the rule of law:[152]

> [J]usticiability is one of the moral principles that determine the ideal content of the rule of law.

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[147] Justin Gleeson, 'Administrative Law Meets the Regulatory Agencies' (2005) 46 *Australian Institute of Administrative Law Forum* 28, 32.

[148] *Reserve Bank Act 1959* (Cth) s 10(2).

[149] Gleeson (n 147) 32.

[150] Ibid 34.

[151] Mason (n 135) 792, Item D.

[152] Timothy Endicott, 'The Reason of the Law' (2003) 48(1) *American Journal of Jurisprudence* 83, 97.

If the actions of the RBA are not justiciable, it means that the role of an agent of the Australian government, which in this instance is also a non-democratically elected agency, is not subject to the normal controls. If there is to be a lack of judicial control, compensation should be made in some manner, and it has been suggested that increased accountability by the RBA may be required.[153] However, where actions of the RBA may be justiciable and subject to judicial review, the courts may exercise restraint if the RBA has a robust system of parliamentary or other accountability. [154]

6 *A Final Brief Cautionary Note*

On a cautionary note, restraint should be exercised. One of the potential issues with judicial review of the acts of a central bank, is '[t]he risk of "supplanting the Bank"' which 'justifies the "degree of caution" that should characterize the intensity of judicial review'.[155] It has been noted that '[j]udges should not overstep the limits of their competences in order to enforce the limits of other actors' competences'.[156] These decisions should only be made by judges with the necessary experience and technical expertise,[157] and understanding of regulatory policy.[158]

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[153] Goodhart and Lastra (n 10).

[154] Ibid. Goodhart and Lastra are of the view that 'judicial restraint is justifiable in the presence of other strong mechanisms of accountability, notably parliamentary scrutiny'.

[155] See Lastra (n 65).

[156] Ibid.

[157] Ibid. Lastra notes: 'However, the deference to the ECB's 'broad discretion' on the basis of the latter's experience and technical expertise strengthens the case for expertise and adequate preparation of the judges that will assess those complex issues. This happens in other areas of economic regulation. Judicial activism has become the norm in the field of EU competition policy'.

[158] Ibid: 'Given the specificity and complexity of monetary policy and other central banking functions (and the added difficulty in the EU context of determining whether a measure is of monetary policy – an exclusive competence of the Union – or economic policy) and considering that only the CJEU can judge the ECB (Article 35 ESCB Statute), the need for competence and expertise in the exercise of judicial review could be served by the establishment of a specialised chamber within the CJEU to deal with these issues. Having dedicated specialised judges with expertise in financial and monetary matters when adjudicating cases related to the ECB would enhance the legal framework of ECB accountability in light of the significantly expanded

In conclusion, the role of judicial review in Australia on the actions of the RBA in relation to financial stability will likely be limited, due in large measure to the lack of clarity in both what the RBA is required to do and empowered to do. It is both hampered by a lack of a statutory mandate for financial stability, and also a motivation for the inclusion of a statutory mandate for financial stability. This point will be returned to later.

D *Deficiencies in Accountability Mechanisms: Regulatory Impact*

The aforementioned gaps in the regulatory framework are caused by an imbalance between hard law and soft law elements in the regulatory framework: there is a preponderance of soft law regulatory mechanisms and insufficient hard law regulatory mechanisms in the regulatory framework of the RBA including in governance and accountability.

The governance and accountability of the RBA for its financial stability mandate is limited or negatively affected in a number of ways.

1 *Absence of Statutory (Hard Law) Controls*

The deficiencies in accountability mechanisms in regulating the conduct of the RBA in financial stability arise from a number of areas. Firstly, there is limited to no statutory compulsion on the RBA to take any actions directly in relation to financial stability generally, no statutory requirement to publish any communications/reports on financial stability, and no compulsion to report on financial stability, except to the extent that the Governor has given such an undertaking captured in soft law in the Statement on the Conduct of Monetary

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mandate of the ECB'. Lastra further notes: 'The need for specific expertise when it comes to the adjudication of complex financial and monetary matters is a relevant issue not only for the CJEU but also, for example, for the UK Supreme Court. If judicial restraint in monetary matters is advocated on the basis of [limited] technical expertise and qualifications of the judges adjudicating such matters, the counter-argument to not 'being equipped' is to actually equip judges'. See also Goodhart and Lastra (n 10).

Policy and it is customary for central banks to do so. This statement has low regulatory effectiveness as it has no permanence, and is amended and signed each time a new government comes into power. There is no compulsion on the RBA to agree to or sign the Statement on the Conduct of Monetary Policy. In any event, a failure by the RBA to comply with the obligations undertaken in the Statement has no clear consequences. There is however a possibility that the Governor's appointment could be terminated by the Treasurer.

2 *Government Involvement Reduces RBA Accountability*

Even if the RBA were to be found to be responsible/accountable/liable for an act or omission in relation to its financial stability role, the involvement of the Australian government reduces any possible accountability of the RBA. The RBA could rely on the involvement of the government (eg the Treasurer) to defend the RBA from any allegation that it has not fulfilled its mandate. Not only is the Australian government involved in the operations of the RBA through its role in the appointment of the key RBA officials and the RBA Board, but also through its role in the RBA's determination of policy, and its presence at the CFR. [159] Government's ultimate control over policy through statutory mechanisms that the government can exercise, could also be used to shield the RBA from accountability. Having such a shield from accountability may undermine the actual performance of the mandated responsibilities. There is a risk however that the RBA will suffer a loss of *prestige* and credibility, which as a regulatory mechanism may ultimately mitigate the deficiencies in the hard law mechanisms.

[159] See above; see also Chapters 4, 5 and 6.

3 *The Shared Nature of the Financial Stability Responsibility Reduces RBA Accountability*

The division of roles and responsibilities between the RBA, government and other regulators together with limited tools and instruments in the hands of the RBA to protect financial stability, dilute the RBA's responsibility for financial stability. The RBA's financial stability responsibility is shared with others, particularly APRA and the CFR.[160] APRA as the prudential regulator has control over most of the tools in the financial stability toolkit (with the exception of the LOLR function as the most important central bank tool). In some instances, therefore, the RBA would be unable to actively prevent instances of financial instability as it itself does not have the tools to do so. As a minimum, the RBA could blame the prudential regulator for financial instability. A loss of prestige and credibility may follow.

4 *Limited Legal Remedies Available against the RBA and its Officers Provide Poor Incentives for the Proper Conduct of Financial Stability Policy*

As private law remedies are unlikely to succeed against the RBA and its officers, the low prospects of legal action would likely not incentivise the RBA to fulfil its mandate in respect of financial stability. It is relatively unlikely that any private law remedies will be available to members of the public and the chances of a successful action against the RBA for losses suffered by members of the public as a result of the failure of the RBA to secure financial stability, are probably remote. The tort of misfeasance in office on the basis that the RBA misguided policy is not only hard to make out, but unlikely to be successful.[161] In addition, not all actions by the RBA are justiciable, and cannot

[160] See Chapters 4 and 5.

[161] See Mark Aronson, 'Misfeasance in Public Office: A Very Peculiar Tort' (2011) 35(1) *Melbourne University Law Review* 1, 51. Aronson notes that 'if misfeasance vindicates 'rights', they are rights in only the loosest sense of the term — the political right to be free of deliberate abuse of public power'. See also De Jager (n 78); See further Jim Davis, 'Misfeasance in Public Office, Exemplary Damages and Vicarious Liability' (2010) 64 *Australian Institute of*

form the basis of judicial review, as they fall in the category of policy decisions. Although a court can, for example, review the procedural aspects of designating a credit card payment network as a designated payment system, monetary policy decisions, and/or statements relating to the RBA's opinion on financial stability conditions are not judicially reviewable. Legal action instituted against the RBA could however damage the institution's *prestige* and credibility.

5 *Sanctions are Less Effective than the Search for Prestige*

The Australian government may override some decisions of the RBA, although in the context of financial stability it is hard to image which type of decision would come into question. That is because some key financial stability tools are in the hands of APRA. Similarly, the sanction of removal from office of the Governor and/or Deputy Governor has limited use except through deterrence for future Governors and Deputy Governors. That makes the form of control over the actions of the RBA ultimately *personal*. The sanction of removal from office of the Governor and/or Deputy Governor by the Treasurer is very *personal* and would also negatively affect the *prestige* in which the Governor and/or Deputy Governor is held.

The accountability measures imposed through the parliamentary report presented by the Governor also ultimately has a *personal* impact. There is the possibility that Parliament as a public forum may serve the purpose of publicly scrutinising and exposing acts and decisions of the RBA. This too is ultimately personal and the personal loss of *prestige* and respect through negative publicity would be a significant sanction for a person such as the Governor. The loss of reputation and credibility are therefore perhaps the most important consequences that can flow from the requirements that the RBA account for its actions – including actions in relation to financial stability – both internationally

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Administrative Law Forum 59. On the manner in which the law of torts could affect regulators, see also Giesen (n 73).

and nationally, and therefore perhaps the strongest ultimate drivers of RBA actions.

The overall architectural design dominated by soft law regulatory mechanisms then results in the situation where the combined effect of behavioural factors – personality and prestige in particular – may have the highest regulatory significance. This architectural design does not adequately support legitimacy and credibility of the regulator as well as democratic and rule of law principles.

Further, it should also be noted that these consequences of accountability for deficient policies or policy implementation are however hardly remedial in nature, and in the big scheme of things, have limited punitive and corrective effect to the institution of the RBA as a whole, even though the relevant individuals may be severely affected.

IV Conclusion

This chapter has set out the existing governance and accountability arrangements of the RBA, the vast extent of ‘controls’ and ‘influences’ on the activities of the RBA along the continuum of governance, transparency, and accountability (see also Appendix 3), and how these ‘controls’ and ‘influences’ may still leave the RBA open to behavioural factors as key sources of control. It concluded that the paucity of hard law mechanisms for the regulation of financial stability leaves certain gaps in the RBA’s governance and accountability frameworks and allows for a disproportionate role in the control and influence of the RBA by behavioural factors.

Despite the large number of internal and external controls and influences on the RBA, its responsibility for financial stability is not strongly controlled. The existing forces of control, including governance (as discussed in Chapter 6) and accountability (discussed in this chapter), are extensive, but in view of the fundamental lacunae in the financial stability regulatory framework, the control of the RBA’s role in financial stability regulation is unsatisfactory, and soft law is predominant. This situation is the consequence of the informal and shared/decentralised nature of the RBA’s financial stability responsibility. It is further the consequence of the difficulties in defining the concept of financial stability, and the complexities that arise when a monetary authority is made responsible for financial stability.

When asked what ultimately drives or controls what the RBA does in relation to financial stability, the answers may be: ‘because that’s what the Governor has directed’ and/or because ‘that will best increase the RBA’s prestige nationally and internationally’. Behavioural factors may dominate, reflecting an architectural design that does not best support the principles of legality, democracy and the rule of law.

CHAPTER 8

Considerations for Redesigning the Regulatory Framework of the RBA's Financial Stability Responsibility

Fuzziness of the regulatory framework in place invites gaming, shirking, and blaming — the characteristic deficiencies associated with overly complex but underspecified regulatory regimes.[1]

I. Introduction

This chapter considers the need and justification for changes to the regulatory framework of the RBA as financial stability regulator. It builds on the analysis in the preceding chapters, which have demonstrated that firstly, the existing regulatory framework of the RBA's financial stability mandate has an informal, shared and decentralised nature. The complexities of a financial stability role are also exacerbated by potential tensions with other central bank responsibilities and the inherent ambiguities of the concept financial stability itself. Secondly, despite the fact that the RBA is subject to a large number of governance and accountability controls and drivers, there are gaps and inefficiencies in the controls over the RBA that allow a disproportionate role for behavioural factors in the governance and accountability framework. Thirdly, there is a preponderance of soft law mechanisms on which the RBA's financial stability responsibility is based, giving rise to concerns about governance and accountability. This chapter considers solutions to these identified problems; Chapter 9 makes concrete recommendations.

[1] Helmut K Anheier, 'Lessons from the Global Financial Crisis', *Australian Outlook*, (Analysis, 26 September 2018) <https://www.internationalaffairs.org.au/australianoutlook/governance-and-global-crises/>.

In this chapter, Part II makes the case for change to the RBA's regulatory framework. Part II A considers practical reasons for change, including difficulties that can arise if the RBA as regulator is scrutinised in its execution of the financial stability role. The potential external threats to financial stability further contribute to the need to improve the RBA's financial stability regulatory framework. In Part II B, theoretical imperatives for change are examined. These include general principles of legitimacy, the rule of law, principles of democracy, and legislating as a government obligation to act in the public interest. Part II C acknowledges the limits of law in regulation.

In order to redesign aspects of the RBA's regulatory framework for financial stability, Part III provides an overview of international best practice in the regulatory framework for financial stability in the G20 countries. Part IV provides a different regulatory lens through which to consider the redesign of the regulatory framework of the RBA, namely Paul Tucker's design precepts for central banks as independent and unelected powers. The RBA's regulatory framework is compared both to best international practice and Tucker's precepts. Part V introduces the concept of the 'fourth branch of government' as a potential method to regulate the regulator. It highlights recent recommendations in that vein by the Murray Inquiry and Hayne Commission, and evaluates the usefulness of the 'fourth branch' as a 'regulator of regulators' for the RBA's financial stability function.

This chapter and the following chapter will conclude that parliamentary action is needed in order to improve the governance and accountability issues that arise as a consequence of the gaps in the RBA's regulatory framework for financial stability. While this chapter considers the rationale behind these recommendations and considers emerging international best practice and legal and philosophical issues, Chapter 9 will provide concrete recommendations for the way forward.

II. The Case for Changing the RBA's Regulatory Framework

As will be discussed further in Chapter 9, legislative change is required to improve the financial stability regulatory framework of the RBA. The reasons are set out below.

A *Practical imperatives*

1 *Justification of Policy Actions*

The current political and social climate is characterised by an increased emphasis on transparency and scrutiny. In the banking sector in Australia, the level of scrutiny of regulators dramatically increased with the Murray Inquiry and the Hayne Commission.[2] Although it was not the target of either of those inquiries, the RBA may also be subjected to scrutiny. This is not to suggest that the RBA has in any way acted in any improper way or has in any way not performed its obligations in an exemplary manner. However, if Australia were to suffer an instance of financial instability, and a commission of inquiry were to investigate the role of the regulators, the RBA will be required to publicly defend its actions. The benefit of hard law in such a scenario is that it provides a neutral and clear base from which to judge the acts of a regulator.[3] The recommendations for improvements to the regulatory framework of the RBA for financial stability as set out in Chapter 9 will assist the RBA by creating clarity and stability.

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[2] Contemporary society is demonstrating a heightened need for disclosure, transparency and scrutiny, from the demand for transparency about the origin of ingredients and employment practices in manufacturing, to scrutiny and accountability in movements such as #metoo, and of government and regulatory action.

[3] See Gregory C Shaffer and Mark A Pollack, 'Hard vs. Soft Law: Alternatives, Complements, and Antagonists in International Governance' (2010) 94(3) *Minnesota Law Review* 706. Although soft law has many benefits in international governance, national systems depend more on hard law.

Whenever a regulator is challenged, government is also open to critique. In particular, the electorate may judge whether government has adequately and appropriately provided for the regulation of threats to the Australian economy and people. The current legal framework, which includes gaps, may also leave the Australian government open to criticism. The recommendations in Chapter 9 will also assist in this regard.

2 *Responsiveness to External Threats to Financial Stability*

The need to ensure that the regulatory framework for financial stability is optimal is also important because of future threats to financial stability. Even before the GFC the importance of the role of law in the economy was acknowledged;[4] it is even more important now. It is commonly accepted that episodes of financial stability are inevitable even though the exact nature, timing and extent cannot be predicted with certainty. Although it is beyond the scope of this thesis to create a full list of potential threats to financial stability in Australia, the list below is reflective of significant and reasonably likely threats that may impact Australia's financial stability and justify revisiting the current regulatory framework.

The following future threats to financial stability can be identified:[5]

1. *Technological developments* creating regulatory challenges (including fintech, cryptocurrencies, big data, artificial intelligence);[6]

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[4] Douglas W Arner, Financial Stability, Economic Growth, and the Role of Law (Cambridge, 2007) 1. Law is important for financial stability, financial market development, and ultimately economic growth: at 2.

[5] See Agustín Carstens, 'The Nature of Evolving Risks to Financial Stability' (Speech, SEACEN Governors' Conference/High-level Seminar and Meeting of the SEACEN Board of Governors, 15 December 2017) <https://www.bis.org/speeches/sp180214.htm>.

[6] See Jason Healey, Patricia Mosser, Katheryn Rosen and Adriana Tache, *The Future of Financial Stability and Cyber Risk* (Research Paper, Brookings Institution, October 2018) <https://www.brookings.edu/research/the-future-of-financial-stability-and-cyber-risk/>.

2. *Market and/or economic changes* in the banking and financial sectors (including open banking, democratization, credit growth, institutional failures); and

3. *Political challenges* that impact geopolitics as well as national economies and financial systems (including trade wars, protectionism, war, political uncertainty through geopolitical shifts, changes to regional and customs unions, migration, political and religious radicalism, climate change, and populism. For example, the particular brand of populism in the Trump era has brought about many changes to the status quo and poses threats to international stability, including financial stability).[7]

In light of such potential threats, the regulatory framework of the RBA's financial stability responsibility should be improved on a proactive basis to ensure that the result of any scrutiny of the government's regulatory design and the RBA's execution of its mandate is positive. Any deficiencies identified will reflect negatively on both the Australian government and the RBA, and the reputational damage can have serious and long-term repercussions for Australia. Inertia and inactivity in this area is not defensible as there are real and potential consequences to not implementing the changes recommended in this thesis.

[7] President Trump has at times hoped to influence monetary policy, and expected some help from the Federal Reserve: See Kevin Carmichael, 'In the Age of Trump, Central Banks Are Only One Populist Uprising Away from Losing Cherished Independence', *Financial Post* (online, 22 August 2018) <https://business.financialpost.com/news/economy/central-banks-wise-to-court-public-in-an-era-of-populism>; See John H Farrar and Louise Parsons, 'Financial Stability After the Global Financial Crisis: 'Financial Stability After the Global Financial Crisis: Globalisation, Nationalism and the Potential Demise of a Rules-Based Order' in John H Farrar, Bee Chen Goh and Vai Io Lo (eds), 'Scholarship, Practice and Education in Comparative Law: A Festschrift in Honour of Mary Hiscock' (Springer, forthcoming); See also Richard Berner, 'Globalization and Financial Stability' (Speech, IMF Jacques Polak Annual Research Conference, 2 November 2017) <https://www.financialresearch.gov/public-appearances/files/Berner-Remarks_IMF-18th-Jacques-Polak_11-02-2017.pdf>.

3 *Justification of Practical and Operational Decisions by the Regulator*

The statutory objectives of a regulator also have practical importance for the day to day governance of the regulator. A regulator's practical decisions for example in relation to resource allocation or staffing will be informed by its statutory obligations. Spelling out the regulator's obligations will ensure that internal management of the regulator and its governance are enhanced.[8]

B *Theoretical imperatives*

Apart from practical considerations, regulatory frameworks also have to satisfy legal and theoretical considerations that attach to the very nature of law. Regulatory frameworks should not be judged purely pragmatically on their real-world deliverables. A regulatory framework forms part of the broader fabric of law in a society and should fit into and reflect the underlying principles of that legal system.[9] That also applies to the financial stability framework of the RBA. The theoretical concerns that underpin the proposed recommendations for changes to the regulatory framework include the legitimacy of the RBA and the regulatory framework, the importance of the law and the rule of law, and the use of legislation to secure public policy objectives. These are discussed below.

1 *Regulator and Regulatory Legitimacy in a Democracy*

The legitimacy of the RBA as a regulator is important, and a lack of legitimacy will have negative consequences for the RBA as a central bank.[10] If something is

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[8] As noted earlier, formal mandates can affect the practical operation on the RBA for example decisions about resource allocation. See Chapter 4.

[9] The principles of the rule of law also include legal cohesion. See Chief Justice Allsop, 'The Rule of Law is not a Law of Rules' (Speech, Annual Quayside Oration, 1 November 2018).

[10] Legitimacy is at heart a normative question: 'When should an actor or a constellation of actors be regarded as legitimate?': Julia Black, 'Constructing and Contesting Legitimacy and Accountability in Polycentric Regulatory Regimes' (2008) 2(2) Regulation & Governance 137,

not legitimate, it is arbitrary.[11] To be effective as a regulator, the RBA cannot be seen to be arbitrary or act in an arbitrary manner. Although central banks derive legitimacy from their expertise,[12] a good legal framework also matters for regulatory and institutional legitimacy.[13] Credibility and legitimacy of the regulator is also linked to whether or not a regulator acts ultra vires – such actions would at common law be void.[14]

Both formal and societal legitimacy are important for a central bank:[15]

> There is 'formal' legitimacy (in a democracy the creation of an independent central bank must be the fruit of a democratic act: statute, constitutional decision or treaty provision) and there is also 'societal' legitimacy, determined by the public acceptance of or loyalty to the system... When societal legitimacy weakens or is no longer present a change in the law is bound to happen.

The legitimacy of the decisions of agents such as the RBA acting for the Australian government will be increased if the roles of the agents have been formalised through a democratic process in Parliament. The real value of

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144. She notes: 'In a governance or regulatory context, a statement that a regulator is "legitimate" means that it is perceived as having a right to govern both by those it seeks to govern and those on behalf of whom it purports to govern': ibid.

[11] See Chief Justice Murray Gleeson, 'Courts and the Rule of Law', (Speech, Rule of Law Series, 7 November 2001) <http://www.hcourt.gov.au/assets/publications/speeches/former-justices/gleesoncj/cj_ruleoflaw.htm>.

[12] Central banks fall into the category of regulatory agencies that get their legitimacy from being insulated from day-to-day politics and technical experts: See Martino Maggetti, 'Legitimacy and Accountability of Independent Regulatory Agencies: A Critical Review', *Living Reviews in Democracy Center for Comparative and International Studies* (Article), 2010 <http://www.cis.ethz.ch/content/dam/ethz/special-interest/gess/cis/cis-dam/CIS_DAM_2015/WorkingPapers/Living_Reviews_Democracy/Maggetti.pdf>.

[13] 'Legitimacy pre-exists and is a requisite of accountability': Charles Goodhart and Rosa Maria Lastra, *Central Bank Accountability and Judicial Review* (Policy Note No 32, May 2018) 1 <https://www.suerf.org/policynotes/2585/central-bank-accountability-and-judicial-review/html>.

[14] See Frank Decker and Sheelagh McCracken, 'Central Banking in Australia and New Zealand: Historical Foundations and Modern Legislative Frameworks' in Peter Conti-Brown and Rosa María Lastra (eds), *Research Handbook on Central Banking* (Edward Elgar, 2018) 245, 266.

[15] Rosa María Lastra, 'Accountability in the Context of EMU & EBU: Judicial Review of the ECB by the CJEU' (EBI Brexit Seminar, Brussels, 10 January 2018).

legislation (hard law) lies not just in its certainty and durability, but also in the fact that it is the fruit of a democratic process.

2 *The Inherent Importance of the Content of the Law (What the Law Says and Does Not Say, Matters)*

As Australia has not recently experienced a period of significant financial instability under its existing regulatory framework for financial stability, it may be argued that the regulatory framework does not have to be changed. Change may seem unnecessary if there are no financial stability problems in Australia.[16] As the regulatory framework per se does not ensure financial stability, changes may seem redundant.

These arguments should however be rejected. The regulatory framework for financial stability has clear deficiencies (see Chapters 4–7), and the Australian government may be criticised if it does not implement effective proactive legislative measures in the interest of Australia's economic future as proposed in this thesis.

The inherent importance of the law in the regulation of public regulatory agencies should also be fully recognised. Firstly, law is an enduring way of organising society[17] – including organising regulatory agencies. Law creates stability and order in social life. Law is also the 'go-to tool' for governments in situations where a remedy is sought, or some forceful measure of protection is required.[18] In that way, law matters. Law has been used as a system of enforcement to back up a

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[16] One could argue that it is a question of 'if it ain't broke, don't fix it'.

[17] See Joe Harman, The Rule of Law: Law as an Instrument of Justice and a Tool of Oppression (Speech, Legal Studies Teachers Conference, 15 March 2014) <http://www.federalcircuitcourt.gov.au/wps/wcm/connect/0145d20f-1cfa-40ed-bd95-e0c0ea156822/Speech-Harman-The-Rule-of-Law-2014.pdf?MOD=AJPERES&CONVERT_TO=url&CACHEID=ROOTWORKSPACE-0145d20f-1cfa-40ed-bd95-e0c0ea156822-lhVCCbF>.

[18] A typical governmental response to a crisis is often legislation, whether it is for example gun control after a mass shooting, public protection because of needles in strawberries, or the prohibition of naked shorting of securities in crisis times.

market system,[19] and as a formal framework of norms that support societal structures that may have evolved over time.[20]

In light of potential future threats and challenges that Australia and the RBA as financial stability regulator may face, a strong regulatory framework will be beneficial. Regulatory disasters in the past have highlighted some of the problems that can arise and that should be guarded against.[21] The design of a regulatory regime matters. For example, poor regulation can lead to disasters.[22] Some of the problems in a regulatory regime that could have negative consequences include: fragmentation in the legal framework,[23] deficient mandates and powers,[24] ineffective organisational dynamics,[25] complexity,[26] informality,[27] and 'weakness, ambiguities and contradictions in the regulatory strategies'.[28] These are all evident in the current financial stability framework of the RBA. The use of more 'hard law' legal tools in the regulatory framework for

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[19] The phrase 'law matters' is not used here in the sense of the so-called 'law matters' thesis used in corporate governance studies. There it refers to 'the quality of investor protection in different jurisdictions. [The authors of this theory] conclude that, in part through a difference in the degree of investor protection, legal origin influences ownership structures': John H Farrar and Pamela Hanrahan, *Corporate Governance* (Lexis Nexis, 1st ed, 2017) 31.

[20] See Jack Knight, 'The Bases of Cooperation: Social Norms and the Rule of Law' (1998) 154(4) *Journal of Institutional and Theoretical Economics (JITE) / Zeitschrift Für Die Gesamte Staatswissenschaft* 754. Law (and institutions), when viewed in an interdisciplinary context do make a difference at the end of the day: Joseph J Norton, 'The Fall of '71 and the Old Quad: A Personal Tribute to Professor John H Jackson' (2016) 19(2) *Journal of International Economic Law*, 407, 410.

[21] See Julia Black, 'Learning from Regulatory Disasters' (Sir Frank Holmes Memorial Lecture) (2014) 10(3) *Policy Quarterly* 3.

[22] Ibid.

[23] Ibid 6.

[24] Ibid.

[25] Ibid 4.

[26] Ibid 8.

[27] Ibid 6: 'In the case of Deepwater Horizon, the overlapping jurisdictions of the MMS and the United States Coastguard led to a requirement to continually renegotiate *informal inter-agency agreements* over an extended period and in effect expand the MMS's jurisdiction, contributing to its under-resourcing' (emphasis added).

[28] Ibid.

financial stability in Australia will realign the balance between hard law and soft law tools in the regulation of the RBA's responsibility for financial stability.[29] Hard law tools of regulation ultimately promote democratic principles.

3 *The Inherent Importance of Law and the Rule of Law*

The regulatory framework of the RBA for financial stability, including the measures for governance and accountability, should satisfy the requirements of the rule of law principles that underpin the Australian legal system. According to Dicey's characterisation of the 'rule of law', it entails firstly an 'absence of an arbitrary or discretionary power on the part of government'.[30] Secondly, under the rule of law, every person is 'subject to the ordinary law of the land administered by ordinary and usual tribunals'.[31] Thirdly, 'the general principles of law, the common law rules of the constitution, in contradistinction to the civil law countries of Europe, are the consequences of rights of the subject, not their source'.[32] The rule of law also provides an 'essential framework for economic activity'.[33]

Avoiding an 'arbitrary and unreasonable exercise of discretionary authority'[34] is important, and part of the rationale behind the judicial review of government administrative actions.[35] It is 'an important element of the rule of law'.[36] The

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[29] Legal tools can and should be used to organise society: See Simon Deakin, Katharina Pistor and Michael I. Sovern (eds), *Legal Origin Theory* (Edward Elgar, 2012).

[30] A V Dicey, *Introduction to the Study of the Law of the Constitution* (Liberty Fund, 1982) Foreword, xx.

[31] Ibid.

[32] Ibid.

[33] Douglas W Arner, *Financial Stability, Economic Growth, and the Role of Law* (Cambridge, 2007) 124. It has been suggested that the best way to develop a state that maximises the market is to create a state that implements and supports the rule of law: ibid.

[34] Goodhart and Lastra (n 13) 1. A solid legal framework also protects against populism: See Francis Fukuyama, 'Opinion: How to Tame the Populists', *Financial Review* (online, 6 February 2018) <https://www.afr.com/news/economy/how-to-tame-the-populists-20180129-h0ppg2>.

[35] Goodhart and Lastra (n 13) 1.

[36] Ibid.

enabling legislation and legal framework of the RBA are therefore important. In other jurisdictions where actions were commenced against central banks, the legal mandates and general legal frameworks of the central banks were particularly relevant and were scrutinised (see the examples in Chapter 7). That approach reflects a general 'rule of law' approach. For example, the High Court in the UK in *Fingleton v Central Bank of Ireland & Ors,* considered the statutory powers of the Bank of Ireland and confirmed that it did indeed have the power to 'commence an inquiry into suspected breaches of regulatory obligations by regulated entities'.[37] The relevant legislation was the starting point. Currently a court would not be able to pinpoint the financial stability mandate of the RBA, and even if an implied or de facto mandate is held to exist legally, its scope and content are unclear.

The law (particularly hard law) is also important in a democracy. Goodhart and Lastra are of the view that[38]

> whether central banks have abrogated to themselves powers which are not in the mandate, and the legal interpretation of whether a central bank is abiding by the mandate or exceeding its powers, are fundamental issues in a democratic system.

'Hard law' or parliament-made law reflects democratic principles. Central banks as government agencies (but unelected powers) should not be able to allocate to themselves powers and roles that have not been assigned to them through the democratic parliamentary process.

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[37] See *Fingleton v The Central Bank of Ireland* [2016] IEHC 1 (Ireland) and *Purcell v Central Bank of Ireland & Ors* [2016] IEHC 514 (29 July 2016); See also Dario Dagostino and Brendan Hayes, 'Court Affirms Central Bank's Powers to Conduct Inquiries', *A&L Goodbody* (Web Page, 13 September 2016) <https://www.algoodbody.com/insights-publications/court-affirms-central-banks-powers-to-conduct-inquiries>.

[38] Goodhart and Lastra (n 13).

In addition, law has always been an important component of economics and the market:[39]

> Markets are crucially underpinned both by a legal system (property law, contract law, bankruptcy law, and so on) and by a monetary system. If either of these key elements of market infrastructure were missing it is hard to see how mankind could have ever progressed far beyond barter (the simultaneous exchange of goods of roughly equal perceived value). Indeed, without a rule of law, the physically weaker of the two parties might even fear that, after an agreed barter exchange, the stronger party might try to seize back the good previously handed over.

4 *The Act of Legislating as a Means for Government to Meet Public Expectations*

The Australian public expects Parliament (and government) to act in its best interest. A failure to do so will likely result in a change of government through democratic means.[40] Parliament can legislate as a way of communicating to the electorate that Parliament is 'listening' to the Australian people and acting for the benefit of the Australian public. Conversely, a failure to legislate, or to properly legislate, will lead to criticism by the Australian electorate. Legislating is a political statement, and a means to address societal problems.[41] By improving the regulatory framework of the RBA for financial stability, Parliament will give effect to the interests of the Australian people and will demonstrate that financial stability is in fact a high priority. Even though the RBA has implied and de facto financial stability roles, these should be clarified, in accordance with the OECD's

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[39] Charles Goodhart and Ellen Meade, 'Central Banks and Supreme Courts' (Special Paper No 153, London School of Economics, September 2003) <http://www.lse.ac.uk/fmg/assets/documents/papers/special-papers/SP153.pdf>.

[40] Less attractive alternatives are demonstrations, strikes, social unrest, and even social uprisings.

[41] The 'mischief' model is still to some extent used in statutory interpretation.

guidelines for regulator governance. These specifically emphasised the need for role clarity for the benefit of the citizens.[42]

C *Limits of the Law*

Hard law sources are not the only sources of the role and functions of the RBA. Not all central banks have a comprehensive underlying legal structure. For example, the Federal Reserve also does not have a comprehensive legal structure underpinning all aspects of its operations. It has been pointed out that the *Federal Reserve Act*[43] does not actually say what people think it says, and that the powers that people seem to think derive from that Act, do not in fact derive from that Act,[44] but are the consequences of history and practice.[45] Conti-Brown notes that '[t]he assumption that law is the exclusive source of Fed independence is wrong. But the opposite assumption, that law is irrelevant, is also incorrect'.[46] Conti-Brown concludes that it's not about the law as written, but the law as applied in practice.[47] He correctly points out that it is not possible or desirable to put everything into hard law. The absence of hard law does not necessarily equate to a less effective regulator. Black also points out that legal validity is not necessarily always a relevant or productive way of identifying the

[42] The principles of best practice adopted by the OECD for the regulation of regulators are: (1) Role clarity; (2) Preventing undue influence and maintaining trust; (3) Decision-making and governing body structure for independent regulators; (4) Accountability and transparency; (5) Engagement; (6) Funding; and (7) Performance evaluation: Organisation for Economic Co-operation and Development, *Principles for the Governance of Regulators* (Public Consultation Draft, 21 June 2013) 7.

[43] *Federal Reserve Act of 1913*, 12 USC.

[44] Peter Conti-Brown, 'The Institutions of Federal Reserve Independence' (2015) 32(2) *Yale Journal on Regulation* 257, 260.

[45] Ibid.

[46] Ibid, 308. Conti-Brown continues: 'The Federal Reserve Act matters, …. But the institutions of Federal Reserve independence also include the role of personalities, including the relationship between the Fed Chair and the President. And the institutions include changes in historical practice, …'.

[47] In essence, it's about the practice of law, or the law as 'lived'.

legitimacy of governance regimes.[48] The RBA's regulatory framework also reflects the reality that hard law is only part of its foundation, and that its roles have evolved partly through a political process of passing legislation, and partly through a process of history and practice in society.[49] The regulatory framework of the RBA consists partly of hard law, but also many soft law sources (as set out above in Chapters 4 – 7).

This thesis has demonstrated that the imbalance between hard law and soft law (and non-legal) sources in the regulatory framework of the RBA for financial stability, leads to the conclusion that the RBA's framework does not support governance and accountability as well as it could and should. A legislated framework that provides for the main aspects of the financial stability mandate will provide important legal anchor points that are not subject to discretion, and less affected by interpretation and other influences such as the behavioural factors discussed above.[50]

Stability and resistance to change – some of the key advantages of hard law in particular – are nevertheless potentially also some key disadvantages in the area of financial stability, where there are significant knowledge gaps and where the economic modelling of financial stability is still relatively young. Economic theory may not have progressed far enough for the creation of meaningful statutory mandates for financial stability.[51] Extra-statutory methods of regulation therefore

[48] Julia Black, 'Constructing and Contesting Legitimacy and Accountability in Polycentric Regulatory Regimes' (2008) 2(2) *Regulation & Governance* 137, 144-5. 'Legitimacy thus lies as much in the values, interests, expectations, and cognitive frames of those who are perceiving or accepting the regime as they do in the regime itself': at 145.

[49] In this regard, although not in relation to the RBA, see Kutsal Yesilkagit and Jørgen G. Christensen, 'Institutional Design and Formal Autonomy: Political versus Historical and Cultural Explanations' (2010) 20(1) *Journal of Public Administration Research and Theory* 53.

[50] See Chapters 6 and 7. 'The argument is not that law is irrelevant, that all is politics. It is that law is incomplete': Conti-Brown, (n 44) 308-9.

[51] The modelling of financial stability is still evolving: See F Caccioli, P Barucca and T Kobayashi, 'Network Models of Financial Systemic Risk: A Review' (2018) 1(1) *Journal of Computational Social Science* 81.

have their advantages especially in light of new knowledge.[52] Also, extra-statutory devices have the advantage that they can, if necessary, be changed, without the onerous and long parliamentary processes. They are ultimately more flexible mechanisms.

One of the fundamental limitations of creating a hard law framework for financial stability lies in the elusive nature of the concept of financial stability. Even if a statutory explicit mandate for financial stability were to be included in the enabling legislation of the RBA, it would still be limited by the uncertainties and elusive nature of the concept of financial stability itself.

The benefits and needs of improvements to the regulatory framework of the RBA however outweigh the negative consequences. The balance of this chapter will now discuss considerations for adjustments to the RBA's regulatory framework. International perspectives and best practice will first be discussed, followed by Tucker's design precepts and the possibility of control by the 'fourth branch' of government.

III. International Perspectives: Best Practice in the G20 Countries[53]

This part examines international perspectives on a national regulatory framework for financial stability regulators and determines an emerging best practice. It does so by extracting the relevant views and recommendations of significant international bodies and international experts, and actual practice in the G20 countries. This blueprint of best practice in financial stability regulation provides guidance as to a way forward for the Australian regulatory framework, which is

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[52] Bank for International Settlements, *Central Bank Governance and Financial Stability* (Report, May 2011) 30 <http://www.bis.org/publ/othp14.pdf> ('Ingves Report'). It is possible to explicitly refer to extra-statutory devices in legislation, such as the inflation-target arrangements in New Zealand and the UK.

[53] This part draws extensively on work published during this PhD candidacy, namely Louise Parsons, 'Domestic Regulatory Architecture for the Protection of Financial Stability after the GFC: Global Order or Disorder', in Leon Wolff and Danielle Ireland-Piper (eds), *Global Governance and Regulation: Order and Disorder in the 21st Century* (Routledge, 2018) 147.

not in line with emerging international best practice. These also reflect the post-GFC lessons for the regulation of financial stability discussed in Chapter 3.

International practices and perspectives are important because despite national differences, central banks (and other financial stability regulators) share many characteristics. Further, commensurable practices internationally are important[54] because of the interconnectedness of global finance.[55] For example, the FSB conducts country peer reviews and thematic reviews of its members with a view to international commensurability. The key sources of benchmarks for international best practice are the G20, IMF, FSB, BIS, and OECD. These are supplemented by the work of international experts such as Charles Goodhart, Rosa María Lastra and David Mayes.

In order to gauge what constitutes emerging best practice, the practices of the G20 countries were considered. They are Argentina, Australia, Brazil, Canada, China, France, Germany, India, Indonesia, Italy, Japan, Republic of Korea, Mexico, Russia, Saudi Arabia, South Africa, Turkey, the United Kingdom, the United States and the European Union. For purposes of this study the EU was excluded as its central banking structure is not a good comparator for a national central bank, and Spain has been included in the analysis, because although not officially a G20 member, it attends all meetings.

Five relevant key characteristics of best practice in regulatory regime have been identified. These are:

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[54] This investigation and analysis incorporated some of the comparative law methodology set out in Chapter 1.

[55] Luis Garicano and Rosa M Lastra, Towards a New Architecture for Financial Stability: Seven Principles' (2010) 13(3) *Journal of International Economic Law* 597 598-9. They point out that most advanced economies suffered in the GFC despite their regulatory architecture: 'While to some extent that may mean that the architecture does not matter, since it was not a cause of the crisis, we do believe, however, that the *institutional design is important* for the resolution of the crisis and for the establishment of a more effective framework of supervision, systemic risk control and crisis management' (emphasis added).

1. The regulatory architecture demonstrates a clear focus on financial stability at a high level;

2. At the highest level, a single regulator is responsible for financial stability;

3. The central bank plays a central role in financial stability;

4. The responsible regulator has been provided with a clear statutory/ legislated mandate for financial stability; and

5. The regulatory framework includes a focus on macroprudential regulation and supervision.

The regulatory framework of the RBA will be compared to these characteristics. The five characteristics will now be discussed individually.

A *The Regulatory Architecture Demonstrates a Clear Focus on Financial Stability at a High Level*[56]

An important lesson after the GFC was that a more dedicated focus on financial stability per se was required, and that there needed to be a broader responsibility for and oversight of financial stability at domestic and international level.[57] This was confirmed in the G20's 2010 Seoul Summit, echoing the earlier views of the IMF.[58] After the GFC, 'achieving and preserving financial stability has now

[56] See Parsons (n 53).

[57] G20, *G20 Seoul Summit Leaders' Declaration 2010* (Seoul, 12 November 2010) <https://www.ilo.org/wcmsp5/groups/public/---dgreports/---dcomm/documents/statement/wcms_146479.pdf>; See also Parsons (n 53).

[58] International Monetary Fund, 'Lessons of the Financial Crisis for Future Regulation of Financial Institutions and Markets and for Liquidity Management' (Policy Paper, 4 February 2009) <https://www.imf.org/en/Publications/Policy-Papers/Issues/2016/12/31/Lessons-of-the-Financial-Crisis-for-Future-Regulation-of-Financial-Institutions-and-Markets-PP4316> ('Lessons of the Financial Crisis'); See also Parsons (n 53).

become a key policy objective in our societies'.[59] Financial stability is 'not only a national but an international public good'.[60]

The importance of financial stability as a public good should therefore be reflected in the importance given to and the actual design of the regulatory framework for financial stability in domestic jurisdictions.[61] The structure, role and administration of the government-mandated regulators and their institutional underpinnings are important.[62] A government should demonstrate the importance of financial stability, and should ensure that the importance of financial stability is also reflected in the regulatory framework designed by the government.[63]

There should be a clear identification of the regulatory authority that is primarily responsible for financial stability,[64] and it should be 'vested with a clear mandate and commensurate powers, so that it can be held accountable for achieving its objectives'.[65]

The Australian government *has not fully reflected the significance of financial stability* in the design of the regulatory framework for financial stability. No

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[59] Peter Praet, 'The (Changing) Role of Central Banks in Financial Stability Policies' (Speech, Annual Internal Banking Conference, 10 November 2011); See also Parsons (n 53).

[60] Charles B Blankart and Erik R Fasten, 'Financial Crisis Resolution – The State as a Lender of Last Resort?' (2009) 29(3) *Economic Affairs* 47, 50; See also Parsons (n 53); See also Joseph J Norton, 'NIFA-II or 'Bretton Woods-II'?: The G-20 (Leaders) Summit Process on Managing Global Financial Markets and the World Economy – Quo Vadis?' (2010) 11(4) *Journal of Banking Regulation* 26.

[61] See also Parsons (n 53).

[62] Ibid; See Erland W Nier, Jacek Osiński, Luis I Jácome and Pamela Madrid, 'Institutional Models for Macroprudential Policy' (Staff Discussion Note No 11/18, International Monetary Fund, 1 November 2011) <https://www.imf.org/external/pubs/ft/sdn/2011/sdn1118.pdf>.

[63] See also Parsons (n 53).

[64] Ibid.

[65] International Monetary Fund, *Global Financial Stability Report: Navigating Monetary Policy Challenges and Managing Risks* (Report, April 2015) <http://www.imf.org/External/Pubs/FT/GFSR/2015/01/index.htm> ('Global report April 2015').

changes to the relevant regulatory framework of the financial stability regulators have been made in the past 10 years following the GFC. A reference to the RBA's mandate for financial stability has been included for the first time in the 2010 Statement on the Conduct of Monetary Policy,[66] which by its nature, is an instrument of soft law with little or no legal significance. This step cannot be seen to be one that truly strengthens the regulatory framework. The current regulatory framework in Australia therefore does not reflect the political or economic importance of financial stability.

B *At the Highest Level, a Single Regulator is Responsible for Financial Stability*

Financial stability can be promoted by the designation of a single high-level regulator tasked with the broad, overarching oversight of financial stability.[67] The ideal regulator is a centralised, national, government-mandated regulator or body that is unambiguously responsible for financial stability overall.[68] The role of such an 'umbrella' domestic regulator[69] would be wide oversight and coordination at a high level, with the ability to gather information and coordinate responses to domestic and international financial stability challenges. It would also be able to identify uncoordinated responses and fragmentation in regulation. In the interest of identifying potential systemic risk, centralising access to the relevant data and information is ideal. As a minimum, one institution should have access to such data and information,[70] including information from microprudential supervisors, macroprudential policy-makers, market and competition supervisors, fiscal

[66] The Treasurer and the Governor of the Reserve Bank, *Statement on the Conduct of Monetary Policy* (Statement, 30 September 2010) <http://www.rba.gov.au/monetary-policy/framework/stmt-conduct-mp-5-30092010.html>.

[67] See also Parsons, n 53.

[68] Ibid.

[69] Ibid.

[70] Nier et al (n 62).

decision-makers, and monetary policy.[71] This structure reflects the reality that financial stability is affected by a range of policies.[72]

It has also been recommended that the regulator with the greatest expertise to assess systemic risk should be allocated the lead role in financial stability.[73] There is therefore a strong view that this function should be performed by the central bank.[74] That is also the case in all the G20 countries, where the central bank is responsible for financial stability either on its own, or with other regulators/bodies.[75] Central banks are not only well-appointed to determine systemic risk because of their role as LOLR. Acting to reduce the systemic impact of a possible or actual failed institution(s) through the LOLR function has the effect that pursuing financial stability lies at the heart of central banking.[76] In addition, central banks have over the past 20 to 25 years also studied financial stability, and have communicated their findings through financial stability reviews. This has happened irrespective of whether the individual central banks have been officially mandated to pursue financial stability.[77]

The Australian regulatory framework *falls short* of this benchmark. In Australia, the financial stability responsibility is shared. Although impliedly the RBA is finally or overarchingly responsible for financial stability, it's not clear what that really

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71 International Monetary Fund, *Key Aspects of Macroprudential Policy* (Policy Paper, 10 June 2013) 9 <https://www.imf.org/external/np/pp/eng/2013/061013b.pdf>; See also Parsons (n 53).

72 Ibid.

73 See Nier et al (n 62); See also Parsons (n 53).

74 See Charles A E Goodhart, *The Regulatory Response to the Financial Crisis* (Edward Elgar, 2009).

75 See Tables 8.1, 8.2 and 8.3 below. See the analysis of the G20 countries' response to the 'best practice' guidelines after the GFC in Parsons (n 53).

76 See also Parsons (n 53). For a discussion as to why central banks should be responsible for financial stability, see Louise Parsons, 'Developments in Central Banking after the GFC: Central Banks, the State, Globalisation and the GFC' in John H Farrar and David G Mayes (eds), *Globalisation, the Global Financial Crisis, and the State* (Edward Elgar, 2013) 218 ('Developments in central banking').

77 See the analysis of the G20 countries' response to the 'best practice' guidelines after the GFC in Parsons (n 53).

means. The RBA may have overall oversight, but it relies heavily on APRA for information and the CFR for coordination. Although it is a vehicle for coordination, the CFR does not fulfil the role of an 'umbrella' regulator because of its informal nature. It simply provides a forum and cannot take any actions of its own accord. Although the CFR provides for the opportunity for the RBA to have access to the relevant information, nothing compels any of the regulators to share information, cooperate and collaborate. The RBA as lead regulator is however the regulator best placed to evaluate systemic risk. There is however currently no unambiguously responsible entity in Australia.

Alternatively, if the financial stability mandate is to be shared, it would be best practice that information-sharing between multiple regulators is regulated clearly. Where multiple regulators are involved, there should be a clear process for the sharing of information. In cases where there is not a single financial stability regulator, or where the macroprudential and microprudential supervision responsibilities are split, information-sharing between regulators becomes very important. For example, in the UK, problems arose when AIG experienced liquidity and solvency problems and these were not elevated to the right level of regulatory oversight at an appropriate time. AIG was at the relevant time regulated by a regulator that was not sufficiently equipped to deal with the problems it caused.[78] This incident ultimately resulted in legislative change in the UK and the incorporation of the financial stability function formally into the BOE.

Garicano and Lastra suggest the following framework for ensuring optimal communication between regulators:[79]

> We propose three ways to facilitate information sharing. *First,* the communication advantages of single organizations can be obtained through the use of centralized and common databases (common codes) together with horizontal (rather than hierarchical) communication. *Second*, organizations, even if separate, should be housed in close proximity to facilitate the creation of bonds

[78] See Garicano and Lastra (n 55).

[79] Ibid 614-615 (emphasis added).

> that facilitate informal sharing. This should be complemented with encouraging an 'esprit de corps' and identification with the ultimate aim. *Third*, while explicit monetary incentives are unlikely to be used, agents should be rewarded as a function of the 'impact' that their recommendations have on final decisions.

The Australian framework *falls short* in this regard too. In Australia, information-sharing between regulators occur generally through the operation of soft law, in particular the MOUs that regulate interagency collaboration at the CFR. These processes have been set out above. Information sharing depends on soft law instruments and ultimately organisational culture and behaviour. This could lead to difficulties.[80]

C *The Central Bank Plays a Central Role in Financial Stability*

After the GFC, the need for the central bank to take the lead in financial stability and to have a financial stability mandate was voiced.[81] Before the GFC, the main focus of central banking was monetary policy and in particular the combatting of inflation (see Chapter 3 above).[82]

Central banks are well-placed to be responsible for financial stability as they have a unique expertise in risk assessment,[83] and as lender of last resort, are 'motivated to take timely action to reduce the buildup *(sic)* of risks'.[84] Further, a strong role for the central bank in financial stability can coordinate well with the

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[80] Garicanos and Lastra point to the possibility of turf wars between agencies: See Garicano and Lastra (n 55). In Australia, difficulties in relation to confidentiality have however been addressed and confidential information is generally protected (including through statute).

[81] Bank for International Settlements, 'Ingves Report' (n 52) 1, 12; See International Monetary Fund ('Global report April 2015' (n 65); See also Parsons (n 53); See Parsons 'Developments in central banking' (n 76).

[82] See also Parsons (n 53); See Parsons 'Developments in central banking' (n 76).

[83] International Monetary Fund ('Global report April 2015' (n 65).

[84] Ibid; See also Parsons (n 53).

monetary policy role, which 'sets the overall conditions that affect the demand for and the supply of credit'.[85] Central bank prestige and independence are also valuable for enforcement actions and enhance the ability of the central bank to 'recruit and retain the best staff'.[86]

Table 8.1 below reflects which regulator is responsible for financial stability in the G20 countries (excluding the European Union and including Spain).

Table 8.1 Regulator responsible for financial stability in G20 countries[87]

	Country	**Which regulator is ultimately responsible for financial stability?**
1	Argentina	Central Bank of the Argentine Republic
2	Australia	Reserve Bank of Australia, the RBA, together with APRA
3	Brazil	Central Bank of Brazil
4	Canada	Bank of Canada
5	China	People's Bank of China
6	France	Bank of France (Banque de France)
7	Germany	Deutsche Bundesbank
8	India	Reserve Bank of India (shared)
9	Indonesia	Bank Indonesia
10	Italy	Bank of Italy (Banca d'Italia)
11	Japan	Bank of Japan
12	South Korea	Bank of Korea and the Financial Supervisory Commission
13	Mexico	Bank of Mexico (Banco de Mexico)
14	Russia	Central Bank of the Russian Federation (also known as Bank of Russia)
15	Saudi Arabia	The Saudi Arabian Monetary Agency (which is both central bank and bank supervisor)
16	South Africa	South African Reserve Bank
17	Turkey	Central Bank of the Republic of Turkey (shared)
18	United Kingdom	Bank of England, incorporating the Financial Policy Committee

[85] Ibid. See also Chapter 3 above.

[86] Garicano and Lastra (n 55) 610.

[87] Table from Parsons (n 53) 153 (updated).

19	United States	The Financial Stability Oversight Council, part of the Federal Reserve System (The Federal Reserve Board of Governors is the central bank)
20	Spain	Bank of Spain (Banco de España)

Australian practice *aligns with general international practice*, in that the central bank is responsible for financial stability, but it is one of a minority in which the responsibility is shared between the central bank and another regulator, which is not in some way institutionally part of the central bank.

D *The Responsible Regulator has been Provided with a Clear Statutory Mandate for Financial Stability*

Best practice would be to provide a clear mandate for financial stability to the responsible regulatory (typically the central bank). That is the case in most G20 countries, where the central bank has an express mandate for financial stability, with *Australia being one of a few clear exceptions.*[88] Whether there is an express statutory financial stability obligation is not part of the framework of the IMF/FSB country peer review assessment framework. However, that does not mean that an express and clear mandate is not important.[89]

The Basel Core Principles for banking supervisors and the IAIS Core Principles emphasise the need for clear mandates.[90] In 2010 the FSB again emphasised the need for clarity in mandates, and suggested that these principles should be expanded 'on what is meant by "clear" when describing an authority's responsibilities and objectives'.[91]

[88] See Parsons (n 53).

[89] Ibid.

[90] Ibid. The Basel Core Principles are known as BCP1.

[91] Ibid 154, citing Financial Stability Board, *Intensity and Effectiveness of SIFI Supervision: Recommendations for Enhanced Supervision* (Report, 2 November 2010) 3 <https://www.imf.org/external/np/mcm/financialstability/papers/sifisup.pdf>.

The vast majority of the G20 countries as identified for purposes of this thesis have provided an express mandate for financial stability, but in the others the mandate is either de facto or implied.[92] See Table 8.2 below.

Table 8.2 – Type of financial stability mandate in G20 countries[93]

	Country	**Is the mandate for financial stability express or implied?**
1	Argentina	Express
2	Australia	Effectively implied or de facto. The express mandate of the central bank is very limited in ambit and scope.
3	Brazil	Express
4	Canada	Express
5	China	Express
6	France	Express
7	Germany	Express
8	India	Not express
9	Indonesia	Express
10	Italy	Express
11	Japan	Express
12	South Korea	No express mandate but the Bank of South Korea has a statutory obligation to publish a financial stability review
13	Mexico	Not express
14	Russia	Express
15	Saudi Arabia	Implied
16	South Africa	Express
17	Turkey	Implied
18	United Kingdom	Express
19	United States	Express
20	Spain	Express

The need for a clear mandate has also been recognised by scholars, such as De Haan and Oosterloo.[94]

[92] See Parsons (n 53).

[93] Ibid 155.

[94] Jakob De Haan and Sander Oosterloo, 'Transparency and Accountability of Central Banks in their Role of Financial Stability Supervisor in OECD Countries' (2006) 22(3) *European Journal of Law and Economics* 255, 260.

The informal nature of the RBA's mandate for financial stability has been discussed in Chapter 4. The fact that the RBA does not have a formal statutory mandate for overall financial stability has not necessarily detracted from the performance of the RBA as regulator. However, a formal mandate for the official financial stability regulator is nevertheless important.[95] The Australian regulatory framework clearly *falls short* in this respect.

E *The Regulatory Framework Includes a Focus on Macroprudential Regulation and Supervision*

The increased focus on financial stability during and after the GFC also led to an increased interest by financial regulators in macroprudential policy and regulation.[96]

The influential Core Principles on Effective Banking Supervision issued by the Basel Committee on Banking Supervision advocate a system-wide approach, emphasising that[97]

> the prevailing macroeconomic environment, business trends, and the build-up and concentration of risk across the banking sector and, indeed, outside of it, inevitably impact the risk exposure of individual banks. Bank-specific supervision should therefore consider this macro perspective.

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[95] See Parsons (n 53).

[96] Macroprudential policy and regulation have been defined and described in Chapter 3. Macroprudential policies 'use primarily prudential tools to limit systemic or system-wide financial risks': Nier et al (n 62). A systemic approach is now sometimes considered to be 'macroprudential policy': Luiz A Pereira da Silva, Adriana Soares Sales and Wagner Piazza Gaglianone, 'Financial Stability in Brazil' (Working Paper Series No 289, Banco Central do Brasil, August 2012) 4 <https://www.bcb.gov.br/pec/wps/ingl/wps289.pdf>. See also Parsons (n 53); See Stijn Claessens, 'An Overview of Macroprudential Policy Tools' (Working Paper No 14/214, International Monetary Fund, December 2014) <https://www.imf.org/external/pubs/ft/wp/2014/wp14214.pdf>; See also International Monetary Fund, *Key Aspects of Macroprudential Policy* (Policy Paper, 10 June 2013) 6 <https://www.imf.org/external/np/pp/eng/2013/061013b.pdf> ('Key Aspects of Macroprudential Policy').

[97] Basel Committee on Banking Supervision, *Core Principles for Effective Banking Supervision* (Report, September 2012) 6 <https://www.bis.org/publ/bcbs230.pdf> ('Core principles'); See Parsons (n 53).

As this ‘broad financial system perspective’ is deeply ingrained in many of the Core Principles, the Basel Committee on Banking Supervision does not include a specific stand-alone Core Principle on macroprudential issues.[98] The importance of macroprudential policy was however emphasised in the GFC (as set out in Chapter 3 above).[99]

The events of the GFC proved that ensuring regulatory compliance by individual institutions did not result in the stability of the entire financial system.[100] Macroprudential issues were not sufficiently attended to before the GFC.[101] In 2009 the IMF recommended that a macroprudential approach to regulation should be adopted as a correction to the overly narrow scope of prudential regulation before the GFC.[102] The IMF further emphasized that macroprudential policy was needed ‘to achieve the stability of the system as a whole’.[103] The FSB also affirmed the need for a well-developed macroprudential surveillance approach by all supervisory authorities,[104] and that such an approach should be ‘designed to identify trends and developments that might negatively impact the risk profile of its firms’.[105]

The effectiveness of macroprudential policy and regulation depends on a clear mandate for taking the lead in monitoring systemic risk. This responsibility should be ‘assigned to the agency best placed to do so at the national level’.[106] The

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[98] Ibid.

[99] See Parsons (n 53).

[100] Pereira da Silva et al (n 96) 4.

[101] IMF ‘Key Aspects of Macroprudential Policy’ (n 96) 6.

[102] International Monetary Fund ‘Lessons of the Financial Crisis’ (n 58) 8; See Parsons (n 53).

[103] International Monetary Fund ‘Lessons of the Financial Crisis’ (n 58) 5.

[104] Financial Stability Board, *Intensity and Effectiveness of SIFI Supervision: Recommendations for Enhanced Supervision* (Report, 2 November 2010) 18 <https://www.imf.org/external/np/mcm/financialstability/papers/sifisup.pdf>.

[105] Ibid.

[106] Parsons (n 53) 156; International Monetary Fund ‘Lessons of the Financial Crisis’ (n 58) 9; See also Nier et al (n 62).

appropriate regulator for macroprudential policy should first be identified. In Australia, macroprudential policy has not been expressly assigned to the RBA or APRA. Rather, in Australia a 'macroprudential approach' is adopted both by the RBA and APRA, rather than the pursuit of a defined macroprudential policy.[107] There is however no legal/legislative certainty as to where any macroprudential responsibility may lie.

However, by assigning the macroprudential mandate 'to *someone*, a body or a committee', the 'willingness to act' will be strengthened.[108] Some are of the view that macroprudential supervision should be the express responsibility of a separate supervisor activity, and should be separate from microprudential supervision.[109] The macroprudential supervisor should then be clearly mandated and identified, and equipped with sufficient powers, including 'the use of prudential tools to address systemic risk'.[110] Without a clear mandate, 'collective action problems lead to underinvestment in systemic risk identification and mitigation across agencies and reduce accountability, since in the end *no one* is fully responsible for the crisis outcome'.[111]

It has been recommended that '[t]he central bank should play an important role in macroprudential policymaking'.[112] The central bank would be well-placed to perform the role of macroprudential authority, as the specific roles of the central

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[107] See Luci Ellis, 'Financial Stability and the Banking Sector' (Speech, Sydney Banking and Financial Stability Conference, 12 July 2016) <https://www.rba.gov.au/speeches/2016/sp-so-2016-07-12.html>.

[108] IMF 'Key Aspects of Macroprudential Policy' (n 96) 29; See Parsons (n 53).

[109] Donato Masciandaro, Rosaria Vega-Pansini and Marc Quintyn, 'The Economic Crisis: A Story of Supervisory Failure and Ideas for the Way Forward' in Morten Balling, Frank Lierman, Freddy Van Spiegel, Rym Ayadi and David T Llewellyn (eds), *New Paradigms in Banking, Financial Markets and Regulation?* (Larcier, 2012) 19.

[110] Nier et al (n 62).

[111] IMF 'Key Aspects of Macroprudential Policy' (n 96) 29 (emphasis unaltered).

[112] Nier et al (n 62); See also Masciandaro et al (n 109); IMF 'Key Aspects of Macroprudential Policy' (n 96) 29.

bank can 'support effective coordination of macroprudential policy with monetary as well as microprudential policy',[113] thereby harnessing the 'institutional incentives and expertise available at the central bank'.[114] This would benefit the 'coordination with other central bank functions, including monetary policy, provision of liquidity, and payment systems oversight'.[115] Garicano and Lastra emphasise that '[s]ystemic supervision must be under the purview of the central bank',[116] as 'a central bank has a responsibility for financial stability, because of its lender-of-last-resort role',[117] and 'those in charge of monetary policy need to know the amount of risk and instability in the system.'[118] Garicano and Lastra however suggest that the central bank's role should be limited to macroprudential supervision, and not all macroprudential tasks.[119]

A country needs a strong and flexible LOLR to prevent systemic problems if financially significant organisations face liquidity problems.[120] It is therefore not surprising that in the G20 countries where the role of a macroprudential regulator has been identified or formalised, this task falls either on the central bank or a committee comprising a number of regulators, but generally including the central bank.[121]

Although the tendency in G20 countries is to allocate financial stability responsibility to the central bank, there is significant divergence in the G20

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[113] Nier et al (n 62).

[114] Ibid.

[115] Nier et al (n 62); See Parsons (n 53).

[116] Garicano and Lastra (n 55) 609

[117] Ibid.

[118] Ibid 610.

[119] Ibid 612.

[120] International Monetary Fund, *Global Financial Stability Report: Navigating Monetary Policy Challenges and Managing Risks* (Report, April 2015) <http://www.imf.org/External/Pubs/FT/GFSR/2015/01/index.htm>.

[121] See Parsons (n 53) 158-9.

countries as to the macroprudential responsibility. The IMF has identified three different models describing the involvement of the central bank in macroprudential policy, some of which are evident in the G20 countries:[122]

1. *Model 1*: The macroprudential mandate is assigned to the central bank, with macroprudential decisions ultimately made by its Board (as in the Czech Republic);

2. *Model 2*: The macroprudential mandate is assigned to a dedicated committee within the central bank structure (as in the UK); and

3. *Model 3*: The macroprudential mandate is assigned to a committee outside the central bank, with the central bank participating on the macroprudential committee (as in France and the US).[123]

The institutional models for the macroprudential regulator fall into different categories: those with a single responsible authority,[124] such as an independent statutory body, an independent non-statutory body, or a statutory body that is not independent.[125] In other countries, the macroprudential function is shared among multiple regulators and bodies.[126] The responsibility can be provided either expressly or impliedly.[127] Some countries have not allocated the macroprudential policy and supervision to a specific regulator or body at all.[128]

[122] International Monetary Fund 'Key Aspects of Macroprudential Policy' (n 96) 30.

[123] Although the IMF include Australia among the countries that have adopted Model 3, this may not be entirely accurate.

[124] See Parsons (n 53).

[125] Ibid.

[126] Ibid.

[127] Ibid.

[128] Ibid.

The different regulatory models based on this categorisation and the G20 countries that have adopted that model are reflected in Table 8.3 below. The table also reflects which institution or body is responsible for macroprudential policy.[129] Some countries have allocated macroprudential responsibilities to more informally structured bodies/institutions. In Australia, for example, the CFR, a non-statutory body with no independent powers, is involved with macroprudential responsibilities, and both the RBA and APRA have a macroprudential approach. The informality of such structures in Australia could be of concern (as discussed above) but collaborative bodies seem to be well-placed to take on such responsibilities. Macroprudential matters include the work of different regulators and/or supervisors, and collaborative, informal meetings or committees may be more effective in arranging cooperation between regulators.[130] The obvious disadvantage of informality include the potential difficulties faced by a 'body' that does not have the powers that a formal regulator would have had to take the necessary steps, or ensure that others do so.[131] There is however no general established international practice in the regulatory architecture for macroprudential policy.

[129] Ibid.

[130] Ibid.

[131] Ibid.

Table 8.3 - Regulatory authority responsible for macroprudential policy in G20 countries[132]

	Different models: Regulatory architecture of the institution(s) responsible for macroprudential policy and supervision	Countries
A single authority		
	Independent statutory body	• **Germany** – Financial Stability Committee • **Argentina** – Central Bank of Republic of Argentina has a financial stability mandate which is equated to a macroprudential policy mandate by Argentina and the FSB • **Indonesia** – Bank of Indonesia • **Canada** – Financial Institutions Supervisory Committee • **France** – Haut Conseil de stabilité financière (HCSF - High Council for Financial Stability), is acknowledged to be the macroprudential authority, installed in June 2014. • **Russia** – Central Bank of Russia • **Spain** – the Bank of Spain has financial stability and macroprudential mandate.
	Not independent but statutory body	• **UK** – Financial Policy Committee under the central bank • **US** – Financial Stability Oversight Council • **Brazil** – Financial Stability Committee under the Central Bank of Brazil • **China** – the People's Bank of China and Joint Ministerial Conference on Financial Regulatory Coordination (led by the People's Bank of China)

[132] Ibid, 158-9 (updated).

		• **Saudi Arabia** – Saudi Arabian Monetary Agency with a Financial Stability Committee • **Turkey** – Financial Stability Committee, chaired by and incorporating government (Treasury) and the central bank of Turkey
	Independent non-statutory body	• Many countries have a financial stability council, or a body aimed at encouraging cooperation between regulators, such as the Australian Council of Financial Regulators, with the main responsibilities falling under the key or mandated regulators.
	Not independent and non-statutory body	• **India** - Joint Ministerial Conference on Financial Regulatory Coordination – all the regulatory agencies are part of this committee, and it is chaired by a government representative, although some functions are executed by the Bank of India.
A split authority for macroprudential policy and supervision		
	Multiple regulators share the responsibility for macroprudential policy and supervision expressly	• **Japan** – Bank of Japan and Financial Services Authority. Council for Cooperation on Financing Stability perform a coordinating function.
	Multiple regulators share the responsibility for macroprudential policy and supervision not expressly but implicitly/de facto.	• **Australia** (APRA and RBA) • **Italy** – the Banca d'Italia, IVASS, and Consob share a financial stability mandate which has to some extent been equated with a macroprudential policy mandate.
	Multiple regulators have an express responsibility for macroprudential policy and supervision	• **Korea** (the Bank of Korea and the Financial Services Commission each have statutory powers for macroprudential and financial stability functions)

In Australia, the macroprudential framework is a lot less formal than in some other jurisdictions.[133] The Australian position has been described as follows.[134]

> The Australian framework includes: a shared responsibility for financial stability across regulatory agencies with effective coordination arrangements; clear mechanisms for identifying and monitoring systemic risk; and a number of policy tools available to contain systemic risk, including supervisory tools. In particular, the Australian authorities have taken a holistic approach, seeing macroprudential policy as being subsumed within a broad and comprehensive financial stability policy framework that is backed by inter-agency cooperation and coordination.

The fact that Australia has no specific designated macroprudential regulatory authority however makes it somewhat unique. The financial stability responsibility is shared between the RBA, APRA, the CFR and Treasury.[135] These roles have been discussed in Chapters 4 and 5. Both APRA and the RBA adopt systemic perspectives in their regulatory work. The approach of APRA has been described as 'bottom-up', whereas the RBA has been developing a 'top-down' approach.[136] The RBA and APRA see macroprudential policy as inseparable from microprudential policy.[137] The RBA has noted: 'In essence, effective policy measures to mitigate financial stability risks are seen as ensuring ongoing good *microprudential* supervision as much as *macroprudential* policy'.[138] APRA's toolkit includes the right to impose countercyclical capital buffers[139] and liquidity coverage ratio capital buffers for domestic systemically important banks,[140] the

[133] David Orsmond and Fiona Price, 'Macroprudential Policy Frameworks and Tools' [2016] **(**December) *Reserve Bank of Australia Bulletin* 75, 81**.**

[134] Ibid.

[135] For a summary of the roles of the Australian regulators, see Orsmond and Price (n 133) 82.

[136] Orsmond and Price (n 133) 82.

[137] Ibid.

[138] Ibid.

[139] Ibid. Using countercyclical capital buffers has been described as a tool having an 'explicit macroprudential focus'. It is also in line with the Basel framework.

[140] Ibid.

right to set regulations that direct behaviour of supervised entities, [141] as well as communications and directive powers.[142] The RBA's toolkit includes the LOLR function, the provision of liquidity to the financial system, research, communication and monetary policy, and macroeconomic policies that are informed by financial stability developments.[143] The RBA also disseminates information through its various publications that have an important role in financial stability. Discussions about the Financial Stability Review with other regulators at the CFR are also of assistance.[144] A recent example of collaborative (and *successful)* macroprudential policy in action was the 'approach taken by the Australian regulators in late 2014 to reinforce residential housing lending practices'.[145]

The informal and shared allocation of macroprudential policy responsibilities in Australia however *exposes the regulators to the same weaknesses/problems* as the informal and shared allocation of a financial stability mandate.

Furthermore, in Australia there is no clear delineation between the RBA's responsibility for monetary policy and its financial stability obligations. If the financial stability obligations slot in seamlessly into its other responsibilities, the consequence is that its financial stability responsibility will be given effect to within its broad independence. As financial stability does not have a limiting framework comparable to the inflation-targeting model in monetary policy, the RBA as a central bank may have *very wide policy-making powers.* Garicano and Lastra are of the view that the macroprudential supervisor should not have the same level of independence as the monetary policy authority.[146] Although the Australian

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[141] Ibid.

[142] Ibid.

[143] Ibid.

[144] Ibid.

[145] Ibid, 83.

[146] Garicano and Lastra (n 55) 616.

government has a statutory right to intervene in the event that it does not agree with the RBA's policies, that right has never been used, and it is submitted that it will take significant political will for a government to invoke those statutory provisions.[147]

On the whole, the Australian regulatory framework *does not reflect* international best practice, and may be improved on the basis thereof.

IV. Perspectives on Delegating Responsibilities to Unelected Independent Agencies: Tucker's Delegation Criteria and Design Precepts[148]

Perspectives on best practice when delegating authority to unelected independent agencies also provide a useful lens and some guidance as to a way forward for the Australian framework. The recent work of Paul Tucker is of particular relevance. Tucker's perspectives on the regulating of regulators draw on his practical background as former Deputy Governor of the BOE, and as current Chair of the Systemic Risk Council of the Federal Reserve in the US.[149] He is also engaged as a fellow at the Harvard Kennedy School. In a recent extensive examination of the manner in which central banks are tasked with responsibilities – including financial stability responsibilities – Tucker focusses on the fact that central banks are both 'unelected powers', and 'independent agencies'.[150] As mentioned earlier, Tucker characterises the role of central banks as similar to that of 'trustees'.[151]

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[147] See Chapters 4, 5 and 6.

[148] Paul Tucker, *Unelected Power: The Quest for Legitimacy in Central Banking and the Regulatory State* (Princeton University Press, 2018) 569-572.

[149] For his biography, see 'Resources', *Paul Tucker* (Web Page) <http://paultucker.me/resources/>.

[150] Tucker notes: 'By "independent agency" (IA) I mean, broadly, a public agency that is free to set and deploy its instruments in pursuit of a public policy goal (or goals) insulated from short-term political considerations, influence, or direction. This means insulation from the day-to-day politics of *both* the executive branch and the legislature. Such policy agencies are *trustees*': Tucker (n 148) 11.

[151] Ibid.

Tucker identifies five 'design precepts' for delegating responsibilities to central banks as 'trustee-like' independent agencies.[152] These design precepts are therefore particularly relevant to this thesis and for its recommendations.

A *The Regulatory Regime should include a Statement of its Purpose, Objective and Powers, and a Delineation of its Boundaries (the 'Purposes – Powers' Precept)*[153]

According to this design precept, the regime should include a 'statement of its purposes, objectives, and powers and a delineation of its boundaries'.[154] This recommendation accords well with the international best practice principles set out above, and also reflects the reasons why regulatory change in Australia should be considered. The analysis in Chapters 6 and 7 demonstrated the lack of delineation of the RBA's purpose, objectives, powers and boundaries in its financial stability mandate. This is a problem for an unelected power in a democratic country. Accordingly, the RBA's purpose, objective, powers and scope of mandate in relation to financial stability by not having been clarified appropriately, *falls short*.

B *Prescriptions should be provided of Who should Exercise the Delegated Powers and the Procedures to be Employed (the 'Procedures' Precept)*[155]

The regulatory framework should include '[p]rescriptions of who should exercise the delegated powers and the procedures to be employed'.[156] Similarly, this

[152] Ibid 110.

[153] Ibid.

[154] Ibid.

[155] Ibid.

[156] Ibid.

recommendation reflects the concerns expressed at the conclusion of the analysis in Chapter 5 above and the resulting problems in relation to accountability for the RBA (see also Chapters 6 and 7). As the financial stability responsibility in Australia is shared among regulators in an informal fashion, it is not clear who should exercise which powers, and which procedures are to be used. The presence of the Australian government representatives in the process, and the controls and drivers that to some extent influence the behaviour of the RBA in its financial stability responsibility, do not give effect to this design precept because of a lack of clarity. In this regard too, the RBA's regulatory framework *falls short*.

C *Principles for How the Agency Will Conduct Policy within its Boundaries should be Stated (the 'Operating Principles' Precept)*[157]

The regulatory framework should include '[p]rinciples for how the agency will conduct policy within its boundaries'.[158] The analysis in this thesis has demonstrated the extent to which there is an absence of guidance on how the RBA is to conduct financial stability policy. In this respect too the Australian regulatory framework *falls short*.

D *Sufficient Transparency should be Provided to Enable the Delegated Policy Maker and the Regime Itself to be Monitored and Held to Account by Elected Representatives (the 'Transparency-Accountability' Precept)*[159]

'Sufficient transparency [is required] to enable the delegated policy maker, and, very important, the regime itself to be monitored and held to account by elected representatives'.[160] In Australia there is a fair number of controls and drivers that

[157] Ibid.

[158] Ibid.

[159] Ibid.

[160] Ibid.

promote transparency and accountability for the RBA. None of these are however particularly focussed on the financial stability objective. In this respect the Australian regulatory framework also *does not match* the design precepts.

E *Provisions for Exceeding Regulatory Boundaries should be Stipulated (the 'Emergencies' Precept)*[161]

'Provisions determining what happens when the boundaries of the regime are reached during a crisis [should be included], including how democratic accountability works then'.[162] Tucker advocates for laying down 'a process for decision-making in unenvisaged, emergency contingencies. It would in effect be a "pause" or "regime shift" button that could be pressed when the boundaries of an agency's powers are reached'.[163] Even though a specific memorandum of understanding exists between the relevant Australian regulators for dealing with emergency situations,[164] it does not meet this level of detail. In this regard too, the Australian framework *can be improved*.

F *Assessment of the RBA against the Principles Identified by Tucker*

When assessing the RBA and its financial stability responsibility against the principles identified and promoted by Tucker, it is evident that the RBA's regulatory framework falls short, as set out in the table below.

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[161] Ibid 111.

[162] Ibid.

[163] Ibid 120.

[164] *Memorandum of Understanding on Financial Distress Management between the Members of the Council of Financial Regulators*, signed 18 September 2008 (Memorandum of Understanding) <https://www.cfr.gov.au/financial-institutions/crisis-management-arrangements/pdf/mou-financial-distress-management.pdf>.

Table 8.4 Comparison of the RBA's financial stability regulatory framework against Tucker's design precepts

The RBA's legislative framework has been assessed as follows:

	Tucker's regulatory design precept (extracted)[165]	**Assessment of the RBA's regulatory framework**
1	'Elected legislators should provide a statement of purposes, objectives and powers, and a delineation of the regime's boundaries. (Purposes-Powers)'[166] Standards are capable of being monitored, and understood	Not met
2	Clear indications to be given as to who exercises which powers[167]	Not met
3	Publication of operating principles[168]	Not met
4	Transparency for stewardship of delegated policy, and ability to monitor the regime.[169]	Mostly met.
5.	Processes for emergencies when boundaries of regulatory framework reached stipulated[170]	Not met

In relation to independent agencies with multiple missions – such as the RBA – Tucker argues that an independent agency should only be given multiple mandates if those are '(a) intrinsically connected, (b) each faces a problem of credible commitment and meets the other Delegation Criteria (as defined by Tucker), and (c) it is judged that combining them under one roof will deliver materially better results'.[171] In the case of the RBA, monetary policy and oversight

[165] Tucker (n 148) 570-2.

[166] Ibid 570.

[167] Ibid.

[168] Ibid 571.

[169] Ibid.

[170] Ibid.

[171] Ibid 572.

over the payment systems can both be seen as roles that complement the financial stability role, but also compete with it.[172] The regulatory framework of the RBA however currently does not include the objectives and constraints of each of the missions (mandates),[173] and there is not a distinct policy body for each of the missions (mandates) in the RBA.[174]

In conclusion, the regulatory framework of the RBA for financial stability *falls short* of the proposed design precepts of Tucker. Both international best practice and Tucker's principles provide guidance for adjustments to the RBA's regulatory framework. These will be discussed in more detail in Chapter 9. The adjustments to the regulatory framework essentially will call for parliamentary action. It is therefore first necessary to consider the benefits of 'hard law' and legislative control for a financial stability regulator.

V. The Potential of Regulatory Control by a 'Fourth Branch' of Government

Control of regulators by a 'fourth branch' of government is also a consideration for a proposed new regulatory framework for financial stability in Australia, and this idea has been gaining support in Australia. The two most recent government-commissioned inquiries into the Australian financial system, the Murray Inquiry and the Hayne Commission, both recommended that there should be more oversight over regulators by a 'regulator of regulators'. This type of 'oversight of regulators' approach accords well with the developing notion of a 'fourth branch' of government – the so-called 'integrity' branch – but there are also some important differences. Whereas the main focus of an 'integrity branch' would be to prevent corrupt practices, a 'regulator of regulators' would be more concerned with the appropriate fulfilment of a regulatory mandate. These types of 'oversight'

[172] See Chapters 3 and 4.

[173] See Tucker's recommendation: Tucker (n 148) 572.

[174] Ibid 572.

bodies outside Parliament, the Executive and the Judiciary, are nevertheless similar enough to be grouped together. They will now be discussed in turn.

A *The 'Integrity Branch'*

The 'fourth' branch of government, or the so-called 'integrity branch' is a relatively new suggestion in relation to the separation of powers model,[175] pioneered by American constitutional scholar Bruce Ackerman.[176] It is an idea that has also gained support among Australian legal scholars. Former NSW Chief Justice, Jim Spigelman, for example, described it as follows:[177]

> The primary basis for the recognition of an integrity branch as a distinct functional specialisation, required in all governmental structures, is the fundamental necessity to ensure that corruption, in a broad sense of that term, is eliminated from government. … The role of the integrity branch is to ensure that that concept is realised … not merely in the narrow sense that officials do not take bribes, but in the broader sense of observing proper practice. … A short definition is that the integrity branch or function of government is concerned to ensure that each governmental institution exercises the powers conferred on it in the manner in which it is expected and required to do so and for the purposes of which the powers were conferred, and for no other purpose.

Existing institutions such as the Auditor-General, Ombudsman and Electoral Commissioner have been considered as part of this branch.[178] A 'regulator of regulators' could also fit within the integrity branch (See Part V B below).

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[175] The original idea of the three branches of government come from John Locke, in the 18th century, and was developed by Montesquieu.

[176] Robin Creyke, Matthew Groves, John McMillan and Mark Smyth, *Control of Government Action: Text, Cases and Commentary* (LexisNexis Butterworths, 5th ed, 2018) 37. See also Bruce Ackerman, 'The New Separation of Powers' (2000) 113(3) *Harvard Law Review* 633.

[177] Creyke et al (n 176) 37, citing Chief Justice Jim Spigelman; See Jim Spigelman, 'The Integrity Branch of Government' (Lecture, Australian Institute of Administrative Law National Lecture on Administrative Law No 2, Sydney, 2004).

[178] Creyke et al (n 176) 37.

The adoption of the 'four branches of government' model is supported on the basis that the three-branch theory of government does not reflect the evolution of modern government.[179] According to McMillan, [180]

> [t]he inescapable reality is that the doctrine of the separation of powers no longer provides an accurate picture of how scrutiny and accountability of government action occurs.

He notes: [181]

> The oversight bodies are different to executive departments, in terms of their role and statutory independence. They chiefly examine the legality and propriety of executive actions, not implement government policy or administer government programs.

In order for a 'regulator of financial regulators' to effectively function in a role that can be classified as part of the 'integrity' branch of government, it would have to overcome one of Chief Justice Martin's concerns, namely clarity of the position of such agencies in relation to government and other agencies. He questions whether these institutions in the 'integrity branch' would 'disrupt the long-established systems of checks and balances between the existing branches of government'.[182]

There appears to be some political will in Australia at the moment for increasing the fourth or integrity branch. For example, the government announced on 13 December 2018 that it intended to create a Corruption Commission. [183]

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[179] Ibid 38.

[180] Ibid.

[181] Ibid.

[182] Ibid.

[183] Commonwealth, *A Commonwealth Integrity Commission — Proposed Reforms* (Paper, December 2018) <https://www.ag.gov.au/Consultations/Documents/commonwealth-integrity-commission/cic-consultation-paper.pdf>. Recently, also the Law Council of Australia called for the creation of a body to handle complaints against the judiciary: Michael Pelly, 'Law Council 'Very Troubled' by Circuit Court Judge's Rulings', *Financial Review* (online, 26 February 2018 3). The Law Council however expressed the view that the judiciary should not be subject to the proposed Commonwealth Integrity Commission because of the importance of the principle of

Further, the government's Statements of Expectations issued to regulators such as ASIC and APRA and the RBA's Payments System Board now include policy requirements for regulators.[184] A further such example would be the now defunct Financial Sector Advisory Council (FSAC).[185]

The exact role of any 'overseer' of financial regulators would be hard to characterise. It would further be difficult for such an entity to exclude matters of policy and limit itself to matters of process thereby limiting the potential effectiveness of a 'regulator of regulators' in that regard.

B *Regulator of Regulators*

1 *Recommendations by the Murray Inquiry*

In its final report, the Murray Inquiry recommended that a Financial Regulator Assessment Board should be created 'to advise Government annually on how financial regulators have implemented their mandates'.[186]

The proposed Financial Regulator Assessment Board would provide a formal mechanisms through which the Australian government would 'receive annual independent advice on regulator performance',[187] thereby strengthening 'the accountability framework governing Australia's financial sector regulators'.[188] This board would only operate in respect of ASIC, APRA and the RBA payments

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the separation of powers: See Law Council of Australia, Submission No 24 to Attorney-General's Department, *Commonwealth Integrity Commission* (31 January 2019).

[184] See for example the most recent statements of expectations issued in 2018.

[185] See Chapter 7.

[186] Recommendation 27. Financial System Inquiry (Final Report, November 2014) *Financial System Inquiry Final Report* <http://fsi.gov.au/files/2014/12/FSI_Final_Report_Consolidated20141210.pdf> (The Murray Inquiry Final Report) (Chapter 5).

[187] Ibid.

[188] Ibid.

Systems Board. Although the regulatory framework for financial stability in Australia was characterised by the Murray Inquiry as ‘informal’ and ‘decentralised’,[189] the Inquiry nevertheless did not ‘see a strong case for change in this area’.[190] A key issue for the Inquiry was that although there were no recommendations for major changes to the roles of the financial regulators, there were ‘some weaknesses in how financial regulation is implemented’,[191] notably because the government lacked ‘a process for holding regulators accountable for their overall performance’.[192]

In the Final Report, the Murray Inquiry detailed that the proposed Financial Regulator Assessment Board should replace the Financial Sector Advisory Council (FSAC).[193] The Australian government, however, did not create a Financial Regulator Assessment Board but formally reconstituted the FSAC in November 2016 with a new charter. It did not incorporate the breadth of recommendations of the Murray Inquiry[194] and focussed mostly on APRA and ASIC.[195] Although the value of the FSAC is not disputed, its focus is probably *not* what the Murray Inquiry had in mind. The Murray Inquiry envisaged ‘[a] more

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[189] See Chapter 5, Commonwealth, *Financial System Inquiry* (Final Report, November 2014) <http://fsi.gov.au/files/2014/12/FSI_Final_Report_Consolidated20141210.pdf> (The Murray Inquiry Interim Report).

[190] Ibid.

[191] Ibid.

[192] Ibid.

[193] The Federal Government created the Financial Sector Advisory Council: Kelly O’Dwyer, ‘Financial Sector Advisory Council’ (Media Release, The Treasury, 6 May 2016) <http://kmo.ministers.treasury.gov.au/media-release/067-2016/>.

[194] The Government described the Financial Sector Advisory Council as a body to provide ‘advice to the Government on policies that will maintain an efficient, competitive and dynamic financial sector to support growth in the economy’, and to advise on ‘the performance of the financial system regulators [and] …. regulatory reform which could improve the efficiency and competitiveness of the financial sector …’: Ibid.

[195] In the Minutes of the FSAC released under FOI obligations, the FSAC expressly noted that at the end of November 2017 it had not really considered the PSB but rather focused on APRA and ASIC: For the FOI documents see Financial Sector Advisory Council, *Minutes of the Meeting of the Financial Sector Advisory Council* (Minutes, 20 March 2017) <https://static.treasury.gov.au/uploads/sites/1/2018/11/FOI-2315-Documents-v2.pdf> (‘FSAC Minutes 20 March 2017’).

effective review mechanism that provides Government with regular formal advice on the overall performance of regulators [that] will improve regulator accountability'.[196] The FSAC does not fulfil these expectations. Its charter requires the FSAC 'to provide *industry views* on the performance of the financial regulators'.[197] The minutes of the FSAC demonstrate that the overall flavour of those meetings were considerations of how regulation could be better implemented in the interest of the regulated *industry* itself (eg through discussion of the removal of red-tape etc at the meetings with ASIC).[198] The work of the FSAC was suspended in light of the 2018 Hayne Commission.[199]

The Murray Inquiry Final Report also recommended more clarity in the interpretation of the mandates of regulators, through 'Statements of Expectations'.[200] More clarity was needed on 'the strategic direction that the government expected the regulators to take, as well as a 'broad outline' of the measure of tolerance for 'financial sector risk'.[201]

The Murray Inquiry considered, but did not recommend, an Inspector-General of Regulation. The reasons were that it would 'involve creating a new agency',[202] and that the Inspector-General model would 'place considerable reliance on a

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[196] The Murray Inquiry Final Report (n 186), Chapter 5.

[197] 'Overview', *Australian Government The Treasury* (Web Page, 25 September 2017) <https://consult.treasury.gov.au/small-business-and-consumer-division/copy-of-financial-services-advisory-council-views/> (emphasis added). The members of the Financial Sector Advisory Council (FSAC) are appointed by the Treasurer from the private sector, and consist of 'a range of financial market participants': 'Financial Sector Advisory Council', *Directory* (Web Page) <https://www.directory.gov.au/portfolios/treasury/financial-sector-advisory-council>.

[198] It is evident that the focus of these meetings reflected the interests of the members – ie the financial industry – and not those of Government: FSAC Minutes 20 March 2017 (n 195) (emphasis added).

[199] Disgraced Ex-AMP chairman Craig Meller was a member of the FSAC: Eryk Bagshaw, 'Ex-AMP CEO Craig Meller Resigns as a Turnbull Government Adviser', *Sydney Morning Herald* (online, 30 April 2018) <https://www.smh.com.au/politics/federal/ex-amp-ceo-craig-meller-resigns-as-a-turnbull-government-adviser-20180430-p4zcf6.html>.

[200] The Murray Inquiry Final Report (n 186) Chapter 5.

[201] Ibid.

[202] Ibid.

single person, while the [proposed] Assessment Board can include members with expertise across the regulators'.[203] It should be noted that the idea of an Inspector-General is not new, and the Uhrig Enquiry of 2003 in fact recommended the establishment of an Inspector-General of Regulation 'to review, independently, a regulatory authority's systems and procedures for the administration of legislation'.[204]

In view of the comments by the Hayne Commission Interim Report, and what appears to be the growing importance of the fourth branch of government, some form of 'Inspector-general of Regulation' may be a thought worth reconsidering. What may be needed is in fact what the Murray Inquiry rejected – 'more detailed assessments of administrative processes of the type currently performed by the [Australian National Audit Office] and the Inspector-General of Taxation (in relation to the ATO)'.[205]

In response to the Murray Inquiry Recommendation, the government rejected the notion of a Financial Regulator Assessment Board,[206] choosing to rely rather on the *PGPA Act*, the reconstituted Financial Sector Advisory Council,[207] and the amended Statements of Expectations of the various regulators.[208] The government however did not focus on the RBA, and issues of financial stability

[203] Ibid.

[204] Commonwealth, *Review of Corporate Governance of Statutory Authorities and Office Holders* (Report, 27 June 2003) 9 <http://www.finance.gov.au/sites/default/files/Uhrig-Report.pdf> (Uhrig Report). The 'Uhrig Commission', chaired by John Uhrig, was tasked with reviewing 'structures for good governance, including relationships between statutory authorities and the responsible Minister, the Parliament and the public, including business': at 1.

[205] The Murray Inquiry Final Report (n 186) Chapter 5.

[206] Commonwealth, *Improving Australia's Financial System: Government Response to the Financial System Inquiry* (Response, 20 October 2015) 23 <https://treasury.gov.au/publication/government-response-to-the-financial-system-inquiry/>.

[207] Ibid.

[208] Ibid.

were addressed as matters of 'resilience', with the Government's focus being on prudential regulation of financial institutions.[209]

2 *Recommendations by the Hayne Commission*

The Hayne Commission did not spare the regulators in its report. Although the issues for consideration by the Hayne Commission were not directly related to financial stability, the conclusions about the role of the regulators are relevant for this thesis. In particular, Commissioner Hayne,[210] in relation to the accountability of the regulators, raised the issue as to whether there should be 'annual reviews of the regulators' performance against their mandates'.[211] In the final report, a recommendation for a new oversight authority was included,[212] specifically for APRA and ASIC. This authority was recommended to be statutory, and independent of government,[213] with the objective of assessing 'the effectiveness of each regulator in discharging its functions and meeting its statutory objects', and reporting to the Ministers biennially.[214] Hayne specifically agreed with the recommendation of the Murray Inquiry, noting that 'a permanent oversight body is now required'.[215]

Although the recommendation is only in relation to the oversight of APRA and ASIC, it is significant from the perspective of the RBA as well. What this recommendation demonstrates, is the need for a type of 'integrity branch' or

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[209] Ibid, Summary.

[210] In the interim report.

[211] *Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry* (Final Report Volume 1, 1 February 2019) 299 <https://financialservices.royalcommission.gov.au/Pages/reports.aspx#final> ('Hayne Commission Final Report').

[212] Ibid, 41, 476.

[213] Ibid 479.

[214] Ibid.

[215] Ibid 476.

‘regulator of regulators’. There is no reason theoretically why the RBA in some of its functions could not also be subject to this type of oversight.

Commissioner Hayne did not make any recommendations as to the manner in which regulators should be regulated, but it is evident from the concerns expressed that the Commission was of the view that the oversight of the regulators was not satisfactory. At the start of this chapter it was pointed out that there is an increased concern with transparency and that it may also affect the way that the RBA is allowed to function. The Hayne Commission’s recommendation is a good and recent example of the identification of the need for oversight over regulators. The relevance of the ‘fourth branch’ of government to the RBA is discussed below.

C *Limited Relevance of the ‘Fourth Branch’ for the RBA*

Although possible entities in the ‘fourth’ or ‘integrity branch’ may justifiably have oversight over the Payment System Board and over the RBA in its more classic ‘regulator’ mode in relation to the payments system, the same cannot be said of the RBA in respect of its other functions.

There are two main reasons for this conclusion:

1. The independence of the RBA in respect of the monetary policy function would be threatened; and

2. Some of the RBA’s actions involve policy and discretion, that are not the type of decisions and actions that are capable of review in the same way that the implementation of policies and procedures, and performance against a given mandate, can be monitored by a regulator of regulators.

The ‘integrity branch’ is predominantly involved with ensuring that processes are followed, and mandates complied with, and is concerned primarily with ensuring due process, and in the main avoiding corruption. The conduct of monetary policy and financial stability policy seem to fall outside such constraints. What would fall within such oversight is the cooperation and interrelationship between the different agencies.

VI. Conclusion

This chapter has demonstrated the extent to which the RBA's regulatory framework for financial stability can be improved so as to align better with international best practice, and also with very recent recommendations for the governance frameworks of regulators that are 'unelected powers'. This chapter commenced this analysis with a consideration as to why a change should be made, and pointed to both practical and theoretical (jurisprudential) reasons as to why the RBA's regulatory framework should be changed. As considerations for regulatory amendments, this chapter has provided guidance from international best practice as well as the design precepts for regulatory agencies such as the RBA developed by Paul Tucker. It has also considered the need for a separate 'regulator of regulators' in the 'fourth branch' of government. The specific recommendations for improving the regulatory framework of the RBA will be dealt with in the following chapter.

CHAPTER 9

The Way Forward: Recommendations and Conclusion

The rule of law is not enforced by an army. It depends upon public confidence in lawfully constituted authority.[1]

I Introduction

The previous chapter discussed the need and justification for changes in the RBA's regulatory framework for financial stability. It highlighted the absence of a formal mandate, the fact that the mandate is shared and decentralised, and that there is a preponderance of soft law instruments that drive and control the actions of the RBA in respect of financial stability including through governance and accountability mechanisms. Chapter 8 justified regulatory change on the basis of practical and theoretical imperatives, and considered international best practice and the design precepts for central bank mandates by Paul Tucker as bases for legislative change. It also introduced and considered the potential relevance of the 'fourth branch' of government for purposes of redesigning the regulatory framework of the RBA for financial stability.

Against this background, this chapter proposes specific changes to the regulatory framework of the RBA's financial stability responsibility in the form of three key recommendations (Parts II A, B and C). It also provides a suggestion for further changes based on additional research that falls outside of the scope of this thesis

[1] Chief Justice Murray Gleeson, 'Courts and the Rule of Law', (Speech, Rule of Law Series, 7 November 2001) <http://www.hcourt.gov.au/assets/publications/speeches/former-justices/gleesoncj/cj_ruleoflaw.htm>. Gleeson noted: 'As an idea about government, the essence of the rule of law is that all authority is subject to, and constrained by, law. The opposing idea is of a state of affairs in which the will of an individual, or a group, (such as a Party), is the governing force in a society. The contrasting concepts are legitimacy and arbitrariness. … The word "legitimacy" implies an external legal rule or principle by reference to which authority is constituted, identified, and controlled' (footnotes omitted).

(Part II D). Part III defends the need for legislative change in principle. Part IV provides an overall perspective of the thesis, and a summary and conclusion.

II Recommendations

Legislative action should be taken to address the problems of the RBA's financial stability mandate. It is only through legislative action by Parliament that the regulatory framework can be improved so as to provide a suitable governance and accountability framework for the RBA as financial stability regulator.

This thesis makes *three key* recommendations for strengthening the RBA's regulatory framework for financial stability, based on the assumption that the current role-division between the RBA and other role-players in financial stability will be retained:

1. *Recommendation 1*: The financial stability mandate of the RBA should be encapsulated in legislation;

2. *Recommendation 2*: The relationship between the RBA and APRA in respect of their roles in financial stability should be clarified and regulated in legislation; and

3. *Recommendation 3*: The CFR should be formalised as a statutory IAC under the auspices of the RBA and the internal governance structures of the RBA and the role of the Governor should be adjusted accordingly.

These recommendations will enhance the role of the RBA as agent of government in financial stability.

The particular areas in which the RBA's governance falls short of international best practice and the design precepts of Tucker have been discussed in Chapter 8. In brief, the current regulatory framework does not reflect the importance of financial stability regulation, particularly its political importance, does not clearly make the central bank overarchingly responsible for financial stability, and does not provide for a strong mandated framework that leads to the proper governance and accountability of the RBA (and other regulators).

A *Recommendation 1: Introduce a Statutory Mandate of Financial Stability for the RBA in the RBA Act*

The recommendation that the financial stability mandate should be codified is the most critical change recommended and will have the biggest impact on the regulatory framework.

1 *Proposed Change*

It is recommended that the *RBA Act* should include an express mandate for financial stability for the RBA.

The statutory mandate of the RBA for financial stability should:

- be clear;
- actively provide the financial stability mandate, and state the purpose of the mandate;
- provide the scope or parameters of the mandate by using appropriate verbs that accurately describe the role of the RBA; and
- provide a definition or description as to what financial stability entails for regulatory purposes.

Further, although clarity is important, this mandate should be a broad enabling mandate, and should allow the RBA some flexibility and room to interpret the mandate.

As examples, the statutory mandates of the SARB and the BOE, which were both incorporated into the relevant legislation after the GFC, can be considered.[2] The financial stability function has been incorporated into the SARB with effect from 1 April 2018 through broad regulatory changes accompanying the introduction of a Twin Peaks regulatory system in South Africa. The prudential regulatory component of the Twin Peaks system has been established as part of the SARB. Under the new legislation, the SARB is also directly mandated with financial stability as follows:[3]

> **Section 11: Responsibility for financial stability**
>
> (1) The Reserve Bank is responsible
> *(a)* for protecting and enhancing financial stability; and
> *(b)* if a systemic event has occurred or is imminent, for restoring or maintaining financial stability.
>
> (2) When fulfilling its responsibility in terms of subsection (1), the Reserve Bank—
> *(a)* must act within a policy framework agreed between the Minister and the Governor;
>
> *(b)* may utilise any power vested in it as the Republic's central bank or conferred on it in terms of this Act or any other legislation; and
>
> *(c)* must have regard to, amongst other matters, the roles and functions of other organs of state exercising powers that affect aspects of the economy.

Specific financial stability obligations are listed in the *Financial Sector Regulation Act*[4] including obligations to monitor risks, take steps to mitigate risks and advise others of steps to take, and to publish a financial stability review. [5]

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[2] These examples are not proposed as legal transplants: See generally Mathias Siems, *Comparative Law* (Cambridge, 2018) Chapter 8.

[3] *Financial Sector Regulation Act 2017* (South Africa).

[4] Ibid.

[5] Ss 11-9 *Financial Sector Regulation Act 2017* (South Africa) provide the SARB with comprehensive obligations.

The BOE also has a statutory financial stability responsibility:[6]

> **Section 2A Financial Stability Objective**
>
> (1) An objective of the Bank shall be to protect and enhance the stability of the financial system of the United Kingdom (the "Financial Stability Objective").
>
> (2) In pursuing the Financial Stability Objective the Bank shall aim to work with other relevant bodies (including the Treasury and the Financial Conduct Authority).

The obligations of the BOE and in particular the Financial Stability Committee, which is a committee of the BOE, are set out in Part 1A, Financial Stability, ss 9A – 9ZA of the *Bank of England Act 1998* (UK). These include obligations regarding financial stability strategy.

The *RBA Act* could be amended by the insertion of the words 'financial stability' into section 8A(2), to read as follows (for purposes of clarity it should be noted that in the *RBA Act*, the RBA is referred to as 'Bank' and that terminology has been retained in the proposals below; the proposed insertion into the legislation has been underlined):

Proposed insertion s8A(2):

> The Reserve Bank Board is responsible for the Bank's monetary, banking <u>and financial stability</u> policy, and the Bank's policy on all other matters, except for its payments system policy (see section 10).

[6] *Bank of England Act 1998* (UK).

It is suggested that this formulation is the *minimum* that is required. It would however not provide a strong mandate to the RBA, and a redraft of the *RBA Act* to include clearer mandates would be preferable. Clearer mandates for both monetary policy and financial stability could be provided in s 8 of the *RBA Act*, which should be amended to provide for both the RBA's mandates and powers, to read as follows (in its relevant parts; proposed insertions are underlined):

Proposed change

Section 8 Mandates and powers

> (1) <u>The Bank is responsible for conducting monetary policy</u> …
> (2) <u>The Bank is responsible for protecting and enhancing financial stability</u> …
> (3) <u>The Bank is responsible for payment system stability and regulation</u> ….
> (4) <u>In the furtherance of its mandates,</u> the Bank has such powers as are necessary for the purposes of this Act and any other Act conferring functions on the Bank and, in particular, and in addition to any other powers conferred on it by this Act and such other Acts, has power to ….'

In light of the fact that the RBA's mandate is shared and decentralised, and that the RBA does not currently have access to all financial stability tools, the most appropriate descriptive verbs that will encapsulate the scope of the RBA's mandate for financial stability would be 'protect and enhance'. It would be impossible for the RBA to 'ensure' financial stability.[7]

[7] Verbs such as 'contribute to' or 'promote' are often used: Jakob de Haan and Sander Oosterloo, 'Transparency and Accountability of Central Banks in their Role of Financial Stability Supervisor in OECD Countries' (2006) 22(3) *European Journal of Law and Economics* 255, 261, 268). See also Louise Parsons, 'Developments in Central Banking after the GFC: Central Banks, the State, Globalisation and the GFC' in John H Farrar and David G Mayes (eds), *Globalisation, the Global Financial Crisis, and the State* (Edward Elgar, 2013) 218.

2 *Rationale*

The importance of a clear, if simple, express financial stability mandate, cannot be overemphasised. The importance of a clear mandate was confirmed by former Governor Ian MacFarlane when he stated that 'the central bank must be able to be judged on whether or not it has achieved its agreed objective'.[8] This view accords well with the views of Paul Tucker, and international best practice. The importance of a clear financial stability mandate has also been emphasised by the BIS: [9]

> Clarity about financial stability responsibilities is needed to reduce the risk of a mismatch between what the public expects and what the central bank can deliver, as well as to promote accountability. Institutions should not be held accountable for tasks they are not clearly charged with pursuing nor equipped to achieve. Even though it is difficult to define and operationalise financial stability concepts, it is important for the central bank to have a formal mandate. Where that mandate gives central banks broad financial stability responsibilities, the group see potential merit in the public announcement of a financial stability strategy that clarifies the central banks' intentions. A similar approach is sometimes used for monetary policy, where the legislative framework sets out overarching objectives and the central bank formulates and publishes its strategy.

A statutory mandate satisfies the need for certainty and clarity, and as hard law provides durability and longevity. It aligns with best international practice, by demonstrating the importance of financial stability for government, placing the responsibility with a senior regulator, involving the central bank and making the mandate clear. It also satisfies the design precepts of Tucker. It further also addresses some of the issues that arise from the current informal and decentralised nature of the RBA's financial stability responsibility. Black has

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[8] Ian J Macfarlane, 'Monetary Policy and Financial Stability' (Speech, CEDA Annual Dinner, 16 November 2004) <https://www.rba.gov.au/publications/bulletin/2004/dec/pdf/bu-1204-1.pdf>.

[9] Bank for International Settlements, *Central Bank Governance and Financial Stability* (Report, May 2011) <http://www.bis.org/publ/othp14.pdf> ('Ingves Report').

identified four challenges that arise in decentred or polycentric regulatory regimes such as that of financial stability in Australia. They are: functional, systemic, democratic and normative.[10] Functional challenges relate to problems of coordination, and the inability to determine a centre of authority.[11] Systemic challenges are posed when it is not clear which norms amount to law, which are soft law, and what the internal hierarchy for law is.[12] Democratic challenges centre around who should be involved in decision-making, and to whom they are accountable.[13] Normative challenges arise when it is not clear what the goal is that should be pursued.[14] These challenges can be overcome with an appropriate mandate for the RBA.

Unless there is a clear and express mandate for financial stability in the *RBA Act*, the RBA cannot truly be judged on whether it has achieved the objective of financial stability. Including a statutory definition along with an indicative definition of financial stability in the *RBA Act* will alleviate some of these challenges.

There are two further important advantages of a statutory mandate. Firstly, a statutory mandate will better allow for scrutiny and accountability of the RBA as financial stability regulator.[15] Although a statutory mandate will not necessarily create legal rights that can be enforced judicially, a statutory mandate promotes

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[10] Julia Black, *Legitimacy and the Competition for Regulatory Share* (Working Paper No 14/2009, LSE Law, Society and Economy, 2009) 7-8 <https://papers.ssrn.com/sol3/papers.cfm?abstract_id=1424654>.

[11] Ibid. 'There may not be a body whose role it is to act as the lead interpreter of the regime's rules or principles, for example, or to otherwise steer or coordinate the activities of the multiple participants in such a way that the regime moves towards the resolution of the problem which it defines and also by which it is defined': at 8.

[12] Ibid, 8.

[13] Ibid.

[14] Ibid.

[15] For example, jurisdictions should clearly identify the leading regulatory authority primarily responsible for financial stability and, further, 'vest [it] with a clear mandate and commensurate powers, so that it can be held accountable for achieving its objectives': Luis I Jácome and Erlend W Nier, 'Protecting the Whole' (2012) 49(1) *Finance and Development* 30 <https://www.imf.org/external/pubs/ft/fandd/2012/03/pdf/jacome.pdf>.

judicial review and accountability either to Parliament and the public or the fourth branch of government (if a regulatory oversight body were to be created).

Secondly, a statutory mandate aligns with the democratic principles adopted in Australia, and ensures that the RBA as a regulatory agency, and agent of government, is tasked with its responsibilities in a legally appropriate manner. The current extra-statutory instruments do not adequately fulfil the function of mandating the RBA with financial stability. It is suggested that without establishing a mandate for financial stability there has been no proper delegation of authority to the RBA for financial stability.

This recommendation may sound 'ridiculously banal',[16] but it's important.

Although it would be preferable to provide a definition of financial stability in legislation as well (Allen and Wood are of the view that concepts should be clearly defined, and that concepts and definitions should be directly measurable and correlated with measures[17]), a statutory definition may also be restrictive. No definition is provided for the BOE's financial stability objective. Financial stability is however defined as follows in relation to the SARB's objectives and can serve as an example:[18]

> **4.** (1) For the purposes of this Act, **''financial stability''** means that
>
> (a) financial institutions generally provide financial products and financial services, and market infrastructures generally perform their functions and duties in terms of financial sector laws, without interruption;

[16] Tucker uses this phrase when advocating for more legal legitimacy for central banks. He notes: 'If that sounds ridiculously banal, remember that the Federal Reserve does not have an overall statutory objective to help preserve the stability of the financial system but only objectives tied to specific powers: for example, safety and soundness for the generality of banks and, since Dodd Frank, stability for its powers over 'systemically important financial institutions'. In the UK, only since 2012 has the Bank of England had macro-prudential and micro-regulatory functions framed in terms of an objective of stability'. See Paul Tucker, 'How can Central Banks Deliver Credible Commitment and be "Emergency Institutions"?' (Speech, Hoover Institution Conference, 21 May 2015).

[17] Bank for International Settlements, 'Ingves Report' (n 9) 1.

[18] Section 4 *Financial Sector Regulation Act No 9 of 2017* (South Africa).

(b) financial institutions are capable of continuing to provide financial products and financial services, and market infrastructures are capable of continuing to perform their functions and duties in terms of financial sector laws, without interruption despite changes in economic circumstances; and

(c) there is general confidence in the ability of financial institutions to continue to provide financial products and financial services, and the ability of market infrastructures to continue to perform their functions and duties in terms of financial sector laws, without interruption despite changes in economic circumstances.

(2) A reference in this Act to maintaining financial stability includes, where financial stability has been adversely affected, a reference to restoring financial stability.

The description provided in s 7 of the *Financial Sector Regulation Act No 9 of 2017* in South Africa is an example of a plain language description of the object of financial stability. The approach to defining financial stability is to include both narrow and broad conceptions of financial stability in the definition, and rather than describing a permanent and stable state, it provides an objective or purpose:[19]

Object of Act

7. (1) The object of this Act is to achieve a stable financial system that works in the interests of financial customers and that supports balanced and sustainable economic growth in the Republic, by establishing, in conjunction with the specific financial sector laws, a regulatory and supervisory framework that promotes —

(a) financial stability;

(b) the safety and soundness of financial institutions;

(c) the fair treatment and protection of financial customers;

(d) the efficiency and integrity of the financial system;

(e) the prevention of financial crime;

(f) financial inclusion;

(g) transformation of the financial sector; and

(h) confidence in the financial system.

[19] *Financial Sector Regulation Act 2017* (South Africa) s 7.

The definition currently provided by the RBA on its website[20] covers the same essential components as those of the SARB's definition and it is proposed that it would be a useful and suitable definition on which to base the definition in the *RBA Act.* Section 5 of the *RBA Act* could therefore be amended with the following addition:

> Proposed addition to s 5:
>
> > '**financial stability** means that the financial system is stable, that financial intermediaries, markets and market infrastructure facilitate the smooth flow of funds between savers and investors and help promote growth in economic activity. A stable financial system is resilient with effective crisis management arrangements that ensure that distressed financial institutions are managed in such a way that public confidence in the financial system is not undermined.

Putting the financial stability mandate into legislation does not mean that the process of safeguarding financial stability will necessarily be any better, but it means that the duty and entitlement to do so will be safeguarded.

This recommendation is the most important of the three recommendations and will have the most impact. It also requires the least change. The difficulties with the RBA's legal framework arise from the fact that it is (1) informal, (2) shared and decentralised, and (3) without directly supportive or supplementary governance and accountability mechanisms.

[20] See Chapter 2.

By changing the first of these characteristics – ie the informality – the impact of the second characteristic is diminished, and the impact of the third characteristic virtually avoided.

Once the financial stability responsibility is formalised, the role clarification between the RBA and APRA will already have been somewhat improved, and the negative impact of a decentralised mandate will have been ameliorated. Similarly, a formalised mandate will also impact the existing governance and accountability mechanisms positively, and existing compulsory disclosure and reporting requirements of the RBA will also have to take into consideration the statutory financial stability obligations.

A regulatory authority without a formal mandate may run into a range of difficulties. A clear mandate is not only enabling for the regulator – and therefore conducive to financial stability – it is also an important tool of accountability. Difficulties may include an inability to enforce its decisions, and uncertainty in determining whether or not the regulator has complied with its tasks, and/or acted within its authority. Moreover, a clear statutory mandate reaffirms the commitment of government to the role of the regulator in financial stability, and constitutes a political statement embodied in legislation about the importance of financial stability.

B *Recommendation 2: Clarify and Regulate the Relationship between the RBA and APRA in Relation to the Financial Stability Objectives in Legislation*

The recommendation that the relationship between the RBA and APRA in relation to financial stability mandate should be codified is based on the assumption that the current division of roles between the RBA and other financial regulators will remain unchanged.

1 *Proposed Change*

Information sharing obligations between the RBA and APRA should be codified. In particular, APRA should be provided with an obligation to provide such information to the RBA as is necessary for the RBA to perform its financial stability function. In parallel to the provisions for Trans-Tasman cooperation, the relationship between APRA and the RBA for purposes of financial stability should be stipulated. The following is suggested:

> Proposed change to the *APRA Act:*
>
> **Section 8B Cooperation with the Reserve Bank for financial stability**
>
> (1) In performing and exercising its functions and powers, APRA must:
>
> (a) support the Reserve Bank in meeting its statutory responsibilities relating to financial stability, including through the provision of relevant information in a timely manner to the RBA, the appropriate use of APRA's role as prudential regulator, and cooperation with the RBA on matters of financial stability; and
>
> (b) to the extent reasonably practicable, avoid any action that is likely to have a reasonably detrimental effect on the Reserve Bank's financial stability responsibilities.

Minimum practical requirements for cooperation and collaboration could also be included in the *APRA Act*, but these are beyond the scope of this thesis and no specific suggestion will be made in that regard. The existing statutory protections for confidentiality of information in information-sharing between APRA and the RBA do not require adjustment.

2 *Rationale*

By addressing the information-sharing and cooperation requirements between APRA and the RBA for financial stability in legislation, the same benefits will be provided as those listed in respect of Recommendation 1, the express statutory mandate of the RBA for financial stability.[21]

C *Recommendation 3: Formalise the CFR as a Statutory IAC in the RBA and Adjust the Internal Governance Structures of the RBA and the Role of the Governor*

The CFR fulfils the role of an inter agency financial stability committee, but functions informally through the operation of MOUs. It is chaired by the RBA Governor. It is recommended that the CFR be recreated as a formal IAC inside the RBA. This recommendation is made on the assumption that the current roles of regulators in financial stability remain unchanged. The importance of collaboration and cooperation between the financial stability regulators have been emphasised in Chapters 5 and 7.

1 *Proposed Change*

In order to incorporate this proposed change, the *RBA Act* will require substantial redrafting. Accordingly, no specific sections for inclusion in the *RBA Act* (or section numbers) are proposed.

The *RBA Act* should expressly establish a Financial Stability Council and the manner in which the Financial Stability Council is to be constituted should be

[21] For example, Luci Ellis pointed to the limits of persuasion – when one regulator is not persuaded by another regulator with whom it is required to cooperate. Luci Ellis, 'Macroprudential Policy: What Have We Learned?' (Presentation, Bank of England Roundtable for Heads of Financial Stability) 16 <https://www.rba.gov.au/information/foi/disclosure-log/pdf/131413.pdf>. She noted that cooperation and maintaining relationships with her peers in APRA formed part of her job KPIs in the RBA.

contained in the *RBA Act*. The Financial Stability Council should include the current members of the CFR (representatives of APRA, ASIC and Treasury) as members of the Financial Stability Board. It should be given the power to determine the financial stability policy of the RBA, and the *RBA Act* should state that the Financial Stability Committee has the power to take whatever action is necessary to ensure that the RBA gives effect to the policy it determines, subject to the balance of the *RBA Act.*

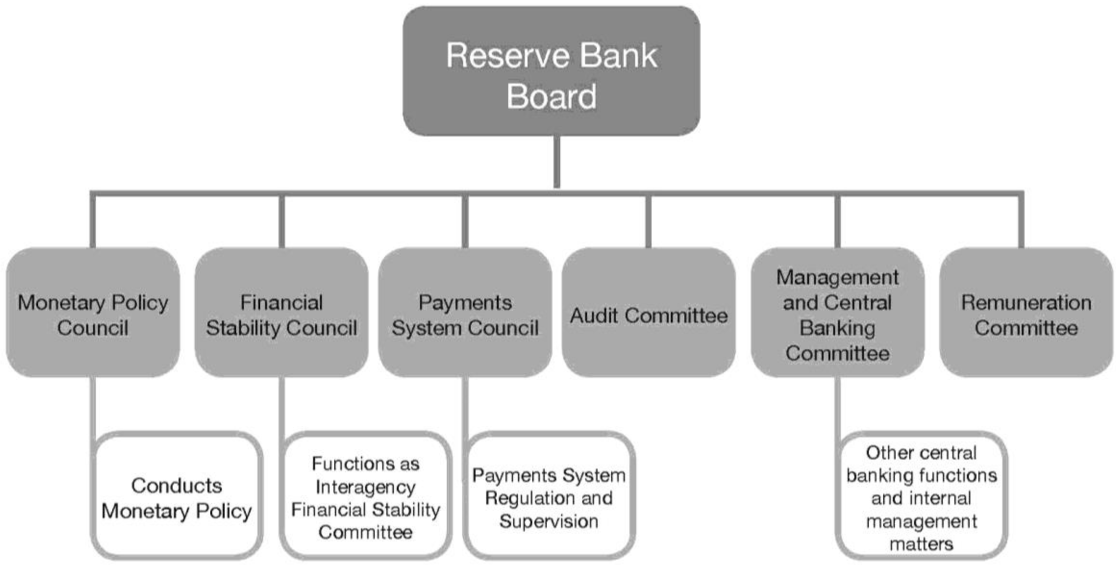
The *RBA Act* should further stipulate that it is the duty of the Financial Stability Council to ensure that, within the limits of its powers, the financial stability policy is directed to the greatest advantage of the people of Australia, and that the use of its powers will best contribute to controlling risk in the financial system, promote the efficiency of the financial system and promote financial stability. Similar wording would mirror the existing wording in the *RBA Act* in relation to the Payments System Board.

The word 'Council' has been deliberately selected and it is suggested that the internal governance structures of the RBA should be further amended to both better reflect the four key roles of the RBA (monetary policy, financial stability, payment systems and general central banking), and to improve the internal governance mechanisms of the RBA. Some aspects of the suggested change to the internal governance structures may however only be indirectly relevant to the scope of this research but are included because they address problems that have been identified, and are earmarked for future research.

It is proposed that the hierarchy of the internal governance structures of the RBA be changed as follows:

Figure 9.1 Proposed internal governance structure of the RBA

Proposed internal governance structure of the RBA



A general Reserve Bank Board should be created that oversees all the work of the RBA. The following boards, committees and councils would in the proposed framework report to the Reserve Bank Board:

1. Monetary Policy Council;

2. Financial Stability Council;

3. Payment Systems Council;

4. Management and Central Banking Committee;

5. Audit Committee; and

6. Remuneration Committee.

Financial stability policy should be determined separately from monetary policy,[22] and different relationships with government can be established for the different councils.

2 *Rationale*

By formalising the role of the CFR as an IAC inside the RBA, a number of regulatory objectives will be met. The benefits attaching to legislation as a tool of regulation set out in respect of Recommendation 1 above apply here as well.

There are however some additional benefits that attach firstly to the formalisation of the CFR and its incorporation into the RBA. The CFR as the Financial Stability Council can have formal statutory decision-making powers, and will be subject to more governance and accountability mechanisms than at present. Thereby the entire regulatory framework for the governance of financial stability will be significantly improved and effect can be given to more of the considerations discussed in Chapter 8. In additional, cooperation and collaboration between different regulators can be protected in statute, and the suggestions of Garicano and Lastra in relation to geographical proximity, physical sharing of databases and staff cooperation incentives[23] can be accommodated. It is likely that the macroprudential focus of the regulators will be facilitated.

As noted by the OECD,[24]

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[22] Financial stability policy should not be part of monetary policy: Loretta J Mester, 'Five Points About Monetary Policy and Financial Stability' (Conference Paper, Sveriges Riksbank Conference on Rethinking the Central Bank's Mandate, 4 June 2016).

[23] See Luis Garicano and Rosa María Lastra, 'Towards a New Architecture for Financial Stability: Seven Principles' (2010) 13(3) *Journal of International Economic Law* 597. See further below.

[24] OECD Best Practice Principles on the Governance of Regulators', *Organisation for Economic Co-operation Development* (Web Page) 7 <http://www.oecd.org/gov/regulatory-policy/governance-regulators.htm>.

> [t]o reduce overlap and regulatory burden, all regulators should be explicitly empowered and required to cooperate with other bodies (non-government and other levels of government) where this will assist in meeting their common objectives.

The relationships and the duties of collaboration, cooperation and consultation between different regulators should be formalised, and as far as possible governed in legislation.

Although having legislation does not necessarily ensure compliance, and having a legislated obligation to consult, or to collaborate, will not necessarily result in consultation or collaboration, the existence of a legislative provision will enhance accountability in the event that individuals or organisations/agencies resist. The governance structures of regulators matter for their overall performance.[25]

Legislation should ensure that the RBA has access to the necessary information in order to perform its functions. For example, the BIS recommends that a central bank that is responsible for financial stability should also 'have the power to obtain information directly from financial firms, through the legal authority to call for reports and to conduct onsite inspections if judged necessary'.[26] Legislation should include mechanisms to ensure that consultation between agencies will not be perfunctory.[27]

3 *Changes to the Role of the Governor*

The role of the Governor in the current internal governance structures of the RBA is of concern. It is however not unusual, and it has been pointed out that '[i]n

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[25] Graeme S Cooper, Michael Dirkis, Jennifer G Hill, John G H Stumbles, Greg Tolhurst, Richard J Vann and Sheelagh McCracken, *Regulation and Reforms to Enhance Financial Stability in the Post-GFC Era* (CIFR Paper No 036/2014, Centre for International Finance and Regulation, 11 August 2014) 14-8.

[26] Bank for International Settlements, 'Ingves Report' (n 9) 2.

[27] Ibid.

central banking, the governor is traditionally both chief executive and chairman of the board'.[28]

The main concern, as set out in Chapter 7, is that the Governor wields significant power, rivalling and at times even exceeding that of a government minister, despite the fact that the Governor is not a democratically elected official. The governance model of the RBA around the Governor is akin to the US presidential model and does not reflect modern corporate governance practices.[29] The Governor has a disproportionately large role both in policy governance and institutional governance, with only some measure of Parliamentary control. Modern corporate governance practice favours the so-called CEO/Chairperson duality,[30] where the CEO and the chairperson are not one and the same individual.

Concerns about the role of the Governor and about the manner in which the financial stability responsibility of the RBA is regulated, are not simply of academic importance. It is a principle of the rule of law that it is the law that should be the governing principle, not an individual. The current role of the Governor allows an individual to have disproportionate sway, and this could lead to arbitrariness, and a lack of legitimacy for the institution.

The role of the Governor at present does not allow for sufficient discipline that will control the Governor's authority. When the Governor is the only person who can exercise their powers, then the Governor's powers should be subject to robust

[28] John Mendzela, 'Improving Institutional Governance in Central Banks' (2009) 20(1) *Central Banking* 62, 62 ('Improving institutional governance'). See also John Mendzela, 'Governing the Governors' (2012) 23(2) *Central Banking* 74.

[29] It has been suggested that modern corporate governance principles can also be effectively applied to regulators with a view to regulating the regulator: See Hadar Yoana Jabotinsky and Mathias Siems, *How to Regulate the Regulators: Applying Principles of Good Corporate Governance to Financial Regulatory Institutions* (Working Paper No 354/2017, European Corporate Governance Institute, 2 June 2017) <https://ecgi.global/working-paper/how-regulate-regulators-applying-principles-good-corporate-governance-financial>.

[30] See Stephen Bainbridge, *Corporate Governance after the Financial Crisis* (Oxford University Press, 2012) 104.

conditions that are provided by the Australian people through Parliament. It is accordingly suggested that the role of the Governor be moderated. In the governance structures proposed above, the Governor could chair the three councils, but should not chair the three committees. The Reserve Bank Board should also be a board reflective of the 'supervised model' of governance.[31] The Reserve Bank Board could be an 'accountability' board and should comprise some political appointees. Voting should be regulated so that the Governor does not have a casting vote. The RBA will however be accountable to this board. That means that the Governor's role in policy matters will be enhanced (as chair of the three councils), but their influence overall reduced.

Recommendation 3 however does not address concerns about the lack of a CEO/chairperson duality. It would be contrary to the role of the RBA itself if the chairperson of the RBA board were able to override policy determined in, for example, the proposed Monetary Policy Council, and it is possibly inevitable that the Governor should still chair both. This suggestion therefore does not provide true duality. The success of this model will depend on appropriate legislated mandates, the appropriate board composition, and accountability.[32]

Further, the possibility for the Governor to be effective in their job should be carefully evaluated. Recent changes at the BOE in including financial stability and prudential supervision under the auspices of the BOE have brought about severe challenges for the BOE Governor. Concern has been expressed that 'the role of governor has become an impossible job':[33]

> The current arrangements place too many competing and complex demands on one person's time. There is a real risk that valuable time spent reflecting on events, debating with colleagues or refining the Bank's medium-term strategy will be crowded out by the day-to-day demands of keeping the show on the road …

[31] See Mendzela, 'Improving institutional governance' (n 28) 65.

[32] Ibid 67.

[33] Richard Barwell, 'A New Vision of the Old Lady' (2014) 24(3) *Central Banking* 47, 51.

A final benefit of this revised structure is however that although behavioural factors will still be controls and drivers of RBA action, the changes in recommendations 1 and 2 will already significantly moderate those, and under the revised internal governance model, behavioural factors in governance will also have reduced importance.

D *Issues for Consideration for Future Research: Reincorporation of the Prudential Supervision Function into the RBA*

Recommendations 1 - 3 of codifying the financial stability mandate and APRA's duty to collaborate and cooperate, as well as incorporating the CFR into the RBA are necessary for improving the regulatory framework of the RBA for financial stability. The proposed changes to the internal governance of the RBA may be less essential, but nevertheless address issues related to the key recommendations, and address the possibility for the unjustified significance of behavioural factors as controls and drivers of the RBA's actions.

In this part, suggestions for further regulatory changes are discussed that are related to the research conducted for this thesis, but require further research (which falls beyond the scope of this thesis). It is suggested that consideration should be given to reincorporating the prudential supervision function of APRA into the corporate structure of the RBA, and that further concomitant changes should be effected to the internal governance structures (the boards and the role of the Governor).[34]

[34] For a concise summary of the background to the separation of the prudential supervision function from the RBA, see Cooper et al (n 25) 6. The UK has incorporated the Financial Services Authority into the BOE, thereby making the BOE also responsible for prudential supervision. This decision was based on the experience of the GFC, in which it was evident that the previous tripartite system (the FSA, BOE and HM Treasury) was flawed. See HM Treasury, *A New Approach to Financial Regulation: The Blueprint for Reform*, (Report, June 2011) <https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/81403/consult_finreg__new_approach_blueprint.pdf>.

Incorporation of the prudential supervision function into the RBA may be a controversial topic, and it is introduced in this thesis cautiously, for the following two reasons. Firstly, where the responsibility for prudential supervision lies, relates to the topic of this thesis *indirectly* – the RBA is not currently responsible for prudential supervision, but prudential supervision is an important component of financial stability regulation. The importance of information-sharing and collaboration in the promotion of financial stability however cannot be overemphasised. It has even been suggested by Garicano and Lastra that staff should be personally rewarded for the impact that their work and recommendations have, and that physical geographical proximity between the prudential and financial stability regulators is important.[35] In many countries the financial stability regulator is also the prudential regulator.[36] Incorporating the CFR into the RBA only partly addresses these issues.

Secondly, the problems associated with the significance of the role of the Governor of the RBA in financial stability matters relate to other aspects of the RBA's responsibilities, and *directly* relates to this thesis. The difficulties arising from the existing internal governance structures (the twin board structure without an overarching board), impact the financial stability function directly as well as other central bank functions. A change to the organisation structure of the RBA will also result in a change to the internal governance structures and would require a reconsideration of the role of the Governor.

The reason that APRA was created subsequent to the Wallis Inquiry was to remove an expectation on the part of supervised entities that the RBA as bank supervisor and LOLR would always provide emergency liquidity assistance. It was a move that sought to strengthen the avoidance of moral hazard. That may no longer be necessary, as the attractiveness of obtaining LOLR assistance from the central bank has diminished.[37] The microprudential supervisor could be

[35] See Garicano and Lastra (n 23).

[36] See Chapter 7.

[37] As demonstrated by the experience of Northern Rock Bank in the UK.

reincorporated into the RBA as a department of the RBA (similar to the approach taken in the UK with the adoption of a model with three committees in the BOE: the Monetary Policy Committee, the Financial Policy Committee and the Prudential Regulation Committee, and in the SARB where the Prudential Authority functions as a department of the SARB). This suggestion would return Australia to some extent to a pre-Wallis Inquiry position, but with some significant differences related to express financial stability objectives.

APRA's exercise of control over certain key financial stability tools also support a very close working relationship with the RBA. Further, as the regulatory agency ultimately responsible for financial stability, the RBA should have access to policy instruments to effectively pursue and protect financial stability. If the prudential regulator forms part of the organisational structure of the RBA, it will allow for optimisation with the RBA's role as LOLR and its ability to use its balance sheet to manage liquidity – the RBA's key tool in promoting financial stability.[38] Monetary policy will still be conducted separately but greater coordination with financial stability will be possible,[39] and monetary policy will still be able to contribute to financial stability, a view predicated on the assumption that a stable inflation rate and a stable and strong value of the currency would also lead to financial stability.[40]

Currently, some of the financial stability instruments that have been considered to be among the most critical in the pursuit of financial stability, lie solely in the hands of APRA, who as prudential regulator can 'influence and respond to banks' risk taking without the use of prescriptive rules',[41] and can set and control both 'structural' prudential instruments aimed at promoting a generally robust financial

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[38] See Malcolm Edey, 'The Financial Stability Role of Central Banks' (Speech, Thomson Reuters' Australian Regulatory Summit, 1 May 2013).

[39] See generally Nier et al (n 15) 6.

[40] One of the lessons of the GFC was in fact that it was a false assumption that stable and low inflation and interest rates would create financial stability.

[41] Edey (n 38).

system'[42] such as the setting of capital and liquidity standards. It is of some concern that the RBA does not control the responsibility for supervision; it is further of concern that the Australian government has hardly clarified the relationship of the RBA with APRA.[43] Concerns about the effects of a similar division of responsibilities between the BOE and the Financial Services Authority were fundamental to the recent changes in the UK that resulted in the reincorporation of the function of the supervision of financial institutions into the BOE as the central bank.[44] It is submitted that these are considerations that could be taken into account by the Australian government. There is currently an in-depth review of the Reserve Bank of New Zealand underway, including whether it should have a financial stability objective (and if so, whether it should be construed narrowly or broadly), whether it should also be the prudential supervisor, and how it should be governed.[45] Australia may follow a similar path.

III The Need for Legislative Intervention: A Legal Approach to a Legal Problem

A *Legislative Intervention: Benefits and Advantages*

Parliamentary action is needed to improve the regulatory framework of the RBA for financial stability in accordance with the recommendations set out above. The

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[42] Ibid.

[43] The key formal structure for bilateral cooperation between the RBA and the APRA is the Coordination Committee that meets roughly every six weeks to discuss market developments and issues relating to any regulated institution.

[44] See Charles A E Goodhart and Dimitrios P Tsomocos, 'Analysis of Financial Stability' (Special Paper No 173, London School of Economics Financial Markets Group, May 2007) 16 <http://www.lse.ac.uk/fmg/assets/documents/papers/special-papers/SP173.pdf>.

[45] Consultations are still underway in Phase 2; Phase 1 dealing with Monetary Policy has been completed. See 'Information Release: Phase 2 Reviewing the Reserve Bank of New Zealand (RBNZ) Act - Proactive Release' The Treasury (New Zealand) (Web Page) <https://treasury.govt.nz/publications/information-release/reserve-bank-act-review-phase-2-proactive-release>.

purpose and powers of the RBA as financial stability regulator[46] as well as its procedures and requirements[47] should be set out in legislation. This view accords with those of Tucker. Tucker points out that the legislature should choose 'the high-level goals [of regulatory agencies], not the agency heads who, as unelected technocrats, are not free to impose their sense of the public interest'.[48] Tucker advocates for legislative guidelines in the interest of 'clarity, fairness and … procedural justice'.[49] Tucker however does not advocate for legislating everything, and considers it appropriate for the regulatory agency to set its own operating principles.[50]

The Australian Federal Parliament retains the ultimate legislative control over the RBA. An important characteristic of parliamentary regulation is that it's part and parcel of the democratic process, and '[a]ny democratic regime can alter the mandate of the central bank following the required normative procedure (a statute for example can always be replaced by another statute …)'.[51] In a democracy a change in the law may be necessary 'if the mandate [of the central bank] gets overstretched'.[52]

The reasons why the Australian government should take action are set out below.

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[46] Paul Tucker, *Unelected Power: The Quest for Legitimacy in Central Banking and the Regulatory State* (Princeton University Press, 2018) 111 ('Unelected Power').

[47] Ibid 114.

[48] Ibid 111-2.

[49] Tucker is also of the view that this design precept requires 'mandatory procedures for consulting on rule-making, due process for the exercise of adjudicatory powers, and, more generally, giving reasons for decisions': Ibid 114.

[50] Ibid 115.

[51] See Charles Goodhart and Rosa Maria Lastra, *Central Bank Accountability and Judicial Review* (Policy Note No 32, May 2018) <https://www.suerf.org/policynotes/2585/central-bank-accountability-and-judicial-review/html>.

[52] Ibid.

B *Importance of Financial Stability and Government's Obligation to Act (and Legislate) in the Public Interest*

The Australian government recognises the importance of finance and the financial system for Australia. For example, at the start to the government's recent response to the Murray Inquiry, the government noted:[53]

> The financial system touches the life of every individual, family and business. … Our largest lifetime undertakings — including purchasing a home, providing for our retirement or starting a business venture — are all supported by the financial system. A competitive, innovative and efficient financial system supports the operation of the whole economy.

The importance of the financial system and financial stability for the Australian government has not always been reflected in legislation.

As a liberal democracy, Australia adopts the principle of the separation of powers, and respects the rule of law.[54] The role of government under the Constitution is to metaphorically 'steer the ship', not just through the executive, but also through the legislature. Government has the prerogative to create legislation and should legislate for good governance,[55] and in the interest of the electorate. That includes creating a regulatory framework that best supports financial stability. Government has a duty to organise society in the best interest of the electorate, using the best selection of the tools at its disposal, including legislation through Parliament, and the creation of regulatory agencies.

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[53] Commonwealth, *Improving Australia's Financial System: Government Response to the Financial System Inquiry* (Response, 20 October 2015) 3 <https://treasury.gov.au/publication/government-response-to-the-financial-system-inquiry/>.

[54] See A V Dicey, *Introduction to the Study of the Law of the Constitution* (Liberty Fund, 1982). The Rule of Law involves an acknowledgement that regular law is supreme and that there can be no influence of arbitrary power, not allowed for in law. Punishment can only be made for a breach of law. Further, there is equality before the law and no-one, including officials, is above the law or exempt from its operation. The rule of law principles are also embodied in clause 5 of the Preamble to the Australian *Constitution*: 'This Act, and all laws made by parliament of the Commonwealth under the Constitution, shall be binding on the courts, judges, and people of ever state and of every part of the Commonwealth': *Australian Constitution*.

[55] *Australian Constitution* s 51.

The choice of effective tools for the regulation of the RBA (and other regulators) is important considering the importance of financial stability in Australia. It would be reasonable to expect that the Australian government would use the most effective regulatory tools that it has at its disposal for the benefit of the Australian people, and that it should deal appropriately with the effectiveness and accountability of the institution (or institutions) that is responsible for the protection of financial stability.

Government to some extent assumes the role of both protector of and provider for the citizens. Accordingly, the Australian government should ensure that the regulatory framework it creates, or allows to develop, for a matter of national importance, is optimal, reflects good principles of regulation, and maximises the principles of the rule of law.[56] This is particularly important in an area such as that of financial stability, where it is unlikely that regulation by the market alone would provide the desired welfare outcomes. The regulation of the financial stability regulators should reflect the significance of their task and the impact it may have on the Australian people.

C *Benefits of Legal Clarity and Certainty*

Legal and regulatory clarity is important, and legislation and/or other hard law assist with providing clarity and good governance and accountability. Clarity does not only come from legislation,[57] however, but '[w]hen the legislation does not

[56] Government can be judged for a failure to properly regulate matters of public importance, as was the case after the collapse of HIH Insurance. 'The Australian community had an expectation that corporate regulation, audit and good corporate governance should have triggered early warnings of any looming crisis. Public confidence has been shaken': Brendan Bailey, *Report of the Royal Commission into HIH Insurance* (Research Note No 32, Parliamentary Library, Commonwealth, 13 May 2003) <https://parlinfo.aph.gov.au/parlInfo/download/library/prspub/XZ896/upload_binary/xz8964.pdf;fileType=application%2Fpdf#search=%22library/prspub/XZ896%22>.

[57] Clarity and certainty were for example introduced in relation to monetary policy by the introduction of inflation targeting, which did not form part of the *RBA Act*. Ian MacFarlane, then Governor of the RBA, noted that '[t]he reason for inflation targeting was in order for there to be proper accountability': Ian J Macfarlane, 'Monetary Policy and Financial Stability' (Speech, CEDA Annual Dinner, Melbourne, 16 November 2004) <https://www.rba.gov.au/publications/bulletin/2004/dec/pdf/bu-1204-1.pdf>.

have clarity, different people will have different ideas'.[58] It is perhaps inevitable that different central bank governors and boards will have different approaches to interpreting their mandate.[59] Although it may not be possible to clearly legislate all aspects of financial stability, in alignment with Tucker's design precepts, at least the fundamentals should be clear.

The Australian government can give effect to its obligations to the Australian electorate in the regulation of the RBA for financial stability by creating a reasonable measure of clarity and certainty, and it could enhance the clarity and certainty about the roles and functions of the RBA as a well-governed and accountable regulatory agency. The Australian government should ensure that its agents act at a standard similar to (or better than) that of government.

D *Legal Formalism and Positivism or only a Legal Solution?*

This thesis argues that the regulatory framework of the RBA for its financial stability responsibility should be improved to not only reflect emerging best practice in the regulation of financial stability, but also to improve the legitimacy and credibility of the RBA as financial stability regulator, and give effect to the rule of law approach adopted in Australia. Tucker argues that what is de facto should also be recognised de iure.[60]

Consideration should however be given to a possible fundamental question as to whether it matters if the regulatory framework of the RBA for financial stability is 'legally' inadequate. Does it matter if the regulatory framework of the RBA for

[58] Ibid.

[59] Ibid: Macfarlane emphasized that the board in his time did not adopt a narrow interpretation.

[60] 'Since unelected power needs framing carefully in democracies, the de facto position I have outlined should be recognized de jure': Tucker (n 16). '

financial stability is not ideal, or not optimal, if there have been no known negative practical consequences?

From a pragmatic perspective, the RBA has performed its responsibilities adequately, and as there is no economic or financial evidence that the RBA's framework should be amended, it may be argued that there is no need to do so. From a legal realist perspective, an express legal mandate and express legal 'checks and balances' are not required in order to properly regulate the functions (including the powers and obligations) of the RBA in respect of financial stability. Not all regulation is the result of codification and legislation,[61] and formal law does not necessarily best govern behaviour. 'Law' is not always necessary to reach the desired outcomes; other forces can have bigger or more effective regulatory power and effect. Legislation is also not enough for legitimacy.[62]

However, from a public and regulatory perspective, the lessons of the GFC should not be ignored. The public expects that the government will take reasonable steps to guard against wide-scale economic distress, and in light of such potential crises, there is a positive duty on governments to use their regulatory tools appropriately.[63] An overemphasis of legal formalism and formal legislation may however amount to a legal positivist approach. That is not the general approach adopted in Australia; instead, a more flexible approach of enabling legislation is preferred. It is also not the intention of this thesis and its recommendations to further a position of legal positivism.

Good regulation however supports the rule of law, a fundamental tenet of Australian law. Good legislation and formal legal regulation are part of organised and civilised society, and supports democracy and the separation of powers principle. The absence of problems in the past offers no guarantee that future problems may not arise. Good law is a way that the present can take steps

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[61] See Arie Freiberg, *Regulation in Australia* (Federation Press, 2017) 1, 11.

[62] See Tucker, 'Unelected Power' (n 46).

[63] 'The state is designed to provide in the most efficient way public goods such as security': Alon Harel, *Why Law Matters* (Oxford University Press, 2014) 3.

against future aberrations and mischievous or wayward individuals. The legal framework still matters for governance and accountability reasons. These are important as '[t]he Australian constitutional system of government is premised on a principle of accountability'.[64] 'Government should not be arbitrary and uncontrolled, but act in the public interest and according to the rule of law'.[65] Important accountability mechanisms established in the Constitution include elections, Parliamentary processes, and judicial oversight.[66]

The present regulatory arrangements leave the RBA and the Australian government exposed. The RBA, if subjected to regulatory scrutiny, may be criticised for its interpretation of and approach to a vague (legally non-existent) mandate for financial stability. Similarly, the Australian government, in the event of a financial crisis where there are concerns about the performance by the RBA (or any of the other financial stability regulatory agencies), may be criticised for not using more effective and clear regulatory tools to regulate a matter that is of national interest to Australia.[67] In finance, trust is important, and the credibility of the Australian financial system is the bedrock of the Australian economy, and by implication, the welfare of the Australian people. Financial stability is of the utmost important to the Australian people and to government,[68] and legislation should reflect that.

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[64] *John McMillan. '*Commonwealth Oversight Arrangements: Re-Thinking the Separation of Powers' (Speech, Australian Study of Parliament Group Annual Conference, 1 October 2013) <https://www.oaic.gov.au/media-and-speeches/speeches/commonwealth-oversight-arrangements-re-thinking-the-separation-of-powers>.

[65] Ibid.

[66] Ibid.

[67] Governments have been judged by their responses to crises and the use of the legal tools they have available: See Julia Mahoney, 'Takings, Legitimacy, and Emergency Action: Lessons from the Financial Crisis of 2008' (2016) 23(2) *George Mason Law Review* 299.

[68] See David Gruen, 'Towards an Efficient and Stable Financial System' (Speech, CEDA State of the Nation 2014, 23 June 2014) <https://treasury.gov.au/speech/towards-an-efficient-and-stable-financial-system/>.

IV Summary of the Argument of the Thesis: Overview per Chapter

The arguments presented through this thesis are now summarised with reference to the different chapters.

This thesis has demonstrated that the regulatory framework of the RBA for financial stability lacks essential hard law components that will increase the quality of the legal framework, especially in light of the governance and accountability of the RBA for its financial stability responsibilities.

This thesis forms part of the academic conversation envisaged by Dr Guy Debelle, current Deputy Governor of the RBA, around financial stability regulatory frameworks of central banks. He effectively invited academic investigation, noting that the financial stability responsibility of central banks was a 'hot topic'.[69] Of particular relevance are questions of how and by whom the goal of financial stability had to be defined, and the independence of the central bank in determining the goals of financial stability.

This thesis considers these issues to some extent and focusses on the fundamental legal issue of the responsibility of the RBA for financial stability, and the overall regulatory framework for financial stability.

The contribution to knowledge that this thesis makes in particular is in the detailed critical analysis of the regulatory framework of the RBA's financial stability responsibility. It demonstrates how the regulatory framework of the RBA for financial stability is deficient, and why, and it suggests the areas in which the framework can be improved, and why. To do so, this thesis has considered the

[69] Guy Debelle, 'Central Bank Independence in Retrospect' (Speech, Bank of England Independence: 20 Years On Conference, 28 September 2017) <https://www.rba.gov.au/speeches/2017/pdf/sp-dg-2017-09-28.pdf>. See the Preface of this thesis.

statutory and extra-statutory framework within which the RBA finds its mandate for financial stability and the factors that complicates this regulatory framework.

Chapter 2 dealt with the concept of financial stability and concluded that it is an elusive concept. Requiring a regulatory agency to pursue financial stability involves a significant degree of interpretation and financial stability may mean different things at different times. The fact that the economics discipline lacks conclusive research in this area makes the creation of a statutory mandate for financial stability even more complex. In many instances, it is more pragmatic to avoid instability, rather than to strive for stability. From a regulatory perspective, the elusiveness of the concept creates difficulties.

Chapter 3 dealt with the nature of a central bank as a regulator of financial stability. Not only is financial stability a complex, undefined concept, but a central bank is a unique type of institution, for whom a financial stability mandate may be challenging or problematic. Central banks are sui generis institutions. They are unique in their structures and roles, and in particular in relation to their independence, notwithstanding the performance of a highly important public policy function. The independence of central banks in the monetary policy arena (specifically for purposes of the effective conduct of monetary policy), as well as the potential for conflict and competition between the mandates for monetary policy and financial stability, make the governance of and accountability for the financial stability function more complex. The role of a central bank in financial stability is, despite the complications, also ideal, and it presents the best vehicle for the protection of financial stability, given the expertise and research capabilities of the central bank, and its system-wide focus. In fact, during and after the GFC, the importance of the financial stability mandate for central banks was emphasised by international authorities such as the FSB, BIS and IMF, and international political powerhouses such as the G20. Chapters 2 and 3 frame the nature of the RBA as a regulator and financial stability as the object of regulation and provide context to the rest of the investigation.

Chapters 4 and 5 analysed the financial stability responsibility of the RBA – a mandate that is both informal, and decentralised and shared. **Chapter 4** dealt with the extent to which the RBA's mandate for financial stability is informal. It demonstrated that the RBA has a limited express statutory responsibility for financial stability in the payments system area. Notwithstanding some references to 'financial stability' and 'financial system stability' in the relevant legislation, there is no concrete, clear, overarching mandate for financial stability in the RBA's enabling legislation (hard law). The financial stability mandate can at best be implied generally from the enabling legislation, but the most important sources of the mandate – or confirmations of the mandate – come from informal documents and statements (soft law), and the mandate is implied and/or de facto.

Chapter 5 dealt with the financial stability mandate of the RBA as a shared and decentralised mandate. The financial stability functions are shared between the RBA, APRA and the CFR (in the main, although other regulators like ASIC also play minor roles). Coordination, cooperation and collaboration between regulators are therefore of the utmost importance, and the CFR has been created to fulfil that need, as well as the need to enhance communication between the regulators. However, the CFR itself is an informal arrangement, relying on MOUs for its operation. The informality of the decentralised and shared aspect of the RBA's responsibility was also emphasised.

Chapters 6 and 7 dealt with the manner in which the regulatory framework for financial stability does not create an optimal framework for control over the regulator's actions, and leaves important gaps. Some of the governance and accountability measures of the RBA are general in nature, and are not exclusive to the financial stability function. These chapters described the various governance and accountability mechanisms of the RBA in its financial stability mandate. These are also summarised in Appendix 3. Chapters 6 and 7 concluded that notwithstanding the vast number of 'controls and influences', the paucity of hard law mechanisms for the regulation of financial stability left certain gaps in the governance and accountability frameworks, including for the possibility that behavioural factors (personality and prestige) could play a disproportionate role in the control and influence of the RBA. The deficiencies are both in the mandate and in the additional governance and accountability mechanisms.

Chapters 8 and 9 dealt with how these gaps in the regulatory framework, and in particular the arrangements for governance and accountability, may be addressed. Chapter 8 provided important considerations for adjusting the regulatory framework of the RBA. It stipulated the practical and theoretical imperatives for regulatory change. The need for an improvement to the regulatory framework for financial stability of the RBA does not just stem from the existence of threats to future financial stability, but also from the importance and likelihood of regulatory scrutiny. A further important consideration is the legitimacy of the RBA in its role as financial stability regulator, as well as conformity to the broad underlying principles of law in Australia, where legal frameworks should reflect the rule of law principles and regulatory agents should be appointed and mandated in accordance with democratic values. This chapter provided three practical lenses appropriate to the RBA as an institution, through which to consider possible amendments to the regulatory framework of the RBA. The first is emerging international best practice in the area of financial stability regulators. The benchmarks of emerging best practice in this field comprised recommendations by experts in relation to financial stability regulatory framework, recommendations by significant international institutions in the field, and also the actual regulatory frameworks implemented in the G20 countries. The regulatory framework of the RBA was shown to fall short. The second are the design precepts proposed by Paul Tucker for regulating central banks government agencies that are unelected powers. The regulatory framework in Australia also does not meet these precepts. Thirdly this chapter considered the possibility of the fourth branch of government imposing an accountability mechanism, but concluded that it may be ineffective because of the difficulty in overseeing policy, not just process.

The only arm of government that would likely have any significant influence over or impact on the regulatory framework of the RBA for financial stability, is the legislative arm. It is suggested that Parliament should step in to improve the regulatory framework of the RBA for financial stability not just because of the existence of threats to future financial stability, but also because of the importance of regulatory scrutiny. Chapter 9 provided three key recommendations for legislative reform. These three recommendations will put the Australian legal framework on par with international best practice and will also satisfy the design precepts of Tucker. These are that the financial stability mandate should be formalised in legislation, that APRA's obligations to cooperate with the RBA be codified, and that the CFR be incorporated as a separate council inside the RBA, resulting in a reorganisation of the corporate governance structures of the RBA, and reducing the role of the Governor. Chapters 8 and 9 also provided rationales for the changes, including the need for legislative change, and Chapter 9 alluded to further possible changes that will require further research. The key legislative change involves the introduction of a legislative mandate for financial stability for the RBA as a minimum. Such a step will mitigate the problems associated with the informality but also the decentralised and shared nature of the mandate. It will also allow the currently inefficient governance, transparency and accountability mechanisms to be more efficient as governance tools. It will also improve the legal character of the financial stability role and support the legitimacy of the RBA as regulator and align with rule of law and democratic values.

In conclusion, legislative action is needed to improve the regulatory framework. The balance between hard law and soft law mechanisms in the regulatory framework should be adjusted, in particular, by providing the RBA with an explicit statutory mandate for financial stability, clarifying the role between the RBA and the microprudential regulator in legislation, and through the formalisation of the role of the CFR inside the RBA.

V Final Remarks

The RBA currently has an uneasy mandate for financial stability. Although it may be well-established in practice, the financial stability mandate's informality together with its decentralised and shared nature, present a fundamental question: if there is *no legal compulsion* to pursue financial stability as an objective, or pursue it in a certain way, what drives the RBA to do so, and how can the Australian government can be assured that the RBA is pursuing financial stability in the desired manner? Governance and accountability issues arise because of gaps in the foundations of the financial stability responsibility and the hard law framework. The potential importance of behavioural factors that potentially fill the gaps – mainly personality and prestige (but also including power and peer pressure)– run contrary to the fundamental principles of Australian law, and should be curtailed. The choice of effective tools to regulate the regulator is important in consideration of the vital role of financial stability in Australia. It would be reasonable to expect that the Australian government in making its architectural choices for this public policy regime would use the most effective regulatory tools that it has at its disposal for the benefit of the Australian people, and should deal appropriately with the effectiveness and accountability of the institution (or institutions) that is responsible for the protection of financial stability. By doing so it will further legitimacy of the regulator, democratic principles and the rule of law.

Jeremy Bentham noted that 'uncertainty is of the very essence of every particle of law'.[70] In areas of law that relate to matters of national interest and significant public importance, legal uncertainty, whilst it can never be completely avoided, should be rationalised and diminished. That is the task for Parliament to consider in relation to financial stability in Australia.

[70] Jeremy Bentham, *An Introduction to the Principles of Morals and Legislation* (Jonathan Bennett, 2017) 159 <https://www.earlymoderntexts.com/assets/pdfs/bentham1780.pdf>. The quotation that is widely attributed to Jeremy Bentham is that '[t]he power of the lawyer is in the uncertainty of the law': See for example Alice C Linsley, 'A Thumbnail Sketch of Jeremy Bentham', *Philosopher's Corner* (Blog Post, 17 October 2013) <http://justgreatthought.blogspot.com/2013/10/a-thumbnail-sketch-of-jeremy-bentham.html>.

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APPENDICES

Appendix 1: RBA Hard Law Framework: Table of Legislation that Regulates the RBA and has an Impact on the Roles and Functions of the RBA in Relation to Financial Stability

Legislation	**Importance/effect of the legislation and potential relevance to a financial stability mandate**
Reserve Bank Act 1959 (Cth)	This is the founding legislation of the RBA. It establishes the RBA and contains the RBA's charter in s 10(2). It is the main source of the roles and responsibilities, powers and obligations of the RBA. It also creates the two boards of the RBA that are responsible overall for the RBA's operations, namely the RBA Board and the PSB. This Act contains three references to financial stability in largely synonymous phrases, but this Act does not express an overarching mandate for financial stability for the RBA. All the references to financial stability considerations occur in relation to the duties of the PSB. The three references are in s 10B3(b)(iii), s 10B3(c) and s 25M. Sections 10B3(b)(iii) and 10B3(c) refer to '*stability of the financial system*' in relation to the functions of the PSB, whereas s 25M contains a broader reference to '*Australia's financial stability*' but it is still a reference limited to the functions of the PSB.
Payment Systems (Regulation) Act 1998 (Cth)	This Act gives regulatory powers to the RBA in connection with the payments system and payments system services providers. The phrase 'financial stability' appears in s 8 where it is described as a matter of 'public interest'.[1] However, s 12 allows the RBA to determine its own obligations and/or actions with the use of the

[1] *Payment Systems (Regulation) Act 1998* s 8. Section 8 defines what 'public interest' means. In essence, something (in this instance, a payment system) would be 'in the public interest' if it is financially safe for use by the participants, and also efficient and competitive. It should further not materially cause or contribute to risk in the system. In addition, the RBA is empowered to consider other matter – which presumably could include a range of financial stability issues – if it is relevant – but the RBA is not required to do so.

	phrase 'any other matters that the RBA thinks relevant'.[2]
Payment Systems and Netting Act 1998 (Cth)	This Act grants powers to the RBA with regard to the payments system. These are general powers that relate to the regulation of entities over which the PSB has regulatory authority, eg the power to approve netting arrangements. Although this Act does not refer to financial stability, it envisages that the RBA will be concerned about potential *systemic risk and systemic disruption*.[3] Systemic risk has generally been considered a matter of importance because it can lead to financial instability.
Financial Services Reform Act 2001 (Cth)	This Act provides the RBA with obligations and powers in relation to persons who hold a financial services licence. The RBA may determine '*financial stability standards*' in relation to providers of financial services, in terms of s 827D of the *Corporation Act*[4].

[2] See s 12.

[3] The Act refers to 'systemic risk' or systemic disruptions in s 9 (emphasis added):
"9 Reserve Bank may approve payment system
(1) The Reserve Bank may, by legislative instrument, approve the system if it is satisfied that:
(a) *systemic disruption in the financial system* could result if a participant went into external administration and the system were not approved under this section;"
"12 Reserve Bank may approve netting arrangement
(1) The Reserve Bank may approve the arrangement if it is satisfied that:
(a) *systemic disruption in the financial system* could result if a participant went into external administration and the arrangement were not approved under this section; and …"
"15 Declaration that section 14 does not apply
(1) The Reserve Bank may declare in writing that section 14 does not apply to a close-out netting contract if it is satisfied that *systemic disruption in the financial system* could result if a party to the contract went into external administration."

[4] *Financial Services Reform Act 2001* s 827D. It states:
'827D Reserve Bank may determine financial stability standards
(1) The Reserve Bank of Australia (the Reserve Bank) may, in writing, determine standards for the purposes of ensuring that CS facility licensees conduct their affairs in a way that causes or promotes overall stability in the Australian financial system.'

This legislation also added s 25M to the *RBA Act*.
"25M Payments System Board's report to the Minister
(1) The Payments System Board must, as soon as practicable after 30 June in each year, prepare and give to the Minister a report that:
(a) describes the standards determined under section 827D of the Corporations Act 2001 during the financial year ending on that 30 June; and
(b) describes any variations made to standards determined under that section that were in force during the financial year ending on that 30 June; and
(c) describes any revocations of standards determined under that section that were in force for part of the financial year ending on that 30 June; and

Payment Systems (Regulation) Act 2006 (Cth)	This piece of legislation contains no specific provision in relation to financial stability.
Corporations Act 2001 (Cth)	The *Corporations Act 2001* (Cth) grants the RBA power to set standards for *financial stability* in s827D, effectively mirroring the provision in the *Financial Services Reform Act 2001*. The *Corporations Act 2001* (Cth) further includes as an objective 'the reduction of *systemic risk* and the provision of fair and effective services by clearing and settlement facilities'.[5] 'To support this objective, the Act sets various obligations for providers of clearing and settlement facilities, and gives the RBA the power to set financial stability standards. It gives both the RBA and ASIC various powers relating to licensing, standard-setting and direction over a provider of such facilities.'[6]
Cheques Act 1986 (Cth)	This Act contains no specific provision in relation to financial stability and places no specific obligation on the RBA in relation to financial stability.
Public Governance, Performance and Accountability Act 2013 (Cth)	This Act, which took effect on 1 July 2014, makes no mention of financial stability or any synonymous term, and does not place any unique obligations on the RBA. It also does not include any obligation to account for the exercise of a financial stability mandate. It replaces the *Commonwealth Authorities and Companies Act 1997* which applied to the RBA previously. This Act applies to the RBA as a Commonwealth

(d) discusses developments in the clearing and settlement industry during the financial year ending on that 30 June that are relevant to Australia's financial stability."

What is interesting is that financial services licensees should not threaten 'overall stability in the Australian financial system' and it is the task of the RBA to oversee that. It is interesting to consider what exactly financial stability means in that context. In this context it likely has to do with consumer issues. It is further interesting that in this regard consultation has been legislated.

[5] Reference legislation and also the APRA-RBA 2012 doc.

[6] Reserve Bank of Australia and Australian Prudential Regulation Authority, *Macroprudential Analysis and Policy in the Australian Financial Stability Framework* (Report, September 2012) 3<https://www.rba.gov.au/fin-stability/resources/2012-09-map-aus-fsf/pdf/2012-09-map-aus-fsf.pdf> (emphasis added).

	entity, and requires accountability from the RBA in respect of the use and management of public resources.
Electronic Transactions Act 1999 (Cth)	This Act contains no specific provision in relation to financial stability.
Banking Act 1959 (Cth)	The *Banking Act 1959* (Cth) is referred to in s 26(c) of the *RBA Act*, in the context of the RBA acting as a central bank. The *Banking Act 1959* (Cth)does not include any mandate for financial stability for the RBA. Under the *Banking Act 1959* (Cth), APRA is authorised to revoke a corporation's authority to conduct banking business if the corporation poses a risk to *financial system stability* in Australia s 9A(2)(ba). Section 11AB provides a similar authority in relation to NOHCs. Similarly, s 11CA(1)(k) authorises APRA to give directions to support financial system stability. Further the APRA is obliged to protect depositors and to promote financial system stability in Australia (s 12(1)). There are various related obligations in the Banking Act relating mostly to the preservation of financial stability in the event of the failure or potential failure of an institution under the supervision of the APRA.
Public Service Act 1999 (Cth)	This Act is referred to in the *RBA Act*, but the *Public Service Act 1999* (Cth) has as its object the establishment of an apolitical and efficient public service, and focuses predominantly on employment issues in the public service. It does not deal with financial stability issues.

Appendix 2: Communication and Disclosure by the RBA as Sources of Control and Influence

Table A Communication and disclosure by the RBA - Summary of some key sources of control and influence through transparency

This table summarises and groups together the different communications/disclosures by the RBA.

Formal Communication **Statutory**	**Formal Official Communication** **Extra-statutory**	**Official Communication: Ad hoc discretionary**	**Official Communication: by Compulsion**
• Annual Report • Payments Systems Annual Report • Reports to Treasury and Minister of Finance in terms of the *PGPA Act*	• Bulletin • Financial Stability Review • Minutes of the MPC • Minutes of the CFR meetings	• Statement on Monetary Policy • Speeches by Governor, Deputy Governor and Assistant Governors	• Reports to IMF, FSB, Inquiries, Commissions

Table B Ways in which the RBA's actions are made transparent to the Australian public

This table sets out the ways in which the RBA's actions are made visible, and provides the vehicle through which the Australian public has access to that information.

Vehicle through which the RBA's actions are made transparent to the public	
Parliament	Appearances and statements in Parliament Indirectly through accounting to, and providing information to Treasurer
Press/media	Reports by media ad hoc
Direct communication by RBA	Own publications Speeches Website information

Appendix 3: Analytical Overview of Governance and Accountability Mechanisms and their Effectiveness as Controls and Drivers of the RBA's Financial Stability Function

This analysis categorises the controls and drivers of the RBA's actions according to their key characteristics:

- Whether they fall within the broad category of *governance* mechanisms and are therefore predominantly proactive in nature, or whether they fall into the category of *accountability* mechanisms, which includes transparency as part of accountability, and are therefore more 'reactive' in nature;
- Whether their *origin* is in *hard law* or *soft law*, or *non-legal.* In this regard, hard law is taken to mean legislation and regulations that have binding legal effect, and soft law is considered to be quasi-legal instruments that either have no legally binding force but carries some other compulsion or have weaker legally binding effect. Non-legal origins have no direct connection with the law at all;
- Whether their *origin* is *public or private*, and *national or international*;
- Whether they have been assessed in the course of this research as being *effective or not* as regulatory mechanisms in the overall regulatory design. The regulatory driver will be considered to be 'effective' if it is a compelling driver in ensuring the RBA properly pursues financial stability as a regulator.

The table below provides a list of the key controls and drivers of the RBA's actions in relation to financial stability. This list demonstrates the extensive number of controls and drivers on the RBA but also that only a very small number of the formal hard law controls and drivers are actually directed at the financial stability function. There is a preponderance of soft law and non-law controls and drivers.

	Regulatory control or driver of conduct	Source of control/ driver	Type of control/ driver	Public/ Private National/ International	Type of mechanism: Governance Disclosure (Transparency) Accountability	Hard Law Soft Law or Non-legal origins	Likely level of direct effective-ness in governing or directing the RBA's financial stability obligations
1	Mandate for financial stability	Specialised (RBA-specific) legislation *RBA Act* – BUT only an implied and de facto mandate Also various Acts re financial stability considerations in payments system	Statutory (Parliament)	Public National	Governance	Soft law	Low *There is no express financial stability mandate. In addition, the listed powers of the RBA do not include specific powers that relate directly to financial stability*.
		Second reading speech of the *APRA Act*	Parliament	Public National	Governance	Soft law	Low *The confirmation of an existing mandate of the RBA in a second reading speech of the legislation of a different regulator has little legal relevance and has been rated as low. The fact that the RBA attaches some significance to this document may however place it in the 'moderate' category.*

2	Board structures and representation on board	Specialised legislation *RBA Act*	Statutory (Parliament)	Public National	Governance	Hard law	Low *The RBA Board has no express financial stability mandate or role.*
3	Position and role of Governor	Specialised legislation *RBA Act*	Statutory (Parliament)	Public National	Governance Accountability	Hard law	Low Allows for behavioural factors to dominate. *Although the power given to the position of the Governor in the RBA Act paves the way for the significance of psycho-sociological factors in the RBA's financial stability role, the Governor has no direct or express financial stability obligations.*
4	Relationship of Australian government with RBA	Specialised legislation *RBA Act*	Statutory (Parliament)	Public National	Governance	Hard law	Low *The relationship with government created through the legislation does not specifically provide for financial stability.*

		Statements on the Conduct of Monetary Policy	Government/ Executive	Public National	Governance Some disclosure	Soft law	Low → Moderate *The Statement on the Conduct of Monetary Policy illuminates the relationship between the government and the RBA and since 2010 a financial stability mandate was included. The effectiveness of this document is nevertheless ranked as moderate as it is soft law.*
5	General internal governance	*RBA Act* *PGPA Act*	Government/ Executive	Public National	Governance Transparency Accountability	Hard law	Low *These controls are general in nature and aimed more at internal governance of the RBA as a statutory corporation.*
		Management practices in the RBA, internal committee structures, departments	RBA	Private	Governance	Hard law Non-legal	Low *The RBA's management committee for example deals with RBA internal issues, not financial stability.*
		Statement of Expectations in relation to the Payment System Board	Government/ Executive	Public National	Governance	Soft law	Low *This statement is general in nature and not directed to*

							the financial stability responsibility.
6	General legislation	Legislation relation to cheques, banks, insurance, employment, tax, AML-CTF, etc *The RBA is subject to a very long list of statutory obligations – it is beyond the scope of this thesis to list them all. What is emphasized here is that notwithstanding an extensive statutory framework, a statutory framework for financial stability is lacking.*	Statutory (Parliament)	Public National	Governance Transparency	Hard law	Low *Largely irrelevant to the financial stability responsibility.*
7	International best/ current practice	G20 meetings; BIS All Governor's Meeting; Financial Stability Board (including Committee of Central Banks and Treasurers); Basel committee on Bank Supervision (with APRA); Other committees at BIS and Basel (including reports and peer reviews)	International bodies and committees	Public International	Governance Transparency	Soft law	Low *Although the standards and opinions of international bodies are influential, they constitute soft law, are not binding, and depend on voluntary adoption by the RBA and the Government.*
8	General statutory disclosure requirements	Various statutes (eg Tax, AML-CTF, Health and Safety, etc) *The RBA is subject to a very long list of statutory obligations – it is beyond the scope of this thesis to*	Statutory (Parliament)	Public National	Transparency	Hard law	Low *Largely irrelevant to the financial stability responsibility.*

		list them all. What is emphasized here is that notwithstanding an extensive statutory framework, a statutory framework for financial stability is lacking.					
		Annual Financial Statements	Statutory	Public National	Transparency Accountability	Hard law	Low
9	Disclosure required to Parliament: Governor to Standing Committee on Economics; House of Representatives	Agreement, potentially now convention Statement on the Conduct of Monetary Policy	Non-statutory	Public National	Transparency Accountability	Soft law	Low *Disclosure may be a deterrent, and it could possibly motivate a ranking of moderate.*
10	Disclosure to other regulators	Memoranda of Understanding	Non-statutory	Public National	Governance Transparency	Soft law	Low *These documents do not clearly address responsibilities in relation to financial stability.*
		CFR – structure and cooperation, including the relevant MOUs and charter	Non-statutory	Public National	Governance Transparency	Soft law	Low → moderate *Although the CFR de facto is the main coordinating body for financial stability, as a control or driver its effectiveness is low.*

11	Compulsory ad hoc disclosure	Royal Commissions; Commissions of Inquiry; Law reform commissions	Statutory	Public National	Transparency	Hard law	Low *Both the actual report and the outcome have a low impact.*
12	Involuntary ad hoc disclosure through external critique	Press and/or media	Non-statutory	N/A	Transparency Accountability	Non-legal	Low *Press primarily revolves around disclosure/transparency, although they could also involve public censure.*
		Financial Sector Advisory Council (not currently in operation)	Non-statutory	Public	Transparency Accountability	Non-legal	Low *The nature of this council is to assess how regulation affects regulatees.*
		ANU 'Shadow Board'	Non-statutory	N/A	Accountability	Non-legal	Low *The ANU Shadow Board's comments can be construed as a form of criticism if it differs from the decisions of the RBA, but the effectiveness is low as the focus is monetary policy.*
		Academic analysis and critique	Non-statutory	N/A	Transparency Accountability	Non-legal	Low *Academic critique can involve a form of censure but on its own has a low driving effect as it has no legal basis.*

13	Potential of legal liability in tort (individuals, class actions)	General law	General law, including potentially statutory law	Public National	Transparency Accountability	Hard law	Low *The effectiveness is low because the legal framework is not express in imposing legal obligations, and to make out the elements of the tort of misfeasance in public office involves a high threshold. There is no possibility of a statutory breach as there are no express statutory obligations.*
14	Potential of judicial review	Specialised law General law	General law	Public National	Transparency Accountability	Hard law	Low *Although actions of the RBA are open to judicial review, the acts in relation to financial stability would not be reviewable in relation to anything more than procedural issues, not substantive issues or policy matters. The decisions of the RBA are outside of the purview of the courts in that respect.*