



**PROFESSOR PAMELA HANRAHAN**

**At the limits of law: Regulating for Non-financial Risk in  
the Aftermath of Australia's Banking Royal Commission**





**UNSW Business School**

**School of Taxation and Business Law**

# **At the limits of law: Regulating for non-financial risk in the aftermath of Australia's Banking Royal Commission**

Professor Pamela Hanrahan  
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*... conduct by many entities that has taken place over many years causing substantial loss to many customers but yielding substantial profit to the entities concerned. Very often, the conduct has broken the law. And if it has not broken the law, the conduct has fallen short of the kind of behaviour the community not only expects of financial services entities but is also entitled to expect of them.*

Hayne Final Report, p 1

# Is the answer more law?

*I begin from the premise that breaches of existing law are not prevented by passing some new law that says ‘Do not do that’. And given the existing breadth and complexity of the regulation of the financial services industry, adding any new layer of law or regulation will add a new layer of compliance cost and complexity. That should not be done unless there is a clearly identified advantage.*

Hayne Interim Report p 290

This season really began for me  
with a meditation between  
east and west



# How do you get banks to behave?

- Pass another law that says, obey the law?
- More effective enforcement?
- The cool-aid of 'regulate thyself'?
- Change the mindset? The milieu?



# Financial sector regulation

- The mosaic of financial sector regulation
  - Macro-prudential regulation
  - Micro-prudential regulation
  - Conduct regulation and mandatory disclosure
  - Market integrity regulation
  - Competition regulation
- What is its relationship with Australian corporate law and regulation?

# The (new) thinking?

- Focus on 'non-financial risk':
  - Operational risk
  - Compliance risk
  - Conduct risk
- The thesis is that, over the last decade, financial regulators have become increasingly interested in regulating for non-financial (as well as financial) risk
- Has this reset the 'traditional' roles?
  - Prudential regulator = capital and liquidity, financial risk management
  - Conduct regulator = market rules and responsive regulation
  - SROs = better governance through guidance and disclosure
- If so, how and what are the implications?

# Regulating for NFR

- Regulating for NFR has caused regulatory agencies and SROs to up their rhetoric and engagement in four key areas:
  - Purpose/values
  - Culture
  - Accountability
  - Remuneration

Keep your eye on:

- Content – what do they want financial institutions, and those who work in them, to do or be?
- Strategies – what regulatory tools are they using?

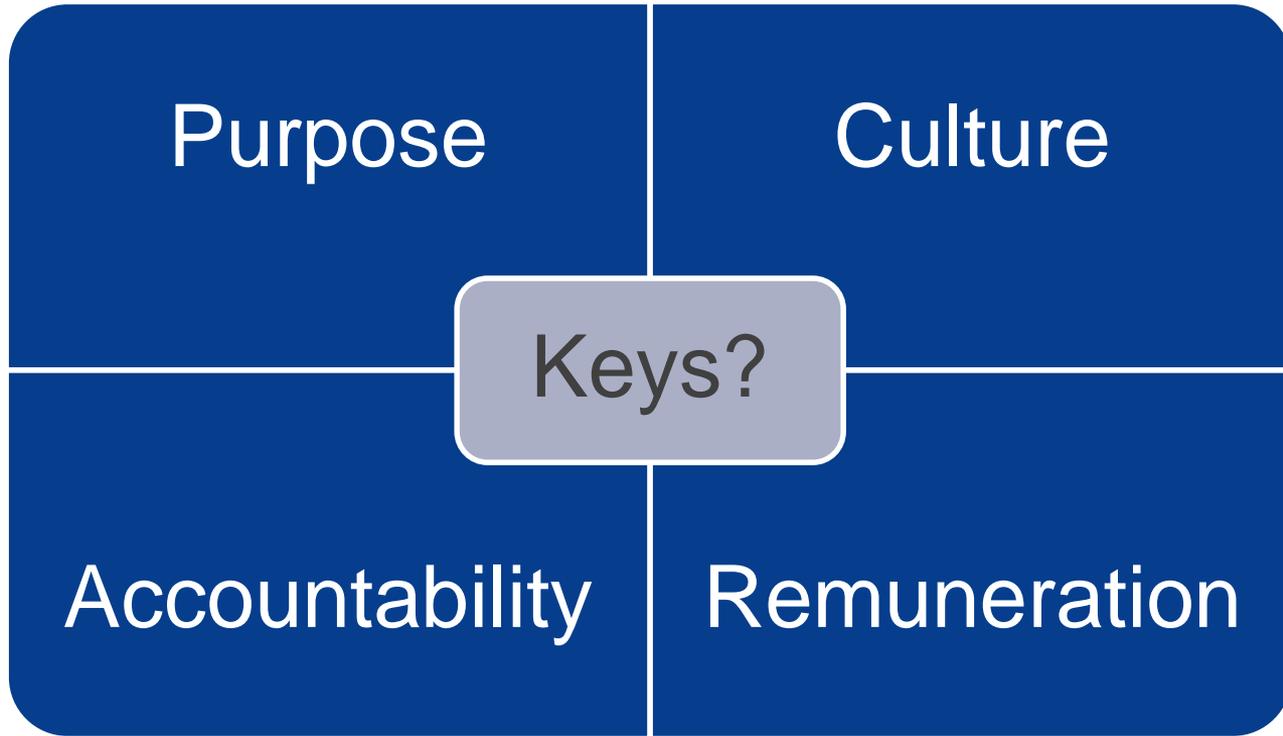
# Regulatory agencies are special

Globally, regulatory agencies – defined as governmental or public authorities that operate independently of executive government and exercise law-making or law-enforcement powers or both – are part of a larger regulatory ecosystem. In ‘decentred’ understandings of regulation, the ecosystem includes other actors – supranational standard-setters, self-regulatory organisations (SROs), civil society organisations, media and other reputational intermediaries, incentivised third-party law enforcers such as class action lawyers and litigation funders, and regulated firms themselves. Regulatory agencies are unique in this ecosystem because of the coercive nature of their powers, which they exercise as instrumentalities of the state and subject to administrative law oversight. The way regulatory agencies carry out their functions has practical and theoretical consequences in political economy and jurisprudence that distinguishes them from other regulatory actors. This includes implications for the rule of law.

# Watch this re-regulatory shift

Are we at the end of the age of 'deregulation'? Are banks the canaries in the coalmine?





# Regulatory goals and tools

Regulatory practice around NFR is becoming more explicit and standardised:

- Group of Thirty, *Banking Conduct and Culture: A Permanent Mindset Change* (G30 2018)
- Financial Stability Board, *Strengthening Governance Frameworks to Mitigate Misconduct Risk: A Toolkit for Firms and Supervisors* (FSB 2018)
- Financial Stability Board, *Implementing the Principles for Sound Compensation Practices and their Implementation Standards, Sixth Progress Report* (FSB 2019)
- Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry, *Final Report* (AGPS 2019) Ch 6



# Implications?

It blurs the distinction between prudential and conduct regulation, which is said to underpin the twin-peaks regulatory architecture of several jurisdictions including Australia and the United Kingdom. This creates stresses on that architecture. It represents a challenge to the place and limits of law (as distinct from other forms of control over behaviour) in financial regulation. And it has been accompanied by a growing appetite, on the part of regulators, to insert their views and inquiries into what we might describe broadly as the ‘sociological’ attributes of financial institutions. This includes organisational culture and values, and the internal governance and management practices within financial institutions that shape them. These are not necessarily matters that lend themselves to legal rules.

# Bigger picture?

- Does it signal the re-regulatory shift? What does this say about regulatory theory over the last 40 years?
- What makes a rule or requirement have the character of 'law'? It is the attribute of formality – a certain and knowable requirement?
- Does regulating for NFR require or encourage the use of non-law rules?
- What happens when you put non-law rules in the hands of government regulators to formulate, 'monitor' or enforce? Are there rule-of-law implications?



