Financial regulation: trends and prospects

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Achieving and maintaining an optimal regulatory structure for the financial sector is an ongoing challenge in the face of the continual evolution of the sector. What is the scope for improving Australia's financial regulation and how can we ensure that regulatory evolution reflects social cost–benefit considerations?

The Australian finance sector is subject to a wide range of often complicated regulations. This reflects the fact that there is general consensus that some level and form of regulation is required because of the special features of this sector. Involvement in the financial sector is unavoidable, its smooth operations are crucial for economic growth and development, and information deficiencies (including the inability of participants to adequately assess risks) can create undesirable market characteristics. But there is no consensus about the degree and type of regulations that are appropriate.

Australia underwent significant financial deregulation in the final two decades of the twentieth century.[1] However, recent trends in regulation have led to a widespread concern that financial regulation has again become excessively complicated and overly intrusive in the management of financial firms, with many components that would fail a social cost–benefit test.[2]

This article examines how the nature of financial regulation has changed in recent years and its implications for the future of regulation. It also outlines some key features of the financial system which influence the design of regulation and suggests some approaches available for achieving improved regulation.

Types of financial regulation

With the diversity of activities and participants in the finance sector, there are some aspects of regulation which affect only certain participants while others have far broader impacts. Because the volume of regulation is so significant and wide-reaching, it is helpful to have some organising framework for analysing different types of regulation and their rationale.

One such framework has been provided by White (1999). He identifies three types of regulation:

- ‘Economic regulation’ — such as controls on prices, profits, entry/exit;
- ‘Health-safety-environment (HSE) regulation’ — including prudential regulation, the development of corporate governance and bankruptcy systems, safeguards in securities markets; and
- ‘Information regulation’ — requirements for specific types of information, often in a standardised format, that must be provided with the product or service.

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These three types of regulation, respectively, are aimed at:

- Market efficiency: ensuring no excessive concentration of market power, and that market participants face appropriate incentives for efficient operations.
- An effective safety net and system stability: ensuring that exit of institutions takes place in an ‘orderly’ fashion which does not disrupt the financial sector or economy.
- Contractual integrity: ensuring contracts are understood and that participants have ‘reasonable expectations’ about the commitments involved.

In the case of the Australian financial system, the first of these categories is, primarily, the responsibility of the ACCC and the Payments System Board within the Reserve Bank. The second category is the responsibility of APRA and ASIC (albeit with significant RBA interest in implications for financial stability), while the third category is primarily the responsibility of ASIC (and the ASX).

The financial deregulation of the last two decades of the 20th century involved primarily a lightening of economic regulation. The current concerns about excessive regulation relate primarily to growth in the latter two forms of regulation (although some issues relating to economic regulation remain, particularly involving the suitability of access arrangements for the payments system). Prudential regulation and governance requirements have increased markedly, and there has been a substantial increase in regulatory attention paid to financial advice, fund raising, suitability of product styles and sales practices.

There have been a vast number of specific concerns about financial regulation identified in submissions to the Federal Government's Regulation Review Task Force[3] which reflect this trend. Common concerns include: regulatory overlap; excessive regulatory intrusion into corporate governance; and onerous disclosure requirements.[4]

Why the shift in emphasis?

There are three factors which help to explain the change in regulatory emphasis.

First, the economic reform agenda has been largely achieved, with the removal of controls and explicit entry restrictions affecting the financial sector. However, there are still several areas in which significant debate is likely in the near future. One is payments system regulation, which is to be reviewed by the Reserve Bank over the coming year. The other is the continued existence of the 'Four Pillars Policy', the rationale for which is declining over time with the recent growth and increasing market share of foreign and other local banks. (At the same time, many would point to the high rates of profit of the major banks as indicating that exploitation of market power is still possible, reflecting factors such as customer switching costs and imperfect information).

Second, economic reform increased the need for HSE and information type regulation. In a less regulated, more competitive market there are more opportunities for mistakes and unacceptable conduct to occur and for unexpected, undesired outcomes which prompt demands for regulation. *Caveat emptor* appears to be a difficult maxim for regulators to enforce, and it is not necessarily optimal when customers have neither the resources nor information required to pursue legal redress from suppliers of 'faulty' financial services.

Third, the increasing complexity of the financial system, combined with the necessity for involvement, means that effective methods must be found for dealing with the problem and consequences of consumer participation without adequate information. Individuals have increasing access to, and information about, an ever-expanding range of possible financial transactions available to them, but limited understanding of the risks and expected outcomes associated with many of those transactions. Whether they enter such transactions with 'reasonable expectations' about possible outcomes is a moot point.

These increased opportunities for inadequately informed risk-taking are occurring at a time when paternalistic government support of individuals is being replaced by an increasing emphasis (via compulsion or incentives) on self-reliance and self-funding of various needs. This is forcing individuals to be increasingly engaged in complex financial arrangements. Pensions, health and education are the three main areas where this is evident; each generating requirements for asset accumulation and/or debt incurrence to meet lifecycle needs. When combined with the need for housing finance, and the explosion in access to a widely increased range of financing techniques, there is a growing potential for unexpected, unhappy outcomes for which blame is laid elsewhere and redress sought.

Financial regulation: some features & consequences

To understand the implications of the changing shift in regulatory emphasis, it is important to recognise several features of the financial system which influence the evolution and nature of regulation.

One is that there is no 'static equilibrium' financial system or regulatory structure which, once achieved, will persist. The financial system is dynamic and continually evolving, with changes being driven by technology, information, innovation and the forces of competition. Compounding this process is the effect described by Kane (1981) as the 'regulatory dialectic': regulation breeds financial innovation (to avoid limits on profitable opportunities from such regulation) which, in turn, breeds further regulation.

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Apart from the implication that there will always be ongoing regulatory change in the financial sector, and associated debate about merits of the extant regulation, there are a number of important consequences from this simple observation.

First, there is a risk that the regulatory burden can accumulate over time as new regulations are introduced to plug holes and support previous regulations which have lost their effectiveness.

Second, and reflecting the potential for such a cumulative effect, there is a strong case for regular review of existing regulation to determine whether it remains the optimal way of achieving its objectives. Mechanisms for doing so include: the use of 'sunset clauses' when regulation is introduced; by holding occasional independent reviews (such as the Campbell and Wallis Inquiries); and the activities of the Office of Best Practice Regulation (recently established within the Productivity Commission).

Third, while it has been proposed by the Regulation Review Task Force that cost-benefit analysis be required of all proposed regulatory changes, ability to apply this technique to analysis of financial regulation is highly problematic. Regulatory changes lead to a change in the dynamic evolutionary path of the financial system, and it is therefore necessary to compare the merits of one future path against another.

This is far more complex than the typical use of cost–benefit analysis in comparing one static equilibrium position against another — if only because it requires speculation about the potential future evolutionary path. For example, when the Campbell Inquiry was considering the merits of financial deregulation at the start of the 1980s, it was noted that the static 'welfare triangle' benefits of removing various implicit taxes on financial intermediation were potentially miniscule relative to the benefits which would evolve over time from a more dynamic and innovative financial sector. And this proved to be the case, but not without some initial adverse consequences due to inadequate attention to appropriate HSE (health, safety and environment) and information regulation to underpin a smoothly functioning, liberalised financial sector.

Fourth, ongoing evolution of the financial sector means that regulation of the 'black letter law' type which attempts to write rules to prevent particular specific actions

or contractual features will struggle to succeed. Financial innovation and engineering will typically produce alternative techniques and financial products, not captured by the regulations, which achieve the same outcomes. Consequently, there is considerable merit in a 'principles based' approach to regulation, within which regulators can deal with specific cases as they arise. Of course, that also has implications for the relative roles of politicians and regulators in the design of legislation and accompanying regulations. It also affects the potential need for mechanisms for those affected by regulatory interpretation of principles to appeal against incorrect interpretations.

Another important feature of the financial system and financial regulation arises from the fact that, particularly in the case of HSE and information regulation¸ much of the rationale for regulation is based on preventing or limiting undesirable practices by 'bad' institutions (and consequent undesirable outcomes). But a critical problem lies in distinguishing between entities that are likely to engage in such practices ('bad' institutions) and those that are not ('good' institutions). If there is no way of making such a distinction, regulation will be applied to all, and impose unnecessary costs on 'good' institutions. In circumstances where there are only a small number of 'bad' institutions, the cost–benefit calculus from such regulations may be highly adverse.

With the growth of HSE and information regulation, which (unless carefully designed) imposes costs on all participants and not just those for whom regulation is necessary, it is not surprising that there are such concerns being expressed about excessive regulation.

Several consequences for the design of regulation flow from this observation. These reflect the view that efficient regulation will seek to find ways of achieving a separation of market participants into categories, each subject to appropriate regulation, rather than pooling participants and applying blanket regulation to all.

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One consequence is that there is a need for regulation to be designed with careful attention to the relative emphasis given to restriction of activities, degree of enforcement, and penalties. Optimal regulation is highly unlikely to preclude all bad outcomes. The merit of imposing regulatory costs on both 'good' and 'bad' institutions to prevent 'bad' institutions from offending, rather than identifying and imposing substantial 'ex post' penalties (with their general deterrence effects) in those latter cases, needs to be carefully assessed on a case-by-case basis.

There is also some merit in an 'institutional' focus for regulation, if the institutional categories signal different standards of behavior. Where continuing membership of some institutional category is conditional upon meeting certain standards, and involves costs which 'bad' institutions are unwilling to incur, there may be a case for different regulations applying between members of that category and others. The recent Basel 2 distinction between banks accredited to use the Internal Ratings Based (IRB) approach and those required to apply the Standardised approach in determining regulatory capital requirements can be thought of in this context (although the 'good' and 'bad' labels used above are not the appropriate ones here).

An alternative distinction which can be drawn to prevent use of 'blanket' rather than 'targeted' regulation is based on the nature of the counterparties involved in financial transactions. Thus, for example, there is significant merit in identifying suitable differential information requirements for issues of securities to wholesale (sophisticated) investors compared to issues to retail investors.

Finally, there is potential for self-regulatory and professional associations to play a role as an alternative to official regulation. However, viability of that role requires that they must be able to enforce high standards of participation or membership, and ensure that adequate compensation is available for victims of self-regulatory failure.

Conclusion

Achieving and maintaining an optimal regulatory structure for the financial sector is an ongoing challenge in the face of the continual evolution of the sector. And because all regulation involves winners and losers, there are significant political challenges in ensuring that regulatory evolution reflects social cost–benefit considerations rather than the self-interest of affected parties.

Whether current approaches to the manufacture and design of financial regulation in Australia are optimal is a matter worthy of further attention, as is the analysis of the extant regulation produced by those processes.

Unfortunately, there is a dearth of independent, impartial and informed commentators in this sphere, and a surfeit of well-resourced vested interests focused on preventing regulatory change which is adverse to their own self-interest. Finding ways to change incentive structures in academia to make analysis of financial regulation a priority area (which it currently is not), and developing truly independent financial sector 'think-tanks' outside of universities may be important precursors to developing an effective financial regulatory reform process. n

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ENDNOTES:

1. Davis 2003 provides an overview.
2. This concern led to the recent review of regulation (Regulation Taskforce, 2006).
3. http://www.regulationtaskforce.gov.au/submissions
4. In late 2006, the Government released proposals (Treasury 2006a, 2006b) to address some of these issues. Davis 2003 provides an overview.

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