Financial Liberalisation: Evaluating Options

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Outline

- Session Objectives
- Some Starting Principles and Consequences
- Introduction to Cost Benefit Analysis
- Applications

Objectives

- Develop intuition for assessing conditions needed for successful changes
- Explain basics of cost-benefit approach for assessing changes
- Applying the approach

Some Starting Principles (1)

- Successful financial reform requires existence of strong financial infrastructure and financial institutions
  - Adequate legal systems – protection of property rights
    - Insolvency laws, creditor rights, duties of agents
  - Supervisory and Regulatory capacity
    - Budgetary, Personnel, Independence, Accountability
  - Strong corporate governance mechanisms
    - Director’s duties, shareholder rights, market for corporate control, product market competition
  - Strong financial institutions
    - Well capitalized, good internal risk management and reporting systems
  - Appropriate disclosure and transparency
    - Accounting and auditing standards
  - Appropriate financial “safety net”
    - Investor (depositor) protection, crisis management mechanisms

Strong Infrastructure and Institutions

Without these "preconditions"

- Decision makers are not well-informed
  - End-users (firms, households), counterparties
- Reliable financial contracts cannot be written
- Excessive risk taking is not controlled
- Confidence is fragile
- Resolution of problems and failures is messy

Some unfortunate examples (1)

- Banking system previously highly regulated
- Restrictions removed and
  - Prudential supervision weak
  - product market competition liberated
  - limited stock market or (deposit) customer discipline
  - poor internal risk management controls in banks
  - Poor corporate governance (managerial ambitions dominate decision making)
- Consequences?

Consequences

- Competition for deposits
  - higher interest rates
- Substantial growth in lending
  - Lowering of credit standards
- Unsustainable asset price inflation
- Eventual banking crisis
  - Non-performing loans and write-offs
  - Inadequate bank capital
  - Bank failures

Some Unfortunate Examples (2)

- Liberalization of securities offerings
  - Can be marketed to retail investors
  - Financial advisers able to receive commissions from securities issuer (without disclosing)
  - A range of financial instruments possible, and differently regulated regarding information disclosure requirements
    - Property developer able to issue large denomination promissory notes, involving limited disclosure, which were "mezzanine" finance
- Consequences
  - High risk, illiquid, promissory notes marketed by advisers as secured by promise of property developer to poorly-informed investors
  - Failure of property developer and large scale losses for investors

Lessons

- Successful change requires preconditions of strong underpinnings of financial infrastructure and institutions
- Assessing consequences of change requires understanding of financial infrastructure strength

Some Starting Principles (2)

- Financial systems are continually changing organisms
- Responding to
  - Changing demands for delivery of core economic functions
  - Technological changes which alter relative cost and methods of supply of services
  - Regulatory hindrances and opportunities

Implications

- Inappropriate to view consequences of regulatory change as involving a shift from one “equilibrium” financial system structure to another “equilibrium”
- Need to assess consequences in terms of how development path of financial system is likely to be affected

Example

- Privatization of a large dominant government – owned & controlled bank
- Consequences may include
  - Allocation of credit to industry sectors, and emergence of alternative suppliers
  - Banking industry structure – mergers etc
  - Competitive pressures and interest rate effects
  - Innovation in range of financial products
  - Capital market deepening and broadening of share ownership

Some Starting Principles (3)

- All regulatory change involves a cost benefit analysis
- But
  - By whom?
  - How detailed, how accurate, implicit v explicit ?
  - For whom – social or private cost-benefit?
- Distributional consequences can create opposition from vested interests to socially valuable changes

Cost-Benefit Analysis

- The UK's FSA has led in requiring explicit application of cost benefit analysis of expected effects to proposals for regulatory change
  - "CBA sorts those economic impacts into costs and benefits, and, where possible and worthwhile, quantifies them using statistical techniques and economic analysis".
- Principles, if not practice, of cost-benefit analysis are simple and useful

Cost-Benefit Analysis

- Not a simple process
  - Some effects not quantifiable
  - Expected effects are “model dependent”
    - Linkages, interactions need to be understood to identify indirect effects
  - Discount rate for future costs and benefits?
  - Possible (virtual) irreversibility of some changes and need for “real options” approach
- Doesn’t capture distributional effects but
  - Helps identify key consequences
  - Can (via sensitivity analysis) assess risks

Implementing the Approach (1)

- One approach is to identify particular types of effects and attempt to quantify
- FSA handbook lists six cost-benefit categories
  – Direct costs (to regulatory agencies)
  – Compliance costs
  – Quantity (output) effects
  – Quality effects
  – Product variety
  – Efficiency of competition

Complementary Approaches (1) cont

- Note: price changes are not included
  - gains/losses to sellers/buyers net out
  - output consequences of price change matter
  - distributional effects may matter

Implementing the Approach (2)

- Alternative approach – start with analysis of overall financial sector reactions:

Agree Framework	Impact Analysis	Quantify
Scope	Primary impacts	Estimate costs
Baseline	Transmission mechanisms	Analyse benefits
Stakeholders	Final outcomes	Risk and uncertainty

- Greater need for analysis/understanding of eventual effects, including interaction with existing regulatory framework
  - Include risk analysis

Cost-Benefit Analysis

"a successful CBA might be rather like an impressionist painting – much less detailed than a photograph but much more recognisable than an abstract image would be".