
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
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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
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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)

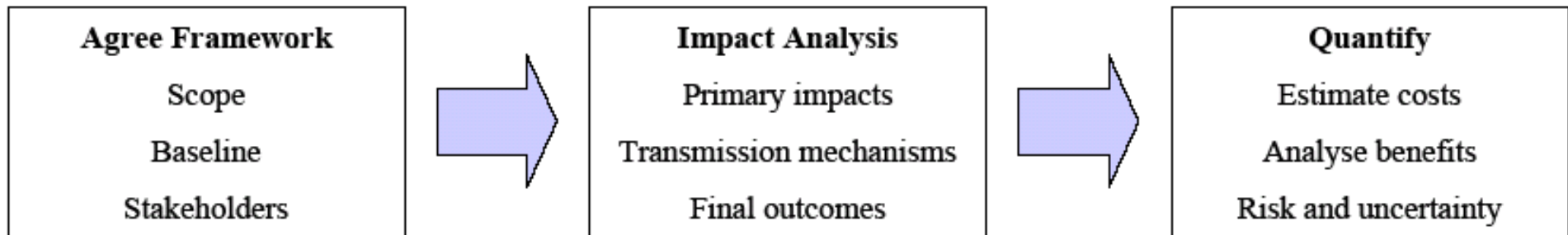
- One approach is to identify particular types of effects and attempt to quantify
- FSA handbook lists six cost-benefit categories
 - Direct costs (to regulatory agencies)
 - Compliance costs
 - Quantity (output) effects
 - Quality effects
 - Product variety
 - Efficiency of competition

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:



- 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”.