"Proportionate" Regulation in the Financial Sector: Underlying Issues

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Financial regulation has an ultimate objective of preventing financial sector participants from undertaking actions which are judged to fail a social cost-benefit test. Indeed, all financial regulation (and legislation) should be subjected to such a test before introduction and at appropriate intervals to assess its continuing suitability in an ever-changing world. As discussed below, such cost-benefit analyses are not simple, nor necessarily conclusive, because the potential effects of regulatory change can be diverse, hard to identify, and hard to quantify.

Why is regulation needed? One reason is that there are situations in which private incentives will lead all relevant financial market participants to take actions which are not socially beneficial. This may arise because market "imperfections" cause private profit maximization to be inconsistent with maximization of social welfare. Several examples are obvious.

- Governments may impose taxes or provide implicit subsidies (such as adopting "too big to fail" responses to financial institution failure) which the private sector seeks to avoid or to exploit. Minimum capital ratios are, for example, a response to banks attempting to use excessive leverage to maximize gains from implicit government support and "bail outs.
- Barriers to entry may lead to some providers of financial products or services having market power, and consequently restricting output and charging higher prices or fees than are desirable on social welfare grounds. The payments sector is one such example, where "natural monopoly" features of interchange arrangements and concerns about fair pricing of access for providers of payments services may lead to regulatory oversight of pricing.
- Imperfect information, where customers are unable to properly assess the value or risk associated with a particular financial service may lead to profitable opportunities for financial firms supplying products to customers which are overpriced or not appropriate for their needs. Here, a balance needs to be struck between *caveat emptor* (buyer beware) and Government regulation based on paternalism to protect such customers. With both approaches having costs as well as benefits, a common feature of financial sector policy has been attempts to reduce the information gap. Disclosure requirements and financial literacy education are obvious examples.

Because such policies impede all financial firms exploiting profitable opportunities it is natural to expect private sector concerns about the extent and severity of such regulation. However, it is an alternative aspect of regulation which tends to create most concerns. This is the fact that some individuals/institutions will be willing to break laws for private gain, at the risk of being caught doing so and punished. The

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difficulties in identifying those *ex ante* means that laws and regulations designed to prevent such behaviour apply across the entire population, imposing costs on others who would not behave in that manner. Similar situations arise in which some suppliers of products and services are incompetent, and where customers are unable to identify competency – until it is too late. Examples include:

- Licensing and training requirements for financial advisers, where some financial institutions with valuable reputations to protect ensure competency of staff in other ways which are less costly than those arising from compliance with the regulation.
- Reporting requirements associated with anti-money laundering.
- Regulations to limit default risk by unscrupulous financiers who borrow funds from the public. One regulatory approach to dealing with this is the "if-not-why-not" disclosure regime applied in Australia by ASIC. This requires financial firms engaged in certain activities to disclose, and explain, to the public if, and why, their business and financial operations do not conform to a recommended template from ASIC.

Financial Evolution and Innovation: Consequences for Financial Regulation[1]

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 Professor Ed Kane as the 'regulatory dialectic': regulation breeds financial innovation (to avoid limits on profitable opportunities from such regulation) which, in turn, breeds further regulation. 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; creation of such organisations as an Office of Best Practice Regulation (established several years ago in Australia within the Productivity Commission).

Third, while cost-benefit analysis is often seen as a desirable requirement for 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 against another.

[1] This section is adapted from: Kevin Davis "Financial Regulation: trends and prospects" The Melbourne Review, 3, 1, May 2007, 35 - 40.

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.

Types of Regulation

Financial regulation can, at the risk of oversimplification be divided into three types – although there are interdependencies and overlaps between the types.[2]

- *Economic Regulation* – aimed at limiting or influencing the decisions made by financial market participants in order to achieve a more efficient allocation of economic resources. Examples include such things as: competition policy aimed at preventing excessive concentrations of economic power; pricing regulation arising as a result of natural monopoly or market network characteristics such as in the provision of payments services. Such regulations are based on rectifying market imperfections, although it is necessary to continually assess whether the regulated outcome is socially preferable to the unregulated situation. Historically, in many countries, it has also been the case that *direct control* regulations, such as asset portfolio restrictions, interest rate ceilings, activity restrictions have also been applied because of perceived (although rarely proven) market failings.

  Such economic regulation may also have a *positive* focus – such as where it is recognised that market imperfections preclude adequate access to financial services by particular groups. Government support for micro-finance organisations, government provision of certain services (such as trade finance insurance), and mandating of credit information provision to central credit bureaus are examples.

  In recent years another form of regulation has emerged which could be argued to fit within this category – namely *financial stability regulation*.[3] Current proposals for Central Clearing Counterparties (CCCPs) for derivatives, structural separation of investment (casino) banking and commercial (utility) banking such as the Vickers Report recommendations in the UK, special taxes on large banks, are examples of this trend. In essence, such proposals are based upon the view that interdependencies within the financial sector create spillovers (externalities) among financial institutions and markets which are potentially harmful to financial stability. Regulations to redesign the financial sector structure or impose

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[2] The categorization adopted here is a variant on that suggested in White, L. J. 1999, 'The Role of Financial Regulation in a World of Deregulation and Market Forces', IMF Conference on Second Generation Reforms, Washington, DC, November 8–9, 1999.
http://www.imf.org/external/pubs/ft/seminar/1999/reforms/white.htm

[3] It could be argued that this type of regulation is better considered under the next heading, but it spans both categories.

constraints and costs on those responsible for such externalities may thus be warranted.

- *Prudential Regulation and Consumer Safety*. A dominant theme in regulation of the past three decades has been that of protection of end-users (households, businesses) of the financial system. Financial products and services provided by financial firms to end-users involve promises (of varying degree) about future outcomes and about the robustness of processes and procedures used by the financial firms in leading to those outcomes. The recognition that *caveat emptor* (buyer beware) is an inadequate approach when customers of financial firms do not have adequate information or expertise to assess those promises prompts a role for this type of regulation. Regulatory oversight and imposition of regulatory standards consistent with those promises substitutes for individual evaluation and monitoring.

  Examples of this form of regulation include: licensing requirements; bank capital and liquidity requirements; supervision of particular financial institutions; fiduciary duty requirements of agents managing funds of third parties; product suitability assessment requirements for providers of certain financial products to consumers.

  Also relevant and important in this regard are arrangements for dealing with the consequences of “broken promises”, where individual action may be infeasible, and leading to some form of collective action arrangements. Examples include government compensation schemes and financial ombudsman and complaints/arbitration arrangements. More generally, the structure of legal arrangements is also relevant, such as whether *class actions* are allowed, and whether *third party litigation funding* is also permitted.

- *Information Regulation.* Also important in recent decades has been emphasis upon improved provision of information by financial sector participants, aimed at overcoming the *opaqueness* which characterises financial firms and creates information asymmetries which impedes good decision-making by potential users. Not only do information deficiencies expose users to risk of unexpected bad outcomes (due to fraud, miss-selling, misunderstanding) it also inhibits use of the financial system with adverse consequences for economic growth and development.

  To the extent that information deficiencies can be reduced and individual decision making enhanced there can, arguably, be less reliance on prudential and consumer safety regulation. However, this assumes that improved provision of information translates into enhanced use of that information – requiring a degree of financial literacy which is generally sadly lacking in all economies. Thus requirements for production and distribution of information are not sufficient – and ability to understand information can be impeded by excessive volume and complexity. Requirements for the type and form of presentation of information required need to be carefully assessed and matched with programs to ensure financial literacy adequate to deal with such information. While financial analysts and financial advisers may be able to interpret and disseminate complex financial information to the broader community, there are dilemmas arising in this process due to the

nature of their compensation arrangements which can create conflicts of interest. Hence, consumer/investor protection regulation may involve constraints on remuneration structures such as preventing commission payments from manufacturers of financial products.

Among the various types of information regulation are : disclosure requirements for the issuance of new securities and managed funds; requirements for disclosure of fees and charges; provision of information in standardised forms to enable comparisons across firms (such as annual percentage rates for loans).

Approaches to Regulation: Some Issues

Legislation versus Regulation

An important consideration in financial sector policy is the extent to which preferred outcomes should be achieved by use of legislation or through regulation. Legislation can set down specific requirements which need to be met, or proscribe certain activities, as well as being the basis for delegation of powers to government authorities to make regulations about allowable behaviour. Thus, for example, banking legislation may prevent any institution from accepting deposits without a prospectus unless they meet certain prescribed conditions and are granted a banking licence. Legislation will typically also provide the prudential regulatory authority with power to make and enforce regulations limiting the activities of holders of a banking licence.

The extent to which constraints on financial sector participants should be imposed by legislation or by regulation depends on a number of factors. Relevant considerations include: the ease of enforcement and application of penalties; the relative ease of changing constraints through legislation or regulation in response to changing financial and economic circumstances; incentives of the relevant authority to ensure enforcement.

The ASIC “if-not-why-not” approach (discussed above) can be viewed as an attempt to enforce particular requirements on financial firms without use of legislation even though, arguably, those requirements are socially desirable and warrant legislation to ensure compliance.

Principles v Rules

An ongoing debate in financial regulation concerns the extent to which regulation should be achieved through a “principles” or a “rules” approach. In the former, entities are required to operate in a manner which is consistent with certain principles and which it is believed will thus lead to desired outcomes. Conceivably, there are numerous operational arrangements which are consistent with those principles, some of which will be more suited than others for some entities, and which they can choose to use. While the principles may limit choice, they provide flexibility for entities to adopt a preferred approach. In this regard, the approach seems most suitable when (a) relevant entities vary sufficiently in their characteristics as to make one rule unsuitable for all (b) governments and regulators do not have sufficient information to determine a rule which would best achieve social goals at minimum cost. The

downside of a “principles based” approach is that entities may have difficulty in determining whether particular operational activities fully comply with the principles, leaving them exposed to legal liability.

The rules approach involves the setting down of explicit requirements which must be met by entities. It has the advantages of simplicity and enforceability, but limits flexibility. It also faces the problem of dealing with financial innovation (which it breeds) where substitute financial products and services emerge which are not captured by the rules. Over time, the cumulative effect of rule-making to plug holes can lead to excessive (and inconsistent) regulation.

Self (Industry) Regulation and Official Regulation

There is potential for self-regulatory and professional associations to play a role as an alternative or complement 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.

Cost Benefit Analysis of Financial Regulation

Since financial regulation is designed to improve social welfare it must involve at least an implicit cost benefit analysis. But:

- by whom;
- how detailed, how accurate is it;
- is it implicit v explicit;
- on what basis is it done, is it focusing on social or private cost-benefit consequences;
- who knows the results;
- is there learning from back-testing?

Some starting principles for regulatory changes can be readily identified.

First those responsible for regulatory change should be accountable, for rigorous, informed, analysis and decision making. Such accountability requires transparency and disclosure both *ex ante* (are the changes justified and best possible) and *ex post* (if there were unexpected outcomes, what was the cause)?

Second design of good regulation requires good information and good analysis of consequences. Unfortunately the required information is dispersed and held by diverse stakeholders and analytical ability and approach to assessment can differ between stakeholders (eg private interest versus public interest perspectives).

–Third, regulatory change is a battle of vested interests, because it is extremely rare (impossible?) to identify regulatory changes which are *Pareto Improvements* (ie where no one is worse off). And in this regard it is worth noting that legislators and regulators will be influenced by their own private interests (as well as, hopefully, the broader social interest), as are private sector participants.

Some consequences for the regulatory design process follow.

- Public consultation is desirable to gain information and test analysis (although public consultation may involve little more than spirited debate in pursuit of private interests dressed up as social interest)
- An explicit framework for assessing social costs and benefits and distributional (private) effects is warranted with results subject to public scrutiny both for good decision making and for accountability

One such framework is *Cost-Benefit Analysis*

The UK's FSA has been a leader in requiring explicit application of cost benefit analysis (CBA) of expected effects to proposals for regulatory change and defines it as follows "CBA sorts those economic impacts into costs and benefits, and, where possible and worthwhile, quantifies them using statistical techniques and economic analysis".

It is not a simple process however.

- Some effects not quantifiable
- Expected effects are "model dependent"
- Linkages, interactions need to be understood to identify indirect effects
- What is the appropriate discount rate for converting future costs and benefits into present value terms?
- Possible (virtual) irreversibility of some changes and hence there is a need for a "real options" approach
- It doesn't capture distributional effects but helps identify key consequences and can (via sensitivity analysis) assess risks

In applying CBA the FSA handbook lists six cost-benefit categories

- Direct costs (to regulatory agencies)
- Compliance costs
- Quantity (output) effects
- Quality effects
- Product variety effects
- Efficiency of competition effects

Note that price changes are not included, because gains/losses to sellers/buyers net out. However, the output consequences of price changes matter, and distributional effects may matter. It has been suggested that "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".

Some Concluding Questions

- Are consultation processes for regulatory change adequate for information gathering, informed decision making? Or do they inappropriate facilitate influence of vested interests
- Should explicit cost-benefit analysis be required?
- How should the additional resource cost of CBA be funded?
- Who should do CBA – regulators or independent consultants?
- How is accountability for thorough analysis of regulatory change improved?