

## Approaches to Financial Regulation

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### Introduction

4.1 A basic aim of this Inquiry is to determine how the financial system can best perform its economic functions in the public interest, particularly in the light of the major changes which have occurred or now face the system. In particular, the Inquiry has been asked to make recommendations on the best regulatory arrangements for the financial sector.

4.2 The financial system is part of the broader national economy. The services it provides have real resource costs and, overwhelmingly, the benefits of those services accrue directly to their users. Accordingly, like most other goods and services, financial services are best provided through free and efficient markets which best match these costs and benefits.

4.3 The chief advantage of markets, particularly in a commercially sophisticated economy, is that they are the most flexible and efficient means for ensuring that:

- services provided by suppliers respond to the diverse and changing needs of consumers; and
- prices charged for services reflect their true costs so that economic resources are allocated to their most highly-valued uses.

4.4 This is not to say that markets always work as well as they should without any intervention by government. To ensure that markets work well, government has an important role in regulating the financial system.

4.5 One of the most complex issues facing government is identifying the appropriate level and form of intervention. Its efficiency as a regulator is a significant determinant of the overall efficiency of the economy. The extent of regulatory intervention may also determine whether financial markets can develop to their full potential. Ultimately, any inefficiency must be funded by higher charges or taxes, or passed on to the community as costs arising from poor service or uncompetitive pricing.

4.6 This chapter provides an introduction to these issues by:

- discussing the basic objectives of regulation;
- considering whether there is a basis for special regulation of the financial system;
- identifying the main forms of financial sector regulation; and
- setting out some broad principles for the assessment of regulations.

4.7 Subsequent chapters discuss the specific forms of regulation (including institutions, skills and legislation), taking account of these regulatory objectives and criteria.

## The Objectives of Regulation

### Broad Purposes of Government Intervention

4.8 The 2 main purposes of government intervention in economic activity are:

- to ensure that markets work efficiently; and
- to redistribute income in accordance with social objectives.

4.9 The Financial System Inquiry is primarily concerned with regulations which pursue the first of these objectives. However, financial sector regulation has sometimes also been used for distributional purposes.

### *Intervention for Market Efficiency*

4.10 Essential to efficient decision-making in markets are a number of requirements which may not be met without government intervention. In general, these requirements can be categorised as follows:

- a reliable legal and ethical framework for commercial exchange;
- competition between suppliers so that none is able to exercise monopoly or oligopoly power; and
- the absence of market failure. Market failure here means that there are factors at work in markets which prevent them from reaching the most efficient price, consumption or supply decisions. The most common of these factors, known as ‘externalities’, are the economic activities of some participants that indirectly affect, positively or negatively, the well-being of others. Another factor can be inadequate exchange of information among market participants.

4.11 The first requirement, a reliable legal and ethical framework for business, is fundamental to the health of modern market economies. Commercial regulation provides the legal and ethical framework within which commercial exchange takes place. For the most part, the issues facing purchasers of goods and services are limited to legal ownership and accurate representation of the quality and nature of the goods or services sold. Also important are clearly allocated and enforceable property rights. For some parts of the financial system, some new issues are emerging in this area — for instance, the need to establish accepted legal rules for electronic commerce and to avoid impediments to new products or processes such as securitisation.

4.12 The second requirement, maintaining competition in markets, is axiomatic to the role of markets themselves. If one or a few firms can restrict competition, they are likely to raise prices, restrict supply, offer poorer service or reduce innovation, none of which is acceptable. Competition regulation aims at preventing industry structures or conduct which endangers or restricts competition.

4.13 The third purpose of regulation is to deal with the existence of externalities or other possible causes of market failure. Examples are the threat of systemic risk in financial markets (see discussion in next section)

and lack of consumer information about complex financial products. The existence of externalities or market failure is a necessary but not a sufficient condition for government intervention, because intervention inevitably involves costs. Efficiency demands that the benefits of correcting the situation outweigh the costs of intervention. These issues are considered in more detail below.

### *Intervention for Distributional Objectives*

4.14 It is beyond the scope of this Inquiry to consider government's overall social or distributional objectives. Generally, these objectives are pursued through transfers, in particular a government's taxation and social security programs, or through other social insurance or expenditure programs in areas such as education and health. However, it is also possible to pursue limited distributional purposes through market regulations such as price controls. Such regulations are sometimes referred to as 'community service obligations'.

4.15 In recent years, there has been a general trend away from seeking to meet distributional objectives through the imposition of regulations on markets. It has been recognised that meeting such objectives in this way is usually inefficient and poorly targeted, and imposes hidden costs.

4.16 In the case of financial markets, distributional objectives have only infrequently been pursued through regulation. Recently, however, there have been suggestions that banks should have a community service obligation to provide basic banking services free of charge. There has also been discussion of the social implications of the closure of bank branches. These issues are discussed in Chapter 8.

## Special Features of the Financial System

4.17 As for many other industries, governments regulate the financial system in varying degrees for each of the purposes set out in the previous section. In some cases, the regulations applying in the financial sector are those which apply to industries across the whole economy but, in other cases, the regulations and regulators are specific to the financial sector. Why does the financial system have special regulators?

4.18 There are 2 particularly important features of the financial system which, although not unique to that system in every respect, give rise to the need for special regulation: systemic risk and information asymmetry.

### Systemic Risk

4.19 By their nature, financial transactions involve promises to make payments at specified times, in specified amounts and in specified circumstances. Such promises inevitably involve uncertainty and yet play a fundamental role in the efficient functioning of commerce, facilitating the settlement of trade and channelling resources efficiently across time and space.

4.20 The more sophisticated the economy, the greater its dependence on financial promises and the greater its vulnerability to failure of the financial system to deliver against its promises. The importance of finance and the potential for financial failure to lead to systemic instability introduces an overarching externality that has been the focus of regulation for most of the twentieth century.

4.21 Systemic instability is not a clearly defined concept. Systemic issues arise where financial distress in one financial institution is communicated to others. This contagion may occur as a result of a crisis of customer confidence in other institutions or because failure of an institution to settle its obligations directly causes the failure of other, fundamentally sound institutions.

4.22 Systemic instability will not occur simply because a financial promise is not met. Such failures are quite common in any market economy.

Since the existence of risk is fundamental to financial choice, there is an inevitable presumption that some investments and institutions will fail from time to time.

4.23 It can be difficult to determine exactly where the risk of systemic effects arises, or what its ultimate causes could be. Contagion risk may be highest among deposit-taking institutions such as banks, due to the inherent difficulties in the nature of the promise they make to transform illiquid assets into liquid liabilities. Such a commitment can be met under most circumstances, provided adequate liquid assets are held in reserve. However, when a sufficiently large proportion of customers demand convertibility at the same time, the commitment cannot be met without outside assistance. Since all deposit-takers suffer the same potential weakness, a crisis of confidence in one entity can quickly spread. Further, the nature of the weakness is such that concern about insolvency, whether or not well founded, may be sufficient to create insolvency if assets are liquidated at reduced prices to meet the demands of withdrawing depositors.

4.24 The failure of entities which provide payment services, particularly where these services extend to final settlement, could also disrupt the integrity of the payments system and precipitate a wider economic crisis. Arguably, it is in the core of the payments system, where obligations are settled between financial institutions, that the greatest systemic risk arises.

4.25 While the potential for systemic instability is normally associated with the promise of liquidity and the danger of contagion among like institutions, loss of confidence in institutional groups can still lead to a crisis of confidence if the institutions are of sufficient size and importance in the functioning of the financial system.

4.26 This source of systemic instability has given rise to the doctrine of 'too big to fail', an unwritten rule adopted by most banking regulators around the world. In essence, the doctrine acknowledges that such institutional failure can be extremely disruptive of the financial system and, through it, the real economy. The doctrine of 'too big to fail' has been mostly applied to banks, although it may also be relevant to other financial (or even non-financial) institutions.

4.27 Systemic issues can also arise where the institutional structure of a market is incapable of coping with extreme pressure for price adjustment. The share price collapse in 1987 is a good example. The chaotic market conditions at the time were compounded by the inability of the stock market trading framework to handle the volume of selling orders. While regulators did not support the stock market directly, they provided the liquidity needed by institutions exposed to that market. This avoided large-scale institutional failure, thereby reducing transmission of problems in the stock market to other markets.

4.28 Ultimately, systemic risk is principally of concern where there is potential for damage to the real economy. Where the risk is greatest, it is likely that prudential regulation, aimed at minimising the risk through the promotion of more prudent behaviour, should be provided. Where the risk is less, the regulatory response may be restricted to crisis arrangements such as liquidity support which should be available to deal with problems once they arise. These issues are explored in Chapter 7.

## Information Asymmetry

4.29 A second special case for regulatory intervention in financial markets arises from the intensity and nature of the informational imbalances or ‘asymmetries’ that exist between financial institutions and retail consumers of financial services. This imbalance extends beyond traditional deposits to other types of financial promises, such as insurance and superannuation.

4.30 There is nothing unusual about the asymmetry of information available to a supplier and a consumer. Many products or services are complex, difficult to compare, have considerable importance for the well-being of their consumers or are provided over a long period of time. Financial products are by no means alone in these characteristics, and not all financial products share them.

4.31 However, financial products are perhaps unique in the nature and intensity of these characteristics. In purchasing a financial promise, consumers often have very limited means of assessing the capacity of the

supplier to meet the promise, and often rely on that capacity being maintained over a long period during which it could radically change.

4.32 These features, in combination, have often been seen as justifying special regulations.

4.33 There are, broadly, 2 types of regulatory response that could be made to overcome information asymmetry in financial services.

- The first is regulation to ensure disclosure, including disclosure of risks (broadly similar to other types of consumer protection regulation). This helps consumers to understand the nature of the contracts they are party to and allows them to make better informed choices between price and risk in the services being considered. Disclosure requirements also expose providers of financial services to public scrutiny and competitive pressure from the professional market.
- The second is regulation to ensure that promises are met. This seeks to provide ‘safe havens’ for investors, and may be achieved by some type of investor insurance, government guarantees and/or prudential supervision.

4.34 Each of these responses may also contribute to addressing systemic risk concerns. Deciding whether one, both or neither of these responses is appropriate in different circumstances is one of the more difficult challenges for regulatory reform.

## Financial System Regulation

4.35 Regulation of the financial system takes 4 main forms:

- regulation to promote financial market integrity;
- competition regulation (principally regarding mergers and anti-competitive conduct);
- prudential regulation (in this paper, the term ‘prudential regulation’ is used broadly, and is not distinguished from the term ‘prudential supervision’); and



- consumer protection regulation. It is the ultimate objective of all of the above forms of regulation to ‘protect’ consumers in one way or another. The last of these categories is a term used to cover those regulations providing for specific financial product disclosures, prescribing specific requirements for the conduct of financial dealings with consumers, and establishing dispute resolution arrangements. It also refers to arrangements to protect depositors (or like arrangements for other classes of investors) in the event of the failure of a financial institution.

4.36 There is often a confusion between prudential regulation and consumer protection. This is particularly so because disclosure requirements may be used as instruments for both purposes (since disclosure may assist in ensuring that market pressures apply against imprudent behaviour). The distinction between the 2 types of regulation can perhaps be best made by reference to the specific purposes of each type of regulation.

4.37 The purposes of financial regulations are to ensure at least that financial promises are understood and, in their more intense form, that they are met. Different forms of regulation primarily meet different aspects of these purposes:

- the purpose of prudential regulation is to ensure (or at least increase the likelihood) that the entity making a financial promise is able to meet it;
- the purpose of consumer regulation is to ensure that consumers understand the promises made to them, including their risks, to proscribe false or misleading promises or to provide recourse in the event that a promise is not met; and
- the purpose of the criminal and civil contract laws is to ensure that promises that can be met are met—that is, that they are not fraudulently made.

## Market Integrity

4.38 In this Discussion Paper, market integrity regulation refers to the regulation of fundraising and securities and derivatives markets, both through exchanges and ‘over the counter’. It encompasses disclosure requirements in these areas, approval and oversight of exchanges, and prohibitions on unfair trading practices or market manipulation.

4.39 In general, market integrity regulation draws little distinction between the retail and wholesale sectors. Issues of overlap and inconsistency sometimes arise between market integrity regulation as it relates to retail investors and consumer protection laws.

## Competition Regulation

4.40 Competition regulation refers to laws which aim to ensure that participants in a market engage in practices which, as far as possible, accord with the principles of perfect competition. Under these principles, the prices of goods and services are set consistently with the resource costs of their supply, and the most successful suppliers are those who best meet the price and quality requirements of consumers. In particular, the aim of such regulation is to prevent concentration of ownership or collusion between suppliers in markets where this leads to monopolistic pricing or to prevent other conduct which damages competition. Competition regulation may be directed at the structure of markets, principally through laws controlling mergers and acquisitions, or it may be directed at the regulation of anti-competitive market conduct.

4.41 Another important consideration in competition policy more generally is to ensure that regulations in other fields achieve competitive neutrality (see discussion in next section) and do not unduly discourage new entry to markets. The threat of new entrants can be a powerful antidote to anti-competitive behaviour in markets.

## Prudential Regulation

4.42 Prudential regulation refers to regulation whose aim is to ensure, or increase the likelihood, that financial institutions are able to meet their promises, whether to address systemic risk or to reduce risks for consumers. It seeks more ‘prudent’ behaviour by financial institutions, thereby reducing the uncertainties faced by those who purchase financial promises from regulated institutions. Examples of prudential regulations are capital adequacy requirements, solvency and liquidity requirements, investment guidelines or restrictions, and requirements to undertake particular risk management procedures. In addition, prudential regulation may also involve arrangements which ensure that where losses occur, they are managed in a way which minimises the damage or the spread of losses to other institutions.

4.43 There are a number of different risks that may be the target of prudential regulation. Risks can be categorised in a wide variety of ways, but it is particularly useful to distinguish market risk and credit risk. In the case of bank deposits, for example, prudential regulation aims mainly at preventing credit risk for the depositor — that is, it aims at ensuring that banks can pay depositors the full amount standing to their credit. In contrast, and in addition to credit risk, many investors in insurance and superannuation funds are subject to market risk whereby the value of the investment may rise or fall with the market value of the assets held by the fund. Prudential regulation in this case may also seek to reduce the extent of investor exposure to market risk (and to prevent fraud or incompetence), but not to eliminate market risk altogether.

4.44 Another risk which is commonly referred to in the financial system is payments risk. This is a form of credit risk that arises where a provider of payments services may be unable to meet obligations arising when there is a delay between the making of a payment instruction (such as writing a cheque) and its settlement. There is a particular concern to minimise payments risk, because there is very little scope for users of the payments system to assess it and, since it may lead to systemic effects, the potential cost to the economy of failure to settle is very high.

4.45 Appropriately, prudential regulation may be applied with varying intensities in different circumstances. Typically, these arguments have led to the strongest supervision being applied to entities engaged in the core payments clearing and settlements systems.

## Consumer Protection

4.46 The term ‘consumer protection’ is used in this Discussion Paper to refer to:

- regulating the conduct of business with consumers;
- regulating for disclosure of information relating to products and services (such as prices, terms and conditions);
- enforcing contracts, preventing fraud and resolving disputes;
- regulating product terms and conditions for social policy purposes; and
- providing arrangements for the protection of depositors (or other investors) from losses due to financial failures.

4.47 Consumer protection is applied in this paper only to business with retail customers (see Chapter 8 for a discussion of this term). Important examples of policies in this area are contract and banking laws, credit laws, disclosure rules and dispute resolution mechanisms. Also important in many sectors are self-regulatory arrangements relating to customer relationships, the provision of information, ensuring that rules and conditions applying to services are fair, and ensuring that complaints are promptly and fairly dealt with.

4.48 Most of these laws are aimed at ensuring that the consumer understands the product or service (the promise) which is being purchased. The term also covers laws such as those allowing for the monitoring of prices, which may in part be used for social objectives.

## Principles for the Assessment of Regulation

4.49 An ‘ideal’ regulatory regime is one that balances the benefits of a vibrant, efficient, forward-looking financial services sector with the need for that sector to be stable and capable of meeting the promises that it makes. Efficiency and stability both demand a high level of consistency and co-ordination between regulatory bodies and legislation.

4.50 Stability also requires some international oversight of institutions to monitor aggregation of risks. There should be neither gaps nor overlaps in regulatory coverage, both nationally and internationally.

4.51 All providers of similar financial products and services should be subject to a similar degree of regulatory oversight and similar cost burdens. This is likely to require a consistent assignment of regulatory responsibilities to government portfolios.

4.52 The following are suggested as essential attributes of an effective regulatory structure:

- competitive neutrality;
- cost effectiveness;
- transparency;
- flexibility; and
- accountability.

### Competitive Neutrality

4.53 Competitive neutrality requires that the regulatory burden associated with a particular financial commitment or promise apply equally to all who make such commitments. It requires further that the barriers to entry and exit from markets and products be no greater than necessary, that institutions be not unduly restricted in the products they can offer and that markets be open to the widest possible range of participants. Increasingly, to the extent that markets are becoming globalised, competitive neutrality

needs to be assessed on a global as well as domestic basis — that is, the rules applying to domestic participants should not be unduly costly or restrictive compared with those applying to overseas participants.

## Cost Effectiveness

4.54 Cost effectiveness is one of the most difficult issues for regulatory cultures to come to terms with. Any form of regulation involves a natural tension between effectiveness and efficiency. The greatest danger in any regulatory system is that regulation becomes an end in itself. Regulation can be made almost totally effective by simply prohibiting all actions potentially incompatible with the regulatory objective. But, by also inhibiting productive activities, such an approach is likely to be highly inefficient, as many countries concluded about their over-regulated financial systems in the 1970s.

4.55 A cost-effective regulatory system requires that:

- there be a presumption in favour of minimal regulation unless a higher level of intervention is fully justified;
- regulatory functions be allocated among regulatory bodies so as to minimise overlaps, duplication and conflicts;
- regulatory bodies have an explicit mandate to balance efficiency and effectiveness, both at a point in time and dynamically over time;
- the underlying legislative framework be effective (including, increasingly, taking account of the globalisation of markets);
- different regulatory objectives be clear, where possible capable of objective measurement, and appropriately co-ordinated; and
- the costs of regulation be allocated (albeit often indirectly) to those who enjoy the benefits.

## Transparency

4.56 Transparency of regulation requires that any guarantees and other regulatory promises be made explicit and that all purchasers of financial products be fully aware of their rights and responsibilities. It also requires regulation to have clearly stated objectives. This is essential for the efficient operation of markets which thrive best where the regulatory arrangements applying to them are certain. Equally important for an effective regulatory structure is that regulations, and hence public and private promises, be fully understood.

## Flexibility

4.57 One of the most pervasive influences over the financial system as it evolves into the next century will be technology. While it is not possible to forecast with certainty the impact of technology on financial services and service delivery, it is certain that it will be dramatic. The level of uncertainty clouding the future puts a premium on flexibility. It is critical that the regulatory framework has the flexibility to cope with changing institutions, product structures and delivery mechanisms without losing its effectiveness.

4.58 Experience has shown a clear tendency for institutional boundaries and even product boundaries to blur over time. Not only has this been a natural result of market pressure and innovation, but in some cases it has also been a response to the regulatory structure itself. Regulatory failures have often resulted from regulators falling behind market developments. Flexibility and responsiveness to such changes lie at the core of an effective regulatory framework.

## Accountability

4.59 Regulatory agencies should be accountable to their stakeholders for the achievement of their objectives and should be subject to regular reviews of their efficiency and effectiveness.





