Chapter 5

OBJECTIVES AND PRINCIPLES FOR REGULATORY REFORM

The Terms of Reference establish a set of objectives for the reform of regulatory arrangements, namely that they should:

- ensure an efficient, responsive, competitive and flexible financial system to underpin stronger economic performance, consistent with stability, prudence, integrity and fairness;

- be adaptable to innovation in technology, services and markets; and

- be consistent for similar financial functions, products and services.

While these are desirable objectives for any regulatory framework, they leave open the question of the rationale or need for regulatory intervention in the first place. It is therefore important to clarify this rationale and to set out clear principles which should guide the application of regulation to achieve these objectives.

5.1 Rationale for Regulation and Supervision

The justification for existing regulatory intervention is based on two broad beliefs:

- that in important instances and left to its own devices, the market will fail to deliver an outcome which optimises benefits for the community as a whole (usually described as *market failure*); and

- that *social concerns* require market interventions (often involving a political response by Governments to pressures for action to protect different groups in the community).

5.1.1 The market failure rationale for regulation

The important role the financial system plays in the economy was reviewed in Chapter 2. Broadly speaking, regulatory intervention may be seen as necessary to achieve outcomes which are economically desirable but which the market, left to its own devices, will not always deliver. These include ensuring:

- *depositor confidence to help underpin a stable and efficient flow of funds within the economy from suppliers to users;*

  - Regulatory intervention is considered necessary to ensure a high level of depositor confidence, and to ensure that investment opportunities cover the full spectrum of risk to cater for the diverse needs of the community, including a relatively safe haven for unsophisticated depositors.

- Such intervention is also considered necessary to avoid bank liquidity problems, as the majority of liabilities are short term with assets having a longer maturity. Depositors typically lack the information and/or skills to value bank assets and thus assess the institution's overall viability. An unwarranted loss of confidence could therefore result in a run on a bank leading to its failure and, ultimately, the loss of depositor savings.

- The close relationship banks have with each other through the payments system means that any loss of confidence could rapidly spread to other banks. Not only would more depositors' savings be at risk, but the resulting contraction in bank lending would adversely affect the rest of the economy, impairing economic growth and employment.

• *Financial and payments system stability;*

- To the extent that a loss of confidence in one bank were to spread to others, the stability and soundness of the payments system and the financial system would be threatened. In turn, the ability of the economy to function smoothly and efficiently could be seriously impaired.

• *Adequate information for consumers to make informed decisions in relation to borrowings and investments; and*

- Left to its own devices, the belief is that the market may not provide the information necessary for depositors to make informed decisions about the soundness and long term safety of institutions, or for consumers to make informed decisions about their contractual relationship with institutions from whom they have borrowed funds. As a consequence their decisions may be distorted, impairing both their welfare and the efficiency with which resources are allocated within the economy.

- This "information asymmetry" also underpins the use of regulation to protect customers of financial institutions against unfair terms and conditions, misrepresentation, negligence, incompetence, fraud, etc. The importance of this lies in the fact that financial transactions are often complex and involve major financial commitments by consumers.

• *The community's confidence in the integrity and safety of insurance cover and claims.*

- The provision of insurance against death and disability involves a commitment by insurance companies to make a specified payment in specified circumstances at some future time. Regulation which protects policyholders is seen as contributing to economic efficiency by ensuring community confidence in the on-going viability of insurance companies. This is critical to the community's willingness to insure against various risks.

5.1.2 The social rationale for regulation

There are also various instances of formal or informal regulation which are not readily justified by market failure. Typically, these reflect political responses to public concerns about the need to provide greater protection to some sections of the community against what are perceived by some to be inequitable practices or unjust outcomes. Such concerns are often said to reflect a lack of competition, but in fact are frequently designed to address issues, such as the removal of cross-subsidies on retail transaction accounts, which arise as financial institutions respond to the competitive pressures flowing from deregulation, new technology and globalisation.

Examples of such regulation include consumer credit regulation, restraints on pricing and access to retail transaction accounts, calls for banks to lend more and/or at lower rates to small business and the NSW Farm Debt Mediation Act.

Paradoxically, by adding to costs or reducing the scope for flexibility and innovation, such regulation may often reduce the level of competition. While such regulation has not had adverse effects on the viability of financial institutions, in a rapidly changing competitive market place, it could do so in future if the result is to unnecessarily limit flexible competitive responses.

5.1.3 Balancing the benefits and costs of regulation

Westpac believes that regulation is only justified where there is a clear case of market failure or clear evidence that government intervention will produce a superior outcome.

Social objectives should be achieved in ways that do not distort the efficiency of financial flows in the economy. An example of well intentioned but poorly designed regulation is the Uniform Consumer Credit Code which, it will be argued in chapter 10, is unnecessarily prescriptive and results in major costs, which are ultimately borne by consumers or shareholders.

The issue then is how to achieve an appropriate balance between a carefully defined need for regulation (in terms of the rationale in section 5.1.1) and the degree and form of regulation required to meet that need. This requires an assessment of the impact regulation has, or will have, on market efficiency in terms of cost of production, flexibility and innovation and the allocation of resources within the economy to their most productive use.

For regulation then to be justified, net community benefits must result. That is, the community would need to be better off than if financial markets were to regulate themselves.

Assessing the costs of regulation

A major problem for those seeking to evaluate the net benefits of regulation is that the benefits of regulation are usually more visible than the costs. This sometimes leads to an expectation that there is a net community benefit when this may not be the case.

The financial deregulation of the early 1980's was in large part a response to the Campbell Committee which demonstrated how well intentioned regulation actually produced negative net benefits.

The costs may be both direct and indirect:

- *Direct costs* include the cost of system changes, staff training, the provision of information to customers, monitoring compliance, reporting to regulatory authorities, etc. These costs are ultimately passed on to users or shareholders.

- *Indirect costs* involve either:

- a reduced capacity to innovate and adapt, thereby affecting user choice and competitive neutrality; or

- distortion of price signals, thereby affecting the efficiency of resource allocation.

These costs of regulation often cannot readily be quantified. This is well recognised:

> "There are serious methodological problems involved in conducting a cost-benefit analysis of regulation: the difficulty of placing a precise valuation on the consumer welfare benefit of correcting for market failures; identifying the value that consumers place on relevant information; the extent to which a probability of failure is reduced; the problems of defining, measuring and locating incremental costs of regulation on firms; determining how regulation affects competitive conditions in the industry, etc."[1]

Nevertheless, there is considerable qualitative and some quantitative evidence to support the view that the costs of regulation may be significant. For example, the Australian Bankers' Association Submission to the Inquiry conservatively estimates that the cost to the banking industry of preparing for the Uniform Credit Code is more than $160 million. And this represents only direct costs. It does not include the indirect costs, such as those noted above.

An example of an indirect cost of intervention has been the pressure applied by government not to charge fees on retail transaction accounts. The inability to charge fees has resulted in high cost channels such as branches being over-used at the expense of lower cost delivery channels such as ATM's. Such an outcome does not produce the best outcome for the community as a whole.

The scope for self-regulation

It is even more difficult to assess whether net community benefits would be greater through regulatory intervention or through financial markets regulating themselves. Here the issues to be balanced are whether self-regulation can be effective in achieving its objectives, while permitting more flexible institutional responses to the changing market place, and at the same time preserving high levels of competition.

The Campbell Committee recognised the difficulty of achieving this balance and favoured co-regulation, ie. "self-regulation but with some limited government involvement to the extent necessary to ensure that the desired prudential objectives are achieved effectively and equitably".[2]

5.1.4 Conclusion

Whenever regulation is proposed, there needs to be a mechanism to establish clearly the benefits and likely direct and indirect costs to the community. This matter is discussed in some detail in Section 6.6.

The discussion of regulation in the following chapters also covers a number of instances where, in Westpac's view, there are opportunities to reduce the degree of regulation without sacrificing community welfare concerns and benefits.

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1 *Regulation of Retail Investment Services: A Background Report,* D.T.Llewellyn, 1996, page 25
2 *Report of the Australian Financial System Inquiry,* 1981, page 290

5.2 Principles Which Should Govern Regulation

Three over-arching principles are nominated in the terms of reference: efficiency, stability and benefit to financial system users. The Campbell Committee was concerned with broadly the same principles and, in relevant chapters of its final report, identified a number of what might be described as supporting principles.[3] These principles are as relevant today as they were in 1980, despite the enormous changes in the financial system over the past 15 years.

The following principles are adapted from those used by the Campbell Committee but also reflect the priorities indicated in the present Committee's Terms of Reference. They underpin many of the recommendations for change outlined in the following chapters.

5.2.1 Efficiency

Regulation should enhance the efficiency of the financial system, without impairing the stability and integrity or competitiveness of the financial system. Efficiency will be enhanced where the regulatory intervention is structured to ensure that:

- there is competitive pressure through *freedom of entry* to different areas of the financial system, subject to the preservation of stability;

- resources will be allocated within the economy to their most productive use - *allocative efficiency*;

- the financial system is able to innovate and adapt in a flexible and responsive way to the opportunities provided by changing technology and communications, the changing needs of customers and changing competitive conditions, both domestically and internationally - *dynamic efficiency*;

- resource costs are minimised for any given level of service - *operational efficiency*;

- the regulation impacts in a way which is *competitively neutral* among different kinds of institutions competing in the provision of services designed to meet the same customer needs; and

- sectoral assistance, is effected, as far as practicable, directly through the budget wealth redistribution process - and not through the financial system, except where the problem lies within the system itself.

5.2.2 Stability

Regulation should enhance, or at a minimum, not impair the stability and integrity of the financial system, but in a way which is consistent with maintaining the efficiency of the financial system. This balance will be achieved where:

- the *scope and level of protection* is closely related to the clearly defined need for that protection;

3 Apart from the discussion in Chapter 1, the Report outlined a number of principles in chapters 18 (Investor Protection) and 36 (Sectoral Assistance).

- there is a *safe haven* for small depositors while preserving a full spectrum of investment risk to cater for the diverse needs of the community;
- the *integrity of the payments system* is preserved;
- the scope for *moral hazard* is minimised[4]; and
- there are adequate controls on the *extent and exercise of market power.*

5.2.3 User benefit

Regulation should enhance the fairness of the financial system, but is only required where it will increase the welfare of the community as a whole to a greater degree than would happen if financial markets were left to their own devices. Some aspect of market failure is a necessary but not sufficient condition for government intervention.

Community welfare is most likely to be enhanced where efficiency and stability objectives are achieved in a balanced way and where:

- there is *diversity of choice* for customers between financial institutions and their products and services, having regard for risk, return and liquidity;
- the *quality of products* and services is in keeping with changing customer needs;
- the *cost of products* and services is minimised and is passed to consumers;
- products and services are offered on *fair terms and conditions*, with this being achieved by *disclosure*, wherever practicable. In doing so, the emphasis should be on the quality rather than quantity of information so as to maximise its usefulness to investors; and
- the need to protect users is balanced with the need to retain a role for user responsibility, core and judgement in the acquisition of financial services.

[4] Moral hazard occurs where financial institutions engage in greater risk-taking behaviour in the belief that, as they are supervised by Government agencies, the Government will prevent them failing. Similarly, investors may seek higher returns on more risky investments in the belief that the Government will not let them lose their savings.