

## Chapter 5 Summary . . .

# Philosophy of Financial Regulation

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## Overview

- This chapter considers the purposes of financial regulation and presents a philosophy for determining whether, where and how such regulation should be applied.

## Key Findings

- The general case for regulation is founded in market failure, where efficient market outcomes are inhibited.
- In the financial system, specialised regulation is required to ensure that market participants act with integrity and that consumers are protected. The financial system warrants specialised regulation due to the complexity of financial products, the adverse consequences of breaching financial promises and the need for low-cost means to resolve disputes.
- Some areas of the financial system require financial safety regulation which generally takes the form of prudential regulation. Its intensity should be greatest where the intensity of financial promises and hence risks of market failure are greatest.
- Governments should not seek to impose safety regulation across the entire financial system. The assurance provided by prudential regulation should not extend to a government guarantee of any financial promises.

- Obliging financial institutions to subsidise some activities through ‘community service obligations’ compromises their efficiency and is unlikely to prove sustainable in a competitive market.
- Regulation imposes costs both directly and on the wider economy. This highlights the need to balance prudential and efficiency considerations.
- The principles of regulation which have guided the Inquiry are competitive neutrality, cost effectiveness, transparency, flexibility and accountability.

# Philosophy of Financial Regulation

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## *Introduction*

Free and competitive markets can produce an efficient allocation of resources and provide a strong foundation for economic growth and development. Governments also play a vital role in maintaining a healthy economic and social environment in which enterprises and their customers can interact with confidence.

The general case for regulation is founded in market failure. This occurs when factors are present that prevent efficient market outcomes. The potential for market failure is a necessary but not sufficient condition for government intervention.

One of the most complex issues facing governments is identifying the appropriate level and form of intervention. Regulatory efficiency is a significant factor in the overall performance of the economy. Inefficiency ultimately imposes costs on the community through higher taxes and charges, poor service, uncompetitive pricing or slower economic growth.

The best way to control the costs and to ensure the effectiveness of regulation is to place it within a consistent framework. To do this, it is necessary to establish clearly what needs to be regulated and why, as well as to define the principles for effective and efficient regulation.

Regulation of all markets for goods and services can be categorised according to three broad purposes.

- The first purpose, which applies in all sectors of the economy, is to ensure that markets work efficiently and competitively. Regulation for this purpose includes rules designed to promote adequate disclosure, prevent fraud or other unfair practices and prohibit anti-competitive behaviour such as collusion or monopolisation.

This type of regulation does not materially alter or prescribe the nature of products or services, but simply aims to ensure that they are traded in fair and efficient markets.

- The second purpose, which applies less generally, is to prescribe particular standards or qualities of service (or to prohibit certain goods or services). This form of more intensive regulation is restricted to areas where the consumption of goods or services carries risks, so that safety is a focus of concern. While most examples—such as food standards, prescription of medicines, and regulation of air travel—relate to physical safety, regulation may also aim to promote financial safety.
- The third purpose of regulation, which is applied more rarely, is to achieve social objectives. This includes regulation conferring subsidies on one group of consumers in preference to others. Regulations of this kind are often referred to as ‘community service obligations’ and typically take the form of price controls. An example is the single postage rate for ordinary letters applied throughout Australia.

This chapter considers each of these regulatory purposes in the context of the financial system. It sets out a philosophy for determining whether, where and how such regulation should be applied and provides a foundation for the recommendations set out in subsequent chapters.

Section 5.2 sets out a broad conceptual analysis of financial contracts, markets and institutions which together constitute the financial system.

Section 5.3 considers financial system regulation for each of the broad purposes identified above, namely:

- general market regulation;
- regulation for financial safety; and
- regulation for social objectives.

## 5.1 The Financial System

### 5.1.1 Basic Concepts

In developing a philosophy of financial regulation, the Inquiry's starting point is to identify the core characteristics of the products, markets and institutions which may be subject to regulation. The Inquiry has approached this task by examining the economic function of financial markets and institutions in facilitating the exchange of financial contracts.

Financial contracts play a fundamental role in the efficient functioning of commerce, facilitating the settlement of trade and channelling resources efficiently across time and space. The basic elements of financial contracts are promises—promises to make payments at specified times, in specified amounts and in specified circumstances. Financial arrangements which take the form of trust relationships also involve promises—promises to manage assets in the best interests of beneficiaries.

Financial promises are among those products and services which incorporate risk, including the risk that the promise will not be kept.

The financial system provides the framework within which these promises are created and exchanged. Unlike the markets for most other goods and services, the exchange of many financial contracts takes into account both the explicit contractual promise and the varying risk that the promise will not be kept. Identifying, allocating and pricing risk is a key role of the financial system.

The exchange of promises can take place directly between parties. This is feasible where the parties have efficient means of conducting transactions and access to the information necessary to make informed judgments, especially about risks inherent in financial promises.

However, imperfections arise in financial markets because information is not complete, and transactions and information are not costless. In the presence of such imperfections, financial institutions have developed to supply

information and transaction services, including the management of risk, wherever financial markets have been unable to do so directly.

Financial institutions have evolved in two main forms:

- intermediaries, including banks and insurance companies, which transact with promisors and promisees on their balance sheets; and
- funds managers and other agents, which act to bring promisors and promisees together in markets.

Financial regulation targets the performance of both financial institutions and financial markets in meeting the underlying promises contained within financial contracts.

## **5.1.2 Characteristics of Financial Promises**

While financial promises vary in many ways, the most important differences relate to the risks of possible breach of promise. In this regard, different promises can be distinguished according to three main characteristics:

- the inherent difficulty of honouring promises;
- the difficulty in assessing the creditworthiness of promisors; and
- the adversity caused if the promise is breached.

These differences in financial promises, considered in more detail below, have profoundly influenced the development of financial institutions and financial markets. They also strongly influence the objectives of, and the approach to, financial regulation.

### **Difficulty in Honouring Promises**

The least onerous financial promise is a commitment to make a payment only if circumstances allow, and then only in strict proportion to some measure of underlying value. This type of promise is made by the issuers of equity instruments such as company shares.

A more burdensome promise is assumed by the issuers of debt instruments. Pure debt promises involve a commitment to make specified payments

(often fixed in nominal terms) at specified intervals in all circumstances. Failure to make payment in full at the agreed times constitutes default and often leads to bankruptcy.

Pure equity and pure debt promises can be combined in ways limited only by human imagination. Examples are convertible notes, preference shares and subordinated debt. The burden implicit in such hybrid promises varies according to the elements of debt and equity they contain. The more burdensome the promise, the more it resembles debt.

Promises which commit the promisor to make specified payments in specified circumstances, regardless of time, are known as ‘pure insurance’. This refers to a contract where particular events trigger payment, such as a fire insurance policy or an option contract. The more that the performance of a contract is contingent upon a particular event, the more it resembles pure insurance.

The intrinsic difficulty in honouring promises can also vary within these broad categories of promises. In particular, a debt promise to make a payment at the sole discretion of the promisee, ie, on demand, is more burdensome than an obligation to pay only at a fixed future time. By definition, the promisor may be called upon to fulfil an ‘on demand’ promise at any time regardless of circumstances.

The major example of a promise to pay on demand is the ordinary at-call deposit account held at banks and other deposit taking institutions. Many of these products provide the store of value used to make payments through instruments such as cheques. The holders of such accounts demand certainty of payment and accordingly such promises are expected to be close to riskless. There is a promise of at-call access to a fixed value but also an implicit promise of freedom from credit risk.

### **Difficulty of Assessing Creditworthiness**

The second characteristics of promises relates to ‘creditworthiness’, in particular whether or not a person or institution making a financial promise can be trusted to keep it. In this context, creditworthiness depends on the honesty, financial standing and operational systems of the promisor.

It is easier to assess creditworthiness in some cases than in others. For example, the creditworthiness of a government bond is highly transparent. In contrast, the creditworthiness of a small business loan can be much more difficult to assess, perhaps because the business cannot provide reliable financial information or lacks a track record. Assessing the creditworthiness of borrowers is a specialised task which can consume considerable resources, time and expertise. It can be undertaken within a financial institution or outsourced to specialist firms, such as rating agencies.

The ease of assessing the creditworthiness of financial institutions can also vary. For example, a unit trust holding only cash and government securities is highly transparent. In the absence of fraud or gross negligence, the creditworthiness of its promises to unit holders is closely linked to the creditworthiness of the underlying government securities. In contrast, it may be very difficult to assess the creditworthiness of an insurance company underwriting long-term mortality or disability risks.

The difficulty of assessing credit risk is exacerbated by information asymmetry, whereby promisees cannot make a reliable judgment about risks, no matter how much information is made available to them (see further discussion in Section 5.3).

### **Adversity Caused by Broken Promises**

Not only are some financial promises intrinsically onerous or difficult to assess, the consequences of breach can also be more or less adverse. These consequences fall into two broad categories.

The first category relates to systemic, or third party, risk. For example, an institution failing to honour its promises could trigger a general panic as people fear (even without justification) that similar promises made by other institutions may be dishonoured. For market efficiency reasons, regulation must also take account of the risk that some financial failures may have onerous consequences for financial system stability and hence the real economy.



The second category relates to the consequences for specific individuals of breaching a financial promise. Where such consequences would be highly adverse, promisees often seek the security of a low-risk 'safe haven'.

### **5.1.3 Characteristics of Financial Services**

The financial system provides the framework for the exchange of financial promises. Financial institutions effect the exchange of financial promises by providing a set of financial services. These services can be grouped under seven broad headings.

#### **Payments Services**

In any financial system, a limited range of financial claims can be used as a means of payment to settle transactions. To serve as an effective means of payment, a claim must have a highly stable capital value, be widely accepted in exchange and be linked to the arrangements for ultimate settlement. The deposit liabilities of banks, mobilised by instruments such as cheques, have provided one of the traditional stores of value upon which payments services are based. Payments services can also be provided through notes and coins and through credit cards backed by lines of credit.

#### **Liquidity**

The ease with which a financial claim can be exchanged for cash defines its liquidity. Liquidity in this sense is not equivalent to predictability of value. For example, some listed equity instruments are highly liquid but exhibit volatile prices. One of the traditional roles for banks is to transform illiquid assets (loans) into liquid liabilities (deposits).

#### **Maturity Transformation**

There is a natural mismatch between the maturity preferences of providers and seekers of capital. Lenders and investors generally wish to commit resources for shorter periods than borrowers need. Economies of scale

enable financial institutions to assume the maturity mismatch by increasing the turnover of liabilities needed to support long-term assets.

## **Divisibility**

Promisors often find it costly and inconvenient to divide their claims into the range of denominations, both large and small, that promisees may desire. Financial institutions can break up large denomination claims and aggregate small denomination claims into an infinite array of parcel sizes. Economies of scale enable financial institutions to tailor both assets and liabilities to meet the needs of borrowers and lenders.

## **Reducing Information Costs**

Information is costly to access and process. An individual lender wishing to make personal loans faces a daunting task in locating potential borrowers, assessing the information provided, analysing the risks involved and choosing a suitable combination of the risks on offer. This is not a task for the financially unsophisticated. Economies of scale and specialisation in risk assessment enable financial institutions to relieve lenders of the burden associated with collecting, analysing and monitoring information.

## **Resolving Information Problems**

Borrowers are often unwilling to provide lenders with sensitive information about their financial situation, unless they are assured that the information will not be used to erode their competitive position in the market. By specialising in finance, financial institutions provide the confidentiality and assurance needed by borrowers to induce them to reveal the information necessary to manage the risks involved in the promise.

## **Resource and Risk Pooling**

By pooling the resources of investors, financial institutions can use diversification to lower risks to a greater extent than is usually available to an individual investor. Scale economies enable financial institutions to incur lower transaction costs, to overcome problems of indivisibility and to

process information more efficiently in seeking to reduce risk through diversification.

## 5.1.4 Role of Financial Institutions

Financial institutions facilitate the exchange of promises by providing the financial services listed above. There are two broad ways in which these services are provided — intermediation and facilitation of markets.

### Intermediation

Financial intermediaries interpose their balance sheet between the parties involved in exchanging financial promises. At one end of the spectrum, deposit taking intermediaries provide a full range of services. They offer liabilities that serve as means of payment, transform longer-term illiquid assets into shorter-term highly liquid liabilities, offer claims in divisible quantities, diversify risk and efficiently manage information needs. The depositor receives the full range of financial services, while the borrower enjoys the benefits of maturity transformation and informational efficiencies. In contrast, life companies offering market linked investment policies primarily provide divisibility and risk pooling services.

In the case of deposit taking intermediaries, the process of transforming promises includes an implicit guarantee of the promises made by ultimate borrowers, as the intermediary absorbs the price and credit risks involved. The transformation is much more limited for a life company investment policy where most of the ultimate risks are passed through the life company to investors.

### Market Facilitation

Funds managers and other agents (such as financial advisers and brokers) act to bring promisors and promisees together in markets. They offer a more limited package of financial services and leave the ultimate risk with investors. A funds manager does not transform financial promises by interposing its balance sheet between promisors and promisees. Advisers

and brokers primarily facilitate the exchange of financial promises by addressing information problems.

## **5.2 Financial System Regulation**

As noted in the introduction, regulation may be applied to facilitate the general operation of markets, to enhance safety or to pursue social objectives. This section provides a basic framework for considering whether and, if so, where and how each of these purposes of regulation should be applied in the financial system.

### **5.2.1 General Market Regulation**

All markets, financial and non-financial, face potential problems associated with the conduct of market participants, anti-competitive behaviour and incomplete information. These common forms of market failure have justified at least a minimum level of regulatory intervention in markets on an economy wide basis. Such intervention generally takes the form of:

- conduct regulation—such as criminal sanctions for fraud and prohibitions on anti-competitive behaviour; and
- disclosure regulation—such as general prohibitions on false and misleading statements contained in fair trading laws.

There are some markets where this minimum level of economy wide regulation is considered to be inadequate. These markets, or their products, have characteristics which warrant more specific disclosure and conduct rules than apply in other industries. In many cases, it is also considered necessary to establish a separate regulatory agency to conduct such specialised regulation.

A key question for the Inquiry was to decide where conduct and disclosure regulation of financial markets is best left to general economy wide arrangements and where more specialised regulation is required. As a general principle, greater regulatory consistency and efficiency will result from economy wide regulation. Consequently, this should always be

preferred unless a clear case for sector specific arrangements can be demonstrated.

The Inquiry examines the case for specialised regulation in:

- financial market integrity (see also Chapter 7);
- retail consumer protection (see also Chapter 7); and
- competition policy (see also Chapter 10).

## **Financial Market Integrity**

Market integrity regulation aims to promote confidence in the efficiency and fairness of markets. It seeks to ensure that markets are sound, orderly and transparent. Financial market prices can be sensitive to information, and this raises the potential for misuse of information. For this reason, regulators around the world impose specific disclosure requirements (such as prospectus rules) and conduct rules (such as prohibitions on insider trading) on financial market participants. The complexity of financial products and markets, their intrinsic risks — including those due to limited information— and the detailed knowledge required to deliver efficient regulation in this area argue strongly for continued specialised regulatory arrangements.

## **Consumer Protection**

Consumer protection refers to the forms of regulation aimed at ensuring that retail consumers have adequate information, are treated fairly and have adequate avenues for redress. There are close links and no clear dividing line between consumer protection and market integrity regulation in retail markets since both use the same regulatory tools, namely disclosure and conduct rules. For example, prospectus requirements can promote both consumer protection and confidence in the efficiency and fairness of retail financial markets.

Specialist consumer protection in the financial system is justified on two grounds.

First, the complexity of financial products increases the probability that financially unsophisticated consumers can misunderstand or be misled about the nature of financial promises, particularly their obligations and

risks. This, combined with the potential consequences of dishonour, has led most countries to establish a disclosure regime for financial products that is considerably more intense than disclosure rules for most non-financial products.

Secondly, financial complexity also increases the incidence of misunderstanding and dispute. Given this, and the high cost of litigation, a number of countries have imposed specific regulation of financial sales and advice and established low-cost industry complaints schemes or tribunals for resolving disputes.

## **Competition Regulation**

Competition regulation refers to laws which ensure that all markets are competitive. Two main areas of concern are market concentration and collusion which can lead to overpricing of financial products and underprovision of services essential to economic growth and welfare.

While financial products are complex and any assessment of competition requires detailed analysis of markets, the key features relevant to competition assessment in this sector are not unique. The application of economy wide competition regulation to the financial system ensures regulatory consistency. Anti-competitive behaviour is not unique to financial markets, and it is preferable to establish both the bounds of acceptable competitive behaviour and rules for mergers and acquisitions which are common to all industries. Accordingly, the case for specialised arrangements in this area is relatively weak.

## **5.2.2 Regulation for Financial Safety**

### **General Principles**

A further case for financial regulation arises from the risks attaching to financial promises. While in some other industries safety regulation aims to eliminate risk almost entirely (for example, to eliminate health risks in food preparation), this is not an appropriate aim for most areas of the financial

system. One of the vital economic functions of the financial system is to manage, allocate and price risk.

However, there are some areas of the financial system where government intervention is aimed at eliminating or reducing risk. One of the most difficult tasks facing those charged with designing financial market regulations is that of defining the aims and boundaries of regulation for financial safety.

In essence, the task is to decide which financial promises have characteristics that warrant much higher levels of safety than would otherwise be provided by markets (even when they are subject to effective conduct, disclosure and competition regulation).

The Inquiry has approached this task by considering the risk characteristics of financial promises set out in Section 5.2, namely:

- the inherent difficulty of honouring promises;
- the difficulty in assessing the creditworthiness of promisors; and
- the adversity caused by breaching promises.

As a general principle, financial safety regulation will be required where promises are judged to be very difficult to honour and assess, and produce highly adverse consequences if breached.

In this Report, promises which rank highly on all three characteristics are referred to as having a high ‘intensity’. The higher the intensity of a promise, the stronger the case for regulation to reduce the likelihood of breach.

## **Causes of Market Failure**

The underlying reason for regulating intense promises is that markets are more likely to fail where more intense promises are being exchanged. In markets for intense financial promises, two sources of potential market failure have long been recognised:

- the risk of third party losses due to systemic instability; and



- the problem of information asymmetry facing most consumers, which means that they cannot reliably assess risk, particularly the creditworthiness of the promisor.

### **Systemic Stability**

The first case for regulation to prevent systemic instability arises because certain financial promises have an inherent capacity to transmit instability to the real economy, inducing undesired effects on output, employment and price inflation. The more sophisticated the economy, the greater its dependence on financial promises and the greater its vulnerability to failure of the financial system.

The most potent source of systemic risk is financial contagion. This occurs when financial distress in one market or institution is communicated to others and, eventually, engulfs the entire system. The position of banks as the main providers of payments services adds to the risk that bank failure might disrupt the integrity of the payments system and precipitate a wider economic crisis.

### **Information Asymmetry**

The second case for regulation relates to the need to address information asymmetry.

In a market economy, consumers are assumed, for the most part, to be the best judges of their own interests. In such cases, disclosure requirements play an important role in assisting consumers to make informed judgments. However, disclosure is not always sufficient. For many financial products, consumers lack (and cannot efficiently obtain) the knowledge, experience or judgment required to make informed decisions. This is known as information asymmetry — a situation where further disclosure, no matter how high quality or comprehensive, cannot overcome market failure.

In these cases, it may be desirable to substitute the opinion of a third party for that of consumers themselves. In effect, the third party is expected to behave paternalistically, looking out for the best interests of consumers when they are considered incapable of doing so alone. To some extent, such third parties can be supplied by markets (such as the role played by rating

agencies). However, for many years the practice in all countries has been for government prudential regulators to take on much of this role.

## **Regulatory Assurance**

In altering the risks that would otherwise attach to financial promises, financial safety regulation effectively provides a degree of assurance to promisees.

The need for ‘safe havens’ in key financial services does not mean that all financial services should be subject to financial safety regulation. If regulation is pursued to the point of ensuring that promises are kept under all circumstances, the burden of honour is effectively shifted from the promisor to the regulator. All promisors would become equally risky (or risk free) in the eyes of the investing public. Regulation at this intensity removes the natural spectrum of risk that is fundamental to financial markets. If it were extended widely, the community would be collectively underwriting all financial risks through the tax system, and markets would cease to work efficiently.

Thus, regulation cannot and should not ensure that all financial promises are kept. Indeed, the Inquiry considers that the government should not provide an absolute guarantee in any area of the financial system (just as it does not do so in other areas). Primary responsibility should remain with those who make financial promises. It would be inequitable for the government to underwrite some financial promises but not other promises made by participants in the broader economy.

How intensively, then, should financial safety regulation be applied? How much regulatory assurance should it provide in the various areas of the financial system?

As noted above, the Inquiry considers that the intensity of financial safety regulation should be proportional to the intensity of financial promises.

The most intense financial promises are those which provide payments services. Such promises are intrinsically difficult to honour. Those who use them rarely have the time, motivation or resources to assess the risks, and any breach would have potentially highly adverse consequences for the

efficient conduct of commerce in the whole economy. The most intense safety regulation should therefore apply to the provision of means of payment, to the point of securing their safety at the highest possible level, short of an outright government guarantee.

Beyond this, the extent of regulatory assurance is a matter for judgment. Where systemic risk and information asymmetry are greatest, regulation should at least strive to minimise the risk of promises being dishonoured. If regulation stops short of providing a guarantee against failure, it must provide speedy and efficient mechanisms for resolving financial distress when it arises, so as to minimise the danger of loss or contagion. At a minimum, this requires that the regulator have unambiguous powers to intervene in the operations of institutions making such intense promises.

A product which provides investors with a risk exposure rather than a payments service is a less intense promise requiring less intense financial safety regulation. Regulation should seek to ensure that, while risk remains, those making promises ensure that risks are appropriately managed in accordance with the reasonable expectations of their promisees. This may involve varying degrees of regulatory intensity—greater regulatory intensity is appropriate for a life company annuity product involving both investment and mortality risks than for a market linked investment.

In practice, the application of this general principle for determining the degree of regulatory assurance may require adjustment to take account of other factors. Two additional factors which may have a significant influence are:

- the implications of compulsory contributions and tax assistance for superannuation—these arguably combine to imply that government should provide greater regulatory assurance in relation to superannuation than would normally apply for market linked investments; and
- pragmatic considerations resulting from the structure of financial markets and institutions. For example, it is difficult to separate some classes of financial promise from others where they are made by the same entity subject to institutional regulation. In these cases, the practical course may often be to broadband regulatory interventions, applying them across a wider spectrum of promises

than strict adherence to the general principle may otherwise suggest.

## Preventative Strategies

The most common form of preventative regulation to promote financial safety is ‘prudential regulation’. At the high-intensity end of the spectrum, prudential regulation involves the imposition of prescriptive rules or standards governing the prudential behaviour of institutions making certain types of promises. These rules may be directed at specific areas of concern, such as minimum liquidity standards for institutions with liquid liabilities. Alternatively, they may be directed more generally at minimising the risk of failure (such as minimum capital requirements and risk management standards).

Prudential regulation in part substitutes the judgment of regulators for that of regulated financial institutions and their customers. To the extent that the regulator absorbs risks which would otherwise bear upon financial institutions and their customers, it faces the twin problems of ‘adverse selection’ and ‘moral hazard’. In this respect the prudential regulator acts like an insurer.

- When an insurance company sells fire insurance, for example, it immediately attracts those people whose premises are more likely to be destroyed by fire. After all, those whose premises are fireproof have no need of insurance. This is known as the problem of ‘adverse selection’.
- Similarly, once a person has obtained, say, insurance against car theft, the incentive to be vigilant against car theft can be reduced. The tendency for insured parties to alter their behaviour in ways which increase the risk of loss is known as ‘moral hazard’.

The incentive problems associated with adverse selection and moral hazard explain the particular approaches that prudential regulators normally adopt to different aspects of prudential oversight.

The problem of adverse selection leads an insurer to discriminate carefully among risks, and to refuse risks which it cannot clearly discern. Similarly, a

prudential regulator may seek to maintain strict entry criteria, thereby screening out riskier participants and reducing the likelihood that a supervised institution will fail. While this is an understandable response on the part of a prudential regulator, it reduces competitive pressure on regulated institutions. Hence, imposing prudential regulation lessens competitive pressure and is a source of efficiency loss.

The problem of moral hazard leads an insurer to grant insurance on condition that it can monitor its risk exposure during the tenure of the insurance contract. Similarly, moral hazard dulls the incentive of a regulated institution to monitor risks incurred in its operations. As a result, the prudential regulator insists on supervising and limiting the behaviour of regulated institutions in order to limit the regulator's exposure to failure. Again, such rules carry efficiency costs by limiting the scope for commercial judgment by financial institutions.

The Inquiry's recommendations on the appropriate balance between prudential and efficiency objectives are set out in Chapter 8.

## **Response Strategy**

Instability arising in that part of the financial system which is subject to prudential regulation is only one of a series of potential threats to systemic stability—a variety of financial and real economic shocks can strike any economy. Prudential regulation, even in its most intensive form, cannot guarantee that systemic instability will not occur.

In the event of such instability, the task of restoring stability falls to the central bank (in the first instance) through the provision of liquidity and other means. In extreme cases, government may also play a role. Ultimately, the central bank has the primary responsibility for systemic stability in an economy, irrespective of who has responsibility for prudential supervision.

An important judgment in developing financial system regulatory arrangements is to decide the balance between prudential supervision (acting on a preventative basis) and central banking (maintaining stability with both preventative and response strategies).

Recommendations on financial system stability are presented in Chapter 9.

### **5.2.3 Regulation for Social Purposes**

A further case for regulation is sometimes made on the grounds that financial institutions have ‘community service obligations’ to provide subsidies to some customer groups. For example, financial institutions are urged to deliver certain services free of charge or at a price below the cost of provision. This is the least persuasive case for intervention.

Financial institutions, like other business corporations, are designed to produce wealth, not to redistribute it. This is not to say that their creation of wealth should ignore the claims of social and moral propriety. But it is another thing entirely to require financial institutions to undertake social responsibilities for which they are not designed or well suited.

Obliging financial institutions to subsidise some activities compromises their efficiency and is unlikely to prove sustainable in a competitive market. This issue is explored more fully in Chapter 11.

If there is a social concern about imposing the real cost of financial services on certain groups, this is more efficiently dealt with through direct government funding, transfer payments or provision of services. This approach is used to fund most other goods and services required by disadvantaged groups. If access to financial services is as important as access to transport or medicines, this should be recognised explicitly and funded in the same way.

## **5.3 Principles of Regulation**

This chapter has set out a broad philosophy for regulating the financial system. Regulation, however, has great potential to impose costs and should be designed to meet its purposes while minimising such costs. Thus regulation requires that a careful balance be struck between effectiveness and efficiency.

Many of this Inquiry’s recommendations are directed at reducing the costs of financial system regulation in Australia — both the direct costs of regulation and the broader costs arising from rules which restrict economic

activity. An indication of the potential for gains is provided in Chapter 6 which examines the cost of financial intermediation in Australia.

The Committee has reviewed arrangements for financial regulation and has proposed a more effective and streamlined framework. Recommendations for financial regulation are set out primarily in Chapters 7 to 10. At the same time, the Inquiry has formed a general view that there is considerable potential to improve financial system efficiency through a broad range of reforms set out in Chapter 11.

In recommending these reforms, the Inquiry had regard to the regulatory principles outlined below.

### **Competitive Neutrality**

Competitive neutrality requires that the regulatory burden applying to a particular financial commitment or promise apply equally to all who make such commitments. It requires further that there be:

- minimal barriers to entry and exit from markets and products;
- no undue restrictions on institutions or the products they offer; and
- markets open to the widest possible range of participants.

### **Cost Effectiveness**

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. Regulation can be made totally effective by simply prohibiting all actions potentially incompatible with the regulatory objective. But, by inhibiting productive activities along with the anti-social, such an approach is likely to be highly inefficient.

The underlying legislative framework must be effective, including by fostering compliance through enforcement in cases where participants do not abide by the rules. However, a cost-effective regulatory system also requires:

- a presumption in favour of minimal regulation unless a higher level of intervention is justified;

- an allocation of functions among regulatory bodies which minimises overlaps, duplication and conflicts;
- an explicit mandate for regulatory bodies to balance efficiency and effectiveness;
- a clear distinction between the objectives of financial regulation and broader social objectives; and
- the allocation of regulatory costs to those enjoying the benefits.

## **Transparency**

If there is a general perception that a particular group of financial institutions cannot fail because they have the imprimatur of government, there is a great danger that perception will become reality. Transparency of regulation requires that all guarantees be made explicit and that all purchasers and providers of financial products be fully aware of their rights and responsibilities. It should be a top priority of an effective financial regulatory structure that financial promises (both public and private) be understood.

## **Flexibility**

One of the most pervasive influences over the continuing evolution of the financial system will be technology. While it is not possible to forecast with any certainty the precise impact that technology will have on the shape of financial services and service delivery, it is certain that the impact will be considerable. These developments make flexibility critical. The regulatory framework must have the flexibility to cope with changing institutional and product structures without losing its effectiveness.

## **Accountability**

Regulatory agencies should operate independently of sectional interests and with appropriately skilled staff. In addition, the regulatory structure must be accountable to its stakeholders and subject to regular reviews of its efficiency and effectiveness.