Chapter 16
Summary . . .

Stocktake: Financial Regulation

Overview

- This chapter reviews the main effects, both anticipated and unintended, which the recommendations of the Campbell Committee report have had on financial regulation.

Key Findings

- In response to the financial problems which occurred in the late 1980s and the expansion of superannuation, prudential regulation was upgraded through tougher capital requirements and structurally reformed through the consolidation, refocusing and better coordination of regulatory agencies.
- The greater range and complexity of products and, in some areas, concerns about more aggressive selling practices, have led to an increased focus on consumer protection. This has resulted in new consumer credit regulation and new rules for disclosure, codes of conduct and dispute resolution.
- Globalisation has created an increasing need for global harmonisation of, and cooperation in, the conduct of financial regulation.
- In the face of new technologies, alliances and market structures, increased regulatory attention has been given to ensuring competitive conduct in all segments of the market and to providing a competitively neutral environment.

- The ad hoc nature of some new regulation has created a quite expensive regulatory framework. Over 800 staff are now involved in financial regulation in Australia, resulting in direct and compliance costs which appear to be high by international standards.

Chapter 16

Stocktake: Financial Regulation

16.1 Introduction

Through its impact on the structure and conduct of the financial system, the deregulation which followed the report of the Australian Financial System Inquiry 1981 (Campbell Report) has had a consequential impact on the role, structure and cost of the regulatory arrangements themselves.

The main effects, many of which were anticipated and indeed recommended by the Campbell Report, have been:

- upgrading and structural reform of prudential regulation in response to the financial problems which occurred in the late 1980s and the expansion of the superannuation sector;
- increased focus on consumer protection in response to the greater range and complexity of products and in some areas the introduction of more aggressive selling practices;
- increased global harmonisation of, and cooperation in, the conduct of financial regulation; and
- increased focus on ensuring competition in markets in the face of new technologies, alliances and structures.

This chapter discusses each of these main regulatory responses. In addition, it provides some observations on the resulting cost of regulation.

16.2 Prudential Regulation

Adoption of the Campbell Report recommendations did not simply reduce government intervention in financial services, but shifted its focus from one outdated type of regulation — restriction of market forces — to another type: higher prudential standards.[1] This shift to a new focus was achieved through three initiatives: tightening of capital and prudential requirements; consolidation and refocusing of regulatory agencies; and increased coordination of new policies.

16.2.1 Tightening of Capital Requirements

A by-product of deregulation was the increased availability of debt in the second half of the 1980s. In conditions of intense competition and growth in some asset prices, many banks dropped their lending standards which led subsequently to significant write-offs in the early 1990s (see Chapter 17). This was an experience common to many countries, and prudential regulators around the world reacted by first standardising, and thereafter steadily increasing, capital adequacy and other prudential requirements.[2]

The impact can be seen to some extent in Figure 16.1, which shows the growth of equity and reserves of Australian banks relative to the size of the balance sheet. After a low start at just over 6 per cent of the total balance sheet in 1986, Australian banks strengthened their capital base first to comply with regulatory requirements and later for commercial reasons, and to give regulators, rating agencies and investors the confidence that had disappeared during the losses of the early 1990s. More recently, banks have been reducing capital in an effort to boost returns for their investors.[3]

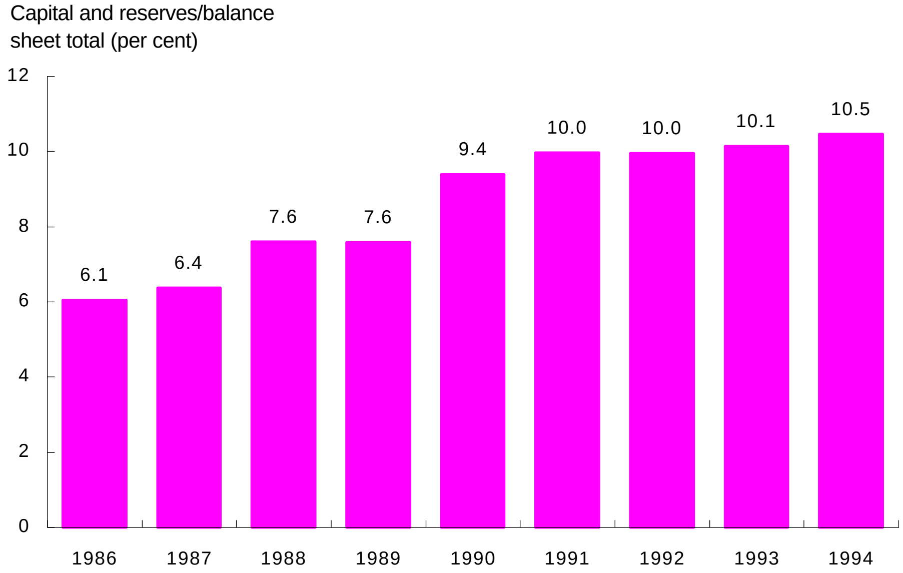
[1] Argy 1995, p. 10.

[2] The 1988 accord of the Basle Committee on Banking Supervision is the best known example.

[3] While the measure in Figure 16.1 is not strictly comparable with the capital adequacy requirements stipulated by the RBA and the Basle agreement, the conclusions are still valid. The RBA issued capital requirements prior to the recommendations of the Basle Committee (1988). However, it did not capture capital adequacy information consistently prior to 1989. See also RBA 1994, *Reserve Bank of Australia Bulletin*, December edition, Table B. 17.

Banks have Increased their Capital . . .

Figure 16.1: Growth of Capital of Australian Banks



Source: OECD 1996, *Bank Profitability*.

In addition to capital requirements, the Reserve Bank of Australia (RBA) has introduced, as have many other prudential regulators overseas, a set of increasingly sophisticated risk management guidelines. These guidelines have led to more differentiated capital requirements which better reflect the specific risks of individual institutions, countering the claim that current capital requirements are arbitrary, and force banks to hold too much capital for some risks.[4]

Capital adequacy requirements were also introduced and tightened for non-bank deposit taking institutions over the same period. Tighter capital adequacy rules and minimum capital standards also apply to life and general insurance companies.

[4] Reserve Bank of Australia, Submission No. 111, pp. 35-36.

16.2.2 Consolidation and Refocussing of Regulatory Agencies

In addition to tightening prudential standards, governments consolidated, federalised and refocused existing regulatory agencies to address the increasingly complex task of supervising a widening range of risk exposures. The Insurance and Superannuation Commission (ISC), the Australian Securities Commission (ASC) and, most recently, the Australian Financial Institutions Commission (AFIC) are all products of this response.

The ISC was founded in 1987 with a brief to supervise the insurance and superannuation industries. It brought together the offices of the Life Insurance Commissioner, the Insurance Commissioner and the Australian Government Actuary, and assumed much of the regulatory role for superannuation previously conducted by the Australian Taxation Office. Its role and resources were expanded over time as a result of government's increasing desire to regulate superannuation prudentially.

The ASC is the product of the amalgamation of formerly State-based corporate affairs commissions. In this process, the creation of a national regulator reflected the extension of trade and business to national and global levels.[5] At the same time, more attention and resources were assigned to the regulation of markets and the enforcement of market conduct rules.

AFIC was established in 1992 to administer the Financial Institutions Scheme for the prudential regulation of building societies and credit unions throughout Australia. While its primary objective is prudential, its secondary objective is to ensure regulatory coordination and uniformity of standards and practices across State boundaries. The day-to-day supervision of building societies and credit unions continues to be carried out by State Supervisory Authorities (SSAs).

While new agencies were being created, existing agencies responded by refocusing their activities. The RBA, for example, which since its inception in 1960 had been charged with overseeing the banking system, established the Banking Supervision Department in 1984 to centralise all related RBA

[5] For example, the six State-based stock exchanges in Australia only came together to form one national exchange, the ASX, in 1987.

activities. Only after this date did the RBA begin to issue prudential statements (such as for capital adequacy) with which banks were required to comply. In 1989, the *Banking Act* was amended to give the RBA explicit responsibility and related powers for the prudential regulation of banks.[6]

16.2.3 Greater Regulatory Coordination

The need for coordination of policy setting, supervision and enforcement increased in line with the increase in the numbers of regulators and institutional developments such as blurring and conglomeration (see Chapter 4). The body charged with coordination is the Council of Financial Supervisors (CFS).

The CFS was created in 1992. It is a non-statutory body which aims to harmonise the activities of the four financial regulators: the RBA, AFIC, ISC and ASC.[7] CFS activities have focused on eliminating regulatory gaps, overlaps and on harmonising the regulators' inconsistent treatment of products. A recent focus of activity for the CFS has been the supervision of financial conglomerates — the CFS has served as a forum to develop principles of supervision based on a 'lead regulator' model.[8]

A range of formal operating agreements among regulators has also been established.[9] There has been more focus on bilateral policy coordination, information sharing and staff exchanges in recent years. An example is the ISC/ASC project on harmonising the regulation of investment sales and advice.

[6] RBA 1996, *Reserve Bank of Australia 1996 Report and Financial Statements*, pp. 55-56.

[7] Council of Financial Supervisors, Submission No. 62, pp. 1-11.

[8] Under such a model, all entities of a conglomerate are assessed on a stand-alone basis by their respective regulators. In addition, the whole group is reviewed by an assigned lead regulator.

[9] For example, there is an agreement between the ACCC and the Australian Banking Industry Ombudsman and regular liaison between the ASC, ISC and RBA.

16.3 Increased Consumer Protection

The regulatory focus on specific financial sector consumer protection increased significantly after deregulation (see Table 16.1). However, this development is only partially related to the outcomes of deregulation — other contributing factors are discussed below.

The new regulations fall into four distinct groups:

- consumer credit regulation;
- disclosure for banking and insurance-style products;
- dispute resolution schemes; and
- consumer protection in financial markets.

16.3.1 Consumer Credit Regulation

The roots of modern consumer credit regulation go back to the 1960s, when finance companies grew rapidly as a result of restrictions on banks' lending, high interest rates and a rise in consumer demand for consumer durables. The largely unregulated activities of finance companies and the greater availability of credit in the 1970s led to the first round of consumer credit legislation between 1972 and the mid-1980s.

By the mid-1980s, deregulation had led to a rapid expansion of credit, much of which was not covered by the existing consumer credit laws. Poor lending practices, professional consumer protection activism by financial services specialists and the desire expressed by institutions for regulatory neutrality and nationally uniform legislation led to revived efforts to achieve uniform consumer credit legislation. Those efforts culminated in the *Uniform Consumer Credit Code* (UCCC), which came into operation on 1 November 1996.

Most Consumer Protection Regulation was Created in the 1980s and 1990s . . .

Table16.1: Consumer Protection Regulation Timeline(a)

Year	Legislation/Regulation	New	Update
1972	SA Consumer Credit Act (since replaced)	X	
1974	Trade Practices Act (TPA)	X	
1981	Securities Industry Code commenced	X	X
1983	Prices Surveillance Act	X	
1984	Insurance Contracts Act	X	
	Insurance Agents and Brokers Act	X	
	NSW, VIC and WA Credit Acts (since replaced)	X	
1985	ACT Credit Act (since replaced)	X	
1986	TPA unconscionable conduct provision	X	
	Electronic funds transfer (EFT) Code of Conduct (first of the consumer protection codes)	X	
	Futures Industry Code	X	
	Fidelity Fund for Futures Brokers		X
1987	National Guarantee Fund for ASX Brokers		X
	Qld Credit Act (since replaced)	X	
1989	Banking Ombudsman Scheme	X	
1990	Credit Union EFT Arbitration Scheme (since replaced)	X	
	Part III A of the Privacy Act 1988	X	
1991	Corporations Law commenced	X	
	General Insurance Inquiries and Complaints scheme	X	
	Life company product disclosure	X	
	Life Insurance Complaints Service	X	
1992	TPA unconscionable conduct for business provision	X	X
1993	Banking Code of Practice (fully operational 1996)	X	
1994	NSW Farm Debt Mediation Act	X	
	Superannuation Complaints Tribunal	X	
	Life company product disclosure upgrade		X
	Building Society Code of Practice (fully operational 1996)	X	
	Credit Union Code of Practice (fully operational 1996)	X	
	General Insurance Code of Practice (fully operational 1995)	X	
1995	Life Insurance Code of Practice on advising, selling, complaints handling	X	
	Financial Planning Association's Complaints Resolution Scheme	X	
1996	General Insurance Brokers' Code of Practice	X	
	Uniform Consumer Credit Code	X	X
	Credit Union Dispute Reference Centre	X	X
	Insurance Brokers Dispute Facility	X	

(a) Includes both government regulation and self-regulatory initiatives.

16.3.2 Disclosure for Banking and Insurance Products

Disclosure regimes and related consumer protection rules for both banking-type products and life and general insurance products have been developed since the 1980s. Most of these disclosure regimes have taken the form of codes of conduct.

By the late 1980s, it was apparent that the proliferation of banking-type products and the wider range of providers of such products which resulted from financial deregulation had created significant consumer confusion and had widened the scope for abuse. The Government responded to these problems (which were amplified by consumer dissatisfaction with high interest rates) by announcing a parliamentary inquiry into the banking industry — the House of Representatives Standing Committee on Finance and Public Administration (Martin Committee).

The Martin Committee recommended the development of a banking code of conduct and accompanying product disclosures to better enable consumers to make informed decisions when purchasing banking products.[10] The banking code was subsequently developed, as were similar codes for credit unions and building societies. Earlier, a separate code for electronic funds transfer (EFT) activities based on cards and personal identification numbers had also been introduced.

The rise of consumer protection and disclosure regulation for the life and general insurance industries derived originally from Australian Law Reform Commission (ALRC) reports which had been sought by the Commonwealth Government because of concerns about broker insolvency. The ALRC reports resulted in the *Insurance Contracts Act* and the *Insurance Agents and Brokers Act*.[11]

A second wave of disclosure and consumer protection regulation for insurance and superannuation occurred in the early 1990s. This was principally the result of increasing concern among consumers, the media and regulators about the selling practices for some types of products,

[10] House of Representatives Standing Committee on Finance and Public Administration (Martin Committee) 1991.

[11] Australian Law Reform Commission 1980 & 1982.

especially life company savings policies. These concerns led to the Trade Practices Commission (TPC) report on the life insurance industry and multiple enforcement actions by the TPC.[12] These actions illustrated the extent of consumer confusion about the nature of life insurance products, the frequency with which consumers were sold inappropriate products for their needs and how the regime of commission payments facilitated bad selling practices. Similar concerns were found on a smaller scale for some types of general insurance products.

Investigations in these areas resulted in the development of consumer protection codes of conduct for both the life and general insurance industries covering such issues as disclosure, selling practices, the provision of advice and complaint resolution. The investigations also led to an upgrading of ISC disclosure rules for some life insurance promotional material.

Prior to this positive disclosure regime for the banking and insurance industries, consumer protection concerns had been covered by economy wide laws such as the *Trade Practices Act 1974.*

16.3.3 Dispute Resolution Schemes

The creation of industry based alternative dispute resolution schemes (ADRs) is a reflection of the high costs for consumers of pursuing redress through the courts and, to some extent, of the increased risk and confusion which can initially be created by a widening of customer choice.

The Electronic Funds Transfer Code of Conduct was the first self-regulatory scheme to set out rules for alternative dispute resolution. This development was driven by concerns about the terms and conditions attaching to early EFT schemes, the need to develop consumer confidence in the use of electronic transfers and the desire of industry to avoid the prescriptive regulatory alternatives which were being introduced overseas.

By the mid-1980s, the number of complaints about banking products and services had increased. This can be explained by such factors as the

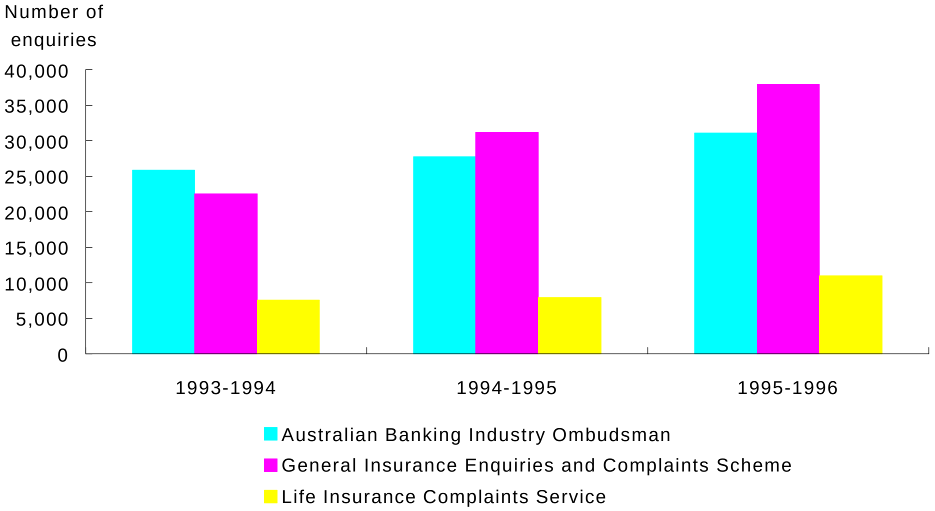
[12] Trade Practices Commission 1992. On the enforcement actions, see Trade Practices Commission 1994.

proliferation of products after deregulation, the increasing competitiveness of the sector, the unpopularity of the banking sector at the time and a heightened consciousness of consumer rights. With pressure from government and consumer groups, and given the positive experiences with similar schemes overseas, the industry established a banking ombudsman in 1989.

Other sectors of the financial services industry, such as credit unions, life insurance, general insurance and financial planners, have since developed their own dispute resolution schemes. In addition, the Superannuation Complaints Tribunal has been established by statute.

ADR Schemes Answer Thousands of Inquiries Annually . . .

Figure 16.2: Annual Inquiries to Alternative Dispute Resolution Schemes



Note: Life Insurance Complaints Service figures are for the calendar years 1993, 1994 and 1995 and like those of the Banking Industry Ombudsman relate to telephone inquiries only.
Source: Australian Banking Industry Ombudsman 1996; General Insurance Enquiries and Complaints Scheme 1995; Life Insurance Complaints Service 1995.

The dispute resolution schemes appear to have filled a significant need: over 80,000 inquiries were made between July 1995 and June 1996 to the banking, life insurance and general insurance schemes alone (see Figure 16.2). Prior to the establishment of ADRs, it is likely that there would have been no ready means of seeking information about rights or resolution of complaints for many customers.

However, the widening of the range of schemes and their industry focus at a time when industries are reshaping their activities have created some duplication of, and uncertainty about, responsibilities.

16.3.4 Consumer Protection in Financial Markets

The type of information given to prospective investors and the markets has been altered substantially by two disclosure policy initiatives in the early 1990s.

The first was a change to the provisions governing the contents of a prospectus. The checklist approach used prior to 1991 (under which the legislation prescribed a number of matters to be included and the regulators pre-vetted the document before registration to ensure compliance) was replaced by a general disclosure requirement and a regulatory post-vetting program. Prospectuses are now required to include all information that a reasonable investor and the investor's adviser would expect to find in the prospectus to make an informed investment decision. This places the onus on the issuer to determine what information should be provided.

The second policy initiative was the introduction of a statutory continuous disclosure regime in 1994, to complement the regime applying to listed companies under ASX listing rules.

These initiatives have placed the onus for providing information to prospective investors and markets squarely on the entities seeking to raise funds or maintain publicly listed securities, and have led to improved and more relevant information being disclosed. They have also led to complaints that too much information is now provided and that investors suffer from information overload.

The close of the 1980s saw some very large corporate failures in Australia, primarily because of poor standards of corporate governance and some outright fraud. The establishment of the ASC was one response to those events, as were efforts to promote best practice and self-regulatory efforts by bodies such as the Australian Institute of Company Directors, aiming to promote ethical behaviour in business. In the early 1990s, the ASC concentrated its enforcement efforts with mixed success on investigating and prosecuting major collapses.

16.4 Harmonisation with Global Regulation

Three forces have been driving the increasing globalisation and harmonisation of regulation:

- the increasingly global focus of many large players in the financial system and the increasing interdependence of financial markets;
- the failures and (often fraudulent) losses of some internationally operating financial institutions and the related concern about unclear accountability of regulators in different jurisdictions; [13] and
- increasing trade liberalisation, through the General Agreement on Trade in Services and the Asia-Pacific Economic Cooperation (APEC) agreement, which create pressure to remove regulation inconsistent with international standards (as such legislation may be perceived as a non-tariff trade barrier).

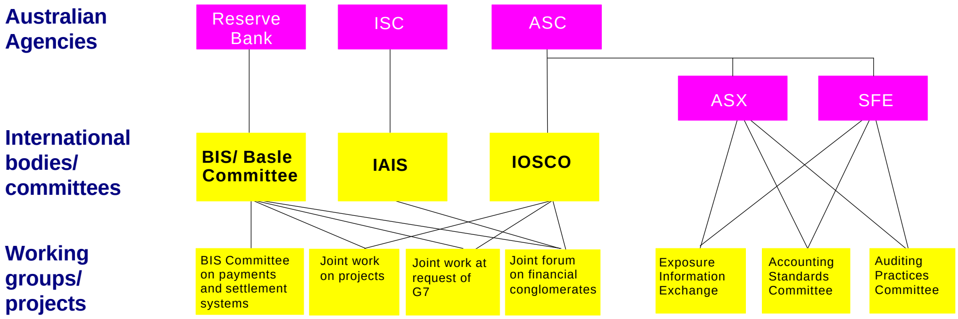
Efforts to harmonise and standardise regulations and practices have taken place primarily at two levels: government-initiated agreements between supervisory bodies of different nations, and more informal working agreements which are driven by commercial needs. The former type of cooperation has largely focused on encouraging greater consistency in regulation, whereas the latter has been more concerned with the interoperability of systems and markets.

[13] Examples include the Bank of Credit and Commerce International, Barings in Singapore, Sumitomo and Deutsche Bank in London and Daiwa in New York.

Most of Australia's current regulatory agencies have found avenues for international cooperation (see Figure 16.3).[14] The Basle Committee on Banking Supervision which is set up under the auspices of the Bank for International Settlement (BIS) has provided a forum for the collaboration of banking supervisors since 1974. Its most important initiative, the Basle Accord on capital adequacy, was not put in place until 1988. In 1996, the Committee published a report which aimed to formalise the coordination agreements among supervisors of internationally operating banking groups.[15]

Regulators Need to Cooperate Internationally . . .

Figure 16.3: Overview of Major Avenues of International Cooperation


Australian Agencies
Reserve Bank
ISC
ASC
ASX
SFE
International bodies/ committees
BIS/ Basle Committee
IAIS
IOSCO
Working groups/ projects
BIS Committee on payments and settlement systems
Joint work on projects
Joint work at request of G7
Joint forum on financial conglomerates
Exposure Information Exchange
Accounting Standards Committee
Auditing Practices Committee

The International Association of Insurance Supervisors comprises insurance regulators from over 70 countries. It was established in 1994, 'recognising that most domestic insurance markets are being integrated into a global market'.[16]

The International Organisation of Securities Commissions was established with the objective of improving market regulation, establishing standards and providing assistance in international enforcement matters.

[14] Nell 1996, pp. 199-207.

[15] *The Financial Regulator* 1996, p. 66-68.

[16] Nell 1996, p. 204.

Other related international organisations and agreements include APEC and the Organisation for Economic Co-operation and Development (OECD), which deal with issues such as international money laundering, reporting of financial statistics and the liberalisation of capital flows.

The agencies discussed above have been successful to date in limiting duplication, but still have a long way to go to substantially reduce national differences. Some countries, such as New Zealand or member states of the European Union and the European Economic Area, have gone further than Australia along this path by striking a wide range of bilateral agreements with other countries to recognise parts of each country's supervision.

Many self-regulatory efforts are also taking on a global dimension. An example is the International Securities Market Association, which focuses on self-regulatory efforts to ensure orderly functioning of international securities markets.[17] The 1995 Windsor Declaration by key regulators and the 1996 Boca Raton agreement signed by major futures exchanges, options exchanges and regulators aim in the same direction. They focus on increased international cooperation, information sharing, customer protection and procedures in the event of major defaults and market emergencies.

In addition to the more formal types of government-initiated cooperation, commercial needs flowing from the globalisation of finance are driving the harmonisation of regulation. Examples are bilateral agreements between stock exchanges to disclose large exposures, initiatives to standardise documentation for securities or derivatives traded on multiple markets, and efforts to develop technical standards for international payments systems.

While progress has been made in international regulatory coordination, some submissions noted the slow response of Australian regulators to issues relating to the competitiveness of the Australian financial system.[18]

[17] AFMA 1996, *Manual, Standards and Guidelines for the Australian OTC Financial Markets* ss. AM 600-AM 610.

[18] See, for example, the Investment Funds Association, Submission No. 197, p. 4.

16.5 Responses to Anti-Competitive Structures

The potential for anti-competitive structures in the financial system has been driven by three forces: an increasing polarisation of the industry into very large and niche competitors; the importance of some technologies; and the role of government as a participant in various industries.

Governments to date have tended to focus on the first issue. In Australia, competition assessment processes administered by the Australian Competition and Consumer Commission (ACCC) have been applied to review proposed acquisitions (such as the 1995 takeover of Challenge Bank by Westpac). In addition, governments created ad hoc rules to preserve industry structures, such as the ‘six pillars’ policy.

Governments around the world have also begun to respond to new potentially anti-competitive challenges created by new technologies.[19] An example of such a potentially threatening structure could be an alliance between a telecommunications company and a financial institution which prevented other financial institutions from accessing the telecommunications platform.[20]

The 1993 report of the Independent Committee of Inquiry on National Competition Policy (Hilmer Report) addressed this issue by articulating the criteria for access to ‘essential facilities’.[21]

The Hilmer Report also proposed structural reform of public monopolies, supporting the sell-off of many State and Commonwealth Government assets in the financial system which had commenced in the early 1990s.[22] While some of the States continue to be active in financial services (particularly in some types of insurance), the RBA’s activities in the payments system and the Housing Loans Insurance Corporation are the

[19] See for example the report by the US Federal Trade Commission Staff, 1996.

[20] As mentioned, for example, in the Westpac Banking Corporation Submission No. 90, p. 137, and echoed by the Australian Association of Permanent Building Societies, Submission No. 43, pp. 49-53.

[21] Independent Committee of Inquiry 1993.

[22] For example State Banks or the Commonwealth Bank, see Table 3.1 in Chapter 3 for a comprehensive list of divestments.

only significant remaining forms of commercial involvement of the Commonwealth in the financial system.

16.6 Cost of Regulation

Much new regulation since the Campbell report has been introduced on an ad hoc basis and has not always adequately anticipated the pace of developments in financial markets. Related to this, a number of submissions to this Inquiry noted a perception of heavy-handedness in regulation and unnecessarily high costs.

Table 16.2 shows the total staff numbers involved in regulation in Australia. About 3,800 staff are currently employed by regulators in Australia, including approximately 100 staff in SSAs in the States and Territories. After allowing for activities which do not directly relate to the regulation and supervision of the financial system (such as the commercial activities of the RBA, or the companies registration function of the ASC), a total of over 800 staff may be considered to be involved in the regulation and supervision of the financial system in Australia. Further staff are employed by self-regulatory and dispute resolution schemes.

A total staff of 900 fulfil broadly comparable functions in Canada, 1,400 in the UK and 1,500 in Germany.[23] Australian regulator staffing normalised against financial sector assets is higher than agencies performing equivalent

[23] Figures include staff as follows: in Canada, staff at the Office of the Superintendent of Financial Institutions, the British Columbia Securities Commission, Ontario Securities Commission and the Commission des Valeurs Mobilères du Québec; in the UK, the Securities and Investment Board, Investment Management Regulatory Organisation, Personal Investment Authority, the Securities and Futures Authority, Financial Stability Wing at the Bank of England and the Insurance division at the Department of Trade and Industry; in Germany, the Bundesaufsichtsamt für den Wertpapierhandel, Bundesaufsichtsamt für das Kreditwesen, Headoffice staff at the Bundesbank and the Bundesaufsichtsamt für das Versicherungswesen. See Nell 1996, pp. 11-12. Figures exclude staff supervising building societies and credit unions for the UK and Canada respectively. On a finance sector assets basis, direct regulator staffing costs in Canada are also high in comparison to European jurisdictions. Some of the difference between Australian and European staffing levels may be explained by Australia’s larger proportion of regulatory resources devoted to the administration of superannuation under its own regime. See National Mutual Holdings 1996, p. 25.

functions in either the UK or Germany. This observation is consistent with the perception, highlighted in submissions, that Australia's regulatory cost is high by international standards. Possible reasons cited in submissions for this perceived high cost were:

- high standards of supervision in Australia;
- costs associated with supervising compulsory superannuation;
- differences in regulatory approaches;
- the wide extent and overlap of regulation; and
- regulatory fragmentation which leads to duplication.

Over 800 Staff are Involved in Financial Regulation in Australia . . .

Table 16.2: Staff Numbers involved in Financial Regulation

Regulator	Total staff	Financial system supervisory/ regulatory staff
Australian Securities Commission(a)	1,398	~ 264
Insurance and Superannuation Commission(b)	474	363
Reserve Bank of Australia(c)	1,779	~ 120
AFIC and State Supervisory Authorities	~ 113	~ 113
Total	3,764	~ 860

(a) As at June 1996.
(b) As at February 1997.
(c) Financial Institutions Division.
Source: RBA 1996, *Reserve Bank of Australia 1996 Report and Financial Statements*, agency data, estimates.

Regulation involves three main costs: the direct (or infrastructure) cost of regulators, the compliance costs of those under regulation, and the allocative efficiency costs of benefits forgone. Each type of cost and Australia's relative international performance are discussed below.

16.6.1 Direct Cost of Regulators

The qualitative impression of more administratively-intense regulation in Australia appears to be confirmed by an international comparison of direct regulatory costs provided in one submission to the Inquiry.[24] It reveals that the direct cost of regulation in Australia is the highest in a sample of jurisdictions (see Figure 16.4). Australia’s higher regulatory cost is neither fully explained by economies of scale against finance sector assets nor economies of scale in the number of institutions supervised.

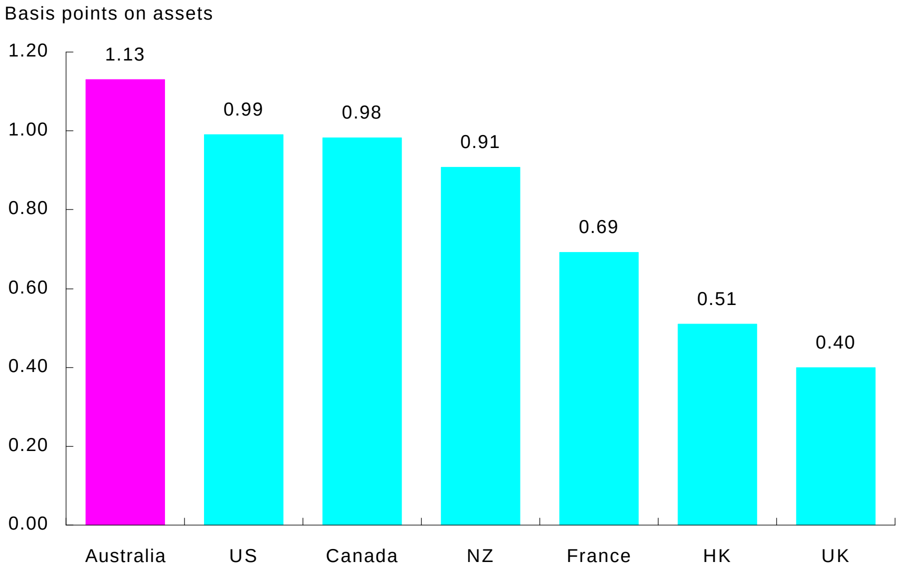
The total annual operating expenses of regulators in Australia amount to $107 million, equivalent to 1.13 basis points of assets. It is important to note however, that these figures represent only direct operating expenses incurred by regulators; in Australia, there is an additional regulatory impost of $171 million as regulatory surpluses which represent net revenues for the government.[25] These net revenues (equivalent to 1.8 basis points on finance sector assets) further sustain claims that the Australian jurisdiction is more costly than its overseas counterparts.

[24] National Mutual Holdings 1996, pp. 6, 15-16.

[25] These regulatory surpluses represent regulator ‘profits’ in excess of operating costs, earned primarily through the RBA’s payment of non-market interest rates on NCDs.

Regulatory Charges in Australia are High . . .

Figure 16.4: International Cost Comparison of Direct Regulatory Costs, (1994-95)



Source: National Mutual Holdings, Submission No. 32, p. 80.

Banks appear to bear relatively more of the overall regulatory burden than other types of institutions, due to higher charges.[26]

16.6.2 Compliance Costs

In addition to the direct costs created by regulatory bodies, regulation can create even more substantial compliance costs for industry participants. The significance of some of the compliance burden can be seen in the cost created by the introduction of the UCCC: one-off implementation costs at one bank alone amounted to over $16 million, with additional ongoing operating costs of close to $3 million per annum.[27] Other compliance costs include the costs of administering codes of practice, training staff, reporting

[26] Non-market interest rates on NCDs, National Mutual Holdings 1996, p. 8.

[27] Westpac Banking Corporation, Submission No. 90, p. 153.

to various agencies, compliance testing of marketing material (often involving external legal advice) and complaints resolution.

It is difficult to assess the national aggregates for compliance costs and compare such costs internationally due to differences in the measurement of compliance cost and different institutional compliance strategies. Within these constraints, the only comparison available to the Inquiry indicates that Australia appears again to be at the high end of a sample of countries. Total compliance costs in Australia are estimated to amount to $720 million, equivalent to 7.6 basis points of assets (see Figure 16.5). Only the US, with total compliance costs of 10.5 basis points of assets, has higher costs than Australia.[28] The additional costs imposed are significant: the differences between cost levels in Australia and the UK or New Zealand translate into additional annual expenses of about $460 million and $600 million, respectively.

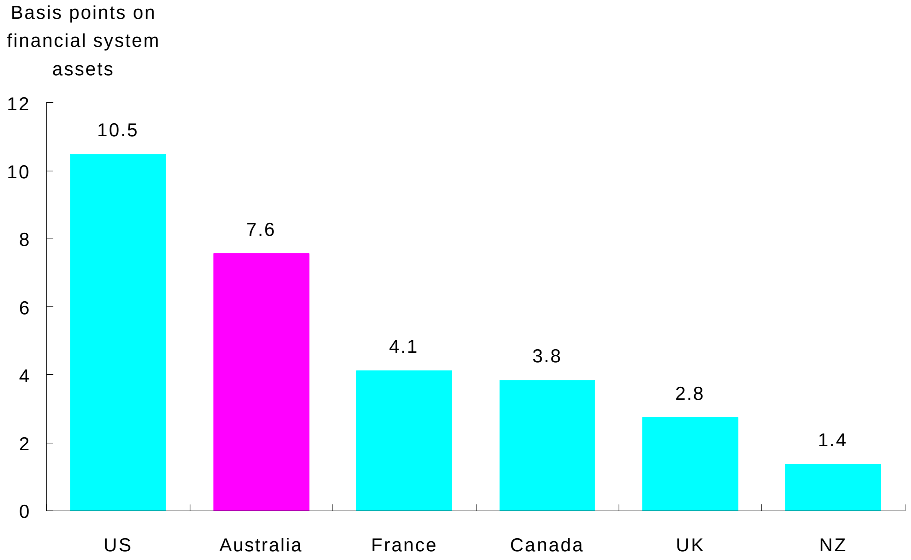
However, the total compliance cost measurement may overestimate the incremental cost of regulation, as estimates presented to the Inquiry suggest that 50 to 65 per cent of total compliance costs would be incurred anyway in the normal course of business.[29]

[28] 10.5 basis points is a midpoint, with estimates for the US varying from 6.1 to 14.8 basis points.

[29] National Mutual Holdings 1996, p. 46 and Appendix p. 17. Figures confirmed by a survey of life insurance companies and fund managers. See Cost of Compliance Survey, attached to AIMA/IFA/LISA, Supplementary Submission No. 113, Trowbridge Consulting Survey Appendix p. 7. The range of incremental compliance costs caused by regulation is likely to vary substantially between institutions due to different compliance strategies, skills and support technologies.

Australian Compliance Costs are High . . .

Figure 16.5: Total Compliance Cost by Country, (1996)



Note: US data is the midpoint of estimates which range from 14.8 to 6.1 basis points
Source: National Mutual Holdings 1996, p. 43.

16.6.3 Allocative and Other Efficiency Costs

The third type of cost caused by regulation is that associated with inefficient allocation of resources to the wider economy. Assessing this impact of regulation is difficult. Allocative efficiency issues relating to the entire economy are discussed in Chapter 17.

Excessive or unclear regulation can also have significant indirect detrimental effects on areas of the financial system itself, such as product development. This can be illustrated by the long delays experienced in bringing new products, such as share ratio contracts, low exercise price options or warrants, onto exchanges. These delays were due to problems associated with unclear classification rules for these products.

Finally, regulation may impose costs by muting price signals that would encourage resources to be directed to their most productive use (see Chapter 11).