

# The Costs of Financial Services Regulation in Australia: The Price of Consuming Regulation

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## 1. Background and aims of project

The pace, volume and cost of regulatory change over the last ten years has been enormous.<sup>1</sup> Until the middle of the 1990s, managed funds and their operators were regulated as part of the securities markets. Regulatory change in 2001 saw the alignment of law governing products and operations, with laws regulating wealth management products (insurance, investments and superannuation). Compliance costs associated with these changes are considerable with the PWC Australian Investment Management Survey 2005 listing “Breaches of FSR legislation” as the biggest risk management issue facing the surveyed firms (2005, 4).

Economists argue that markets provide the most efficient outcome given both allocative and productive criteria of efficiency and that any disturbance to such an outcome will be detrimental for consumers. The market for financial services is one that, on the surface, appears to be an exception to this general rule. Around the globe the financial services industry is laden with regulation. Benston (2003) considers this apparent contradiction, and questions why governments regulate the financial services sector and asks whether this regulation is desirable. He notes that most arguments favouring regulation in financial markets “do not hold water”, though some regulation is desirable.

The *traditional* economic approach to regulation suggests that high compliance costs are not necessarily an explicit objective of regulation. Government intervention is intended to correct for market imperfections, or market failure. Alternatively, the *Modern Economic Theory of Regulation (ETR)*, (Stigler, 1973)<sup>2</sup> assumes that government maximises political gain from supplying regulation. While regulation may advance the interests of regulated firms it also imposes compliance costs (Hail and Leuz, 2006). For example, high compliance costs might act as a barrier to entry, favouring the regulated industry. Indeed, regulation may both limit new entrants and generate rents for established firms that run programs aimed at “certifying” new entrants. The balance between compliance costs and industry protection is critical to the regulated industry.

The aim of this project is to analyse the effect of recent changes to the regulation of the Australian financial services. We consider the impact of regulation on cost ratios as well as *survey* industry views on the perceived success and/or failure of the regulation. This project will be a highly significant addition to the literature, and act as an important reference for future studies of financial services regulation, both in Australia and abroad.

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<sup>1</sup> See, for example, “Fifty Years of Managed Funds in Australia”, in the KPMG/Centre for Corporate Law and Securities Regulation, p116-7.

<sup>2</sup> Important extensions on the basic ETR were made by Posner (1974), Peltzman (1976), and also Becker (1983).

## 2. Significance and innovation

Applications of the ETR to the financial sector are *surprisingly few*, and the literature demonstrates a small number of contributions that have actually extended the insights of Stigler-Posner-Peltzman-Becker.<sup>3</sup> Kroszner and Strahan (1999) emphasise the relative political strength of the “winners” and “losers”. In a 2000 contribution the same authors demonstrate a correlation between an individual parliamentary representative’s vote on financial regulation, and the financial structure of that representative’s constituency. Ramirez (2002) considers the effect of changes to the Glass-Steagall Act of 1933 to find that favours from the regulated industry impact upon the behaviour of legislators, while Barth, Caprio and Levine (2002) present cross-country analysis pointing to deliberate inefficient regulation regimes that benefit favoured constituents. Another important application to the financial services area comes from Stratmann (2002), who shows campaign contributions from agents within the financial services sector acquire legislator voting support.

While a government may attempt to appease the regulated industry, does industry actually get what it wants? The satisfaction of the regulated industry is an important result of the ETR. Heinemann and Schuler (2004) consider what outcomes the banking industry prefers to obtain from the regulators and finds that the banking sector values low compliance costs ahead of protection from new entrants.

Why would the regulated industry prefer regulation that is loose? We believe the cost of regulation is best modelled as the “price” of “consuming” it. Certainly, regulation increases costs, and that these costs are not homogeneous across firms. Further, Hail and Leuz (2006) show that the degree of regulation in securities markets is positively related to the cost of equity capital. Yet, changes to regulation can generate uncertainty. For example, Al Mamun et al (2004) and Carrow and Heron (2002) find the *Gramm-Leach-Bliley Act*<sup>4</sup> generated a mixed reaction from firms within the financial services industry.<sup>5</sup>

This project investigates the costs of change in financial regulation in Australia from the *economic perspective of the finance industry itself*. We examine two specific measurements of this cost. Firstly, we measure the change in cost. If the regulation generates onerous compliance costs, we expect to observe an increase in firm costs. Secondly, we analyse the view of the firms themselves about the regulation: what is their attitude toward the cost of regulation. Thus gives both an objective and subjective measure of the cost of regulation.

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<sup>3</sup> In a contribution by Heinemann and Schuler (2004), to which we will refer further below, the authors also note the lack of efforts to apply these insights throughout the financial sector:

“To our knowledge, this view on regulation has so far not been applied to banking supervision. However, there is a closely related literature on the political economy of banking market entry regulation with empirical application to the U.S. The guiding question of this strand of literature is whether the private interest view on regulation helps to understand the liberalisation steps that had been taken in the U.S. since the seventies” (Heinemann and Schuler, 2004: 101).

<sup>4</sup> The *Gramm-Leach-Bliley Act*, also known as the *Gramm-Leach-Bliley Financial Services Modernization Act*, Pub. L. No. 106-102, 113 Stat. 1338 (November 1999) is and Act of the United States Congress which opened up competition among banks, securities companies, and insurance companies.

<sup>5</sup> Alfon and Andrews (1999) have outlined guidelines for a Cost-Benefit Analysis of financial services regulation. In their report—on behalf of the Financial Services Authority—they suggest examination and measurement of the costs imposed on financial services sector of compliance with regulation, but also measuring the proposed benefits for consumers. Both these measurements can be obtained with the use of industry surveys. The impacts of regulation identified by Alfon and Andrews are: 1) Direct Costs, 2) Compliance Costs, 3) Quantity of the Good Sold, 4) Quality of the Goods Offered, 5) Variety of the Products Offered, 6) Efficiency of Competition. The authors offer suggested methods as to how to obtain measurements of these respective impacts.

### **3. Description of Approach**

#### 1) Modelling the costs

This is our “objective” measurement of the price of regulation.

We use the MorningStar database to compare management expense ratios of mutual funds for 2001 and 2005. After allowing for fund characteristics such as size and fund type, we would expect that there should be an increase in this ratio if the new regulations impose additional costs. Panel data analysis would be used and so only funds in existence since 2001 could be used in this test. This period of analysis is considered appropriate given the significant changes that have been introduced over this period. The project will also examine the changes in the rates of discontinuance of existing funds and new start ups.

#### 2) Surveying the Firms

This is our “subjective” measurement of the price of regulation. A survey will be conducted to obtain data about identified costs in relation to legal, administration, employment, software, etc. which can be identified directly as a result of the introduction of the FSR Act. Face-to-face interviews (in both Melbourne and Sydney) will be conducted using a sample of funds managers to determine their opinions of the costs and benefits of the introduction of the FSR Act.