



3 October 2006

Benchmarking Business Regulation
Productivity Commission
Locked Bag 2 Collins Street East
Melbourne VIC 8003

Performance Benchmarking of Australian Business Regulation

Dear Sir or Madam

1. Introduction

The Australian Financial Markets Association (AFMA) is the national organisation which represents more than 130 participants in the wholesale banking and financial markets. AFMA coordinates the efficient operation and effective management of the over-the-counter financial markets by promoting high professional standards in the conduct of those markets. AFMA's mission includes promoting the development of Australia's financial markets and Australia as a significant centre for financial services.

Our members report that the regulatory burden placed on them has increased sharply over the past 10 years, both in absolute terms and as a proportion of operating income. This is a result of a range of reforms in taxation, financial services regulation, anti-money laundering and accounting, amongst other things. While members understand that the financial sector must be well-regulated and accept they will incur significant compliance costs, the regulatory system is not as efficient as it should be and, thus, the regulatory burden is unnecessarily high.

Against this backdrop, we welcome the Government's initiative to develop performance indicators for an ongoing assessment and comparison of regulatory regimes across all levels of government and believe the Commission is ideally placed to undertake this work. We would look to support the Commission in its endeavour to the greatest extent possible.

2. The Purpose of Regulatory Performance Indicators

The Commission has been asked to develop performance indicators and framework options for benchmarking, measuring and reporting on the regulatory burden on business. At a conceptual level, we believe the focus of this work should extend beyond the measurement of regulatory costs solely by reference to associated administration expenses. A broader approach is required to develop the information base necessary to improve all aspects of the regulatory process.

Administration costs that are unnecessarily high are a matter of concern but their cause may originate in a deficiency at any one of a number of points in the regulatory process. We believe it is necessary to identify the source of the problem in order to deal with it effectively. Some examples of deficiencies we have previously identified in the regulatory process are:¹

- Policy formulation phase - insufficient clarity around the policy objectives of a regulation or a lack of proportionality in the regulatory response;

¹ See the International Banks and Securities Association of Australia's submission to the Taskforce on Reducing the Regulatory Burden on Business (November 2005). IBSA and AFMA merged in December 2005 to form a new association, which retained the name AFMA.

- Policy instrument design phase – flaws in the design of a regulatory instrument (usually the instrument is a law, regulation or a standard);
- Policy implementation phase - weakness in the regulator's administration of the regulatory instrument that emerges.

While a performance indicator that focuses on the size of administration costs is helpful to uncover a problem and is often the most practical measurement option, it may not provide much insight into the source of the problem. Further, information on direct administration costs will not capture the regulatory burden in situations where a deficiency in regulation has the effect of preventing a business activity from occurring (and, thus, no administration costs are incurred).

Also, a singular focus on administrative costs may in practice distract attention from the best remedy to a problem. For example, a regulator charged with implementing a law may be subject to criticism for an unhelpful administrative approach that increases compliance costs, whereas its ability to react in a more accommodating manner may be restricted by a flaw in the law or the policy underpinning it. Of course, there may be other situations where a regulator should do better in the circumstances in which it finds itself.

Therefore, to maximise the potential for benefit through better regulation, regulatory performance indicators should provide some insight into the source of an excessive regulatory burden as well as the size of that burden in terms of the administration cost it generates.

This task could be addressed at two levels:

- First, the identification and adoption of principles or best practices that are most likely to deliver effective regulation (ie regulation which meets the policy objective in the least costly manner);
- Second, the development of measures to assess those with responsibility in the regulatory process against these benchmarks.

The first task can be achieved by developing structured principles for effective regulation to provide guidance and give discipline to the regulatory process. This would include matters like transparency, accountability, proportionality, cost-benefit analysis and effective consultation. For example, a regulatory action should only be taken if there is a demonstrated market failure to be addressed and that particular form of response is superior to the alternatives, as tested through consultations and a cost-benefit analysis. This should lead to outcomes that support effective regulation; like clarity and transparency of policy, regulatory instruments that efficiently target this policy and shrewd administration of the regulation, having regard to both the costs and benefits.

We acknowledge that the formal adoption of principles for effective regulation is the responsibility of governments and beyond the scope of the assignment given to the Commission. However, the Federal Government has accepted the 'principles for good regulatory process' recommended by the Taskforce on Reducing Regulatory Burdens on Business² and there is an implicit framework of government intentions in support of more effective regulation. This provides scope for the Commission to reflect such principles in its study conclusions.

The second task can be undertaken once the principles are established by reference to the expected regulatory outcomes. A measure of the administration costs of regulation would be a key indicator of effective regulation but it would not be the sole measure. Examples of other relevant indicators include checking the existence of a document that clearly articulates the intended policy behind a piece of regulation and an assessment of the adequacy of the consultation processes around implementation of the policy by the regulator. The indicators would be

² Taskforce recommendation 7.1.

interdependent to a significant degree; for example, a high administration cost may be associated with a regulator's difficulty in coping with lack of policy clarity.

The indicators necessary to assess the extent and source of problems with the existing regulatory burden would sit cohesively along side indicators to assess the proficiency of the process around the formulation and preparation of new regulation. For example, policy clarity and effective consultation and transparency are key elements in the disciplined development of new regulation and can be tested within the proposed framework.

It is beyond the scope of this submission to elaborate more fully on the nature of the principles for effective regulation and the full suite of performance indicators that might accompany them. However, we would be able to develop the concept further and provide more information if that is required.

3. Answers to Specific Questions in the Issues Paper

This section provides answers to some of the questions posed by the Commission in its Performance Benchmarking of Australian Business Regulation Issues Paper.

Q1 Are there any other international or domestic studies that could provide useful guidance?

For your information and to illustrate approaches elsewhere, we wish to bring to your attention to a Survey Report on the costs of compliance in the US securities industry, which was prepared by the Securities Industry Association (SIA).³ The survey contains both quantitative estimates of the cost of compliance for securities firms of various sizes.

Because the SIA survey is narrowly focused, the questions are more finely targeted than those that might be used in a survey of businesses in general. However, the basic cost framework that is adopted could be applied more widely, whether in relation to regulation generally or more specific issues.

Q2 What purpose can benchmarking most usefully serve?

We agree that benchmarking would serve a useful purpose in identifying best practices by the comparison of similar regulation across jurisdictions, and by monitoring the burden of regulation over time.

Benchmarking would also provide additional benefits including:

- A transparent measure to assist in promoting accountability of regulators;
- International comparisons of regulatory efficiency;
- Identification of opportunities for more effective regulation.

Because the cost profile of different forms of regulation may vary over time, it may be necessary to make some comparative assessments over a time horizon, rather than at a point in time. For example, regulation through 'black letter' law may entail significant start-up costs, but once regulated entities have put in place compliance measures the regime should not require ongoing structural maintenance.

However, with principles-based law, the initial compliance effort may be lower as regulated entities may use discretion in interpreting their regulatory obligations,

³ Both SIA and AFMA are members of the International Council of Securities Associations. SIA's Survey Report is available on its website at the following address:
<http://www.sia.com/surveys/pdf/CostofComplianceSurveyReport.pdf>

but as interpretational issues are identified and resolved over time higher ongoing maintenance costs may be incurred.⁴

Q3 How wide in coverage should the benchmarking be?

We believe the coverage of regulatory benchmarking should be pitched at two levels:

1. Regulation that affects businesses in general (eg taxation and company affairs).
2. Specific industry sectors that are subject to a relatively high level of regulation and are, thus, exposed to a greater risk of inappropriate regulation (eg financial services).

It would be appropriate to differentiate between large, medium and small businesses in the conduct of benchmarking. However, it would be inappropriate to give preferential treatment to one part of business over another, as all businesses bear a significant regulatory burden.

Q4 Which regulations or regulatory areas should be benchmarked?

The financial services sector should be given a high priority in the regulatory benchmarking process for the following reasons:

- Financial services providers are subject to an exceptionally high level of regulation and many businesses must deal with multiple regulators of their banking and finance business.⁵
- An efficient financial sector that provides competitive financial intermediation, risk management and payments services is vital to facilitate the ongoing growth and development of the economy.⁶
- The finance and insurance sector is the third largest sector in Australia's economy, generating 8.5 per cent of GDP. It is a major driver of economic growth and the expansion of the sector has aided growth in related sectors, such as communications, property and business services.⁷

Q5 Which approach would be most cost effective?

The approach we suggest in response to question 3 above would be most cost effective.

Q 6 How should regulatory burden be measured?

It is far easier to describe the costs that form the regulatory burden than it is to measure them. Further, not all regulatory costs are a deadweight loss; for example, financial institutions would incur costs in the absence of regulation in order to maintain investor confidence and protect their reputation.

Therefore, one of the challenges in measuring the regulatory burden is to identify the inefficiencies in regulation that create an unnecessary burden for business, having regard to the other relevant factors. Thus, the Commission's focus on 'unnecessary' regulatory burdens is appropriate.

⁴ Principles based regulation provides a greater degree of discretion to regulators to adjust to changing market conditions and practices, but it necessarily involves some greater uncertainty (ie it's not possible to simply 'tick boxes' under a principles regime).

⁵ See Chapter 5 of *Rethinking Regulation – Report of the Taskforce on Reducing Regulatory Burdens on Business* (January 2006) for a brief outline of regulation and some of the related issues confronting the sector.

⁶ For example, the *Financial System Inquiry Final Report* (1997) provides an insight into the essential role of financial markets and the contribution of their deregulation to economic growth and development.

⁷ See *AXISS Australia: Australia – A Global Financial Services Centre Benchmark Report*, August 2005.

Regulatory compliance costs typically comprise:

Direct operating costs – Primarily the cost of the internal staff necessary to comply with regulation, including salary, training costs and education;

Business capital costs – The cost of mandated financial capital and working capital embedded in communications and technological systems etc, necessary to support a regulated business;

External costs – The purchase of services from external professionals (eg lawyers and auditors) necessary to ensure compliance with the law;

Opportunity costs – The alternative use to which management time and resources could be put in the absence of regulation, as well as legitimate business opportunities that are forgone as a consequence of regulation.

In our experience, direct operating costs, capital costs and external costs are most amenable to objective quantification - but are nonetheless difficult to collect reliable data on. Opportunity costs of regulation are a different matter and are sometimes impossible to quantify, which is a problem as they can be significant.

For new regulatory measures, it is often possible to estimate the incremental costs associated with the relevant changes. The cost of existing regulation is more difficult to measure as it is embedded in the overall cost of operating a business (for example, regulatory reports may form part of a system used to generate commercial information necessary to run a business).

However, we believe it is possible to combine a range of indicators to capture the efficiency of the regulatory process (as outlined above) and obtain an insight into the cost of regulation by estimating direct costs to business.

Q7 How useful are indirect measures?

Indirect measures of compliance costs and the regulatory burden can be useful in comparing changes over time and across jurisdictions, especially if applied to specific tasks or compliance obligations (eg how long does it take the average business to complete its tax return?).

In some instances, it may not be possible to obtain reliable direct estimates of regulatory costs and the only source of information is an indirect measure of the burden placed on business.

Q8 What scope is there to target incremental or unnecessary cost burdens?

It is difficult to precisely measure incremental or unnecessary cost burdens for the reasons mentioned above. However, it is possible to obtain some useful insights from relative measures, like internal ratios (eg compliance costs to revenue) and cross-jurisdictional comparisons.

Q9 Are these reporting options feasible, and for which areas of regulation?

It is feasible to obtain quantitative and qualitative information on aspects of the regulatory burden that are specific to financial services providers. However, in many instances, this would require input from individual financial institutions which would generate a cost for them. We think it is important to note that this input may not be forthcoming in the absence of a high degree of confidence that the benchmarking process will ultimately lead to more efficient regulation.

The core body of specific financial services regulation is based in Commonwealth law, so domestic cross-jurisdictional comparison is not feasible. However, we hope to gain further insights into the extent to which international comparisons of the financial services regulatory burden can be made and will inform you of any relevant information in due course.

Q10 Which of the feasible options are essential?/Which of the options do you think are cost-effective?

As outlined above, we believe it is possible to combine a range of indicators to capture the efficiency of the regulatory system for financial services (by reference to principles for effective regulation) and to estimate direct costs to business.

We do not believe that opportunity costs are generally amenable to reliable estimation, though this will not always be the case.

Q11 How should the benchmarking deal with such data, measurement and comparability limitations?

Practical constraints will be an impediment to the development of a comprehensive suite of performance indicators. However, it should be possible to draw on industry experience (eg through targeted consultation groups) to identify alternative indicators and enhancements to existing indicators.

Q12 How important is it to enumerate the qualifications for each benchmarking comparison?

It is important that the basis for each benchmark comparison is explained, so users understand the limitations and strengths of the information. This will also assist analysis of indicators, as business or regulators might be able to explain the origin of apparent anomalies and it will enable greater public participation in the development of the indicators, through feedback on their usefulness and practical suggestions for improvement.

4. Selection of Indicators

The range of performance indicators that might be applied to financial services regulation is a matter that requires more detailed attention than we can provide within the timeframe for this response. Moreover, there may be benefit in deferring discussion of detailed sectoral indicators until a decision is made about the framework that will be applied (for example, will the indicators be limited to measures of administrative compliance costs or will it extend to provide information on the sources of the efficiencies/inefficiencies in regulation?).

We suggest that further targeted consultation should be undertaken on the form of indicators that might be feasible and useful for an assessment of the regulatory burden generated by regulation specific to the financial sector.

As a general comment, we note that the selection criteria for indicators outlined in Box 2 in the Commission's Issues Paper are sensible and would assist in the design of both general business and specific sector indicators.

5. Concluding Comments

Thank you for the opportunity to provide input to your work on this important initiative. Please contact me if we can be of any further assistance.

Yours sincerely

David Lynch
Director of Policy