ACCESS ECONOMICS Pty Limited

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Performance benchmarking of the regulatory burden

Submission by Access Economics Pty Limited for

Finance Industry Council of Australia (FICA)

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GLOSSARY AND ACRONYMS

AML	Anti-Money Laundering
APRA	Australian Prudential Regulation Authority
ASIC	Australian Securities Investment Commission
CLERP	Corporate Law Economic Reform Program
COAG	Council of Australian Governments
CTF	Counter-Terrorist Financing
FATF	Financial Action Task Force
FICA	Finance Industry Council of Australia
Financial Sector (the Sector)	incorporates inter alia banking, finance, insurance, superannuation, managed investments and funds/asset management
FSRA	Financial Services Reform Act
IASB	International Accounting Standards Board
MCCA	Ministerial Council for Consumer Affairs
ORR	Office of Regulation Review
PC	Productivity Commission

EXECUTIVE SUMMARY

The Finance Industry Council of Australia (FICA) asked Access Economics to provide comments on the exercise that the Productivity Commission (PC) has been commissioned to do by the Council of Australian Governments (COAG) on benchmarking the performance of Australian business regulation.

In principle, benchmarking the regulatory burden on Australian business will be very useful in improving the regulatory environment in Australia. In practice, it has the potential to be a sizeable exercise, and cost-effectiveness is an important consideration. On any measure, the financial sector is important and needs to be in scope because of its links with the broader economy and role in generating economic growth.

Benchmarking and regulatory costs are complex in nature. A number of key aspects of the project are highly difficult to measure (for example, efficiency losses and regulatory benefits). Excluding elements on the basis that they cannot be quantified could lead to a drift in focus away from the material issues and missed opportunity for reform. As it is, the exercise will need to be conducted and presented carefully to avoid pressures to dismantle good quality, beneficial legislation.

The project needs to encompass the processes by which regulation is developed and reviewed (including measures of consistency of approach across the regulatory landscape), together with its design, implementation and enforcement. All of these factors contribute to the overall regulatory burden.

As such, the exercise needs to comprise:

- Tracking and monitoring of the collective burden of compliance costs in key sectors over time;
- Benchmarking of regulation and regulatory areas (both federal and state) including;
  - Relating compliance costs to regulatory benefits and objectives;
  - Benchmarking of the process of regulatory development and review (including ensuring that harmonisation is a fundamental consideration in the process);
  - Benchmarking the design of regulation against best practice principles; and
  - Tracking the performance of regulatory authorities.

The relevant benchmark — whether state or national — will depend on the case in question. Both national benchmarking over time, and benchmarking across jurisdictions should be used where relevant.

The study will initially be limited by data considerations, and expanding the information base will take time. In part, the benefits will be derived from sustained measurement and reporting over time. It is therefore crucial to view the exercise as a long term investment in reform and economic growth.

1. INTRODUCTION — AN IMPORTANT EXERCISE

The Finance Industry Council of Australia (FICA) asked Access Economics to provide comments on the exercise that the Productivity Commission (PC) has been commissioned to do by the Council of Australian Governments (COAG) on benchmarking the performance of Australian business regulation.

Benchmarking the regulatory burden on business has the potential to be an important exercise in highlighting the magnitude of unnecessary compliance costs, illuminating the underlying causes and sustaining pressure for costs to be minimised. Economic analyses have suggested that reducing the compliance burden on business can enhance economic growth (for example, Djankov et al 2006).

In a review of financial sector regulation in Australia (FICA 2005), FICA outlined the recent substantial increase in compliance costs in the Sector. This reflects both domestic and international pressures. In the submission, FICA expressed the view that the compliance burden has been greater than warranted, little attention has been given to the cumulative impact of the varying regulatory agendas and regulators have had difficulty translating and enacting well crafted regulatory regimes.

The legislative design principles recommended by Wallis (1997) remain highly desirable but the implementation and administration of legislation in the finance sector has not matched the Wallis philosophy. Executing principles such as matching the regulatory approach to the intensity of need can be difficult in practice, and the current external environment has added to the complexity of the regulators' task. There is a need for regulatory accountability, and the development of robust, longitudinal information on compliance costs will contribute to transparency.

In view of this, benchmarking of the regulatory burden is welcomed. As stated in FICA (2005),

> *The development of a more comprehensive and consistent approach to determining regulatory costs would contribute in two important respects:*
>
> > *— The fundamental reform of business regulation as a central element in the next wave of microeconomic reform; and*
> >
> > *— The regular monitoring of how regulations are being implemented during periods when the issue is not centre stage. (FICA 2005 p.37)*

Recommendation 1: The development of performance benchmarks of business regulation and the process of developing and reviewing regulations are endorsed as important elements of improving the design of regulations and implementation by regulators.

Nevertheless, the exercise is partial in nature and the information needs to be presented in context. Regulation is generally introduced where there is actual or perceived market failure, or significant structural change is deemed desirable to better facilitate broad policy outcomes. However, even where market failure exists, regulation should only be introduced if the benefits outweigh the costs. Benchmarking is not able to answer the question of whether regulation was justifiably introduced in the first place.

As the Productivity Commission notes in its issues paper, costly regulation may be justified where there is a net benefit. The terms of reference suggest that the benefits of regulatory regimes are to play a minor role in this exercise, being referenced as contextual information or caveats.

> *In developing options, the Commission is to: … report on any caveats that should apply to the use and interpretation of performance indicators and reporting frameworks, including the indicative benefits of the jurisdictions' regulatory regimes. (Terms of reference)*

As the PC (2006) remarks:

> *Performance indicators are measures of how well something is performing against its objectives. In this study, they are intended to focus on one aspect of regulatory performance — the burden of regulation to business — while having regard for the benefits of each jurisdiction's regulatory regime.*[1]

Recommendation 2: The PC's attempt to focus on instances where the regulatory burden is 'unnecessary' (or above that required to achieve the legislative objectives) is endorsed.

The burden of regulation incorporates the costs of governments administering regulation, the costs of business compliance, and the economic burden associated with inefficiency.

Economic burden of regulation	=	administration costs + compliance costs + efficiency loss.

The Regulatory Taskforce (2006) stated:

> *While the growth in regulation (and frequency of revisions to key regulations) is itself a cause of complexity and cost, arguably greater problems can arise from the nature and design of regulation and how it is administered and enforced. (p. 7)*

It is difficult to estimate precisely all of these costs of regulation, and there are likely to be many gaps. For example, in its issues paper the PC notes that:

> *Some regulations adversely affect economic efficiency and investment. Generally the costs associated with these effects, however, cannot be benchmarked because they are not amenable to simple indicators. They are best addressed in ex ante regulatory assessments and subsequent regulatory reviews. (PC 2006 p.12)*

In particular, in the absence of a counterfactual, it is inherently difficult to measure the economic costs associated with regulation. However, efficiency losses can be substantial and should not be shielded from view.

[1] PC (2006) issues paper pg. 5.

- Based on several Australian and international studies, Lattimore (1997) used a range of 15 to 40 cents in every tax dollar raised with a mid point of 27.5 cents to estimate the efficiency burden of additional taxation needed to support the R&D tax concession. By comparison, the total amounts spent and revenue raised by the Australian Government in 2000-01, relative to departmental running costs, suggests that administration costs of regulation account for 1.25 per cent of each taxation dollar raised (Access Economics, 2005).

Similarly, the benefits of regulation are hard to estimate quantitatively. Nevertheless, it is important that the exercise creates the right priorities for further work, so explicitly identifying where there are gaps in information and suggesting their likely magnitude given predictions from economic theory will ensure that future reform is not misdirected. Excluding components of costs or benefits on the basis that they cannot be quantified could lead to a drift in focus away from material issues and missed opportunities for reform. It is important that — by leaving out key pieces of the jigsaw — the exercise does not create pressure for dismantling high quality regulation which delivers clear benefits.

In view of the potential dangers associated with a partial approach, the data need to be presented in a circumspect manner that provides readers with guidance on interpretation. Regulatory benchmarking will be a multifaceted exercise and the way it is presented should not downplay its complexity.

Recommendation 3: The benchmarks that are developed will be partial in nature. It is important that the evidence on regulatory burden is assessed against the benefits of regulations, and that information gaps are explicitly highlighted. The information needs to be presented in context with clear guidance for readers on its appropriate use.

It is reasonable to expect that the exercise will evolve over a number of years. Expanding and improving the information base so that it is positioned to deliver real benefits in terms of focusing further reform will take time. Periodic regulatory reviews in the past have been worthwhile but have had a temporary impact at best. The potential economy-wide benefits of this benchmarking study are substantial in terms of economic growth and will in part derive from measurement and reporting on a sustained basis over time. It is, therefore, important that the exercise be viewed as a long term investment.

Recommendation 4: It is reasonable to expect that the exercise will evolve over a number of years and take time to deliver benefits. In part, the benefits will be derived from sustained measurement and reporting over time. It is, therefore, crucial to view the exercise as a long term investment.

2. THE FINANCIAL SECTOR SHOULD BE INCLUDED

Given the sizeable nature of the exercise, prioritisation of sectors, regulation and regulatory areas will be important, and a scoping system needs to be developed. It is not clear how COAG's list of hot spots was derived. While the list appears useful, it is not possible at this stage to endorse it. It will, however, be important to focus initially on an area where results are likely to be useful so as to build momentum for progress in the long term.

Recommendation 5: The initial selection of regulatory areas and sectors of the economy to be benchmarked should be based on an assessment of:

- their importance to the economy;
- the extent of the regulatory burden relative to the likely benefits;
- the likely costs of compiling the data; and
- whether the benchmarking approach in any particular area can be used as a template for reporting other areas in future.

The financial sector (incorporating, *inter alia*, banking, finance, insurance, superannuation, managed investments & funds/asset management) has a significant impact on the lives of all Australians and on any measure should be a key contender for inclusion in the benchmarking study.

There is substantial literature documenting that well functioning financial markets accelerate economic growth and foster economic well-being across income levels.[2] The overall objective of regulating the financial sector should be to ensure that the system functions efficiently in helping to deploy, transfer and allocate resources across time and space under conditions of uncertainty (Merton 1990). While financial regulation aims to address externalities and information asymmetries, it also reflects a broad range of social objectives from increasing home ownership to combating organised crime (for example, anti-money laundering, AML) or terrorism (for example, counter-terrorist financing, CTF).

In 1995, the total cost to users (measured by total revenue generated) of Australia's financial system was approximately $41 billion (Wallis 1997). This was at the higher end of the middle range of a set of comparable countries. At that time, this was more than the costs of the residential construction sector or the costs of the entire retail sector.

Wallis (1997) suggested that significant efficiency improvements could be achievable through the removal of inefficient regulation and the enhancement of competition. An assessment of the economy wide benefits of deregulation of the financial system in the 1980s suggested benefits in terms of improvements in allocative efficiency, adjustment, monetary policy and saving — along with reduction of cost to consumers. The Inquiry concluded that Australia's economic structure in the 1990s was more competitive, more flexible and more capable of coping with the pressures of the current decade than would have been the case without financial deregulation.

[2] See Levine (1997) for a discussion on finance and growth while Dollar and Kraay (2000) provide discussion on poverty and growth.

As noted in the introduction, however, regulatory activity in the finance sector has recently escalated and compliance costs have increased. FICA (2005) stated,

> *the regulatory burden being faced by the financial sector has increased sharply in recent years as both the Australian and international authorities have instituted substantial change. Compliance costs have risen significantly and the products being offered to consumers affected. (p. iv)*

A sample of perceptions of 11 financial institutions in the financial sector represented by FICA in response to a questionnaire undertaken in late 2005 are listed in Box 1.

Box 1: Perceptions of compliance costs from FICA members

Direct compliance costs have risen significantly over the past five years, often more than doubling.

The expected costs of complying with two of the major changes — the Financial Services Reform Act and Anti-Money Laundering/Counter Terrorism Financing — were originally estimated to run into the hundreds of millions of dollars. The revisions to these regulations currently being developed will likely lower these costs, but they will still be very large.

Compliance is accounting for between 5 and 20 per cent of senior management time and 25 per cent of board time.

The range of financial services has been restricted by some of the regulations notably under FSRA while investment in new products has been inhibited.

While some institutions commented on the improvement in awareness of compliance matters among staff, the dominant impact on culture was negative. There was a particular concern that customers had become frustrated by the additional complications to service delivery.

Source: FICA (2005) p. 20

Recommendation 6: Given both the relative importance of the financial sector to the Australian economy and the extent of the regulatory burden it faces, the benchmarking exercise should be designed to enable the potential identification of unnecessary regulatory burdens on the Sector (including broader corporations legislation).

3. TEMPLATE FOR A MULTIDIMENSIONAL APPROACH

As the PC remarks in its issues paper, the exercise will be more useful if it is possible to identify whether the regulatory burden arises due to design, administration or enforcement. As the Regulation Taskforce (2006) stated:

> *"While the growth in regulation (and frequency of revisions to key regulations) is itself a cause of complexity and cost, arguably greater problems can arise from the nature and design of regulation and how it is administered and enforced."*[3]

There are numerous dimensions that impact on the cost and quality of regulation, and itemising and monitoring each dimension will contribute to an understanding of the underlying causes of the regulatory burden and — as a consequence — where priorities for reform lie. Information about whether objectives are being met, together with benchmarking of the process for developing regulation, its design, implementation and enforcement, and harmonisation across regulatory authorities are all significant features of the compliance cost landscape and all need to be incorporated into the benchmarking study.

The relevant benchmark — whether state or national — will depend on the case in question. Both national and State/Territory benchmarks should be used where possible. While the terms of reference for the study suggest a focus on comparisons across jurisdictions (see for example, point 4 of the terms of reference under Stage 2), State/Territory benchmarking is only one component of the exercise, and overemphasising this aspect will downplay the importance of other areas of potential reform. The financial sector is an example where national benchmarking over time will be highly valuable.

Recommendation 7: National and state/territory-based regulatory benchmarks should be used, where possible, to measure performance of regulation across jurisdictions.

The task will inevitably be circumscribed by the practicalities of data. That said, data considerations should not drive the exercise — quite the opposite. To illustrate, while the aim is to measure the *incremental cost* (defined by the PC as *the cost avoided if the regulations were withdrawn)*, in some sectors, only total costs will be available. In other cases, distinguishing between the costs associated with individual regulations and/or attributing costs to particular governments (Australian, State or local) will not be feasible.

In the financial sector, while data on compliance costs have been collected from time to time in the past, there is currently no standard, systemic tool used for estimating regulatory costs.

Recently, APRA asked industry respondents to a recent policy proposal to use the Business Cost Calculator developed by the Office of Small Business to estimate compliance costs.

> *In keeping with Rethinking Regulation: Report of the Taskforce on Reducing Regulatory Burden on Business (the Banks report) APRA is further enhancing its approach to cost-benefit analysis. These enhancements will generally require APRA to obtain more granular cost data from the affected stakeholders, in particular the affected industry. The Business Cost Calculator (BCC) developed*

[3] Regulation Taskforce (2006) pg. 7.

> *by the Office of Small Business (OSB) is the preferred tool of the Commonwealth Government in calculating business compliance costs. To ensure APRA gathers such data in a uniform manner, respondents are asked to use the BCC to calculate their assessment of compliance costs of the proposals in this paper. Costs of the proposals that are not covered by cost categories in the BCC are to be advised to APRA separately along with the assumptions underlying the calculation. Attachment C further outlines APRA's approach to measuring the economic impact of the proposal. Costs of the proposals that are not covered by cost categories in the BCC are to be advised to APRA separately along with the assumptions underlying the calculation. (APRA 2006:8)*

The approach outlined in APRA (2006) should not be interpreted as foreshadowing a decision by FICA to use the BCC in a systemic way. However, whatever the mechanism for collection of data, the approach needs to be cost effective and close collaboration with industry groups will assist in ensuring adoption for benchmarking of a nationally consistent and cost effective approach to gathering data. FICA would appreciate the opportunity to work with the PC in developing a cost effective approach and some practical indicators for the finance sector. FICA advocated regular monitoring of regulation in its submission to the Regulation Taskforce (FICA 2005), stating:

> *In order to make sure that such an exercise is realistic in its aims, especially in the initial stages, it will be important for there to be substantive consultation with industry and regulators, particularly on the development of common methodologies.*

Recommendation 8: The PC work with FICA to develop benchmarks for the regulatory burden on the financial sector in a cost-effective manner.

A suggested template for benchmarking is discussed in more detail below, but in summary should include:

- Monitoring the aggregate burden of regulatory systems at a sectoral level over time. This is a highly important element of the exercise — providing a holistic picture that covers all of the components of compliance costs, and includes international pressures where these are relevant (for example, in the financial sector).
- Benchmarking components of compliance costs by jurisdiction or at a national level depending on which is most relevant. One way to approach this would be to focus on a specific regulatory area. This element of the exercise needs to include:
  - Tracking of compliance costs over time (by jurisdiction if relevant);
  - Relating compliance costs to regulatory benefits and objectives;
  - Benchmarking of the process by which regulation is developed and reviewed;
  - Benchmarking of design; and
  - Tracking the performance of regulatory authorities.

3.1 NATIONAL BENCHMARKING OF THE CUMULATIVE BURDEN OVER TIME

Regulation of the financial sector is not restricted to primary legislation, but includes substantial subordinate legislation, policy and market rules (for example, those instituted by Australian and international stock exchanges). As the financial sector becomes more global, financial institutions are increasingly subjected to international rules and standards.[4]

The current sectoral regulatory burden reflects the accumulated impact of a number of major initiatives, generated by several different domestic and international bodies introduced over a short period of time. These have included:

- Financial Services Reform, an Australian Government initiative which became law in September 2001, and which is made up of the *Financial Services Reform Act 2001* (CLERP 6), the *Financial Services Reform (Consequential Provisions) Act 2001*, other FSR legislation that amends the *Corporations Act*, the *Corporations Amendment Regulations 2001* (as amended) and numerous Australian Securities and Investment Commission (ASIC) Policy Statements, Class Orders, guidance notes and other material.[5]
- The *Corporate Law Economic Reform Program (Audit Reform & Corporate Disclosure) Act 2004* (CLERP 9), an Australian Government initiative relating to corporate disclosure and financial services reporting.
- Implementation by APRA of new capital adequacy standards (Basel II) developed by the Basel Committee.[6]
- Review and amendments to the Insurance Contracts Act as well as the implementation of reforms for general insurance by APRA.
- Licensing of superannuation trustees and registration of superannuation entities by APRA.
- Anti-Money Laundering (AML) and Counter-Terrorist Financing (CTF) regulations based on recommendations by the Financial Action Task Force (FATF), an international inter-governmental body that develops policies to combat money laundering and terrorist financing. These are yet to be enacted in Australia, but the process is close to completion.
- The application in Australia of International Financial Reporting Standards (IFRS) developed by the International Accounting Standards Board from 1 January 2005.
- The Sarbanes-Oxley Act introduced by the United States Government covering financial reporting by organisations registered with the US Securities Exchange.
- International regulatory bodies such as the International Association of Insurance Supervisors and the International Organisation of Securities Commissions setting standards for financial services regulators.

[4] A number of Australian regulators participate on international bodies, such as the Bank of International Settlements, the International Association of Insurance Supervisors and the International Organisation of Securities Commissions and implement standards in Australia that reflect, and at times exceed, international practices.

[5] http://www.aar.com.au/fsr/arch/whatis/intro.htm

[6] The Basel Committee comprises representatives from the central banks of the Group of Ten countries. It formulates broad supervisory standards and guidelines and statements of best practice.

This wave of new regulation has resulted in considerable implementation and ongoing costs including staff, resources and managerial time. In a number of cases, the regulatory regimes duplicate each other and are inconsistent, even where there have been common ultimate objectives. For example, a number of regulators have been involved in the development of corporate governance standards (including APRA, the Australian Stock Exchange, and US authorities) and fit and proper standards (ASIC and APRA). While there have been efforts to reduce inconsistencies across the various approaches, some anomalies remain. Furthermore, the time and effort that both regulators and the regulated entities had to devote to these exercises highlight the desirability of developing effective processes, **and the benchmarking of processes**, for the development of regulations.

To adequately understand the impact of the wide range of pressures on the finance sector, the aggregate sectoral regulatory burden needs to be monitored over time. Furthermore, monitoring sectoral compliance costs in aggregate over time will reflect both domestic and international pressures and provide regulators with an indication of the cumulative total experienced on an ongoing basis.

> **Recommendation 9:** In key identified sectors, the aggregate regulatory burden needs to be monitored over time at a national level.

3.2 BENCHMARKING COMPONENTS OF COMPLIANCE COSTS

This could be undertaken for a particular regulatory area such as occupational health and safety, or consumer protection. The nature of benchmarking of specific regulatory areas should be undertaken on a case by case basis, and could include:

- Monitoring of compliance costs over time in selected regulatory areas — by jurisdiction if relevant;
- Monitoring whether regulatory objectives are achieved;
- Benchmarking of regulatory process against best practice principles;
- Benchmarking of regulatory design against best practice principles; and
- Tracking the performance of regulatory authorities.

Each of these is expanded upon below.

3.2.1 MONITORING COMPLIANCE COSTS OVER TIME IN A PARTICULAR AREA

This is essentially similar to monitoring compliance costs in aggregate as outlined above, but instead focuses on the costs for a specific regulatory area. Comparisons across jurisdictions should be made where relevant and feasible.

> **Recommendation 10:** For cross jurisdictional comparisons, benchmarking should be performed within narrow and comparable areas of regulation that are for the most part targeting the same objectives (such as OH&S or consumer protection).

3.2.2 MONITORING WHETHER REGULATORY OBJECTIVES ARE ACHIEVED

Ideally, the benchmarking exercise should consider whether regulation is achieving its objectives as an input to considering whether the cost burden associated with a regulatory regime outweighs the benefits.

As an illustration, the Financial Services Reform Act (2001) sought to address a concern expressed by Wallis (1997) about inadequate disclosure of information to consumers. However, as originally drafted, it was unlikely to achieve its goal. Information disclosure rules were standardised across financial products and services in a "one-size-fits-all" regime, negating the Wallis principle of matching the regulatory approach to the intensity of the need (see Box 2), and reducing flexibility. The legislation was costly and prescriptive. The disclosure requirements were so cumbersome that "*the material conveyed to customers risked being voluminous and complex and of no value*". "*The total implementation costs were likely to amount to many hundreds of millions of dollars*", but it was questionable whether the objectives would be achieved (FICA 2005 p.25).

While benchmarking against regulatory objectives will not always be feasible, it should form a core component of the exercise. Regulatory objectives can be elicited from Second Reading speeches and Regulatory Impact Statements. In the finance sector, the Treasurer's Statements of Expectations to APRA and ASIC will also assist in elucidating regulatory objectives.

Information could be gathered from government department and regulators, from industry representatives and experts, and from consumers and consumer representatives on whether the regulations are meeting stated objectives and what the benefits are.

In the Performance Benchmarking Issues Paper (PC 2006), the PC asks:

> *How important is it to ensure that businesses are sampled rigorously so that benchmarking results are representative and can be aggregated? (PC 2006:18)*

It is certainly important that results are representative and can be aggregated. The expertise of the Australian Bureau of Statistics should be sourced where it is necessary to collect data via survey.

Recommendation 11: Benchmarking against the regulatory benefits (or objectives) should be a core element of the exercise. The Australian Bureau of Statistics should be responsible for the design and operation of surveys of consumers where appropriate.

3.2.3 BENCHMARKING THE PROCESS OF REGULATORY DEVELOPMENT AND REVIEW

Suitable processes for developing new regulations and reviewing existing regulations help to cultivate improved regulatory practice and regulatory accountability. The discussion above demonstrates that process alone will not be sufficient to create the best outcomes, but it is nevertheless a key factor. As the Regulation Taskforce (2006) remarked:

> *Given the pressures and incentives for government to 'regulate first', mechanisms to enforce good regulation-making processes are essential. (p.vi)*

Accordingly benchmarking of regulatory processes should be included in this exercise as a complement to information on the overall regulatory burden experienced day-to-day by firms.

The experience of the financial sector illustrates the impact of regulatory processes on compliance costs. Best practice principles for regulating the financial sector were defined by Wallis in 1997 (see Box 2), but their implementation has fallen short. This can be attributed in part to the less than desirable processes for converting principles into practice. The speed at which financial sector reform took place meant that industry was commenting on draft regulations as they were being implemented, there was inadequate direction for regulators from the legislature, and the regulator's policy statement outlining how regulators would use their powers under the legislation was written before the regulations were finalised.

A better system would have involved:

- earlier and more effective engagement with industry to turn the high-level Wallis design into legislation/regulations;
- better collaboration with industry to allow more flexibility to adapt as the regulations were rolled out (incorporating learning by stakeholders over time); together with
- subsequent ongoing dialogue that encourages continuous improvement.

In other instances, governments have responded with undue haste to particular pressures at a point in time. Some examples of this are provided in FICA (2005), and include the more stringent rules that now apply to all prudentially regulated entities as a result of APRA's response to major corporate collapses such as HIH Insurance Group.

The length of time for development and review, and the timing and nature of consultation are key aspects of regulatory process, as the PC (2005) notes, and provide the basis for indicator development.

> *poor quality regulation making processes are often associated with decisions being made routinely in haste, with incomplete information being provided about options and their impacts. Inadequate consultation with stakeholders and the broader community can also be a feature of poor quality processes. (PC 2005 p.7)*

Consultation early on with the Office of Regulation Review (ORR) (or its successor) is also an important factor in good policy development processes.

> *The RIS process generally works best where there is high level political and bureaucratic support for the process, and where regulators consult with the ORR early in the policy development process and before decisions about regulatory issues are made. (PC 2005 p.7)*

The transition time allowed for companies to comply with newly enacted legislation is another aspect of regulatory process that can also contribute to compliance costs.

Box 2: Wallis principles of regulation

Matching the regulatory approach to the intensity of need

Wallis recommended the desirability of matching the approach to regulation with the 'intensity' of the need. In other words, "*the extent of intervention should be graded according to the nature of the contract involved and the consequences of market failure*" (FICA 2005).

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

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

All providers of financial services and all their customers are fully aware of their rights and responsibilities.

Flexibility

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.

Source: Wallis (1997).

Monitoring aggregate costs against historical benchmarks and trends will contribute to information about regulatory processes, for example, highlighting the impact on businesses of governments responding with undue haste to particular pressures at a point in time. However, aggregation carries with it the complexities associated with interpreting averages and what is driving these. Hence, regulatory processes need to be considered separately as well.

One of the problems with benchmarking process is that it relies on the effectiveness with which it is applied and this is not easily measured. In this respect, moves by the Australian Government to improve the standards for assessing cost benefit analyses and to strengthen the Regulatory Impact Statement (RIS) requirements (as per Regulation Taskforce (2006) recommendations 7.2–7.4, 7.10 and 7.11) are welcomed.

It is possible to develop minimum standards by which processes can be judged, for example, the Regulation Taskforce (2006) provides a useful guide on what constitutes good regulatory process in recommendation 7.1 (p. 147). **Harmonisation should be a fundamental consideration in any best practice process and needs to be added to the Regulation Taskforce list** (discussed next in section 3.2.3.1).

> **Recommendation 12:** Criteria should be developed by which the process of developing new regulations and reviewing existing regulations can be benchmarked.

3.2.3.1 MONITORING THE COSTS OF LACK OF HARMONISATION

Lack of harmonisation can lead to considerable, unnecessary compliance costs. As discussed earlier, the regulatory regime in the finance sector is influenced by a number of Australian and international authorities whose approach is not always consistent. The need for harmonisation extends not only to legislation and regulation, but to the way regulations are administered. The costs of the latter are often shielded from view and would benefit from the transparency associated with developing an ongoing information base. Accountability for ensuring consistency across the broader landscape needs to be at the highest level, including Ministerial Councils, as this is where the problem has tended to be more pronounced in the past.

The desirability of having consistent or harmonised regulations across jurisdictions will vary according to (i) the regulatory burden associated in complying with different regimes; and (ii) the possible benefits that may flow from tailoring regulations for local circumstances. As such, the importance of consistency will differ across regulations and sectors of the economy. Nevertheless, there should be a presumption that different jurisdictions seek to establish consistent regulations across jurisdictions and, where they decide to depart from this objective, they provide an explanation of the reasons for doing so and an evaluation of the costs and benefits. In this regard, Regulation Taskforce (2006) recommendations 7.24 and 7.25 and the Australian Government's response are welcomed.

A priority for harmonisation across jurisdictions includes the state regulated statutory classes of insurance (workers compensation, and compulsory third party).[7] The PC should explore establishing a mechanism which business groups can use to nominate regulatory areas where inconsistency is a source of unnecessary compliance costs.

This component of benchmarking needs to incorporate surveys of industry participants to highlight the extent of the regulatory burden associated with harmonisation of legislation across jurisdictions and to identify where these issues are most problematic.

Recommendation 13: There should be a presumption on State and Territory governments to establish consistent regulations. Where a jurisdiction is considering departing from this objective, it should undertake to consult first and publicise the costs and benefits of their decision. Accordingly, the benchmarking exercise should aim to identify the costs associated with lack of harmonisation and to identify where these issues are most problematic. The PC should explore establishing a mechanism which business groups can use to nominate regulatory areas where inconsistency is a source of unnecessary compliance costs.

3.2.4 BENCHMARKING DESIGN

Like good regulatory process, well designed legislation will on average lead to better outcomes, although it is only one component of the compliance cost landscape.

The Regulation Taskforce (2006) (box 2.3 p.8) provides a guide for minimum standards by which to judge regulatory design. For the financial sector, best practice design principles were outlined in Wallis (1997) (Box 2).

Unlike benchmarking of administration and enforcement, benchmarking design against best practice only needs to be done once for each piece of regulation and then revisited only when legislation changes. This aspect of reporting can be conducted on a rolling basis with the aim of capturing high priority areas gradually over time.

Recommendation 14: Criteria should be developed by which the process of designing and implementing new regulation can be benchmarked.

3.2.5 BENCHMARKING THE PERFORMANCE OF REGULATORY BODIES

The performance of regulators in implementing and enforcing regulation is an important aspect of the regulatory burden and needs to be incorporated into the benchmarking study. As the PC notes in the issues paper, the exercise will be more useful if it is possible to identify whether the regulatory burden arises due to design, administration or enforcement. As the Regulation Taskforce (2006) stated:

[7] Currently each State/Territory licenses and conducts prudential oversight of any insurers that underwrite statutory classes of insurance within its boundaries. This issue is discussed in more detail in the Insurance Council of Australia submission to the Australian Government Regulation Taskforce at http://www.ica.com.au/general/issueslist.nsf/17e2e1f61d0819b9ca256e38001b8277/d2044b454dd42369ca2570d50083c222/$FILE/1105%20Cost%20of%20Regulation%20(Taskforce).pdf.

> *"While the growth in regulation (and frequency of revisions to key regulations) is itself a cause of complexity and cost, arguably greater problems can arise from the nature and design of regulation and how it is administered and enforced."*[8]

As stated already, in the financial sector, the high level principles of regulation were well defined in Wallis (1997). While much of the sector's regulation may reflect these principles of good design, on a day to day basis, the regulatory burden is higher than necessary because of the way it is implemented and enforced.

> *Regulating well is inherently difficult. Very often the devil really is in the detail. The overarching principles may be well specified in legislation and in Second Reading speeches. But once this has occurred, regulators and regulated firms must ensure that the spirit and letter of any legislation and resulting regulation is met at the detailed operational level (FICA 2005).*

The Wallis design principles are outlined in Box 2 and highlight the complex nature of the regulatory task. Translating well designed legislation into an effectively administered, accountable regime is clearly challenging. Regulators must balance a flexible approach against the need for consistency over time and transparency. There is also invariably a need to withstand pressure from stakeholders, whilst remaining accountable.

> *While the presumption in favour of light handed regulation is widely held among policy makers and many observers, it does not always carry the day. The rebukes that politicians or regulators face when a problem emerges typically greatly outweigh any plaudits they may receive for adopting a restrained approach to regulation… The benefits from a sensible approach to regulation are diffuse but substantial while the costs of an unregulated risk materializing are concentrated and highly visible. (FICA 2005)*

Cost effective regulatory benchmarking can assist regulators and those they regulate to monitor the impact of the regulatory approach over time. Further, if benchmarking is done properly, it can assist regulators to withstand pressure from some sectors to intervene in an unnecessarily prescriptive manner. Information that would assist in tracking the performance of regulators includes:

- Time trends in administration costs of key regulators (for example, APRA and ASIC);
- Compliance costs of regulated entities (as discussed earlier);
- Benchmarking of regulatory processes (as discussed earlier);
- Information on whether the regulations are meeting stated objectives (discussed earlier); and
- The number of days taken for decisions to be made.

Recommendation 15: An important priority for the benchmarking exercise will be to measure the cumulative burden of regulation — not just the quantum of regulation but the way it is implemented and administered over time. The corresponding information available to regulators and those they regulate will allow monitoring of the impact of the regulatory approach adopted which is a significant component of compliance costs.

[8] Regulation Taskforce (2006) pg. 7.

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