Submission to

Taskforce on Reducing the Regulatory Burden on Business

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1. Summary

From time to time there are concerted calls to cut ‘red tape’ in the interests of economic efficiency[1]. There certainly are regulations which tie up resources but do not achieve their aim. And from time to time there are regulations that are out of date. But good quality regulation is essential to the operation of effective markets, and it is essential for the protection of consumers when those markets don’t work.

ACA has an established track record in calling for greater competition and opposing protectionism. We have long been publicly sceptical of arguments for special regulatory treatment for “national champions”. We favour regulation that helps make markets work better, not regulation that is simply pro-business.

We want as little regulation as possible – but as much as is needed. The idea that the size of the problem can be measured by the amount of regulation in the statute books – the “quantity theory of regulation”– is dangerously simplistic. Much of the regulation introduced in the past 20 years has been required by new developments in technology, markets, demography, societal expectations or government policy.

The public interest should be the fundamental motivation of regulatory decision-making in the market sphere. In particular, will consumers benefit from regulation? A test for successful regulation should therefore hinge on a broad test of consumer interest. Ultimately consumers endure the burden of both failed regulation either as victims of market failure or increased prices resulting from compliance costs.

ACA believes there are many regulations in Australia that would fail if a test of consumer interest were applied. Much of this excessive regulation has been introduced at the request of industry, who too often lobby for rules and restrictions that will secure their interests. Regulation that is used to unreasonably restrict or prevent competition is a case in point. We have listed examples of such regulation in our submission.

Equally, there is regulation that is integral to the fabric of our economy providing consumers with protection and confidence. First and foremost, regulation underpins markets. Contract law provides certainty for market participants. Markets such as those in electricity are entirely constituted by regulation. Secondly, where markets fail appropriate regulations provide essential safeguards needed to protect vulnerable consumers and maintain consumer confidence in the fairness and security of markets.

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[1] Professor Malcolm Sparrow very effectively sums up the arguments typically put forward about the growth of regulation and problems in the administration of regulation in Chapter 1 of *The Regulatory Craft* (2000). We commend this to the Taskforce.

ACA supports a more coherent "pre" and "post" review framework for regulation. These processes must be appropriately resourced, and must also be able to draw on inputs from all sectors including business and consumers.

It is increasingly obvious that the assumptions underpinning many regulations are inconsistent with actual consumer behaviour in markets, particularly in relation to disclosure. Too often these assumptions are not spelt out. As a result regulatory burdens are imposed on businesses that are ineffective in addressing market problems. To make market regulation more effective there is a need to better understand how consumers actually behave, rather than basing regulation on a view of how the ideally rational consumer should behave.

Any discussion of regulation must also focus on the role and powers of regulators. One of the recurrent weaknesses of many reviews of regulation over the last two decades has been the neglect of regulatory agencies. Well resourced, independent regulatory agencies with flexible powers and a strong commitment to targeted enforcement are fundamental to the effectiveness of regulatory frameworks. Weak regulators are ultimately a recipe for the introduction of additional regulation and an inconsistent and inefficient allocation of regulatory costs.

The focus of this submission is on market and consumer regulation rather than regulation in areas such as taxation or social security.

2. About the Australian Consumers' Association

The Australian Consumers' Association (ACA) is a non-profit, non-party-political organisation. The ACA is completely independent. It is not a Government department or agency and it receives no funding from any Government. Neither does it receive subsidies from industry, manufacturers, unions or any other groups, nor does it take advertisements in any of its printed magazines or on its website. The ACA gets its income from the sale of *Choice* magazine, *Choice Online* and other publications and products. It currently has over 145,000 subscribers to its products.

The ACA represents and acts in consumers' interests. It lobbies and campaigns on behalf of consumers to promote their rights, to influence Government policy, and to ensure consumer issues have a high profile in the public arena.

The ACA is committed to providing information on a whole range of consumer issues including health, financial services, information technology and communications, travel, food and nutrition, computer technology and consumer policy.

3. Regulation – some myths and mistakes

This review provides an important opportunity to revisit some of the unquestioned assumptions about the approach to regulatory policy in Australia. Our argument below is that there are several "myths and mistakes" that are causing significant confusion in the debate about regulation and markets.

In particular, there are several areas where current approaches by policy makers that are designed to ensure "light touch" or less burdensome regulation are actually having the opposite effect. There is confusion between the *market impact* of regulation and the *compliance burden* of regulation – we are seeing too much regulation that has little market impact but imposes significant compliance burdens (eg some disclosure requirements). These approaches are also generating *ineffective* regulation that does not adequately address market problems. Unless the reasons for this are understood, we run the risk of exacerbating regulatory burdens in the rush to implement more "light touch" regulation and avoid prescriptive approaches in the mistaken belief that this will reduce compliance costs.

Myth - "Industry friendly" regulation, particularly disclosure-based regulation, will always be less burdensome.

- The experience of the financial services sector clearly demonstrates how disclosure can become burdensome and yet still fail to address market problems.

Myth - Self-regulation is always less burdensome.

- Self-regulation can work – but often it results in the worst of both worlds by imposing costs on compliant firms while allowing non-compliant firms to free ride without fear of punishment. In many cases it is in fact less flexible than black letter law.

Myth - competitive markets don't require regulation.

- The experience of the last two decades in competition reform demonstrates clearly that effective regulation, and effective regulators, are essential to ensuring that markets are competitive and remain competitive.

Myth - the growth in regulation is a result of an undesirable reduction in the level of risk faced by consumers.

- This argument clearly fails to overlook the growth in regulations that seek to do exactly the opposite. One of the most dramatically burdensome and intrusive regulatory programs of the last few decades – compulsory superannuation – has involved the transfer of investment and longevity risk *to consumers*.

Myth – business is opposed to regulation

- Despite complaints about "rising red tape" businesses are very selective in their criticisms of regulation. Protected industries (pharmacy, broadcasting, airlines,

taxis, the professions) both fight tooth and nail to keep the regulations which insulate them from competition. We have yet to find any business in the finance sector that has called for an end to compulsory superannuation, despite the fact that this is burdensome and radically interventionist. Furthermore, despite paying constant lip-service to "principles-based" regulation, in practice businesses constantly call for detailed, "black and white" guidance on regulatory requirements.

4. What is regulation?

ACA believes the committee should give careful consideration as to what constitutes regulation. In particular, too often the definitions of regulation and deregulation imply that regulation and competition are in conflict. To the contrary, in many instances regulation should be seen as a way of reinforcing market structures and the rules of competition.

A broader definition of regulation also encompasses voluntary regulatory schemes where industry associations, and other institutions, establish explicit rules of conduct that participants must conform with. Regulation in this sense involves the imposition of standards or ethics for given activities by collaboration and peer evaluation[2].

ACA's submission considers both the narrow and broader definitions of regulation.

5. Why do we need regulation?

It is worth reiterating that "an effective functioning modern economy and society depends on regulation" (Productivity Commission, 2005: 1). Regulations are an essential prerequisite to the operation of markets – they establish the ground-rules via property rights, contract law and other legal structures.

From a consumer perspective addressing market failures is particularly important. The costs of market failure tend to transfer to the consumer. There are two sides to this process. Firstly, regulations need to break down barriers to entry on the firm side removing rent-seeking market structures. But secondly, and equally as important, regulations help consumers to exercise their market power to reinforce competitive processes from the demand side (Sylvan, 2005)

The economic rationale for regulation focusing on the need to eliminate market failure is well documented[3]. Examples include:

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[2] See Wikipedia definition of "Regulatory Economics" www.en.wikipedia.org.
[3] For a review of the economic rationale of regulation see Llewellyn, 1998.

1. Regulation developed to address systemic problems where externalities from market failure can compound throughout the economy. Importantly these externalities have social costs that spread. In the financial sector, for example, market failure in the payments system would have a significant impact on the economy through contagion. For example, the RBA has regulatory powers to facilitate the efficient functioning of the payments system, including controls on the costs of the payments system. Another example would be the development of deposit insurance to prevent bank runs should one financial institution fail.

2. Regulation that enforces sensible behaviour between parties, and indeed, makes the ground rules for competition and provides basic societal standards (i.e. safety standards for products, prevention of contaminants in foods etc). Tort and contract law allocate risk between parties establishing where practices are negligent and the party is responsible for them (Sylvan, 2005:40).

3. Regulation that aims to correct market imperfections and failures. This form of regulation concerns demand-side problems where there are information deficiencies (for example, supply of goods, free rider problems, loyalty and branding, complex products and one-off products) that make it difficult to judge the quality of goods and services. Regulations here range from 'don't cheat rules' through to information rules that help consumers make more informed decisions.

4. Regulation that empowers the monitoring of market behaviour to try to resolve principal-agent problems (to reinforce the second form of regulation – listed above). This is a form of regulation that provides economies of scale monitoring. By centralising monitoring function into a regulatory agency using risk analysis, the welfare loss from multiple consumers replicating their monitoring function is reduced.

5. Regulation to unblock grid locks. This occurs when the competitive behaviour between firms induces a form of short-term behaviour that is detrimental to consumers and firms in the longer term. By setting acceptable minimum standards grid locks that lead to a net welfare loss can be eliminated.

6. Consumer Behaviour and Markets

All regulation is underpinned by assumptions about how businesses and consumers behave – after all regulation is ultimately designed to affect or control behaviour in one way or another. But too often these underpinning assumptions are unclear, or they are inconsistent or unrealistic. It is ACA's view that one of the causes of the growth in ineffective and burdensome regulation in some sectors is the combination of:

- inappropriate and incorrect behavioural assumptions; and

- a one-dimensional and inflexible approach which always sees regulating market processes through disclosure as the primary regulatory tool.

This produces regulation that does not work or has perverse effects. Behavioural economics provides an opportunity to rethink some of these approaches.

An example from financial services will illustrate how this problem emerges. Much regulation in financial services is founded on the basis of an assumption that consumers and businesses will use information optimally. As a result, there is a strong tendency towards "disclosure" as the regulatory answer to market problems in financial services. If a market problem emerges, it can simply be addressed by providing more information to consumers, who will use that information optimally in decision making. If the problem persists, then it must be because the quantity or type of disclosure was inadequate, so the regulatory response is to require *more* disclosure or to engage in endless tinkering with the disclosure requirements. New market failures can also be addressed by more disclosure. In effect a huge burden has been placed on disclosure to solve a wide range of complex market problems. In response to the Wallis Inquiry, this approach was vigorously supported by industry groups, although they are now complaining about the burden of disclosure.

As behavioural economics clearly demonstrates, the assumption that consumers will use information optimally, in an economic sense, is wrong in a wide variety of non-trivial ways. Consumers display systematic biases and behaviours in decision making and information use that diverge significantly from the simple rational model. As a result, disclosure is being asked to solve problems that it cannot address in the first place. The losers from this approach are industry as much as consumers, especially more compliant industry participants. As more and more disclosure is required, in an increasingly vain attempt to fix market problems, the "light touch" of disclosure becomes the 100 page document.

Interestingly, a regulatory approach that is heavily based on disclosure may, in some circumstances, exacerbate market problems. For example, research suggests that disclosure is not only a particularly poor tool for reducing the detrimental impact of conflicts of interest in retail markets, it can actually contribute to the problems generated by conflicts of interest. US behavioural economics research on disclosure found that disclosure of conflicts of interest did not actually reduce the business of the biased adviser. In fact, academics Cain, Lowenstein and Moore (2005) found that disclosure of a conflict increased the level of trust between the consumer and the adviser. It also has the additional effect of making the adviser or product provider think that by disclosing the conflict, this activity is normal and their advice is objective. In other words, unethical and anti-competitive behaviour becomes more entrenched and systemic, and unfortunately, broadly acceptable. A much better, and less costly approach from a compliance perspective, would be to give regulatory agencies the ability to prohibit certain types of conflicts.

ACA believes that disclosure and transparency are very important regulatory tools in a range of markets. However, disclosure is not the only tool in the regulatory toolkit. If a product's fees and charges are horribly complex then disclosure will not fix the problem. If the terms and conditions are essentially unfair, complicated and lengthy, then disclosure will not fix the problem. If the advisor is poorly trained and biased then disclosure will not alone fix the problem. If you have a complex market that is supply driven rather than consumer driven then disclosure will not fix the problem. No amount of information available at the point of purchase can address all of these issues.

Part of the explanation for this problem is that in the policy arena there has been an undue focus on the *form* of regulation rather than a focus on the best way to address the underlying *objectives* of regulation. Disclosure is supposedly “market friendly” and less prescriptive, therefore it must always be preferred to other options. In this way decisions are made about the form of regulation rather than focusing on how the regulatory objective can be best achieved, using the most effective mix of regulatory tools. In this environment regulatory agencies are then expected to bend disclosure requirements into shape to meet the policy objectives. This approach has also arisen because of an unwarranted and inflexible preference in some policy areas for regulating processes rather than regulating products, which can be characterised as “anything goes, as long as you disclose”. Again, despite worthy objectives behind this approach – the aim of being ‘market friendly’ – it has added to compliance costs without significantly addressing consumer problems in many areas.

As a result, we need to adopt a more broad based approach to market regulation. We need an approach that is evidence-based and understands the behaviour that is the subject of regulation, rather than based on increasingly untenable assumptions.

The results of research in behavioural economics over the past fifty years has the potential to profoundly impact on how we assess the effectiveness of regulation and policy development. Very recently the *OECD Consumer Protection Committee* began considering how behavioural economics can assist in better targeting consumer protection regulation.

Examples from this body of research include:

- When assessing risky gambles over uncertain outcomes consumers are adverse to losses and dislike choosing in the face of uncertainty. This creates a tendency to become apathetic or not make a decision (Camerer and Weber, 1992)

- Impulsive spending habits can override original goals and divert consumers from a desired course of action (rational objectives) (Lowenstein, 1989).

- Alternatively, consumers do not have well-defined economic goals. Consumer choice can be constructed through impressions rather than rigourous reasoning (Bertrand et al 2004)

- Consumers fail to process information in a systematic manner based on real probabilities, and instead do so through stereotypes (Tversky and Kahneman, 2000).

- Consumers exhibit systematic mis-predictions about the costs and benefits of choices. Here the degree of loss aversion exhibited by consumers can be unrelated to their experience as consumers (March and Shapira, 1987).

- When faced with uncertain information and unable to distinguish between products consumers become risk-adverse and put off their decision. Consumers faced with imperfect information on which to base their choice delay consumption and forgo the possibility of buying a superior product due to the risk of purchasing an inferior one.

- Consumers can trust the advice they are receiving when it is not in their own best interests because the other party discloses a secret (Camerer, Lowenstein, and Weber, 1989).

- Consumers are a hyperbolic discounters. Here consumers exhibit a strong status quo bias. In regards to planning future goals, like retirement income decisions, they procrastinate in favour of the current arrangements or situations even when they realise that it is in their own interests to alter their retirement arrangements (O'Donoghue and Rabin, 1999).

These examples have important implications for how we think about the traditional role of regulation as a solution to market failure. As an example, Camerer *et al* argue that some forms of regulation can be developed along the principals of *asymmetric paternalism* (2003). This means asymmetric forms of regulation are not subject to the traditional criticisms of broader paternalistic regulations (That is, impinge on consumer sovereignty or businesses compliance costs greater than the welfare gain from correcting the costs of market failure). Examples of effective asymmetric paternalist measures include:

- the use of defaults to over come status quo bias (where they are activated only if the consumer does not make a decision)
- targeted forms of disclosure rather than mass disclosure (for example, dollar disclosure); and,
- cooling off periods to allow consumers time to make informed and non pressured decisions.

7. The Role of Regulators

Effective regulators are essential for effective regulation. Properly resourced and independent regulators, with a clear brief to address the most significant risks in the sectors they regulate, will ensure that the burden of regulation falls more heavily on non-compliant firms. Poorly resourced and directed regulators (eg that face constant political pressure) and those that do not have adequate powers will only frustrate businesses and make markets less efficient.

One of the weaknesses of many reviews of regulation is that they fail to properly consider the roles and powers of regulatory agencies. This leads to contradictions in the approach to reducing regulation – for example, businesses seek to have additional layers of review imposed upon regulators as a way of dealing with regulatory problems.

Ultimately it will be impossible to remove all out of date regulations and regulations that impose potentially unwarranted burdens. Therefore the choices regulators make about how they apply their regulatory powers, and what issues they pursue, will be critical in determining whether the regulatory framework is effective. In this light, Professor Malcolm Sparrow's (Sparrow, 2000) emphasis on the importance of the approach taken by *regulators* in responding to concerns about the growth in regulation is critical. In particular, Sparrow argues that a risk-based approach by regulators is essential if regulation is to avoid becoming a burden, applied in an inflexible and unhelpful manner. Effective regulators will allocate "regulatory attention" in a way that does not inhibit legitimate commercial activity but rather focuses on risks to consumers and competitors from illegal behaviour. Regulations that facilitate such an approach are essential – in particular reasonable flexibility in the application of key regulatory requirements (within clear limits).

It is worth noting that industry concerns about regulators in relation to the burden of regulation cut both ways – depending on self interest. Businesses will argue for *less* discretion to be given to regulatory agencies if decisions are made against their interest. They will argue for regulators to be given *more* discretion if the agency is not allowed by law to provide relief from seemingly unreasonably regulatory requirements. Businesses will argue for additional opportunities to review decisions that go against them, but oppose such mechanisms when they want quick resolution to a problem. ACA's view is that regulators should be given significant flexibility in the application of their powers, within transparent legislative or other guidelines that focus their attention on risk assessment in the way described above.

Finally, it is important that the response to perceptions of regulatory overload does not lead to requirements on regulators that distract them from their main task to administer and enforce the law. Exercises such as "industry facilitation", policy adjustments, "customer-focused" consultation etc all have their place, but ultimately regulators must first and foremost ensure proper market behaviour. It is widely recognised that one of the major reasons for the various multi-billion pound mis-selling scandals in the UK that took place in the late 1980s and early 1990s was that the financial services regulators

"took their eyes off the ball" in a policy climate where they were encouraged to engage in endless facilitation exercises and market friendly policy development processes.

8. Regulatory Review Processes

There are currently a number of proposals being discussed to develop a series of administrative processes for reviewing new and existing regulations. To this end ACA notes the following proposals:

- The BCA suggestion of a business regulation advisory council, drawing on the UK experience to Advise Government on the direction of regulatory reform across all levels of government

- Proposals to strengthen the Office of Regulatory Review (ORR) to:
  - challenge the need for new regulation
  - oversee all regulatory impact statements
  - provide training on assessing regulatory impacts to Government departments

- Establish regulatory impact units within Government departments to undertake systematic cost-benefit analysis of new proposed regulations.

- The use of sunset clauses on new legislation.

ACA supports the better resourcing of regulatory impact statements at the front end. We would welcome regulatory impact units within government departments provided they were properly resourced. However, we note the risk that such systems, if badly implemented, could create another red-tape system. We do not want to see situations where new regulations that are widely supported are delayed six to twelve months or more because of inflexible regulatory impact requirements. Even more regulatory impact statements should not become an opportunity for rearguard actions by those whose interests will be adversely affected. It is also important that an upfront review agency, such as the ORR, is not actively biased for or against new regulation. It would be unfortunate if the attempt to solve one problem (insufficient analysis of regulatory compliance impacts) created another (resource consuming delays in regulatory development).

ACA supports a more coherent approach to the development, monitoring and assessment of regulation. There is merit in the establishment of an appropriately resourced advisory council in this area, along the lines proposed by the BCA, and with wide stakeholder participation.

ACA does not support an inflexible "one in one out" rule for regulatory development. While this might be seen as 'politically cute', it is hardly conducive to sensible policy development. A more meaningful approach would be to require agencies proposing new regulations to identify possible regulations that would, as a result, become redundant. However, fixing this into a hard rule would simply be a recipe for unproductive arguments about the relative impact of the old vs new regulation and an incentive for agencies to find ways around the requirement.

ACA supports the flexible use of sunset clauses, but we do not believe that this should be applied in a "one size fits all" approach. Significant administrative burden can be generated, through continual public comment processes or parliamentary reviews, by sunset clauses that are applied without adequate consideration of the need for such exercises (for example, the Commercial Agents Act NSW). While all regulation benefits from review from time to time, there remain questions regarding how limited government and non government resources could manage such a review process. Instead we would support the development of guidelines for policy agencies about the situations and types of regulation where sunset clauses should or could be included. This could include a requirement to consider the issue of whether a "sunset clause" was warranted in the RIS process. This process should also include the requirement to consider whether a full review is required at "'sunset" or a more limited assessment that required less resources – in other words some sunset clauses could potentially have a two tier structure.

9. Risk and Regulation

Reducing harmful and unnecessary risky events is one of the signs of progress in any society, and this will largely be achieved via regulation. There are two related objectives that many consumer protection regulations seek to achieve that relate to risk:

- The *reduction* of risks that consumers face (eg from unsafe products)
- The appropriate *allocation* of risks between suppliers, consumers and other parties (eg government)

One of the major achievements of consumer protection regulation over the last few decades has been the reduction in the extent and severity of risks that consumers face in a range of areas, for example in vehicle safety. This is a very positive development. ACA would strongly oppose any attempt to shift the risk of significant harm onto consumers under the guise of "reducing red tape".

On this point, some commentators have expressed a concern that the quantitative growth of regulations is a response by Governments to community concerns about risks of various sorts, and that this is negative development. In particular, there is a view that much of the growth in regulation in Australia has arisen "because of the shifting of risks from individuals to the state or corporation" (Banks 2005:4). Banks cites UK Prime Minister Tony Blair's May statement this year:

> In my view, we are in danger if having a wholly disproportionate attitude to the risks we should expect to see as normal part of life. This is putting pressure on policy-making [and] regulatory bodies … to act to eliminate risk in a way that is out of proportion to the damage. The result is a plethora of rules, guidelines, responses to 'scandals' of one or another that ends up having an utterly perverse consequence.

Of course, an appropriate balance is required in the allocation and management of risk and any attempt to eliminate *all* risk is not only futile but likely to impose unacceptable costs on society. It will usually be possible to produce anecdotes about legal cases or policy anomalies that suggest a misallocation where someone bears little risk for inappropriate behaviour. However, the view that there is a great wave of risk reduction on the part of individuals, and that reducing the risks that consumers face is undesirable, is both too simplistic and ignores the wider economic and social context in which policies are emerging. This argument may therefore lead to a confused approach to new regulatory initiatives.

A first point to note is that this argument fails to acknowledge the extensive range of regulatory requirements that have been implemented over the last two decades that explicitly shift risk *from government and/or corporations to individuals*. To cite just three examples:

- Compulsory superannuation is one of the most burdensome and radically intrusive regulatory programs to have been implemented in Australia over the past fifty years. In combination with the shift away defined benefit retirement products a major outcome of this policy has been to shift investment and longevity risk *to individuals*.
- Major changes to the funding requirements for higher education mean that individuals now bear the risks involved in financing their education (eg through loan schemes), whereas this cost was previously endured by government.
- The introduction of substantial regulatory regimes around compulsory third party car insurance has shifted the costs of managing risk to all car owners as they now have to pay for the risk of harming third parties. Previously this was paid for by governments and a smaller subset of car owners who had insurance.

ACA is not opposed to these policies. Rather, we have highlighted them to demonstrate that arguments that regulation inevitably shifts risks away from consumers is both empirically wrong and likely to lead to poor policy design.

Secondly, a discussion about the growth of regulation to address risk will be unhelpful if it does not recognise the technological, economic, demographic and policy changes that have altered the risk profile faced by households during the last few decades. That is, it is important to place the desire that individuals have for greater protection against risk into a wider context. There have been fundamental changes in the way our society and economy manage risk in the last 20-30 years. This has seen a transfer of risk onto

households - as the April IMF Financial Stability Report (IMF, 2005) notes, “households have become the shock absorbers of last resort” in the financial system.

We have moved from a system where governments’ collectivised risks through budgetary (welfare) spending programs to one where risk is individualised. The IMF argues that households now have substantial exposure to economic shocks in ways they have never previously seen. The previous post-war collectivised risk-regime largely insulated households from financial market, investment and longevity risk. Examples include:

- Households indirectly insulated from investment risk as banks absorbed these risks paid nominal returns on simply depository products.
- Credit risk was mitigated through deposit insurance
- Many life insurance investment products containing guaranteed returns
- Defined benefit pension provisions in retirement products

The shift toward an individualised risk regime has been significant and pervasive. It includes:

- The winding back of applicability to qualify for State based pensions;
- The elimination of defined benefit plan occupational pensions toward pay-as-you-go pension plans, increasing exposure to investment risk and longevity risk; and
- The shift to private health schemes to cover the cost of the health system, also increasing exposure to investment risk and longevity risk.

The IMF Report sounds a warning on the fact that most consumers do not have the required information or understanding of their levels of exposure and this in turn could create significant difficulties for the finance industry and Government.

> “Households need to understand the financial responsibility they have shouldered and have access to information – including unbiased advice and quality financial advice – about investment and saving options, as well as the available products to manage their risk … [.]
>
> In the case of widespread failure of the household sector to manage complex investment risks, or if households suffer severe losses across the board on their retirement investments … there could be a political backlash demanding government support as an “insurer of last resort.” There could also be a demand for the re-regulation of the finance industry or, at the very least, more litigation would ensue” .

This transfer of risk onto households means that some regulation is necessary so that households do not bear the unnecessary burden and economic hardship as the last point in the counter-party risk chain.

It is also useful to consider some earlier attempts to allocate risk by private sector entities in new markets. The early contracts in electronic banking typically placed all risks onto

consumers, overturning the more a balanced approach to contract law that had developed over hundreds of years. This inefficient and unfair allocation or risk was challenged by consumer organisations. Now under the Electronic Funds Transfer Code of Practice there is a well-established and regularly reviewed policy on the allocation of risk around illegitimate use of debit cards etc. Yet this experience would be classified as "transferring risk from consumers to business".

Finally, it is worth noting that markets are not good instruments for managing risk, and that individuals typically have a poor understanding of risk (Kay, 2004). Private markets can provide products for managing the risk of losing your luggage during a holiday to New Zealand, but they do not deal with the principal risks of modern life very well (if at all) – accidents, complicated health problems, redundancy and unemployment, and relationship breakdown. As John Kay, former Professor of Economic at London School of Economics notes, "the policy choices we have are between letting risks lie where they fall or trying to manage them through social institutions." (Kay, 2004) The latter is generally seen by the community as preferable.

10. Self regulation

Some forms of self regulation[4] can play a very useful role within an overall regulatory framework. However, there is little evidence that most self regulation is cheaper for business or makes markets work more efficiently.

Self regulation is often introduced without being subject to the public policy development process or regulatory impact statements. Too often it is applied to industries that are manifestly unsuited to such an approach (eg newly emerging industries with many small players). Too often it provides anti-competitive barriers to entry. It often is only partial in coverage. Self regulation is also often characterized by the lack of effective enforcement mechanisms, which produces the worst of both worlds – it imposes a burden on compliant businesses while the non-compliant ignore it and "free ride". Finally self regulation is supposed to be more flexible than government regulation – but there is little evidence to support this assertion. Reviews and updates to the banking and general insurance codes, as an example, are infrequent compared to changes in black letter law.

This is not an argument against all self regulation, but rather a plea to judge it with the same rigour as that applied to other forms of regulation. There are of course cases where self regulation has proved effective. This is generally where it is situated within a clear policy framework laid down in legislation – the financial services external dispute resolution schemes (such as the Banking and Financial Services Ombudsman) provided for by the Corporations Act are an example. The regulation of the stock exchange is another example of how self regulation will operate more effectively within an overall statutory framework. This is not surprising. As John Kay has argued (2004p 370):

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[4] Self regulation is taken here to primarily mean regulation undertaken and funded by industry.

> Self regulation has one advantage over statutory regulation. Self regulating entities – companies, groups of professionals – have the information to do it, a government agency does not. It has one disadvantage, too. Self regulating entities do not have much incentive to take regulation seriously, and government does. Yet again, the problems of information and incentives interact. Regulation can get the best of both worlds by giving insiders the incentive to undertake policing which only they have the information to perform. Self regulation is stimulated by external supervision: autonomy, audit and accountability…

Kay goes on to discuss the success of this approach in financial services in the UK, and the failure of self-regulation seen in this light. A similar conclusion could be drawn in Australia.

11. Financial Services Reform Act: How to get consumer protection regulation right and wrong

The Financial Services Reform (2001) Act provides a case study in the area of financial services on where regulation can work well – and where it can go wrong. On the positive side, it provides a good example of how the interaction of government regulation and self-regulation can productively interact. We can also see an example of how prescriptive regulation can actually result in much lower compliance costs. On the negative side, it also demonstrates what can do wrong when the *form* of regulation come to dominates the *rationale* for regulation.

1. Positives - dispute resolution and door-to-door sales

The introduction of a mandatory licence requirement to belong to an ASIC-approved dispute resolution scheme is one of the major consumer protection achievements of the FSR changes. Under this arrangement, many industry schemes – self regulatory schemes – have come to play a significant and effective role in dealing with disputes in the finance sector. Over time several of these schemes have contributed to measurable improvements in industry practices.

A second positive example of effective regulation under FSR is the introduction of a ban on door-to-door sales of financial products and services. This is clearly prescriptive regulation. It's not an approach that says a supplier can sell door-to-door as long as he/she discloses, provide a financial services guide, ensures that a cooling off period applies etc – all of which would require additional regulatory compliance. It's an approach that effectively recognizes that, faced with a salesperson on their doorstep, people will often not make rational, welfare maximizing decisions – and the most vulnerable are consumers with less financial experience. And yet with literally one or two exceptions, there has been no outcry about this as a draconian imposition on the ability of

business to operate in an unfettered environment. One reason is that while this is very prescriptive, the compliance burden that it imposes is zero for almost all firms in this sector. This is an example of where a very prescriptive rule under FSR has generated benefits for consumers at almost no compliance cost to industry.

2. Negatives – fetishizing disclosure

Disclosure was the regulatory tool that most industry groups pushed for under the FSR reforms. Currently many finance industry groups are unhappy with the blow-out in information required in Public Disclosure Statements (PDS) and consequent compliance costs.

FSR came into being in the wake of the Wallis Inquiry into the Financial System. Finance sector industry participants and Treasury saw disclosure as regulation of least interference. The drafters of the FSR regime were alive to the possibility of 'over disclosure' and so included as an overarching principle that disclosure must be 'clear concise and effective'. However, the PDS has evolved into a risk management document. Product providers, sellers, and dealers try to exonerate themselves from all sorts of risks and issues by disclosing everything possible in these statements.

This problem has also emerged for the reasons outlined above – disclosure has been asked to bear the burden of solving a wide range of market problems that it simply cannot address. Endlessly tinkering with the disclosure requirements will not alter this position, and instead is likely to create more problems by distracting regulators and policy makers from the underlying market problems that need improving.

These criticisms should not be taken to mean that ACA does not support disclosure. Clear concise and effective disclosure is vital for transparency and for effective consumer decision making. But the FSR experience also suggests a need to review our regulatory tool kits in financial services. Additional tools should include

- the ability for ASIC and other regulators to forbid a particular practice
- giving consumers remedies for unfair contracts, and
- improving the ability of regulators to obtain redress for wronged consumers

12. ACA Analysis of the Business Council of Australia Position

The BCA Report *Business Regulation: Action Plan* outlines eight basic principles all Governments should adopt in developing, administering and reviewing business regulation (BCA, 2005):

1. Regulation should be the last, not first, response of Government and the benefits of proposed regulation should always be shown to outweigh the costs in

administration and compliance.
2. Regulation should set a framework, not try to cover the field.
3. Regulation has use-by date, after which it may no loner be necessary or appropriate.
4. The current law should always be tested and enforced before more law is added.
5. Governments should not impose regulation upon private persons or companies that they are themselves not prepared to adopt.
6. All businesses, whether large or small, private or public, should be treated equally.
7. Where property rights are affected by regulation, there should be just compensation.
8. There must be full transparency and accountability around the processes for making and administering regulation.

ACA responds to each of these principals in turn.

1. Regulation should be the last, not first, response of Government and the benefits of proposed regulation should always be shown to outweigh the costs in administration and compliance.

ACA agrees that the costs of regulation need to be minimised. While costly regulation may increase compliance costs ultimately these costs are passed onto the consumer. However, we believe the test for successful regulation should focus on consumers' interest rather than on the quantity of legislation businesses are subject to. This is because consumers endure the burden of failed regulation, either as victims of market failure or increased prices, resulting from compliance costs.

ACA also notes the need for improved cost-benefit analysis on the side of the benefits of regulation. Benefits such as public and consumer confidence are often very difficult to calculate in exact dollar terms. Their intangibility should not lead to them being discounted.

ACA agrees that distributional costs associated with regulation need to be taken into account. However, this must not be limited to business but consumers across varying income distributions.

2. Regulation should set a framework, not try to cover the field.

ACA agrees with this broad proposition. However, ACA believes the blow out in regulation is not just about political and administrative expediency, but relates to the form and content of past regulation. Where the development of regulation is designed around the form of regulation – for example disclosure – and not on the problem that

needs to be fixed, over-regulatory blow outs are an inevitable consequence (see our analysis of FSR above).

3. Regulation has a use-by date, after which it may no loner be necessary or appropriate.

Please refer to ACA's comments on the regulatory review processes above.

4. The current law should always be tested and enforced before more law is added.

ACA agrees that existing requirements need to be adequately enforced. Where they are not, second best regulatory measures can be proposed and adopted, when adequate enforcement may have solved the problem.

5. Governments should not impose regulation upon private persons or companies that they are themselves not prepared to adopt.

ACA does not support this proposition. Except when they operate businesses in the market place Governments are qualitatively different to businesses or individuals. Cheap grandstanding diminishes some of the more sensible propositions in this report.

6. All businesses, whether large or small, private or public, should be treated equally.

ACA supports uniform application of regulations where possible; though we note small business have some unique size and compliance issues. Which may on occasion need slightly different treatment.

7. Where property rights are affected by regulation, there should be just compensation.

ACA in principal supports this proposition, but we note there will be times when proprietary interests are questionable and could lead to significant legal proceedings.

8. There must be full transparency and accountability around the processes for making and administering regulation.

ACA supports this proposition.

13. ACA's List of Regulations that are failing consumers

1. The Pharmacy Agreement – this determines price structures for prescription drugs sold in pharmacies, sets up barriers to entry and protects high markups.

2. Broadcast television – the licensing arrangements protect the three free-to-air commercial channels from competition; many other countries have 10 times this number.

3. Digital television – regulation restricts operators from adding value to their content, for example through multi-casting; combined with the failure to increase the number of free-to-air channels available on digital, this has meant very low take-up by consumers.

4. The health insurance rebate – a clumsy, wasteful and hopelessly unsuccessful attempt by government to intervene in the market.

5. The 10% taxi credit card surcharge – why?

6. Product safety laws – the dispersal of regulatory responsibilities between state and commonwealth agencies creates inconsistency and weakens the enforcement of products safety laws.

7. Regulation of the professions – this often restricts competition for services that could be adequately performed by less qualified people (conveyancers, nurse practitioners, etc); few professions have effective and independent consumer complaints processes.

8. Disclosure of conflicts of interest in financial services – requirements to disclose conflicts of interest create more paperwork but do little to protect consumers.

9. The *Air Navigation Act* and associated treaties protect Qantas from competition with rival airlines on some profitable international air routes (e.g. Sydney–Los Angeles).

10. The Fire Service Levy on home building contracts in NSW and Victoria – an illogical rule that deters consumers from taking out home building insurance (due to higher price); this should be replaced with a levy paid by all building owners rather than only those who prudently insure.

11. Identification hurdles (for example, 100-point ID and authorisation by a JP) that make it so difficult to change or consolidate super funds.

14. ACA's List of Regulations that Consumers' need

3. Uniform unfair contracts laws – these would avoid the need for industry- or product-specific regulations by giving consumers and enforcement agencies the tools to challenge unfair contract terms wherever they appear.

4. More effective tools for enforcement agencies: civil penalties, power to claim compensation for unnamed members of a class of affected consumers; power to seek disgorgement of illegally obtained profits.

5. Regulation to prohibit conflicts of interest in financial services (e.g. trailing commissions).

6. The implementation of a licensing and dispute resolution scheme for mortgage and finance brokers. It's been two years in the writing … banks, mortgage brokers and consumer groups all want it … but this much-needed and popular regulation is tied up in the red tape of regulation-making.

7. Effective regulation of advertising of junk foods to children. The current Children's TV Standards and the Advertising to Children Code don't work.

8. Regulation to strengthen the unconscionable conduct provisions to protect consumers from predatory behaviour – for example, where someone seeks out shareholders from demutualisations and offers to buy their shares well below market value.

9. A truly independent and transparent drug approval process. The current Therapeutic Goods Administration, drawing upon industry funding, lacks transparency and is subject to potential conflicts of interest.

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