"ARRESTING VOLATILITY SANS ARRESTED DEVELOPMENT"

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Cost of regulatory compliance

Have you ever wondered as to what is the "value proposition" of a regulation? What is the value derived to the society by enforcing a certain practice or a behavior? Does the value such derived exceed the cost incurred by that enforcement? Popular philosophies did not see the necessity for ten thousand commandments or one crore of precepts to regulate the society, when you could do away with just ten or five.

One can consider regulation as directed behavior or conduct imposing sanctions and penalties in the absence of compliance. Regulations have to be distinguished from statutory legislation or the judge-made law, although imposing a regulation may be promulgated by an authority incorporated by such laws. Also there could be regulations imposed through, self-regulation of an industry such as through a trade association or through market practices.

One of the benefits of regulation that is that being regulated would give banks a 'stamp of approval' that they can use to reassure their customers and counterparties. Thus, banks might have to engage in additional expenditure in the absence of regulation in order to persuade their customers and other counterparties of the strength of their internal systems and controls, or of their financial position.

Regulations have costs as well as benefits. An efficient regulation could be defined as those where total benefits exceed total costs. This is extremely important in the case of regulations that govern commerce and industry. Examples of regulation include controls on market entries, prices, innovations and standards for the delivery of services or goods.

Such regulations are justified for a variety of reasons. Usually the regulations that govern commerce and industry are aimed at ensuring the market stability, system stability and the price stability: **inter aila arresting volatility**. But the regulations that cannot be justified by such reasons would lead the stakeholders to question the competence of the enactors of those regulations.

Over the years the countries have realized the extra cost incurred by regulations. According to the Competitive Enterprise Institute, the United States regulations cost $1.75 trillion in compliance

costs. That is greater than the record federal budget deficit and even greater than all corporate pretax profits.[1]

Thus in the much developed economies there have been ongoing programs to review regulatory practices with a view to minimizing, simplifying, and making more cost effective regulations, in other words to regulate to facilitate the development. **Not to arrest development**.

Over regulation and De-regulation

The industries and commerce always had their fundamental opposition towards regulation. A form of economic theory called ***Laissez-faire*** originated as an alternative to a regulated market. The proponents of this theory foresaw an economic environment in which transactions between private parties are free from all regulatory interference except the minimum rules necessary to protect property rights against theft and aggression. The phrase *laissez-faire* in French gives the literal meaning "let do", implying "leave the markets alone." A perfect *laissez-faire* state has never existed. But there have been countries where the government interference was minimal.

A market is naturally driven by the profit motives. Letting such a market to run free with only minimal regulations has been proven unsuccessful in the recent past. The collapse of the financial markets due to the subprime crisis needed the government funds to resurrect themselves. The burden on the tax payer imposed by this bailout justified tightened regulations on the financial markets.

Even the financial centers that survived the sub-prime meltdown and has been shining for over 200 years as exemplary self-regulated institutions have lost their status with the recent **LIBOR Scandal**.

Banking is no longer a glorious and secure profession that it once was. Bankers are now almost universally downhearted as the combined effect of new regulations, sluggish economies and volatile markets threaten large cuts to their profits, their pay and, for many, their jobs.

The proponents of de-regulation of the financial markets have prima facie lost their battle. Now the markets will have to face the army of regulators that would advance on them with such savagery, the best strategy for the banker is no longer the battle, but pleading justice. Pleading justice (and not pleading mercy) should be based on the principles of good governance and sustainable economies that is the battle cry of the army of regulators.

The regulators must also be subject to the principles of good governance, sustainable economies and the principles of natural justice that they have vowed to uphold.

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[1] The Competitive Enterprise Institute is a non-profit public policy organization dedicated to advancing the principles of limited government, free enterprise, and individual liberty. http://cei.org/studies/ten-thousand commandments-2012

Principles of good regulation

In the United Kingdom the Financial Services and Markets Act (FSMA), is the single piece of legislation that governs the regulator, Financial Services Authority (FSA). The Act sets out statutory objectives to protect consumers, to maintain market confidence, to promote consumer awareness and education, and to reduce the extent to which regulated firms can be used for financial crime.

In delivering these general objectives, the FSMA requires the FSA to have regard to the principle that any burden or restriction that it would impose on a regulated firm should be proportionate to the benefits that are expected to result from any such burden or restriction. Furthermore, when the regulator propose to make any rules or general guidance it must not only publish the proposed text for consultation, but also accompany this by a cost-benefit analysis, an explanation of the purpose of the proposed rules and general guidance, and an explanation of why the regulator believe that making the proposed rules or general guidance would be compatible with its statutory objectives.

These considerations called the 'principles of good regulation' could be described as:

- The need to use resources in the most efficient and economic way;
- The desirability of facilitating innovation in connection with the activities that are being regulated;
- The need to minimize any adverse effects on competition that may arise from regulators actions;
- The desirability of facilitating competition between firms that are subject to regulation;
- The need to take account of the international character of financial services and markets and the desirability of maintaining a competitive position; and
- The importance of having regard to the responsibilities of those who manage regulated firms.

Cost of Financial Regulation

All financial regulations have inherent cost benefit equations. In this regard the UK Financial Services Authority has been attaching significant importance to the cost benefit analysis of the financial regulations[2].

The costs of regulation can be classified as follows

- Direct costs,
- Indirect costs
- Distortion costs.
- Costs of regulatory capital requirements.

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[2] http://www.fsa.gov.uk/library/communication/speeches/2003/sp140.shtml Speech by CLIVE BRIAULT DIRECTOR, PRUDENTIAL STANDARDS, FINANCIAL SERVICES AUTHORITY

In addition to these costs the regulator should also take into account a wide range of considerations relating to competition and innovation in the financial services industry, to market structure, and to the impact of regulation on the availability, the quality and the pricing of financial services.

- **Direct costs**

  This is the 'direct' costs of paying for the financial services regulator or regulators as the case may be. This cost item is relatively easy to calculate, in regimes where regulators are open and transparent about their costs. This transparency is available where the regulator consults in advance before they charge any fees to the industry and where the costs so charged are entirely transparent from the regulators Annual Report. But the direct costs of regulation may not be so clear in countries where there are multiple financial services regulators, where these regulators are less than fully open and transparent about their costs, and where some of the regulation is undertaken by organizations that also have non-regulatory functions. Specially, where banking supervision is undertaken by central banks it is not always easy to separate out the costs of this activity from the other activities that the central bank may perform.

- **Indirect costs**

  The 'indirect' costs of regulation are the incremental costs of compliance. These are the costs to firms and individuals of activities required by regulators that would not have been undertaken in the absence of regulation. It is not the total costs of compliance, but only the additional (incremental) costs required by the regulator. These incremental costs may include some elements of a firm's compliance staff, management time, systems, training, record-keeping, capital, liquidity etc.

- **Distortion costs**

  The 'distortion' costs arise from the way in which regulations may change the nature of markets, may prevent or discourage firms from entering or using markets, may constitute new markets that would not exist in the absence of regulations, and may therefore have a significant effect on the innovation and availability of the products provided by the financial services industry. Although regulations are designed primarily to remove market distortions, or at least to mitigate their adverse consequences, it must also be recognized that regulatory intervention would introduce its own distortions. But if the regulations are well designed these distortion costs should be smaller than the benefits that the regulations should bring.

  These distortion costs need to be taken into account when assessing the costs of regulatory interventions. For example, there has been considerable discussion of the distortions generated by the Basel Capital Accords, even though the existing Basel Accords generated considerable benefits.

Measurability or the quantification of cost of regulation[3]

In the order of importance, costs of financial regulations can be ranked as follows:

1. Direct Costs – Easy to measure
2. Indirect Costs – Relatively difficult to measure
3. Distortion costs – Most difficult to measure and most important

There is a negative correlation between measurability and importance. There have been attempts to measure the costs of regulation in different forms, the most popular of which have been surveys, case studies and 'estimation by analogy'.

Surveys typically take the form of questionnaires sent to a large number of firms, or structured interviews held with a somewhat smaller number of firms. This provides a relatively large sample, but if the researcher relies entirely on a questionnaire there is a strong likelihood that the firms completing these questionnaires will interpret the questions in different ways and will answer accordingly. Structured interviews may increase consistency, but the cost of undertaking such interviews tends necessarily to reduce the number of firms in the sample.

Case studies take this trade-off one step further by focusing on a very small number of firms (in some cases just one or two), but doing so at a high level of detail and therefore providing scope to test quite rigorously the extent to which regulation has imposed additional costs on a firm.

The 'estimation by analogy' method combines a more theoretical analysis to identify the possible changes that firms might need to make (or have made) in response to regulation with an attempt to cost these changes by comparing them with similar changes resulting from earlier regulatory interventions, or from experience in different areas, where these comparisons have already been subject to some form of costing. So, for example, a regulatory requirement to make additional reports to the regulator, or a requirement on firms to send information to new or existing customers, or a requirement to hold more capital or more liquidity, might all be costed by comparing them with similar requirements imposed in the past or similar requirements imposed on other types of firm. And the process of consultation helps to refine this approach. So firms may, for example, respond to the consultation by saying that they agree with the identification of the actions they will need to take, but that they disagree with the estimate of how much each of these actions will cost them. Or they might point to consequences of a proposed regulatory intervention that the regulator had not considered and therefore had not attached a cost to.

Each of these methods may in turn be used to assess either the total or the incremental costs of compliance, and to assess either the costs of a single regulation or of a wider group of regulations.

- **Costs of regulatory capital requirements**

Banks have increased significantly their capital ratios over the last 10 years, so that these ratios are generally very strong, and for many banks these ratios are well above the minimum requirements set by regulators.

Apart from the regulatory capital requirements mandated by the Basel accords, banks tend to hold excess capital due to market forces. The counterparties have demanded that banks remain strongly capitalized in order to offer a higher degree of protection against the risk of default. With the end result that banks are now holding significantly more capital than the minimum set by regulators. Also banks generally hold excess capital in order to satisfy rating agencies to obtain high credit ratings; an attempt by banks to reduce their costs of funding by demonstrating capital strength.

Another reason is capital planning (the building up of capital during a period of consistently strong economic growth and thereby to provide better protection in the event of a downturn) and the freedom that capital provides to pursue opportunities without having to return to the capital market.

But for some banks the incremental cost of additional capital required by the regulator was the most important factor driving their incremental costs of compliance. The magnitude of the impact the new capital requirements have on these banks is considerable.

Undoubtedly, holding more capital and lower-yielding liquid assets will depress returns. The falling ROE of banking stocks would make investors turn elsewhere.

Measuring the cost of holding additional capital is difficult. However one method is to use the difference between the cost of capital and the risk-free rate of return of government securities.

Although it is difficult to measure the costs of regulation, it is important to measure the various costs created by regulatory intervention. If these costs are large, then they should not be ignored. Sometimes the regulations are so commercially restricting to the extent that they curb the ability of banking houses to move out of recession and to re-boot the economy, **thereby arresting development.**[4]

If the benefits of regulation are even larger than the cost then it should be demonstrated through careful analysis, not simply asserted as an act of faith.

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[3] http://www.fsa.gov.uk/library/communication/speeches/2003/sp140.shtml

[4] Banking regulations cost more than they deliver - http://www.dailymail.co.uk/debate/article-2145761/Banking-regulations-cost-deliver.html

Adjudication process of non compliance of regulations

Regulations carry sanctions and penalties in the absence of compliance. Although regulationshave to be distinguished from statutory legislation one may argue that the process of implementing regulations could be classified as an executive or administrative action.

Administrative law is the branch of law that governs the activities of administrative agencies of the government. Government agency action includes rulemaking, adjudication, or the enforcement of a specific regulatory regime.

Thus the actions of the financial regulator are coming under the scope of administrative law. In order to fall in line with the law of the land and the fundamental rights enshrined in the constitution, the adjudication process of noncompliance should adhere to the rules of natural justice.

The rules of natural justice are,

Nemo iudex in sua causa –: No man should be the judge in his own cause

This is the rule against bias. In law bias can take the form of actual bias, imputed bias or apparent bias. It was stated that ""Justice must not only be done, but must be seen to be done"."[5]

Audi alteram partem –: hear the other side too.

This rule refer to the principle that no person should be judged without a fair hearing in which each party is given the opportunity to respond to the evidence against them

However it is observed that in most of the instances the financial regulator acts in a manner neglecting these rules. The letter of notice of non compliance often carries the notice of the penalty. Thus the prosecutor and the adjudicator have become one and the same and the accused is not given an opportunity to state his case.

However it should be emphasized, that it is highly unlikely for the regulator to impose penalties unless there is a blatant violation of a regulation.

In an extreme situation, a party aggrieved by unfair action of the regulator can seek remedies available to them through the common law of the country. But even in such instances the aggrieved party might chose to pay the penalty rather than to challenge the position as the cost of the latter(inclusive of the litigation costs) is much higher than the penalty.

It also should be mentioned that a fit and proper criteria should by laid down for the adjudicators and the regulators. The criteria should be made transparent for the public to be satisfied with the knowledge, skills and integrity of the regulator or the adjudicator.

Financial System stability, Price Stability and the Cost of regulation

The Central Bank of Sri Lanka was established by the Monetary Law Act of 1949. The Central Bank apart from being the regulator of Sri Lanka's financial system is also responsible for safeguarding both the value of the Sri Lanka Rupee and the country's banking, financial and payments system.[6]

The Central Bank has two core objectives:

- Maintaining economic and price stability
- Maintaining financial system stability

The two objectives are correlated and should complement each other. The Central Bank has been given a high degree of autonomy to be able to achieve its objectives. The Banking sector regulator and the supervisor also is the Central bank of Sri Lanka.

Unlike in the United Kingdom, the parent legislation[7] has not imposed the principles of good regulation to the Sri Lankan regulator whilst granting autonomy and authority to make regulations. Thus the local regulator is not made accountable for the costs that it may impose on the banks by introducing various regulations.

As discussed in the previous text the cost of the regulations is considerably high. In order to economically sustain, the banks will have to find ways and means of absorbing this cost. Couldn't it be the consumer at end of the "path of least resistance" when the banks try to pass on these incremental costs? What would happen to the price stability then?

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[5] *R v Sussex Justices, ex parte McCarthy*, [1924] 1 KB 256, [1923] All ER 233

[6] CENTRAL BANK OF SRI LANKA - Objectives, Functions & Organization January 2005 – CBSL Publication

[7] The FSMA as opposed to MLA of 1949

Conclusion

The introduction of fit and proper criteria for bank directors and the regulations for key management personnel as well as the introduction of minimum academic standards and efficiency bar examinations to the middle managers involved in specialized functions had made the Sri Lankan banking industry equipped with maturity, capability and integrity.

Even if it is premature to introduce the concept of self regulation to the Sri Lankan banking industry, the participatory regulatory regime is feasible, and much more appropriate. This would mean the proactive industry participation in the rule making process (which would involve much more participation than the current practice of commenting on the certain draft circulars) and also industry involvement in the adjudication process in instances of non compliance.

Introduction of the principles of good regulation, and a participatory regulatory regime would undoubtedly enable regulators to ensure stability and to arrest volatility without arresting development.

(Any views or opinions presented herein are solely those of the author and do not necessarily represent those of his employer or those of the industry associations where the author is a member.)