FINANCIAL MARKETS REGULATION: THE ROLE OF THE STATE

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"Should governments lean towards libertarianism, freeing us to act as we wish [or]...tilt towards paternalism, constraining the choice of adults to protect themselves, others, and the rest of us from them". Statman[2]

The financial crises of the late 2000s reignited the age old debate about the roles of government and markets in promoting trust and confidence. Relatedly, it also generated debate about the role of government *in* markets, and the role of government in protecting investors from themselves and from one another.

New Zealand, in common with most other OCED countries, has experienced a vast increase in the scope and breadth of the regulation governing financial services. These changes occurred at both the institutional level, in the form of significant reform to a core financial regulator, and at the functional level of regulating the relationship between financial provider and consumer.

Regulation is largely a socio-political question. It reflects a particular view of the appropriate balance between the market system and the collectivist system at any given point in time. The market system is based on a belief that individuals should be left free to pursue their own goals, subject to certain basic requirements underpinned by private law. The collectivist system has the state seeking to direct or encourage particular behaviours which would not otherwise occur owing to actual or perceived shortcomings in the market system.[3] These behaviours are mandated through regulation.

The balance between these two systems of economic organisation fluctuates over time and is driven by a variety of different factors. The regulatory changes which were introduced in response to the Global Financial Crisis, in New Zealand and internationally, reflect a move away from the market system, towards the collectivist system.

This paper explores a number of themes arising from some of the New Zealand reforms. Part I creates a framework for that analysis by examining the conventional justifications for the regulation of financial services, together with some newer and more controversial justifications. Part II reviews recent New Zealand reforms against the framework in Part I and identifies the motivations for those reforms. It is argued that an increasing (but largely unarticulated) motivation for recent financial services reform initiatives has been an erosion of the belief that consumers can, and should, make decisions for themselves.

Part III identifies the downstream commercial and policy consequences which result from that change. A full analysis of the normative question of whether financial services regulation *ought* to assume that individual consumers are rational is outside the scope of this paper. Rather, to the extent that the inability of consumers to behave rationally *is* a motivator for regulation, then its importance lies in identifying what remedies might meet that concern. As Breyer notes: "regulatory failure sometimes means a failure to correctly match the tool to the problem at hand".[4]

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1 This paper is a work in progress, for the purposes of discussion.

2 Meir Statman "*Regulating Financial Markets*" .

3 Ogus *Regulation: Legal Form and Economic Theory,* Hart Publishing, 2004, page 2.

4 Breyer Regulation and its Reform, Harvard 1982 page 191.

PART I: TRADITIONAL AND NOT SO TRADITIONAL JUSTIFICATIONS FOR REGULATION

To date, much of the focus in regulatory debate has been on regulatory methods for dealing with monopolies and natural monopolies and had revolved around the terms and price for access to essential facilities. Very different issues arise in the context of financial services.

Markets for banking and financial services have a number of unique characteristics which make them more complex from a regulatory perspective. Most obviously such markets are (or can be assumed to be) competitive.[5] The markets are heavily integrated – both vertically and horizontally. The range of services and products is wider and more complex than in traditional commoditised markets. Technology has fuelled that development – as shown by the "loan by text" promotion run recently by a Finland-based company, Ferratum.[6]

Traditional justifications

Traditional justifications about the value of markets (and consequential reliance on the market to achieve optimal consumer outcomes) are based around neoclassical concepts of economics (as exemplified by the Chicago School). These rest on two key assumptions:

- that consumers have adequate information about the choices available to them, including the consequences of those choices; and

- that consumers are capable of processing information and of behaving rationally in a way which maximises their utility.

The absence of either of those two assumptions can form the basis for regulation of some sort, although neo-classical economists have generally been reluctant to abandon concepts of individual capacity and choice, instead preferring to deal with problems by improving information flows.[7] For that reason, regulation in banking and financial services markets has tended to focus on information disclosure. This presupposes that consumers are capable of making, and will make, rational decisions provided they have sufficient information of the right type.

Information disclosure regulation seeks to prescribe the form and content of disclosures and to impose penalties for the conveyance of false or misleading information.

Are humans rational? Less traditional justifications

There is a growing body of material which supports an approach to regulation that is at once more paternalistic and more corrosive of choice. This approach challenges the assumption that humans are rational and asserts that, even if full and adequate information is available, consumers will nevertheless make irrational decisions.

The concept has struck some resistance, as shown the following statement from Breyer:

> "this justification is pure paternalism: the government supposedly knows better than individuals what they want or what is good for them. Such distrust of the ability of

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5 This is despite efforts by the New Zealand Commerce Commission to establish otherwise in the context of the multiple party interchange litigation, which alleged price fixing between the major banks.

6 http://www.nzherald.co.nz/nz/news/article.cfm?c_id=1&objectid=10733481.

7 Ogus page 51.

> the purchaser to choose may be based on the alleged inability of the lay person to evaluate the information, as in the case of purchasing professional services, or the belief that, although the information could be accurately evaluated by the lay person, irrational human tendencies prevent this".[8]

The challenge to the assumption of perfect rationality is identified with the work of the behavioural law and economics movement at Chicago Law School in the mid 1990s. The behavioural law and economics scholars worked with social psychologists to demonstrate empirically that humans are in fact subject to a number of rules and biases. What we know about human behaviour and choice should therefore dictate our legal interventions.[9]

Scholars (and in particular Sunstein) identify a number of human traits which they argue support their position, including that:

- humans systematically undervalue the costs and risks arising from the choices which they make;
- humans tend to value the status quo;
- short term consequences tend unduly to influence decision-making relative to longer term consequences;
- choices in purchasing and other activities are highly imitative of those made by others.

These justifications to regulation have been controversial. Many take issue with the robustness of the empirical work. It is clear that, even if human beings are not as rational as they might be, neither are they as irrational as the behavioural law and economic scholars would have us believe. There have been many challenges to the quality of the data relied on by both camps.[10]

Such regulatory interventions create a problem of moral and cognitive hazard in the long term. If consumers are protected from the consequences of their own decisions, they are denied the opportunity to learn from their mistakes and become more and more dependent on government through a vicious cycle of dependency.

Finally, from a policy perspective, interventions which are applied universally also capture, and deny choice to, those individuals who are capable of making decisions in their own best interest.[11]

PART II Recent New Zealand Financial Markets Reforms

This part of the paper examines the application of the principles outlined above to three recent financial services reforms in New Zealand:

- the Consumer Law Reform project;

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8 Breyer page 33.

9 Cass R Sunstein *Behavioural Law & Economics, Cambridge University Press, 2000.*

10 George Gregory Mitchell "Why law and economics is perfect rationality should not be traded for behavioural law and economics is equal incompetence", 91GOLJ67.

11 Ogus page 53.

- the credit reforms; and
- the Financial Markets Authority, and the extensive new legislation it administers.

Consumer Law Reform Bill
The objectives of the Consumer Law Reform Bill, now before Parliament, are to:

- have in place principles-based consumer law that:
  - enables consumers to transact with confidence and protects reputable suppliers and consumers from inappropriate market conduct;
  - is up to date and relevant now and into the future;
  - is easily accessible to those who are affected by it;
  - is in line with international best practice;
  - is appropriate; and
  - is effective and enforceable;
- achieve simplification and consolidation of the existing law;
- achieve harmonisation with the Australian Consumer Law in accordance with the government's Single Economic Market objective.[12]

Officials in the Ministry of Consumer Affairs had participated in the development of the Australian Consumer Law and advocated strenuously that New Zealand should follow Australia's lead and introduce both unfair contract terms and unconscionability provisions.

The relevant Cabinet papers make an interesting read. In relation to the principles which underpin consumer law, they state:

> "The policy underpinning consumer law is essentially that consumers individually and the economy as a whole benefit from consumers making effective purchasing choices from a range of competing offerings. In order to make effective choices, consumers need to have access to both good and accurate information and to be able to make their decisions without undue pressure or duress."[13]

This passage reflects a relatively standard approach to regulation, based around information disclosure.

By contrast:

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[12] The SEM outcomes were agreed by the Australian and New Zealand Prime Ministers in August 2009 with the purpose of advancing a single economic market. The intention is to promote a Trans Tasman economy or market based on the objective that deeper economic linkages provide bigger markets in which to buy and sell goods and services, allow access to a larger and more varied pool of capital and labour, and open a New Zealand economy to new ideas and technology.

[13] Para 38 Office of the Minister of Consumer Affairs dated 1 December 2010.

> "Consumer law provisions covering unfair contract terms concern pre-written terms in standard form contracts which usually cannot be negotiated by a consumer or small business. Types of consumer contracts which are typically standard form contracts include: rental car agreements, electricity and gas agreements, telephone line agreements, gym memberships and retirement home contracts. An unfair term in a standard form contract is considered to be one that causes a party to a contract (usually the consumer) to be at a disadvantage while the term is not really necessary for the protection of the interests of the other party (usually a business)."[14]

So even if consumers have adequate information, there are some contracts which are apparently so "unfair" that they should be prevented from entering into them, or being held to their terms. The implied contradiction between the overt reasons for consumer law reform (properly informed consumers making good purchasing decisions) and the reasons for introducing unfair contract terms (even properly informed consumers should be protected from entering into arrangements which some may view as objectively unfair) is interesting. Does this carry shades of paternalism? Does it implicitly assume that consumers cannot be left to form rational and sensible decisions? Arguably so.

Happily, the Ministry's arguments were not accepted by the Minister. He was concerned that unfair contract terms would cause uncertainty and expense to businesses and that these transaction costs would be passed onto consumers. Neither was he prepared at this time to add unconscionability provisions to the Fair Trading Act.[15] But he indicated that this decision may be subject to subsequent review, saying:

> "...it may be appropriate to consider adding unfair contract terms to our law in the future after observing the application in Australia over the next few years".[16]

Credit Contract and Consumer Finance
The Credit Contracts and Consumer Finance Act 2003 (*CCCFA*) regulates all forms of consumer credit including personal loans, credit sales, hire purchase, credit cards, long-term leases, mortgages and housing buyback schemes. In September 2009, the Ministry of Consumer Affairs commenced a review of the legislation with a view to improving its operation.[17]

The introduction to the policy paper records that "a fundamental principle in the Act is that decisions to borrow will be made by individuals in a rational manner fully taking into account available information". When first promulgated, the purpose statement was:

- to protect the interests of consumers in connection with credit contracts, consumer leases and buyback transactions of land; and

- to provide for the disclosure of adequate information to consumers under consumer credit contracts and consumer leases:

  – to enable consumers to distinguish between competing credit arrangements or competing lease arrangements; and

14 Ibid para 40.

15 Ibid para 55.

16 Ibid para 48.

17 Review of the operation of the Credit Contracts and Consumer Finance Act 2003, Ministry of Consumer Affairs, September 2009.

- to enable consumers to become informed of the terms of consumer credit contracts or consumer leases before they become irrevocably committed to them; and
- to enable consumers to monitor the performance of consumer credit contracts or consumer leases; and
- to provide rules about interest charges, fees, and payments in relation to consumer credit contracts; and
- to enable consumers to seek reasonable changes to consumer credit contracts on the grounds of unforeseen hardship; and
- to provide for the disclosure of adequate information to consumers under buyback transactions of land and for the provision of independent legal advice to those consumers;

• to provide rules about fees in relation to buyback transactions of land; and

• to prevent:

- oppressive credit contracts, consumer leases and buyback transactions of land; and
- oppressive conduct by creditors under credit contracts, lessors under consumer leases, and transferees under buyback transactions of land.

This suggests that, as originally promulgated, the Act was largely based around information disclosure with some fallback paternalistic interventions in particular circumstances.

By contrast, the new Ministry policy paper notes that the effectiveness of disclosure, on which the CCCFA is predicated, will always be linked to the individual consumer's ability and willingness to use the information provided. Where it is not used or cannot be used then its effectiveness is limited.[18]

In the context of considering unsolicited credit, the Ministry notes: "behavioural economics indicates that people tend not to opt out when given a choice that something will occur unless you expressly indicate otherwise. Unsolicited "selling" takes advantage of this inertia".[19]

The discussion paper also asks whether particular regulatory reform is needed in respect of fringe lending practices and whether the disclosure regime in the legislation adequately addresses undesirable lending practices operating in lower socioeconomic communities.

> "The CCCFA is based on the premise that well informed consumers are best placed to make borrowing decisions that are optimum given their own particular circumstances. This is reflected in the disclosure based character of the CCCFA. The CCCFA implicitly assumes that consumers should be responsible for the decisions that they make, for good or for bad.

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[18] At page 14.

[19] Ibid at page 42.

> "Despite the availability of information, in some situations, consumers make what would generally be regarded as poor financial decisions, resulting in excessive debt and/or excessive costs (interest repayments and penalty charges). Of particular concern are those credit providers who exploit poor decision-making, resulting in consumers being much worse off than if they had not had access to credit."[20]

Comment was invited on regulatory initiatives to deal with lending to marginalised groups, on the basis of the behavioural economics assumption that rationality cannot be assumed.

The policy response has yet to be released. Key areas will be how far the Ministry chooses to take these reforms and how it chooses to grapple with boundary issues between consumers who are perceived as competent and those who are perceived as not.

Financial Markets Authority

One of the most significant events in regulatory terms for some years in New Zealand has been the emergence of the Financial Markets Authority (FMA), which opened for business on 1 May 2011. Compared to its predecessor agencies, the FMA has extensive enforcement powers and capabilities, with the ultimate aim of promoting and facilitating the development of fair, efficient and transparent financial markets.

This reform is interesting, not because it contains overt notions of paternalism (which it does not in the sense used in relation to the consumer and credit reforms), but because it reflects such an enhanced role for government in a different way – and thus is reflective of a more general trend.

New Zealand's financial institutions (with the notable exception of the finance companies) in fact survived the GFC rather well. However, of the many views expressed in the aftermath there was one (largely) unifying factor – relevant regulators were letting misconduct slip through the gaps and wholesale changes to the regulatory environment were a 'must' if investor confidence in New Zealand's financial markets was to be restored.

This regulatory underperformance was, at least in the minds of the government, the fault of the regulatory framework and the limitations and complications it placed on any one regulatory agency seeking to exercise powers of enforcement. The blame being levelled at the broader regulatory framework was the topic of a March 2010 article in the New Zealand Herald, the headline to which was: Unify regulatory framework and confidence will grow.

The Herald article was written by Jane Diplock, then head of the Securities Commission, who observed that current regulatory arrangements were not fit for purpose. They did not give "domestic and international investors the confidence to invest in the local securities that provide capital for our local businesses to grow". The solution:

> ...we need a single comprehensive regulatory agency with extended powers to offer real confidence to both domestic and foreign investors...[the] urgent first step to economic growth should be to consolidate New Zealand's regulators...
>
> Those who point their fingers at the Securities Commission and the other New Zealand regulators for doing too little to prevent [the finance company collapses], should look instead at the regulatory framework in which we operate – a patchwork quilt of add-ons and Bandaids cobbled together over the past eight years, none of which helped protect finance company investors.

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[20] At page 54.

> The regulatory vacuum attracted opportunistic operators and the result was market failure of an entire industry and tragically the loss of retail investor confidence in the New Zealand capital markets once again.
>
> Despite warnings by the commission, it could do nothing to prevent this failure. A government agency can only act within its warrant. Time has come to extend the warrant of New Zealand's regulators.

Similar concerns were expressed in submissions to the Capital Market Development Taskforce, the Prada and Walter review of the Securities Commission, and in comments by the Registrar of Companies to the Commerce Select Committee inquiry into finance company failures. All expressed concerns about:

- the fragmentation of market regulators, leading to concerns about gaps and overlaps;
- the regulators' willingness actively and visibly to prosecute wrongdoers, and to take cases in order to clarify the boundaries of the law; and
- the adequacy of regulators' powers.

This idea of "restoring public confidence" resonated throughout the legislative process. This reflected public sentiment that an increased role for government was necessary and desirable. Will that legitimise further interventions? Possibly. Does it reflect a public desire for safe investment at the expense of individual choice? Perhaps.

Why the change in emphasis?

This paper argues that the three regulatory interventions under discussion reflect a mix of regulatory motivations. It is hard to be definitive about whether the paternalistic impulse is more or less dominant than historically. There are a few factors which could suggest that if it is more dominant, or will become so.

First, there appears to be a stronger public desire for (and acceptance of) government intervention in the markets than might have existed prior to the GFC. The New Zealand government recently bailed out South Canterbury Finance for around NZ $1.8 billion (extending the requirements of the Retail Deposit Guarantee Scheme to non eligible deposit holders), and has guaranteed AMI Insurance in the wake of the Canterbury Earthquake.

Secondly, consumer groups are becoming more vocal with the rise of social media. Greater media coverage has put governments under pressure to adopt policies which appeal to broad sectors of the population and to respond quickly to problems when they emerge in acute form.

Thirdly, it seems clear that advances in technology make retail consumers of banking and financial services more vulnerable than they might otherwise have been (e.g. the "borrow by text" promotion), so that the case for intervention becomes stronger.

Finally, the influence of international academic opinion is also relevant – and appears to be more disposed to paternalistic intervention.

PART III: POLICY AND COMMERCIAL CONSEQUENCES

This paper has explored some themes arising from current and recent policy debates in New Zealand. It suggests that under the apparently unobjectionable goal of "consumer protection" lies a more controversial view on the extent to which consumers can be taken to be capable of looking after themselves.

In this part of the paper, a series of propositions are put forward as to the likely policy and commercial consequences which could follow.

The first proposition is that financial services regulation will only increase in scope and depth, and that this cycle will perpetuate for some years. As Richard Epstein has noted[21] "the complete regulator is like the boy and the dam – except he never runs out of fingers". In other words once the process of regulation starts, it tends to increase – a process known as regulatory creep. Indeed, the difficult policy decisions are usually about whether to regulate at all. Once that decision is made, increasing regulation is easier to justify and tends not to be subject to the same degree of political scrutiny.

Furthermore, history suggests that fundamental changes of regulatory direction occur only every few decades (not every few years). Triggered by a constitutional and foreign exchange crisis in July 1984, New Zealand launched into a series of reforms which were described at the time as: "one of the most notable episodes of liberalisation that history has to offer".[22] Retrenchment followed, and New Zealand is now more tentatively entering another round of liberalisation of state assets. Financial services are unlikely to be "deregulated" for many years.

Any further regulation is likely to be accelerated by a change in government. It is clear from the policy papers referred to that current Ministerial opposition to the introduction of an unfair contract terms standard is finely balanced.

The second proposition is that policy makers, with the encouragement of the industry, need to be clearer (or perhaps more honest) about the motivations for reform. While not often overtly invoked in policy discussions, paternalism is a power motivation for policy change. It is not necessarily a wrong motivation, but it is important that the downstream policy implications of particular choices are confronted. In particular, the costs and benefits of "paternalistic" interventions must be properly identified.

Ogus put it this way[23]:

> "Let us assume that, with the aid of the psychological evidence described above we can identify situations in which many, perhaps most, individual decision–makers select options which would not reflect their individual preferences if they had been responding rationally to the information available. The benefit of a legal intervention forcing an individual to adopt the rational choice may then be expressed as the difference between the utility she has gained from complying with the legal requirement and the utility she would have gained from her own preferred option. The social

[21] Epstein as many will know is a Professor of Law at the University of Chicago. The comment was made in a lecture attended by the writer in the 1990s.

[22] David Henderson, quoted in Evans et al " New Zealand's Economic Reforms: 1984-95" Victoria Economic Commentaries, Number 1, 1986.

[23] Anthony Ogus, Costs and Cautionary Tales – Economic Insights for the Law, Hard Publishing, Oxford 2006, at page 238.

> benefit of the measure would then be the aggregate of such increases in utility for all those subject to the requirement..."

There is a need for a more nuanced assessment of proposed regulation whereby the problem is clearly identified, the suite of policy options exposed to a cost benefit analysis, and an appropriate solution crafted.

If, for example, the proposition is that financially and educationally disadvantaged groups should be prevented from borrowing money (which may well be a perfectly laudable and desirable outcome), a more targeted approach is required than a universal tightening of credit criteria. In other words, the fact that some sectors of society may need to be protected from themselves does not mean we all need to be protected from ourselves, and a regulatory intervention which does the latter so as to achieve the former is flawed.

If paternalistic interventions apply uniform controls on certain activities, then those individuals who are more sophisticated and better informed will be deprived of choice. This creates a cost to them in the achievement of a 'benefit' which they do not require and which is irrelevant to them. The regulatory intervention should be crafted so as create some form of default rule whereby those who can demonstrate rationality or likely rationality (however that could be identified) can opt out. Absent very obvious distinctions (retails vs wholesale, for example) this is likely to be difficult ex ante and will, of course, significantly increase compliance costs. This is the type of analysis which the Ministry of Consumer Affairs (and others) needs to undertake.

Thirdly, the (New Zealand) financial markets sector needs to be better equipped to engage in the policy debate. Generally, the larger retail banks (the majority of whom are Australian owned) are held in good regard by government. They are seen as responsible and responsive. That platform can and should be used to increase the quality of the policy dialogue.

The banking and financial services sector has an important role to play here. The challenge is proactively to initiate change rather than responding to policy papers as they emerge and to no longer simply oppose proposed interventions but to propose alternatives. The development of empirical data would assist greatly in elevating the debate beyond the "is/isn't" level of argument, as would sponsoring high quality academic literature and discourse.[24]

[24] On that note, the Institute for the Study of Competition and Regulation at Victoria University of Wellington (www.iscr.org.nz) has done an extremely effective job in some areas of regulation.