REGULATORY REFORM AND COMPLIANCE COSTS IN THE FINANCIAL SERVICES INDUSTRY

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ABSTRACT

In 2004 a significant policy shift occurred in the regulation of the Australian financial services industry when the Financial Services Reform Act 2001 became effective. Many have criticized the complexity of the new laws and suggested that the compliance costs outweigh the benefits envisaged by policy-makers. The objective in this study is to capture data that indicate the incremental costs of the policy change. Findings suggest that while the intent of the policy-makers in introducing stringency to the financial services industry was clear, the incremental cost burden imposed as a direct result of the reforms was severe.

INTRODUCTION

The Financial Services Reform Act 2001 (FSRA) introduced in 2004, forms a key part of the Australian government's transformation of its financial services industry. Many have criticized the complexity of the new laws and the associated compliance costs. Without doubt the compliance requirements associated with holding an Australian financial services license (AFSL) are complex and time consuming, requiring far greater knowledge and effort by all concerned than before the implementation of the FSRA. Whether the economic costs outweigh the expected benefits of the reforms is an important issue for consideration. Additionally, the impact of the cost burden imposed by regulatory reform and compliance has been shown to be relatively more severe for small business than for large. Already there is evidence that some smaller financial service providers are abandoning the industry as a result of the reforms. This is a further important issue for investigative research. The objectives in this study are to estimate the costs incurred to get AFS licensees compliant with the FSRA, the costs to maintain compliance, and the compliance burden on small business relative to large business.

LITERATURE REVIEW

Compliance costs associated with the introduction of new, or amendments to, regulation comprise many components some of which are not easily quantifiable such as the cost of internal staff time and lost business opportunities resulting from redirecting efforts to compliance tasks. There is some debate as to whether compliance costs should be considered net of benefits. For instance should social and industry-specific benefits such as improved decision-making and enhanced reputation stemming from more stringent record-keeping, be offset against compliance costs? Tran-Nam [5] note that because of the difficulty in quantifying benefits they have typically been omitted from empirical studies. Various attempts have been made to measure compliance costs, the first being undertaken by Haig [2] who focused on tax compliance costs. Heij's [3] study of tax compliance costs also shows that compliance costs are quite significant. Although the 'new wave of studies' in this area [5, p.230] has stimulated investigation of the size and locus of the compliance burden, Banks [1] suggests that there is still limited empirical data to enable a consistent assessment of compliance costs, especially over time. In response to the increased public concern about compliance costs, some governments (UK, Australia, New

Zealand) have agreed to accompany new legislation with some form of compliance cost impact statement [5] which must detail the impact on stakeholders of the legislation including total compliance costs. This process is relevant to stakeholders in order that the economic consequences of proposed and revised regulation can be anticipated and rationally assessed. There may be systematic differences between small and large business across a number of dimensions including compliance costs. For instance, studies of the costs of compliance with the Australian Goods and Services Tax (GST) indicate that the burden falls with exceptional severity on small business. Sandford and Hasseldine [4] found that as the size of business increases costs decrease relative to measures of size. It may be that in the financial services industry large business is a net beneficiary if the new regulations cause small business to abandon the industry and the large business market share improves. Key issues of concern include whether the need to seek expert compliance advice comes at a cost which may preclude small businesses from seeking advice on crucial issues; whether compliance costs in the form of additional fees to expert advisors may force small businesses to raise their fees to a level sufficient to discourage new business; and, whether the level of compliance costs may force small businesses to abandon the industry. If any (or all) of these events are occurring, there may be a case for differentiating the AFS licensee compliance arrangements on the basis of either size or main business activity.

RESEARCH METHOD, DATA AND RESULTS

The data was collected directly from subjects in the financial services industry. This method of collecting primary data direct from businesses about the impact of a particular area of compliance has been used successfully in similar prior research [6]. Objective data, and the AFS Licensees' views, were sought across a range of issues associated with the compliance cost debate: namely the size and structure of the organization; the range and scope of business activities including record-keeping; perceptions as to the relative impact of compliance costs; the cost of acquiring and maintaining intellectual capital; and the need for ongoing expert compliance advice and training. From a sample frame of 4,170 surveys, 701 completed and useable surveys were returned. The overall response rate has therefore been calculated as 16.8 %. Sufficient responses were received to enable statistical analysis to be undertaken. Accordingly, with due consideration to the number and percentage of responses received and the costs and benefits, no repeat survey was administered to elicit a higher response rate. A number of discriminators have been used by researchers and others to measure the size of an organization. This study adopted the measures used by the Australian Taxation Office and categories are described as small, medium, and large. Data relating to the number of respondents classified according to size are summarized in Table 1.

Table 1 Size of Respondents' business

Location	ATO Size measure - Turnover of:					
	<$2m		$2m - $100m		>$100m	
	No.	*%*	*No.*	*%*	*No.*	*%*
Total	**391**	**55.8**	**286**	**40.8**	**24**	**3.4**

Compliance costs associated with the imposition of new, or changes to, regulations can be significant and the burden of such costs has been shown to fall with relative severity on small business. Accordingly, investigation of this matter was important. A total of 681 respondents answered a question relating to this issue. The data indicate that over 83% of respondents believe their compliance costs are significant. This outcome (costs are significant) was consistent across all businesses regardless of size. The cost of becoming compliant with the FSRA and the estimated cost of remaining compliant was investigated in the survey. The literature review reveals that the cost of acquiring and maintaining knowledge capital is a largely hidden cost of business – hidden because it is difficult to quantify and because regulations prohibit the capitalization of this cost. Although hidden, this particular cost may (post-implementation of the FSRA) constitute a considerable component of the cost of operating a business in the financial services industry. Accordingly, the cost of knowledge acquisition and maintenance was also investigated. The knowledge acquisition costs incurred by the 643 respondents to this question, to become and remain compliant with the FSRA requirements, are summarised in Table 2.

Table 2 Costs of Knowledge Capital Acquisition and Maintenance

Costs	Small n=348, $	Medium n=275, $	Large n=20, $	Totals n=643, $
Knowledge acquisition (av)	29 489	67 155	281 970	**53 451**
Knowledge maintenance (av)	11 973	25 030	133 800	**21 347**

Respondents were asked to consider the amount they would regard as fair compensation from government for the incremental compliance costs imposed on them in relation to the reform of the financial services industry. The 596 respondents to this question considered that fair compensation for their costs of handling FSRA issues was on average $61 764 per business. This amounts to a staggering $258 million when extrapolated across all AFS licensees.

CONCLUSIONS AND RECOMMENDATIONS

This study has generated significant new data in the compliance field. In particular, data on the costs of acquiring and maintaining knowledge (intellectual) capital in order that the requirements of the FSRA can be properly implemented have been gathered, and verifiable information to confirm the impact of compliance costs on the small, medium and large sectors of the financial services industry. Some major concluding comments can be made including that the size of a business (measured by level of turnover) is an most important factor in determining attitudes to compliance costs and licensee behaviour in the financial services industry.

REFERENCES

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