Regulatory Impact Assessments and market failure analysis

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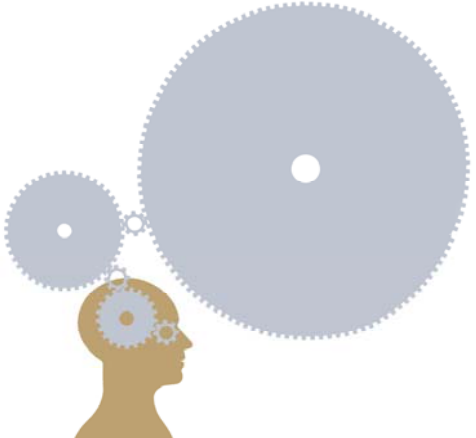

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Overview

- introduction
- review of assumptions of well-functioning markets
- economic rationale for intervention
- the importance of impact assessments
- market failure analysis in practice
- initial steps in preparing an impact assessment

Introduction

- policy-making is about making informed choices
- the use of impact assessments helps in the making of such choices
- creating impact assessments is not an exact science
- in an ideal world an impact assessment can:
  - identify whether there is a need for government intervention in the first place
  - help to identify the most appropriate form of intervention
  - be used to undertake evaluation of existing policies

Review of assumptions of well-functioning markets

- it is important to be able to define a market
- a market is where individuals transact with each other in the specified product
- profit/utility maximisation is the key objective
- a well-functioning market is one in which resources are allocated efficiently
- based on assumptions of:
  - no asymmetries of information
  - prices reflecting all costs, including costs to third parties
  - no excess profits

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Economic rationale for intervention

- in reality, markets are not ‘perfect’ and may fail to achieve ‘efficiency’
- the benefits of government intervention are improvements in market outcomes compared with a situation without intervention (eg, consumer choice, prices, costs of financial failure)
- with no intervention, adverse effects in the provision of financial services may arise from:
  - market failures (asymmetric information, market power, externalities)
  - risks (operational, default, systemic)
  - incentive problems

Importance of impact assessments

- impact assessments should be undertaken at the beginning of the policy-making process—not the end
- market failure analysis is vital at an early stage
- this can be used to justify government intervention, but cannot identify the most appropriate intervention
- all potential government interventions should be considered, including the ‘do nothing’ option
- the do-nothing option may still be appropriate even if market failures have been identified
- monitoring and evaluation plans need to be formulated

Market failure analysis in practice

Asymmetric information

- two types of asymmetric information
  - hidden information prior to a transaction being completed
  - hidden action by one party after a transaction is completed
- with hidden information, the seller will generally have more information than a buyer
  - the purchased product may differ from the buyer’s expectations
  - the price paid may not reflect the underlying value of the product/service
- hidden action may arise in principal–agent relationships
- the principal cannot costlessly observe the actions of the agent
  - for example, a client passing money to another firm for the purpose of investment business
  - the client may be affected by asymmetric information

Market failure analysis in practice
Market power

- in a market where a single firm or firms have excessive market power
  - prices will be higher
  - output will be lower
- compare this with a well-functioning market
- there may be collusion between firms
- the market structure may be one of only a few firms
- the market may be able to support only one firm due to high fixed costs and economies of scale (natural monopoly)
- an example could be clearing and settlement systems

Market failure analysis in practice
Externalities

- externalities arise when the production/consumption of a good or service affects the welfare of other economic agents in addition to those consuming it
- such effects are not taken into consideration by the producers or suppliers of the good/service
- there is a mismatch between private and social costs and private and social benefits
- externalities can be positive or negative
- an example would be when a bank's risk-taking behaviour does not take into account the systemic effect it might have on others

Market failure analysis in practice
Risks

- in financial services market, failures are linked directly to risks
- with little risk, the potential detriment from a market failure would be low
  - information asymmetry is not a problem if there is no risk of consumers losing money in the event of firm default
  - externalities combined with default risk give rise to potential systemic failures in the banking sector
- but risks alone cannot justify intervention
  - if product risks were understood, they could be priced in terms of anticipated returns
- so, the combination of market failures and risks is important

Market failure analysis in practice
Incentive problems

- market failures are also linked with incentive problems in financial services
- asymmetric information might not be a problem if the incentives of the buyer and seller could be matched
    - need for a completely specified contract
- incentive misalignment heightens the negative impact of market failures
    - particularly in retail financial services when products are provided on a commission basis by intermediaries
- an example would be where an independent financial adviser is receiving commission from a product provider

Preparing an impact assessment
Initial steps

- beware: market failure alone may not be sufficient justification for intervention
- market failure, risks and incentive problems are all linked
- may also need to assess the impact on competition and distributional issues
- need to think about these market failures/risks/incentive effects in terms of adverse/unwanted outcomes
  - prices too high
  - costs too high
  - consumer choice is limited

Concluding remarks

- impact assessments
  - are a vital tool in the policy-making process
  - can be used to inform policy choices
  - must be undertaken at early stage in the policy-making process
  - must be combined with market failure analysis and assessment of risks and incentive problems
- always think in terms of desired outcomes and how they can be measured

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