

# Prologue

**Peter Carroll**

In a 2008 address to the Museum of American Finance entitled ‘Lessons from Financial History’, Niall Ferguson, the Laurence A. Tisch Professor of History at Harvard University and William Ziegler Professor at the Harvard Business School observed:

Most regulations are improvised in the aftermath of a crisis. This is how regulations, generally, are produced. They almost immediately become inappropriate. So, regulators are always chasing the historical process. Like generals, they are always fighting the last war, never the next one.<sup>1</sup>

The quote is interesting and catchy — but almost totally incorrect as regards the assertion that regulations arise primarily in response to a crisis! The vast bulk of regulations are modifications to those that already exist. Occasionally, regulatory zeal is ‘spurred on’ because of a pressing, emergent issue and even, occasionally, a crisis, but not often. Life is more mundane than we like to think.

I do, however, agree with the latter part of the quote. Indeed, regulators, like generals, are often — if not always — fighting the last war. Regulation and regulatory responsiveness, rests on the art of catching up. This is not inconsistent with the ‘policy arts’ generally but, in the case of regulation, the goalposts — or the battleground (to preserve the analogy) — are constantly shifting.

Ferguson’s address posits that financial markets, and the regulations that coalesce around them, exist in dynamic — almost organic systems. Regulators are almost always in a state of catch-up because the initial conditions prevailing at the time regulations are formulated are likely to have changed significantly by the time regulations have been promulgated.

Ferguson frames his remarks in the context of what he calls ‘evolutionary economics’ — the application of Darwinian theory to financial markets. Whatever one might think of such a construct, the metaphor of evolutionary niches has interesting applications to regulatory processes. Gaps in nature, after all, are prone to be filled. So too, gaps between regulation and the behaviours of the regulated will be filled — possibly with new behaviours requiring regulation! To the extent that the time lag between the articulation of a regulatory response and the gazettal of regulation gives rise to ‘regulatory gaps’, the regulatory process — like the environment within which it operates — needs to be dynamic and adaptive. The problem is, as the authors of this monograph observe, that regulatory processes are not as adaptive and dynamic as they should be.

In his 16 May 2008 speech to the Mortgage and Finance Association of Australia National Convention, the Minister for Superannuation and Corporate Law, Senator Nick Sherry, observed:

... we are all operating in an increasingly complex and dynamic environment. And with this complexity comes risk. An optimal regulatory system will harness that risk, and allow us to achieve the right balance between protection, wealth and growth.<sup>2</sup>

Certainly, complexity and dynamism are givens in any policy environment as is the proposition that the management of complexity entails risk. The Minister's exhortation to 'harness risk' seems to suggest regulatory regimes and processes capable of acting in an almost entrepreneurial fashion to leverage community benefit from uncertainty in the environment. However, regulatory bodies exist also to exercise what might be broadly termed 'control functions' and, by nature, tend to be conservative both in their culture and operations. Managing risks and limiting the sometimes unintended impact of individual or corporate behaviour is, from this perspective, the essence of regulation. Institutional conservatism does not, of necessity, preclude creativity and foresight although experience tells us that the influence of stakeholders might result in governments accepting regulatory provisions that are sub-optimal, in effect, 'regulating' policy inventiveness.

That said, creativity and foresight are sorely required — particularly if the Rudd Government is serious about harmonising the regulatory regimes of the Commonwealth and State/Territory governments as part of its drive toward a less costly system of regulatory regimes. 'Getting the balance right', to employ one of the currently popular political catch-phrases, will be essential to the successful management of stakeholder interests. A recent survey commissioned by the Australian Securities and Investments Commission (ASIC) found — not surprisingly — that business thought the regulator should focus on principles rather than rules; collaboration rather than enforcement. Consumers, for their part, felt that regulators tread too softly and were not sufficiently robust in terms of enforcement or the application of sanctions.<sup>3</sup> Obviously, perceptions of and attitudes toward regulation will differ. Achieving 'balance' in ways that do not impose undue cost, unfairly transfer risk or compromise the public interest will never be easy.

The environment *is* complex, the risks *are* great and the rewards of success and the costs of failure will be enormous. The true measure of success will be how effectively we are able to close the gap between promise and performance. This book suggests that our abilities, based on observations of past performance, are limited.

## ENDNOTES

<sup>1</sup> Professor Niall Ferguson, 'Lessons from financial history', broadcast 11 May 2008 on *Big Ideas*, ABC Radio National. The podcast of Professor Ferguson's address can be downloaded from: <http://www.abc.net.au/rn/bigideas/stories/2008/2237927.htm>

<sup>2</sup> Accessed 19 May 2008 at <http://minscl.treasurer.gov.au/DisplayDocs.aspx?doc=speeches/2008/012.htm&pageID=005&min=njs&Year=&DocType=>

<sup>3</sup> Emma Connors, 'Regulator gets mixed messages', *Australian Financial Review*, Monday 19 May 2008, page 5.