OECD/ADBI 7th Round Table on
Capital Market Reform in Asia

27-28 October 2005
ADB Institute, Tokyo, Japan

SESSION 1: FINANCIAL POLICY LANDSCAPE

Mr. Stephen Lumpkin
Principal Administrator, Financial Markets and Policies, OECD

7^{TH} ADBI-OECD ROUND TABLE ON CAPITAL MARKET REFORM IN ASIA

Tokyo, 27-28 October 2005

Basic Propositions Regarding the Financial Policy Landscape Based on a review of the OECD Experience

Stephen A. Lumpkin

Principal Administrator

O.E.C.D.

1. Interdependence of Objectives

Proposition: ***Public policy toward finance attempts to achieve several interdependent objectives that are not always consistent.***

- Policy can protect against systemic breakdowns, for example, but if it does so single-mindedly it stifles creativity and innovation and impedes competition, which eventually may make the system less safe.
- Over-regulation stifles competition and renders the system inefficient and unprofitable or simply drives the business to more favourable jurisdictions.
- Too lax regulation opens the door to moral hazard and conflicts of interest and, once again, invites disaster down the road.

2. The moving target

Proposition: ***The formulation of financial regulation takes place against a changing backdrop of market innovation and pressure for efficiency and competitive advantage.***

- As institutions search for ways to exploit or develop a competitive advantage, they explore various strategic alternatives, including the introduction of new products and services, new ways to produce established products at lower costs, and changes in institutional structure.
- To avoid making contradictory changes in policies or implementing rules that quickly become obsolete or counterproductive, authorities must anticipate whether innovations introduced at any particular time will become permanent features of the financial landscape.
- Regulations that are implemented must be subject to periodic review to ensure they remain relevant to the task for which they were intended.

3. Path dependence

Proposition: ***There is a complex interaction between financial services regulation and the evolution of the financial system.***

- Regulation of the financial services industry must ultimately satisfy the environment in which it is to be implemented, taking full account of the relevant country-specific factors, including the different initial conditions on which the financial services industry is structured.
- Political and social structures and government, industry and societal relations are important as well, along with the relative size and mix of regulated and non-regulated entities, the business practices of each group, and the behaviour of consumers and investors.
- Regulation both influences and, in turn, must be influenced by these various factors.

4. Financial intermediation entails risk

Proposition: ***The financial intermediation process is inherently risky and increasingly complex…***

- Financial intermediaries exist to assume and manage financial risks.
- Some, maybe even most, of their bets win out. Others prove to be poor choices; some prove to be disastrous.
- Financial intermediaries operate on both sides of the savings-investment relationship, typically using other people's money.
- Clients and small investors have limited capability to monitor final uses of funds.
- Financial services have been subject periodically to problems of insolvency, illiquidity, and fraud.

5. Objectives of financial regulation

Proposition: ***Financial regulation is justified when it is needed to address identifiable market failures, can succeed in correcting the problem without making matters worse, and can do so efficiently*.**

- Regulatory intervention in financial markets has often been predicated on the grounds of the existence of market failures arising from externalities, market power imbalances, and information asymmetries
- Enduring objectives of financial regulation include:
  1. Protection against systemic risk
  2. Proper market conduct
  3. Consumer/investor protection
  4. Certain resource allocation goals

6. The way we were (prior to regulatory reform)

Multiple goals:

- Ensure systemic stability
- Limit risk taking (prevent failures and protect retail customers)
- Limit competition (trade-off between competition and stability)
- Support industrial and regional policies
- Support social policy, especially for housing
- Facilitate government finance

Regulatory authorities directly monitored and controlled a wide range of financial activities using a host of structural controls.

Rules in some jurisdictions sought to prevent “excessive” concentration of market power by separating the banking and insurance business, while in other jurisdictions banking was separated from the securities business.

7. The financial services landscape associated with these policies

Strict limitation on assets and lines of business achieved its main purpose:

- limited institutions’ scope for taking on non-core risks.
- meant that institutions were “safe” in a narrow sense,
- but with limited financial resilience owing to regulation-induced distortions in the allocation and pricing of credit.

A key lesson:

- Strict controls can, perhaps, work if they are at once all encompassing and universally applied and if barriers to entry are impenetrable (albeit at a risk of non-competitive behaviour).
- In this particular case, they weren’t: some business moved off-shore and non-regulated entities made inroads in some market segments.

8. 1980s & 1990s: Regulatory reform and other developments

Proposition: ***regulatory policy in financial services tends to be circumstantial; that is, it tends to be modified periodically in response to institutional and structural changes in the financial services industry rather than evolve according to a comprehensive and pre-determined plan.***

Market developments:

- Dramatic improvements in technology and in the quality of telecommunications and information services
- Growing economic and financial interdependence at the international level
- Rise in capital markets in financial intermediation process

Reforms:

- Barriers between different segments of financial services relaxed or removed
- Easing in restrictions on the range of products and permissible activities
- Policies adopted to preserve or enhance international competitiveness of the financial system
- Increased reliance of market forces
- Fewer structural rigidities
- Liberalisation of foreign entry

9. What do we regulate?

Proposition: ***regulations in financial services cover just about everything --***

- Transactions infrastructure (payments, clearing & settlement, custody, trading platforms, etc.)
- Information infrastructure (market data, financial research and portfolio diagnostics, financial disclosures, etc.)
- Financial products and services
- Financial institutions that provide the products and services
- Their market conduct
- Their interface with clients, customers, policyholders, employees, owners, creditors, and so forth.

10. Good cooks, imperfect recipes

Proposition: ***There is no one-to-one correspondence between the objectives of financial policy and the regulatory apparatus that exists to achieve them.***

- Financial innovation, convergence, and other developments can pose challenges for existing regulations, rendering them ineffective, costly to enforce, or counterproductive.
- Policy needs to strike the right balance between different types of service providers and between the interests of the service providers and those of their customers, shareholders, creditors, etc.
- Not altogether a trial-and-error process, but a considerable amount of re-evaluation and adjustment may be required to maximise the efficiency of the process.

11. How do we regulate: regulatory underpinnings

Proposition: ***The successful implementation of financial policies requires a well-developed infrastructure.***

- Supportive legal and institutional framework
- Company law, contract and property law, securities law, laws governing consumer and investor protection and, for when things go wrong, insolvency or bankruptcy law
- These bodies of law establish the basic framework within which financial institutions and markets work
- Well-functioning judicial system
- Different sectors of financial services have their particular requirements, but these are the common elements.

12. How do we regulate: who does it?

Proposition: ***The typical legislative process is costly and generally does not lend itself to making speedy decisions. Nor is it practical for legislative bodies to directly monitor and oversee all institutions, markets, and industries.***

- Legislative bodies in most jurisdictions pass statutes delegating such authority to various administrative bodies – "regulators"
- In some jurisdictions, regulators are given broad enforcement powers
- Where that is the case, regulators can function proactively in setting rules *ex ante* to forestall problems, as well as render corrective decisions *ex post*
- In some jurisdictions, federal regulators oversee some institutions, products, markets, etc., while others are under the purview of regional authorities
- Rule making authority over certain practices may be further delegated to private sector bodies

13. How do we regulate: regulatory powers

Proposition: ***The laws that give life to regulatory bodies are contextual; they are drafted to suit a given structure of the financial system under a set of assumptions regarding its likely evolution.***

- The range of activities undertaken by regulators is determined in part by the powers granted under legislation
- These powers and activities vary from country to country and may not be the same across all sectors
- Historically, the statutory framework has had different levels of regulatory involvement depending on the nature of the market participants and the mix of business of regulated entities
- Regulatory authorities were given a strong institutional focus at inception that reflected the perceived specificities of the different kinds of institutions
- Specialist regulators were given responsibility for certain types of financial institutions and were given mandates tailored to the traditional business mix of the particular type of financial institution. Financial supervision followed suit.

14. How do we regulate: regulatory structure

Proposition: ***Inasmuch as regulation and supervision must reflect country-specific factors and given the fact that economies and financial sectors are not all alike, it may be that no one institutional structure of regulation and supervision will ever suit each and every country.***

- Over time, many changes in the institutional structure of regulation have been made, often in response to particular institution or market failures.
- As the incidence and severity of failures have varied across countries, so, too, have the regulatory responses.
- As a result, no one regime has been universally adopted.
- Models range from disaggregated structures to single regulators with statutory authority, with various mixtures in between.
- Some models preserve a role in financial supervision for the central bank, while others have removed banking oversight responsibilities from the central bank.

15. How do we regulate: regulatory and supervisory practices

Proposition: ***Regulation and supervision must be adapted to the new environment in which the once neat conjunction between a particular type of institution and a limited range of products has mostly disappeared; where loans and other traditional forms of credit are increasingly traded in somewhat opaque derivatives markets; where various other risks are unbundled, repackaged and traded separately; and where institutions increasingly make use of quantitative techniques to help manage their assets and liabilities, in some cases on a global scale.***

- There is a need to accompany the convergence between financial sectors with related coherence of disclosure requirements and related rules, so as to avoid regulatory gaps, conflicts, or arbitrage.
- Prudential regulation addresses some risks by dictating that financial service providers operate in a safe and sound manner and competition regulation ensures that providers of financial services observe proper market conduct.
- Other types of regulations such as accounting and disclosure rules help to cope with the problem of asymmetric information and work to prevent fraud and other practices by which institutions unfairly exploit consumers.
- Supervision ensures that institutions comply with the rules.

16. How we regulate: the ongoing challenge

Proposition: ***The goal of regulation and supervision is simple – prevent crises by establishing rules of behavioural norms and ensuring that market participants and service providers comply with all regulatory requirements and that markets remain liquid and orderly – achieving it is not.***

- The challenge for policymakers is to devise and implement measures that are effective without undermining competition and innovation in the financial system.
- Overly detailed regulation can work at cross-purposes with the desired goal.
- The regulatory choices that are made are complementary to other aspects of a jurisdiction's corporate governance regime and of regulation of the broader economy, including tax, labour, competition, pension regulation, and so on.
- For cross-border issues, the three Cs of international financial policy are of increasing importance – ***communication*** (which means that all relevant information is shared to the extent allowable under domestic law), ***cooperation*** (in monitoring and other ongoing supervisory efforts), and ***co-ordination*** (of policy responses in the event corrective action is required).