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The Financial Policy Landscape

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The financial services landscape

- All financial services landscapes are linkages among a few basic components:
  - savers and investors,
  - financial infrastructure (transactions, information, legal),
  - financial supervision & regulation
  - financial instruments (products and services) and the markets they trade on, and
  - financial institutions
- But the specifics tend to vary according to domestic historical situations and differences
- Two main channels operate to facilitate these transactions: intermediaries and markets
  1. Intermediaries match suppliers and users of funds indirectly by transforming terms, maturities, etc. through the issuance of claims on themselves.
  2. Financial markets match suppliers and users of funds more or less directly.
- Modern financial systems tend to provide a mix of the two intermediation channels.

The role of financial services in the broader economy

- The financial system provides an important means by which savings, public or private, are transformed into productive investments.
- Important functions include:
  - the efficient allocation of credit and resources,
  - facilitating the exchange of payments (both domestic and international via currency exchanges);
  - gathering and disseminating information (especially on prices); and
  - facilitating maturity transformation and the management of liquidity, market and other forms of risks.
- How efficiently the financial system is able to perform these functions is a major contributor to stable economic growth.

Prerequisites for financial system efficiency

- Link between financial system efficiency & growth → how can policymakers support efficiency?
- Prerequisites:
  - Sound fiscal and macroeconomic policies & monetary controls
    - Support sustainable aggregate economic activity
    - Constrain major internal & external imbalances
  - Well-developed infrastructure for financial services
    - Reliable accounting, auditing, legal & judicial, and tax systems
- Other measures (supervision & regulation)
  - Ensure safety and stability
  - Protection of consumers and investors
  - Ensure proper market conduct
  - Promote competition

Principles for an effective regulatory framework

1. 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**.**
   - Over-regulation stifles competition and renders the system inefficient and unprofitable
   - Too-lax regulation opens the door to moral hazard and conflicts of interest
2. Regulation of the financial services industry must ultimately satisfy the environment in which it is to be implemented.
3. The rules must be enforced.

Tailoring the rules to domestic circumstances

- Financial services have been susceptible to periodic problems of insolvency, illiquidity, and fraud
  - Concerns about safety and stability in the financial services industry are legitimate
  - Changes in financial regulation have often been implemented in response to particular financial failures, rather than as part of a comprehensive and predetermined long-run plan
  - Because the incidence and severity of failures have varied across countries (and sectors), so, too, have the specific modalities of policy implementation
- Change in this environment is *incremental* and *reactive* to institutional and structural change in the financial services industry (absent some type of “big bang”)

…but the circumstances change

- Easing or removal of barriers to entry → increased competition across institutions, both within and across sectors
- Growing economic and financial interdependence at the international level → increased competition and interpenetration among national financial systems, in particular, at the wholesale level:
  - Different production, distribution, and corporate organisation structures
  - Horizontal integration of financial products and activities via formation of diversified, multi-product financial groups
  - Increased outsourcing and formation of specialised institutions
  - Horizontal & vertical linkages between and across trading platforms and clearing and settlement entities

Competition in the new financial services landscape

- Competition in this new landscape may occur on the basis of:
  - Fees and charges (price)
  - Products (range, quality, existence of substitutes)
  - Distribution channel (electronic, telephone, face-to-face)
  - Market access (availability of competitors)
  - Reputation (risk, safety)
  - Technology (economies of scale, switching costs, barriers to entry)
  - Consumer preferences (demographics, culture, information set, risk aversion, desire for privacy vs. transparency)
  - And more

Fitting policy to the new landscape

- On the one hand: An increasingly complex matrix of financial instruments, institutions, savers and investors, and markets all interacting in myriad ways, including growing linkages between national financial systems with different legal characteristics, technical specificities, languages, cultures, and practises.
- On the other: Nationally based financial supervision and regulation

The consequences of regulatory *path dependence*

- During periods of rapid innovation and marked structural change in financial services, authorities with different mandates and constituencies take inconsistent approaches to similar problems.
- perhaps not surprising
- but also not without consequences

The view from the private sector

- Broad-based regulations play a beneficial role in financial services: regulation helps to maintain consumer and investor confidence and to preserve the stability of the financial system
- The issue is, thus, not whether there should be regulation but rather what type and how much regulation is needed
- Regulation is not needed to the same extent in all market segments
- It is costly, not necessary, and counterproductive for the regulatory framework to change too often → avoid *ad hoc* changes in policy and put in place a flexible framework that guards against market failure but does not undermine competition and innovation in the financial system
- Regulatory procedures should be aligned with the size and complexity of the financial firm, with large, complex firms being more heavily regulated than small firms, but with full regard for their internal risk management practises
- A *principles-based* regulatory approach is preferred to a *rules-based* approach; it is sufficient to protect against system breakdowns and provide protection for consumers and investors, but flexible enough to accommodate institutional and structural changes in the financial services business

The task for supervisors and regulators

- On the one hand, the aim is to ensure the safety, soundness, and stability of the financial sector to protect the system against the severe consequences of failures but, on the other, it’s to promote the competitiveness of the domestic financial services industry
- As always, there are trade-offs.
- The key is to find the optimum balance between these objectives, which includes removing unnecessary barriers to a level playing field and seeking some degree of consistency on the international level in the design and implementation of rules