OECD Policy Framework for Effective and Efficient Financial Regulation

General Guidance

and High-Level Checklist

Background

- OECD has conducted work on the efficiency of financial regulation over the last several years
  - Committee on Financial Markets (CMF) and Insurance and Private Pensions Committee (IPPC)
  - Perception of overregulation in financial sector
    - Post-Enron environment
    - New capital, governance, and accounting standards
    - Concern with rule-based approaches
    - Obstacles to internationally active financial firms
  - Roundtables, extensive stocktaking of country initiatives, and Committee discussions

Background

- Focus has not simply been on efficiency
  - Importance of effectiveness of financial regulation – extent to which policy objectives are achieved and benefits realized
  - In comparison with efficiency, which refers to the extent to which direct and indirect costs of regulation are minimized
  - Consensus on primacy of regulatory effectiveness
    - *Policy objectives* are thus critical – reference point for discussion
- CMF & IPPC sought conclusions
  - Develop general principles with financial sector specificity
  - Principles to apply to all financial sectors
  - Interlinkages to be drawn out with existing OECD principles and with international standards in financial sector

Policy Framework for Effective and Efficient Financial Regulation

- New direction – offers a **general, integrated** framework for understanding financial regulation
- Premise is that a sound **policy framework** provides the basis for effective and efficient financial regulation
  - Financial regulation cannot be understood in isolation
  - Rather, it must be understood in the context of:
    - The financial landscape and its expected evolution
    - The policy objectives that have been elaborated for the financial system
    - The range of policy instruments available to governments,
    - The system of institutions in place to implement these instruments.

General Guidance

- There are 5 elements to this framework:
  1. **Financial landscape**
     - There must be a clear understanding of how the financial system should operates, how it operates in practice, and what failures exist
  2. **Policy objectives**
     - Objectives should be clearly articulated and be based on market failure analysis and the identification of broader needs.
     - Benchmark for effectiveness and efficiency and the accountability of governments and regulators.
  3. **Policy instruments**
     - The government must examine all the tools of intervention, how they work and interact, and how they can best be combined.
  4. **System design and implementation**
     - The institutional set-up for government intervention and regulation can have a large impact on the success and efficiency of intervention.
  5. **Review**
     - Rapid pace of the financial sector demands constant review.

1. Financial Landscape

- Define attributes of a well-functioning financial system – reference benchmark ("ideal" system)
  - Scope and functions of financial system within economy
  - Linkages – macroeconomic and international
  - Expected outcomes
  - Supporting foundations
- Ensure transparency of the financial system
  - Products, services, transactions; institutions; markets; participants; infrastructures; and interlinkages
- Understand financial system and its potential failures
  - Surveillance and market failure analysis
  - Transparency, expertise, and international collaboration

2. Policy Objectives

- Identify problems and establish case for intervention
  - Specify problems and broader economic and social needs
  - Assess case for intervention: net expected benefit(s)?
- Articulate policy objectives
  - Correspondence with expected benefits of intervention
  - Anchor for policy and regulatory framework
  - Applicable across sectors, but specificity possible
  - Prioritisation necessary -- primacy of systemic stability
- Ensure an accountability framework
  - Explicit incorporation into mandates and other mechanisms

3. Policy Instruments

- Identify available policy instruments
  - Possibilities include:
    - Surveillance
    - Market-based solutions
    - Regulation
    - Guarantees
    - Lending
    - Subsidies, grants and programmes
    - Government ownership and control
  - Understand and evaluate impacts of their use
    - Primary and secondary impacts
    - Benefits but also negative effects (e..g., incentives) and costs
  - Assess policy spillovers (-/+) → international dimension
    - Need and scope for international coordination must be identified

3. Policy Instruments

- Match policy instruments to policy objectives
  - Mixture of instruments generally necessary to achieve objectives, and need to factor in spillover effects
    - Complexity of financial sector policy and regulation
  - Instruments to be tailored to problems and reflect priority attached to each objective and risk tolerance for failure
  - Explicit consideration of incentive effects and need for ex ante controls
  - Choice, design, and implementation of instruments to reflect any policy spillovers among countries
  - Transparency important in the application of instruments, but possible need for constructive ambiguity and confidentiality

3. Policy Instruments: Financial Regulation

- Key policy instrument available to governments
- Distinct nature of this policy instrument
  - Financial regulation is an instrument (e.g., law, regulation, order, decree) by which the state compels an entity or individual to comply with specified requirements
  - Key features: (i) directive order; (ii) element of compulsion; and, generally,(iii) supervision of compliance
  - Should be viewed broadly:
    - Rules or principles
    - Compulsion through prescription or prohibition, or influence on behaviour (e.g., through setting of expectations, liability rules)
    - Direct specification of outcomes (e.g., insolvency)
    - Mechanisms and systems for implementation, including supervisory action

3. Policy Instruments: Financial Regulation

- *10 key principles of financial regulation*

Nature of regulation

1. Precaution
   - Precautionary approach is warranted
   - Need for pro-active anticipation of emerging risks; not reactive
   - Follow-up OECD work in this area – regulatory approaches to financial innovation
2. Risk-based
   - Financial regulation should oriented to the risks in the financial system arising from market failures
   - Should focus on risks that, due to nature or impact, have greatest potential of compromising policy objectives
   - Promote sound risk management in the financial system and incentives for proper behaviour

10 key principles (continued)

3. Sound incentives
   - Financial regulation is particularly concerned with the behaviour of participants in the financial system – large impact
   - Need to carefully adjust nature, form, and strength of regulation and supervision to achieve proper outcome – not a simple matter (e.g., remuneration guidelines)
   - Importance of effective enforcement
   - Failure resolution framework important – TBTF problem
4. Comprehensiveness
   - All participants and products, services, institutions, markets, etc. should be subject to appropriate regulation and oversight
   - Interconnected components and macroeconomic conditions should be subject to an integrated global view to identify interrelated risks and contagion channels, at micro/macro level
   - All tools and mechanisms should be employed

10 key principles (continued)

5. Consistency and competitive neutrality
    - Consistency and "functional equivalence" of financial regulation across financial groups, markets, and borders
    - More coordinated, integrated forms of regulation and supervision needed both within and across countries

Regulatory process and enforcement

6. High-quality and transparent decision-making and enforcement
    - 1995 Reference Checklist for Regulatory Decision-making, with some caveats
    - Effective mechanisms for enforcement
7. Systematic review
    - Ex-post assessment of quality, implementation, and impact

10 key principles (continued)

International dimension

8. International coordination, convergence, and implementation in policy and rule-making
    - Comprehensiveness and consistency at international level
    - Effective coordination and convergence where appropriate, and prevent regulatory arbitrage
9. International coordination in the regulation of internationally active financial firms and groups
    - International cooperation and coordination in regulation and supervision
    - Includes failure resolution and crisis management
10. Promotion of open, competitive, and safe markets
    - Level playing field
    - Removal of unnecessary obstacles

4. System Design

- Match policy instruments to institutions responsible for their development and implementation
  - Special considerations for system design in financial sector
    - Linkages with macroeconomic policy
    - Implicit or explicit government financial exposures
    - Rapid evolution of the financial system and convergence
    - Global linkages and policy spillovers
  - Principles of institutional design
    - Maximize synergies (e.g., policy objectives, instruments, information and expertise, administration)
    - Consistency and coherence in use of policy instruments
    - Align incentives and minimise conflicts
    - Promote accountability
    - Minimize risks for taxpayers

4. System Design

- Ensure proper systems for coordination, oversight, and control
  - Need to consider interrelationships among, and information flows between, institutions responsible for intervention and regulation
  - Under normal circumstances and crisis situations
  - Formal linkages desirable
  - Importance of challenge functions within system

5. Review

- Conduct timely reviews
  - Consistency with rapid evolution of financial system and its integration with international economic and financial system
  - Framework for intervention and regulation should be reviewed on a periodic basis (every 5-8 years)
  - Follow up on impact of specific interventions and rules
- Supplement domestic reviews with international review and peer pressure

Reflection on Crisis

- Policy Framework provides some insights, e.g.:
  - Importance of the **macroeconomic** dimension
    - Emphasis now on macro-prudential regulation
  - Fundamental need for **transparency** of financial system
  - Need for heightened **surveillance and analysis** of operations of the financial system
  - Inadequate **accountability** for policy and regulatory failures
  - Importance of **policy spillovers** internationally and need for improved coordination
  - Regulation needs to be **comprehensive** and **consistent**
  - **Synergies in policy objectives** (solvency, market conduct)
  - Importance of effective **crisis management** and a need to rethink **institutional structures and responsibilities**

Implementation and follow-up

- Adoption as an OECD Recommendation in November 2009
  - Non-OECD countries encouraged to adhere
- Use of High-Level Checklist as a mechanism to review implementation
- Follow-up work, e.g.
  - Regulatory approaches to financial innovation
  - System design

  → *OECD Strategic Response (www.oecd.org/crisisresponse)*

Thank you

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