



ORGANISATION FOR ECONOMIC  
CO-OPERATION AND DEVELOPMENT



# *Policy Framework for Effective & Efficient Financial Regulation*

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# Background

- Work on the assessment of regulatory efficiency has featured prominently over the years in the work programmes of the OECD Committee on Financial Markets (CMF) and the Insurance and Private Pensions Committee.
- This work has involved Committee papers and discussions, roundtables with the private sector, and stocktaking efforts.
- Topics covered: regulatory reform (liberalisation, deregulation and also re-regulation); the structure of regulatory and supervisory agencies, competition, and overregulation to name a few.
- After pursuing initial efforts separately, both committees agreed that it would be worthwhile trying to synthesize this work and lay out some general good practices;
- Taking into account inter-linkages with existing OECD principles and relevant international standards

# Some relevant OECD guidelines and principles

- The OECD Reference Checklist for Regulatory Decision-Making (1995)
- The OECD's Competition Assessment Toolkit provides a broad guide and set of principles for performing competition assessment. It addresses the question: given a particular policy goal, what is the best feasible form of government or private action for achieving that goal?
- The 2005 OECD Guiding Principles for Regulatory Quality and Performance, which state, for example, that when analysing alternatives, “consideration must take account of their costs, benefits, distributional effects, impact on competition and market openness and administrative requirements”
- The OECD has further stated that: “*High-quality regulation is increasingly seen as that which produces the desired results as cost effectively as possible.*”

Over-arching objective: some form of inter-temporal welfare maximisation (e.g. long-term sustainable growth)

- It has long been noted that finance affects growth. The financial system influences the allocation of resources across space and time.
- To exploit growth potential of an economy resources need to be allocated towards the most valuable investment opportunities.
- This allocation is affected by the costs of acquiring information, enforcing contracts, and making transactions.
- A ***well-functioning*** financial system permits the economy to fully exploit its growth potential by ensuring that investment opportunities receive necessary funding at minimum costs.

## What does the financial system do?

Growth suffers when frictions hinder the flow of resources to the best possible uses. The financial system attempts to overcome frictions as it:

- Produces and disseminates information about potential investments and the possibilities for allocating capital;
- Monitors investments and ensures that investors and savers are paid back according to the contracts they hold;
- Allows the trading, diversification and management of risk;
- Mobilises and pools savings; and
- Facilitates the exchange of goods and services

## Rationale for government intervention

Where proper rules of behaviour do not exist, one finds short-term contracts and less reliability.

The existence of a non-self-correcting market failure (or where markets cannot meet performance objectives on their own) provides a *prima facie* case for government intervention,

In general, regulation exists because of the potential economic and social costs of major financial instability, the desirability of maintaining markets that are efficient, orderly, and fair, and the need to protect retail customers in their dealings with the financial services industry.

Regulation is a *necessary, though not sufficient*, condition to guarantee market integrity

- These arguments for the existence of regulation are widely, though not universally accepted.
- Nonetheless, the more extensive debate is about how, and not why, we regulate.

## Why and how should regulation be applied and what form should the regulation take?

An appreciation of why regulation exists does not offer guidance as to what should be regulated or what form that regulation should take.

No simple formula exists for defining the 'best' boundaries of regulation: may differ among countries and may change over time within countries as the financial system evolves.

The basic rationale is to deliver **objectives** that are both in the public interest and would not be achieved without some form of public intervention.

There are three conditions:

1. The existence of **market failure** (competition and market discipline alone cannot solve all systemic problems or moral hazard issues);
2. Regulation can correct the problem without making matters worse (**effectiveness**); and
3. The benefits of doing so exceed the costs (**efficiency**)

## What are the objectives of regulation?

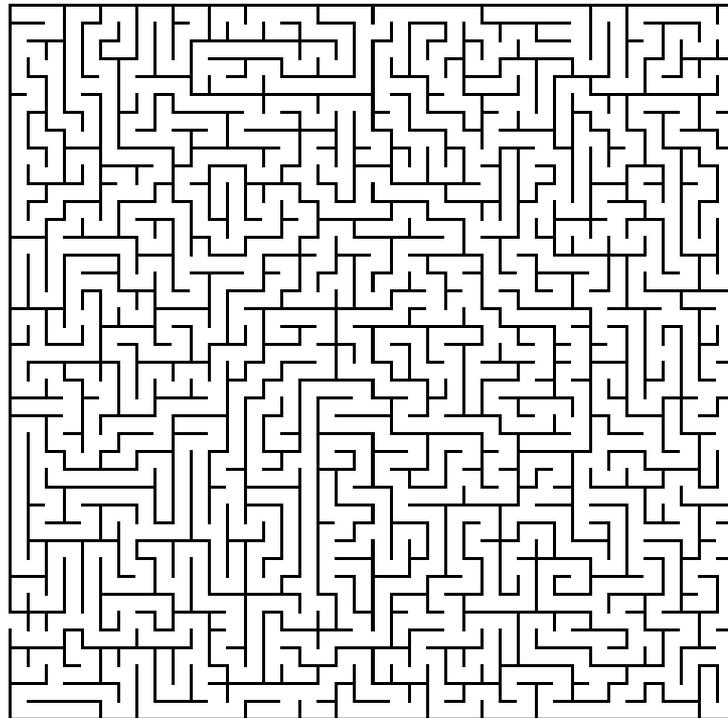
Objectives generally include the following:

- Safeguarding the system against systemic risk
- Protecting consumers against opportunistic behaviour of suppliers of financial services
- Enhancing the efficiency of the financial system
- Social objectives (such as increasing homeownership or channelling resources to particular sectors of the economy or population, e.g. SMEs).

Under what conditions do systems depart from efficient outcomes?

- Information imperfections (e.g. consumers' inability to monitor institutions results in an inefficient allocation of capital, instability, loss of confidence, and higher costs);
- Market externalities
- Market power imbalances
- Organisational failures (principal-agent problems)
- Transactions costs (including search costs, regulation, and constrained choice sets)

# An up-close view of the financial regulatory roadmap



# The Policy Framework

**The financial landscape**  
and its expected evolution

**The policy objectives**  
That have been elaborated for the financial system

**The policy instruments**  
available to governments

**The system of institutions**  
in place to implement these instruments

# Core elements of the framework

## Financial landscape

- Need clear understanding of how the system should operate and how it operates in practice

## Policy objectives

- Clearly articulated and rooted in sound market failure analysis and the identification of other needs; provide the benchmark for effectiveness and efficiency and the accountability of governments and regulators

## Policy instruments

- Need to consider all the tools of intervention and understand how they work and interact and can best be combined

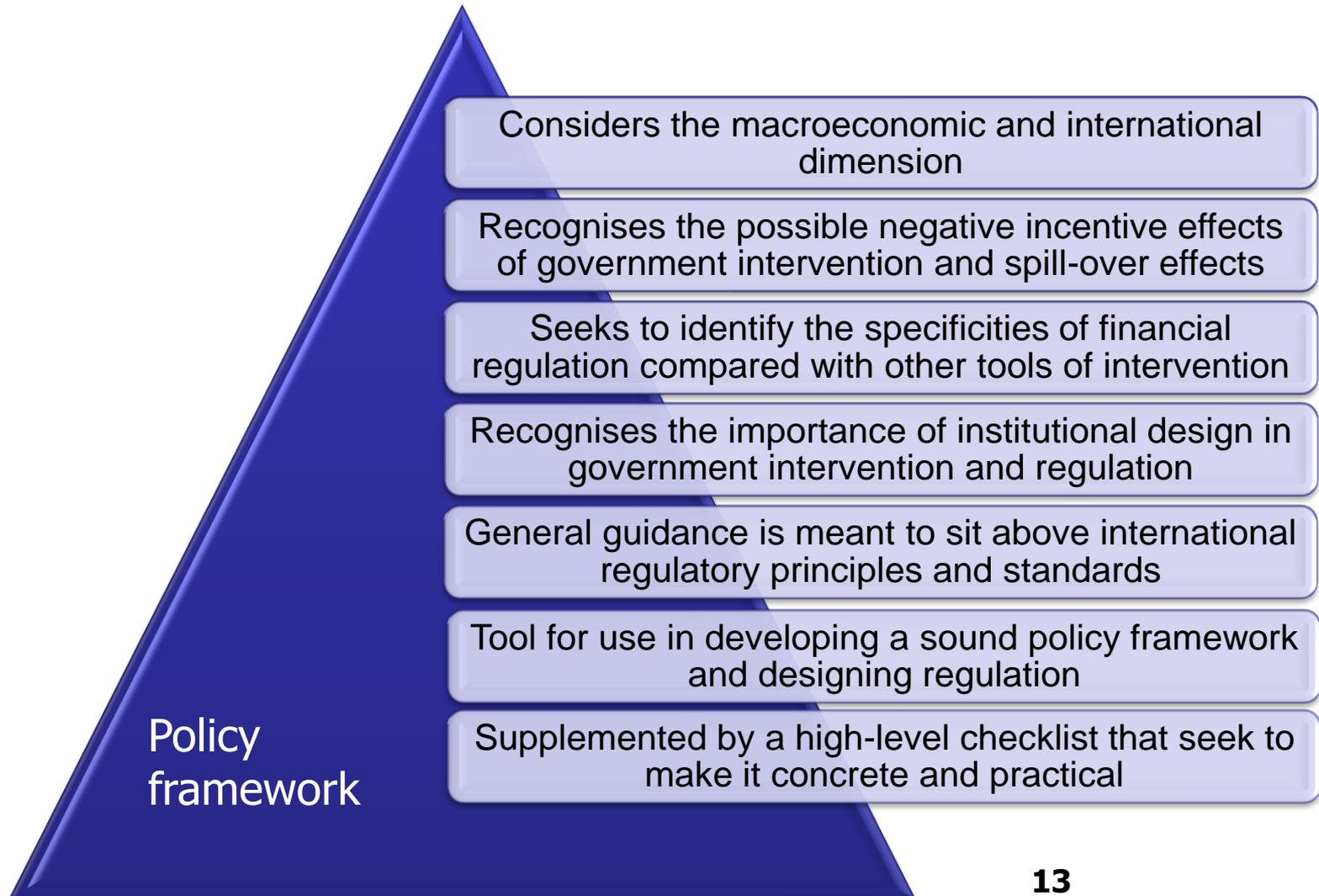
## System design and implementation

- Need for an appropriate institutional set-up for intervention and regulation

## Review

- Need for an established process of evaluation

# The Policy Framework



# The Committee on Financial Markets

## Participants:

- High-level staff from finance ministries & central banks of all member countries as well as the
- European Commission, including representatives of the European Central Bank (ECB)
- Representatives of international organisations: BIS, EIB, IMF, World Bank
- Singapore and Hong Kong, China (regular observers)
- Chile, Slovenia, Estonia, Israel, Russian Federation (accession)

**Working Party on  
*Financial Statistics***

**Co-operation with  
private sector:  
*OECD Financial  
Roundtable***

**Co-operation with  
other institutions  
and bodies: *e.g.*  
*FSF, IMF***

**Working Party on  
*Debt Management***

**Co-operation with other  
OECD Committees, e.g.  
*Insurance and Private  
Pensions Committee***



THANK YOU

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