



Regulatory Reform in the Financial Sector

APEC-OECD Co-Operative Initiative on Regulatory Reform

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Special Characteristics of Financial Institutions

- Allocate savings throughout the economy
- Widespread consequences for economic stability and monetary policy
- Repositories of national savings
- Agency relationships
- Highly regulated
- Frequently used to support government aims
- Vulnerable to “capture” by non-financial institutions
- Systemic risks

The Financial Sector before the 1980s

- Segmentation by product determined by national rules
 - Banking
 - Capital Markets
 - Insurance
- Geographic limits on operations
- Strict regulation of activities
 - Interest rate controls
 - Credit allocation guidelines
 - Limits on product innovation
- Divergences: bank centred and market-centred countries
- Limits on foreign establishment and discriminatory treatment of foreign institutions
- Controls on capital movements



Before 1980s: Multiple Regulatory Objectives

- Systemic stability
- Limit risk taking
- Support industrial and regional policies
- Support social policy, especially for housing
- Facilitate government finance
- Limit foreign influence
- Protect consumers
- Widespread government guarantees
- Risk of moral hazard
- Disparities of regulatory practice

The 1980 and 1990s: Deregulation, Liberalisation and Innovation

- Disintermediation: From banks to capital markets
- Disintermediation benefits:
 - Government
 - Corporate sector
 - Public
- Financial innovation
 - Derivatives
 - Off balance sheet activities
 - Securitisation
- Liberalisation of exchange controls
- Offshore financial markets “Euromarkets”
- Globalised trading and portfolio investment
- Single European financial market

Internationalisation and Competition Drive reform: Some Key events

- Authorisation of new instruments in France (certificates of deposit, commercial paper etc) in 1983
- United Kingdom Financial Services Bill (1986) followed by reform of continental European markets
- Liberalisation of foreign entry (Canada, Australia, Nordic countries)
- Gradual abolition of exchange controls in 1980s and early 1990s
- Single European financial market 1992
- Abolition of separation among banking, securities and insurance (US, Japan & Canada) in 1990s
- Laws to promote capital market development in Germany 1990s



Convergence among Financial Systems

- Converging institutional patterns
- Similarity of product
- Institutionalisation of wealth
- Competition among trading systems
- Increasingly larger institutions
- Mergers among different kinds of institutions (financial conglomerates)

New Stresses in the financial system

- 1982 LDC Debt Crisis
- 1987 Worldwide “market break”
- 1989 United States S&L Sector
- Early 1990s:
 - Systemic Bank Insolvency in Scandinavia
 - Banking problems in many countries (e.g. US, UK)
- Post 1990 banking crisis in Japan
- ERM crisis 1992 - 1993
- 1994-95 Mexico
- 1997 Asian Crisis
- 1998 Russia/Brazil
- Post 2000 “tech bubble” and bear market in equities



High Costs of Financial Crises

- Loss of real income declines in real wages
- “Lost decade” in 1980s in Latin America
- Huge costs of banking rehabilitation (>30 % of GDP in Korea)
- Loss of savings and wealth
- Insolvency of pension systems



New Supervisory Paradigm

- Fewer objectives of regulation
 - Minimise systemic instability
 - Avoid government bailouts
 - Fair and transparent markets
- Decentralised supervision
 - Increased responsibility of each institution
 - Reliance on markets
 - From regulation to supervision

A Modern Supervisory Regime

- Independence and institutional capability of supervisors
- Transparency in accounting and disclosure
- Reliance on international supervisory standards
 - ⇒ Basle Core Principles (Banking)
 - ⇒ IOSCO Principles (Investment and Securities)
 - ⇒ IAIS Principles (Insurance)
- Multi-tiered supervision
 - ⇒ In-house governance of each institution
 - ⇒ Industry standards/self-regulatory organisations
 - ⇒ Discipline by the market
 - ⇒ Official supervision
- Prompt corrective action
 - ⇒ Automatic progressive sanctions if specific indicators deteriorate

Governance Regime for Financial Intermediaries

- Board of Directors accountable for performance
- Names, monitors, remunerates and replaces management
- Responsible for designing adequate systems
 - ⇒ Risk management
 - ⇒ Compliance
- Three highest duties
 - ⇒ Adequate return (owners)
 - ⇒ Prudential soundness (supervisors)
 - ⇒ Fiduciary obligations (depositors, investors, pensioners, insured, etc.)

Differences in Governance Regimes

Corporate Governance

- Mainly the private relationship between shareholder and the company
- “Optional” recognition of stakeholder rights

Governance of Financial institutions

- Shareholders (as well as “optional” stakeholders)
- Other legitimate claimants
- Many institutions not organised in corporate form (Mutual, trust, contractual, etc.)
- Regulatory structure is an integral part of the governance process



Current trends and Issues

- Optimal institutional arrangements for financial Supervision
- Basel II
 - Toward better measurement of risk
 - More reliance on "in-house" risk management
- Self-regulation or official regulation?
- Gaps in Coverage and Consistency: The Role of the Financial Stability Forum



Market Integrity

- Pillars of Market Discipline
 - Accurate disclosure
 - Credit assessments by financial institutions
 - Credit rating agencies
 - Shareholder oversight
- Possible Shortcomings
 - Accounting and audit
 - Oversight by boards
 - Research: Conflicts of interests
 - Activities of institutional investors



Risk Transfer and Systemic Stability

- Reinsurance
- Credit derivatives
- Alternative Risk Transfer

Emerging Markets and the Global Financial System

- Emerging Markets are following a similar pattern to OECD countries
- Less advanced in liberalisation and modernisation
- History of industrial policy
- Ownership linkages between financial and non financial institutions
- Vulnerability to international capital movements
- Improving financial oversight: An urgent priority