Abstract: The Financial Policy Landscape: A Conceptual Overview

This article discusses different aspects of the formulation of financial policy against the backdrop of a changing financial services landscape. Recent trends and developments in the financial services industry, and some longer dated issues as well, present a number of challenges for regulators and supervisors. Some challenges can be linked to technological developments and related advances in financial engineering; some challenges are related to the increased internationalisation of some categories of financial services, what might be termed, for want of a better word, "globalisation"; some problems have their origin in demographic developments. Among OECD countries, one finds some conversion in the basic objectives of financial policy (*e.g.* systemic stability, consumer/investor protection, and conduct of business), but still fairly wide variation in regulatory regimes and regulatory practices, as the various member countries and official observers map the objectives of financial policy to their domestic regulatory and supervisory apparatus.

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The Financial Policy Landscape: A Conceptual Overview*

I. Background and overview

The financial services landscape, in its present stage of evolution, is one in which financial institutions of various types offer products and services (directly or through affiliates) that compete not only against those offered by similarly licensed institutions but also against those offered by other categories of domestic and foreign service providers. Moreover, technology has given rise to scale economies in trading and other infrastructure services, which in conjunction with the removal of legal and regulatory barriers to entry has lessened the importance of location for many types of operating services. This structure is not the type of landscape the regulatory framework in many countries was designed to cover. Indeed, many national supervisory frameworks were structured in view of some separation between the activities and products of banks, insurance companies and securities firms, along with domestic provision of infrastructure services. This approach has become increasingly more difficult. It has been argued, for example, that the application of different rules to products and services that are functionally equivalent is a source of inefficiency, as it imposes on institutions competitive inequalities that are not related to underlying risks. Such inequalities create incentives for regulatory arbitrage and might create confusion for clients and investors.

The financial services landscape is not static. Rather, there have been periodic bouts of innovation and heightened competition, which have usually been linked with alternating episodes of regulation, deregulation and re-regulation. The direction of the causality is not always clear, however. There is a complex interaction between regulation and the evolution of the financial services landscape. A common presumption is that regulation establishes framework conditions for the financial services industry and it is against a given regulatory backdrop that the

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financial sector landscape evolves. That is true. However, it is also true that financial innovation can result in products or activities that are not foreseen under a given regulatory framework, in which case it is regulation that has to respond. That fits the historical pattern reasonably well. Regulation in financial services is contextual. It is adapted to meet a changed set of circumstances.

The developments in the OECD area during the 1980s and 1990s are an example of the interplay between financial policy and the changes in the financial landscape. During that period, competition in financial services increased sharply as various measures to liberalise entry and ownership and facilitate international trade in financial services were introduced. Regulatory reforms had the effect of enlarging the set of tactical and strategic manoeuvres institutions could employ in response to competitive impulses, by relaxing or removing altogether various cross-sector and cross-border restrictions. At that time, technological developments and advances in financial engineering had already begun to stimulate a fading of barriers between different financial sectors and a lessening in the importance of geography for the provision of financial services. Hence, though regulatory reforms were a significant development, in some cases they merely re-aligned policy to suit the realities of a changing marketplace.

Partly as a consequence of the reforms, the nascent process of conglomeration in financial services intensified, which posed new challenges for regulatory and supervisory authorities, who in many cases were more accustomed to viewing a world of specialised providers. This development prompted authorities to reconsider anew the legal and regulatory framework in which financial institutions operate. Among the policy responses were changes in the institutional structure of supervision to address cross-sector concerns and the adoption of new regulatory objectives. Financial policy still endeavours to ensure that the financial services industry remains safe and sound, but also flexible, innovative and efficient.

These latter goals represent fairly recent additions to the mandates of most financial regulatory authorities. Before then, the guiding purpose of financial policy in most jurisdictions was maintaining stability and soundness of the financial system; first, by restricting market forces in order to shield the financial sector from the presumed disruptive forces of unrestrained competition and, second, by prudential regulation. Financial authorities in all OECD regions have been moving for some time towards less protectionism and direct interference with the market mechanism. Instead, more emphasis is being placed on finding the right balance between setting appropriate limits on the scope of institutions' activities to promote stability and fostering fair and efficient markets. This task is not easy.

With the eroding importance of international financial borders in many categories of financial services, it is now more widely accepted that efforts to insulate the domestic financial sector may in the long run only lead to its inefficiency. The

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challenge for policymakers is to design and implement regulations that not only ensure stability of the financial system as a whole, but also promote competition and efficiency in the system and avoid "fault lines" across regulatory regimes.[1] There are, of course, differing views as to how these objectives can best be achieved and the specific modalities with which policy changes have been implemented vary greatly across countries, mirroring their historical, cultural and institutional differences as well as differences in perceptions of the role financial intermediaries should play in the overall economic and social setting.

The present paper looks at the challenges for financial policymakers given recent trends and developments in the financial landscape. The growing complexity of financial products and of the financial services business, along with the rise in importance of conflicts-of-interest and conduct-of-business concerns raise a number of challenges for policymakers. They include in no certain order the following:

- The tendency toward very concentrated market structures comprising only a few service providers in operating services such as global custody.
- Where to draw the line between monopoly and the realisation of network externalities in trading platforms and other market infrastructures.
- The increased tendency for conflict of interests and conduct of business problems to arise in large, integrated service providers.
- Technological barriers to entry and other switching costs.
- Differences in prudential standards across sectors.
- Differences in the approach to risk management across sectors.
- Differences in reporting standards across sectors and across borders and between tax and prudential purposes.
- Increased complexity of products and risks.
- Greater dispersion of risk, but in some cases to more opaque participants.
- Governance problems and the lack of appropriate market discipline.
- How to optimise policy at the national level without compromising broader regional or international goals.
- Financially uneducated investors, and more.

On a more fundamental level, regulators must decide what their priorities should be when financial innovation and the emergence of markets for new products and services add to the complexity of the financial system in general and to the risk characteristics of financial institutions in particular. This task is particularly difficult at present given the rapid pace of change. 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

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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 under these circumstances or implementing choices that quickly become obsolete or counterproductive authorities must anticipate whether innovations introduced at any particular time will become permanent features of the financial landscape. As well, those regulations that are implemented must be subjected to periodic review to ensure they remain relevant to the task for which they were designed.

To begin, there are a number of prerequisites for the regulatory process to work as intended. They include, at a basic level, sound fiscal and macroeconomic policies and monetary controls to support a sustainable level of aggregate economic activity and to constrain major internal and external imbalances. Such an economic backdrop is needed to enable financial institutions to be profitable without taking on excessive risks to achieve the result. A well-developed infrastructure for financial services is also required, with reliable accounting, auditing, tax, and legal and judiciary systems, and various other measures attuned to the specificities of particular marketplaces. These instruments are the ingredients of an efficient system of financial policy. Put another way, they are inputs to the "production" of regulatory policy. As such, there are many alternative ways in which the inputs can be combined to produce a given regulatory outcome. In short, as inputs to the production of effective regulation, the regulatory pre-conditions mentioned above are neither "perfect substitutes" nor "perfect complements". It might be possible, for example, to trade off a little more market discipline for a little less supervisory oversight, but few regulators would opt for a wholesale substitution. To do so may be a recipe for disaster. By the same token, exclusive reliance on supervision may be too costly or simply infeasible. Instead, policymakers must seek the right balance among policy instruments. The fact that financial policy instruments are complementary implies that changing one measure alone could prove to be counterproductive, just as adding more salt without adjusting the other ingredients might spoil the broth, but for want of a good recipe that shows the exact ratios in which various instruments can be substituted one for another, what's a good policymaker to do?

Another challenge is the fact that it is difficult in practice to achieve a precise mapping between the objectives of financial policy deemed to be in the public interest and the regulatory apparatus used to achieve them. In the attempt to achieve even the most straightforward objectives of financial policy, policymakers must inevitably invoke secondary considerations to strike the right balance between different types of service providers and between the interests of the service providers and those of their customers, taking into account the different needs of sophisticated clients *versus* retail customers and non-professional inves-

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tors. As always, the devil is in the details and authorities have yet to produce the perfect regulatory cookbook with "recipes" that tell, for example, just how much prudential supervision is required to ensure a safe and sound financial system; how much competition between institutions can be used as a substitute for prudential supervision; how much intermingling of banking, insurance, securities and other financial services can be permitted without sacrificing other policy goals, and so on. Most attempts result in a multiplicity of rules, some of which overlap in their areas of coverage while at a more micro level others vary depending on the type of institution, the nature of the product or service, how it is distributed (*e.g.* publicly *versus* privately) and to whom. Some rules address broad, system-wide goals, while others are concerned with market-based goals or are narrower institution- or product-specific measures. Some rules are active; others are more passive. Some rules are prescriptive; others are principles-based. Among prescriptive rules, some are positive (*i.e.* do this), while others are negative (*i.e.* don't do that). Some rules are quantitative (*e.g.* capital adequacy requirements); others are qualitative (*e.g.* "fit and proper" tests for shareholders, directors and managers of financial institutions). For any given financial system, the full legal and regulatory apparatus consists of measures from each group in various combinations.

Another major consideration is that the regulatory process is ***path-dependent***. 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,[2] taking full account of the relevant country-specific factors, including the different initial conditions in the country on which the financial services industry is structured. Over-regulation stifles competition and renders the system inefficient and unprofitable or simply drives the business to jurisdictions perceived to be more favourable. Too lax regulation opens the door to moral hazard and conflicts of interest and invites disaster down the road. In all but the most static environment, the formulation of financial policy requires regulatory and supervisory authorities to make guesses about the evolution of the markets for financial services to avoid making incorrect choices when confronted by various policy trade-offs. Political and social structures and government, industry and societal relations are important as well, along with the relative size and structure of the country's financial services industry in the broader economic context, including the mix of regulated and non-regulated entities, the business practices of each group, and the behaviour of consumers and investors. Regulation both influences and must, in turn, be influenced by these various factors. How regulation is supposed to adapt to changes in the markets and institutions it covers is an open question. After all, the regulations (or rules) themselves are only part of a broad range of measures that underpin the proper functioning of financial systems.

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The paper proceeds as follows: the next section presents a framework for the analysis of financial policy, based on answers to three questions: Why do we regulate? What do we regulate? And finally how do we regulate? Section III looks more closely at the formulation of financial policy under changing conditions and provides brief concluding remarks.

II. Financial regulation: purposes and functions

All financial system architectures are a matrix of a few basic components: savers and investors, financial infrastructure, financial regulation and financial institutions, although the types of enterprises that are included in the financial institution sector and the role said intermediaries play in the overall economic context tend to vary according to domestic historical situations and differences. Financial instruments (products and services) and the markets they trade on complete the package we term the financial system.[3] The financial system provides an important means by which savings, public or private, are transformed into productive investments. In addition to the efficient allocation of credit and resources, financial systems also facilitate the exchange of payments (both domestic and international via currency exchanges); gather and provide information (especially on prices); and facilitate maturity transformation and the management of liquidity, market and other forms of risks.[4] How efficiently the financial system is able to perform these functions is a major contributor to stable economic growth.[5]

The financial intermediation process

Two main channels operate to facilitate these transactions: intermediaries and markets. The entities in the former category match suppliers and users of funds indirectly by transforming terms, maturities, etc. through the issuance of claims on themselves. They include commercial banks and other depository institutions, the traditional sources of intermediated finance, and investment banking organisations, the primary sources of securitised intermediation. Although financial institutions are themselves major conduits through which the financial assets of the ultimate savers are transformed and flow through to the liabilities of the ultimate users of funds, they generally make extensive use of financial markets to achieve their goals. Financial markets match suppliers and users of funds more or less directly, most often effected via purchases and sales of securities. These transactions may take place on a bilateral basis, as in the case of over-the-counter (OTC) fixed-income trades or off-exchange equity trades, but occur more often on more formalised platforms such as registered exchanges.

Modern financial systems tend to provide a mix of the two intermediation channels, giving borrowers a choice of depository credit or securities issues. Historically, though, different jurisdictions have been characterised by a pre-

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dominance of one channel *versus* the other. For example, among OECD countries financial systems in continental Europe have tended to be bank-based models, compared with the United States, where corporate bond and especially equity markets have been predominant. Various factors account for the differences across countries, including legal and regulatory preferences. In the case of the United States, for instance, the fairly strict institutional separation (largely on conflict-of-interest grounds) between commercial banking and a large number of securities-related activities embodied in the 1933 Glass-Steagall Act, along with restrictions on geographic expansion, stimulated competition between different classes of intermediaries and fostered an environment in which capital market financing was able to flourish. In continental Europe, by contrast, securities services have been regarded as an integral part of the conventional banking business for a much longer period, while public policy tended to stress safety and soundness and the avoidance of "excessive competition". This approach along with weaker statutory protections for minority investors tended to favour banks in the intermediation process.[6] Differences in the risk attitudes of borrowers and users of funds in both regions have also contributed.

The key of course is not which entities perform financial intermediation but rather that the financial system effectively matches suppliers and users of funds. Both bank-based and market-based approaches appear to have succeeded in this regard. There is little if any empirical evidence regarding financial system architecture, thus far, that shows any one type to be *unambiguously* superior to another.[7] The degree of capital market development and the level of banking sector development are both positively and significantly linked to per capita GDP growth.

In general, the growth and development of financial systems over time owes in part to successful product innovations (*e.g.* the creation and introduction into widespread use of new financial instruments) and process innovations (*e.g.* new risk management tools) that provide for a more efficient allocation of resources and thereby a higher level of capital productivity and economic growth. Necessary supporting factors include the appropriate financial infra-structure, such as trading platforms, financial research and its dissemination, credit rating services, information and payments processing systems, and custody services. Efficiency requires as well that participants have the *incentives* to make the correct economic choices and the relevant *information* on which these decisions can be based.[8] Legal and regulatory (and supervisory) arrangements can either assist or impede this progress.

Why do we regulate?

"A *watched pot may never boil, but if you never watch, it boils over*"

History has shown that markets for some types of financial products or services can develop and flourish for many years in the absence of formal regulation,

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relying instead on the basic legal infrastructure or on the regulatory framework in place in other components of the financial system. The hypothetical example in this regard is a market for a financial product or service that develops or is introduced outside of the formal regulatory framework, but in which many of the participating institutions are themselves regulated. In such a situation, the market in question can operate indirectly under the framework conditions provided by regulation of the participating intermediaries. Financial markets in a number of OECD countries have evolved precisely along these lines, operating for many years free of formal regulation.[9]

Citing these same developments, some analysts have joined market participants in questioning whether regulation *per se* is strictly required in all circumstances, for example, in truly competitive markets.[10] All administrative "solutions" entail specific *costs* as well as *benefits* and, thus, they would argue that a valid case for regulation can be made only in situations in which regulation is capable not only of achieving its express purposes but also can do so at "reasonable" cost. Oft-raised in this context are concerns about the compliance costs of regulation (*i.e.* costs of personnel and systems to provide information and fulfil other regulatory requirements) and its structural costs (*e.g.* the constraints placed on innovation). On the other side of the debate are those who contend that the case for regulatory intervention in financial services is not disputed. It helps protect against system breakdowns. When the costs of failures are factored in, adherents to this view contend that the cost-benefit ratio of regulation shifts far more clearly in favour of regulatory intervention. Proponents of financial services regulation might note as well that, even in cases in which markets have developed without regulatory support, public intervention when it has occurred has in many cases been in response to market crises of one sort or another.

The financial intermediation process is inherently risky and increasingly complex. One of the reasons intermediaries exist is to assume and manage various types of financial risks. Normally, but especially in competitive environments, while some bets will win out, others unfortunately will inevitably prove to be poor choices. Some will be disastrous. To prevent negative spill-overs in these circumstances, authorities supplement their formal rule making (regulation) and *ex post* corrective actions with ongoing monitoring (supervision). At a basic level, the goal of the traditional regulatory and supervisory process 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.

Objectives of financial policy

Concerns about safety and stability in the financial services industry are legitimate, given its periodic susceptibility to problems of insolvency, illiquidity, and

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fraud. Regulatory intervention in financial markets has, in fact, often been predicated on the grounds of the existence of market failures arising from externalities,[11] market power (including imprudent and fraudulent behaviour), and information problems.[12] These externalities, in turn, create a need for *protection against systemic risk, for proper market conduct, and for consumer/investor protection*, all of which regulation is intended to provide. E*x ante* monitoring may be especially important in situations in which the failure of one party to perform according to the terms of a contract can spill over to disinterested third parties. Indeed, an oft-cited rationale for government provision of a safety net for banks (*e.g.* lender-of-last-resort facilities and procedures for failure management, including deposit insurance) is to avoid the negative externalities of financial instability.

Most national regulatory frameworks embody these objectives in one form or another. Even so, regulatory arrangements have tended to be somewhat more complex than these basic objectives would seem to imply. For one, as noted above, the political process has not always been neutral with respect to distributional effects of economic outcomes and, thus, financial regulation has at times been used to achieve objectives that on closer scrutiny have been unrelated to prudential concerns or consumer protection, such as preserving a dominant position for domestic providers or supporting specific industrial or regional policies by channelling funds to particular sectors (*e.g.* housing or so-called high-technology industries). Moreover, the goals of regulation have changed over time and across countries, by and large reflecting country-specific factors.[13] Even when the core objectives have been the same, authorities have not always assigned the same relative weights to them, thereby resulting in markedly different regulatory choices.

Interaction between regulation and the evolution of financial services

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. Indeed, the fact that changes in financial regulation have often been implemented in response to particular financial failures has resulted in a patchwork structure inside national jurisdictions and because the incidence and severity of failures have varied across countries, so, too, have the regulatory responses. Nonetheless, there have been some common trends.

Financial services providers operate today in many OECD countries and elsewhere under conditions of relatively open price, product, and geographic competition, and they generally have access to most of the many compartments of the vast market for financial services at home and abroad. This degree of openness

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has not, however, always been obtained. A few decades back, the provision of financial products and services was characterised by a much greater degree of segmentation than in today's environment, along with much tighter limits on foreign establishment and discriminatory treatment of foreign institutions. Prior to the start of widespread regulatory reform in the 1980s, regulation in the financial services industry, especially as applied to banking organisations, tended in many countries to focus almost entirely on safety (*e.g.* prevention of failures and protection of retail customers), with much less attention paid to competition and efficiency. Regulatory authorities directly monitored and controlled a wide range of financial activities using a host of structural controls, owing in part to concerns that "excessive competition" was at odds with stability and also raised consumer protection issues. Official rules in some jurisdictions sought as well 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.

Against that regulatory backdrop, a close correspondence (one-to-one for some products) developed between each institutional type of service provider and the range of products it offered. The strict limitation on assets and lines of business achieved its main purpose of limiting institutions' scope for taking on risks associated with entry into non-core lines of business. A side-effect was that the same provisions left many institutions at a competitive disadvantage relative to non-regulated institutions and with limited financial resilience as a consequence of regulatory-induced distortions in the allocation and pricing of credit.

The perceived burdens were sufficient in some cases to drive business offshore, while other institutions developed innovative ways to bypass regulatory barriers. The incentives to innovate or contract around regulatory hurdles are especially pronounced when legal or tax rules make what in the view of market participants are artificial distinctions between institutions offering otherwise similar products or performing functionally equivalent services. Strict controls can perhaps work well if they are at once all encompassing and universally applied and barriers to entry are impenetrable. These conditions were not all satisfied in the case of financial services and as a consequence some business moved off-shore, while non-regulated entities made inroads to the provision of some financial products and services. It is often the activities of the market that force regulatory policymakers to respond, and the developments in the financial services landscape in the 1980s led to the reforms of the late-1980s and 1990s, which were motivated at least in part by a need to re-align policies with market realities and to level the playing field between the regulated and non-regulated sectors.

The reforms themselves were fairly broad based and included an easing in or outright elimination of interest-rate controls and other price controls, quantitative

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investment restrictions (*e.g.* compulsory holdings of government securities), credit allocation rules or guidelines, which had been applied particularly to banks, and controls on the total volume of credit expansion. Line-of-business regulations and regulations on ownership linkages among financial institutions also were relaxed, as were restrictions on entry by foreign financial institutions. Many of the rule changes have taken the form of an easing in "downstream" restrictions on the range of products and permissible activities of various types of institutions. As these regulatory barriers between different segments of financial services began to be relaxed or removed over the past two decades or so, the close correspondence between institutions and products began to give way. In the process, access to various market segments has been opened to new participants, explicit obstacles to competitive forces have been dismantled or lessened and administrative interference has been reduced in some areas. The effect is to allow complementary or competing products to be created by cross-sector participants or new entrants.

In sum, for most jurisdictions, the number of explicit objectives of financial regulatory policy has declined over time. Moreover, the fact that the evolution of financial systems shares some common trends across countries, which include an increase in market concentration, a move toward universality of institutions, and the commoditisation of certain products and services, has promoted some convergence in the broad goals of public policy in financial services. Some differences remain, but most authorities are now more inclined to accept the view that regulatory intervention should be maintained or implemented where it is needed to address identifiable market failures, can succeed in correcting the problem without making matters worse, and can do so efficiently. Two such failures continue to exist in the new financial services arena – systemic risk and the market power imbalance and information asymmetry associated with monitoring the behaviour of financial institutions.

What do we regulate?

Sufficient evidence has yet to be accumulated to permit a precise correspondence between policy goals and regulatory and supervisory actions. As a consequence, a variety of regulations have typically been used to meet each objective. In fact, many have been used. Regulatory reforms notwithstanding, the short answer to what regulations in financial services cover is just about everything. Regulations cover the transactions (payments, clearing and settlement, and custody) and information (market data, financial research and portfolio diagnostics) infrastructures; the various financial activities and services (matching savers and investors, maturity transformation, auditing, hedging, risk management, trading, lending, underwriting, origination, distribution, investment banking, etc.); and the various types of financial firms that provide the services or products indicated and

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their interface with clients, customers, policyholders, employees, owners, creditors, and so forth. In short, financial regulations cover structural, prudential, organisational and protective issues and govern which financial institutions may operate in the domestic market, what they are permitted to do, who is allowed to own or manage them, and what basic requirements they have to satisfy.

The different objectives of public policy in financial services are served by many different types of regulation. Investor protection, for instance, is served in part by regulations that have a product focus and are aimed at appropriate levels of disclosure and standards of proper business conduct with respect to particular activities or markets. Examples include prospectus requirements and insider trading laws. Among other objectives, at the core of most efforts to protect customers are rules on disclosure and fair business practices, but also included is some form of prudential oversight. Consumer/investor protection is also served by measures designed to ensure that financial markets are efficient and competitive. These measures may take the form of conduct of business rules, which focus directly on the behaviour of service providers *vis-à-vis* their clients, or prudential rules, which work to ensure that institutions are safe and sound. From the perspective of macroeconomic policy, the systemic stability objective is of key interest. Systemic stability is also a main objective of prudential regulation. As such, it gives rise to rules that focus on institutions rather than products, which is logical considering that a major concern with systemic risk is that the failure of an individual institution will threaten the stability of the financial system as a whole, and it is institutions and not products that become insolvent. Opinions vary, however, as to which institutions are systemically important. In the past, systemic risk was seen by many authorities as primarily a banking sector problem, arising from banks' payments system exposures, depositor runs, or more general problems of banks' balance sheets. The evolving view of systemic risk is that it is associated as well with banks' involvement in securities and derivatives markets and encompasses a wider variety of institutions.

Even if authorities settle on systemic stability, conduct of business, and efficiency as enduring objectives of financial policy, there is no one-to-one correspondence between the objectives 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. Given this imprecision, policymakers cannot be sure *ex ante* that any particular rule, method, or structure will long suffice. Regulating is 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. Thus, while it is simple to suggest that regulations cover all value chains in financial services, from the customer interface on up, that statement alone tells little about *how* we regulate. Among the issues that are relevant to such a discussion are the regulatory powers of the agency or authority, regulatory and supervisory structures, and regulatory practices.

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How do we regulate?

"The trick to juggling is determining which balls are made of rubber and which ones are made of glass"

The first step in devising a system of regulation is the determination of a set of policy objectives that are deemed to be in the public interest. Next comes implementation, a main goal of which is to devise a framework for achieving the policy objectives without imposing unnecessary burdens or giving rise to market distortions. Success in the final analysis will depend in part on proper enforcement mechanisms to ensure compliance with the regulatory standards that are adopted and on a means of sanctioning non-compliance when preventative measures prove insufficient. The successful implementation of financial policies requires a well-developed infrastructure. This infrastructure includes a supportive legal and institutional framework. Necessary conditions underpinning regulation in financial services generally include laws on contracts, property, and rights to collateral, a well-functioning judicial system, with efficient foreclosure and bankruptcy procedures. Different sectors of financial services have their particular requirements, but there are many common elements. In the case of financial markets as distinct from institutions, necessary conditions include a well-functioning tax and accounting framework in addition to an effective legal framework. Efficient financial markets, in turn, help underpin effective oversight of insurance concerns. According to the IAIS Core Principles, other preconditions for effective oversight include an effective, well-developed financial market infrastructure for financial markets and an effective policy, institutional, legal and policy framework for financial sector supervision. In the private pensions area, the OECD's Core Principles for Occupational Pension Fund Regulation also cite the need for well-functioning capital markets and financial institutions. For commercial banks, the infrastructure for effective regulation according to the Basel Core Principles includes: 1) sound and sustainable macroeconomic policies; 2) a well-developed public infrastructure, including reliable accounting, auditing, and legal and judiciary systems; 3) effective market discipline; 4) procedures for efficient resolution of problem institutions; and 5) proper mechanisms for providing an appropriate level of systemic protection.

Regulatory underpinnings

Regardless of the channel of intermediation – through markets, for example, or through the intermediaries operating in them – all financial transactions depend crucially on the enforceability of contracts, preferably at low cost and with minimum delay. This enforceability derives from the legal system, its institutions, procedures and rules. The legal system governs the linkages between market infrastructures, service providers, their products and activities, and their clients

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Box 1. The legal tradition

Broadly speaking, there are two state-based legal traditions in the OECD area – the civil law variants (codified and uncodified) in continental Europe and elsewhere, which have their origin in Roman law, and the common law tradition, which evolved initially in England and spread subsequently to many of its colonies. There are fundamental differences between the two legal traditions, rooted in their historical development. In general, civil law relies primarily on *doctrine*; that is, it relies on a specific set of legal rules and principles, while the common law tradition gives greater priority to *jurisprudence* in which legal principles are supplemented by a body of precedent setting case law derived from rulings by independent judges and juries. Coming on the heels of an era in which judgeships had been doled out as favours from the crown, the role of the judiciary in civil law was expressly limited to enforcing the law as written. The converse is true in the common law tradition, in which the judiciary evolved as a constraint on the ability of the crown (or State) to abrogate private contracts and property rights.

The legislature functions as the primary law making body under both civil law and common systems. Courts intrinsically function as *ex post* law makers under common law, while this function is largely proscribed for the judiciary under civil law, where law making as noted is the province of the legislators, often working in close cooperation with the executive branch of government. The judiciary functions as *ex post* enforcers of the law under both systems.

A growing literature has begun to examine the role the legal system plays in the development and operation of the financial system.[16] In particular, researchers have sought to determine whether differences in legal systems of the sort just described can explain differences in the extent of financial sector development across countries. Starting from the casual observation that civil law countries tend to be largely bank based financial systems, while financial systems in common law countries are more often market based, research has sought to identify the causal or contributory factors. Some authors have taken a broad approach and have focused on the ability of a given legal system to evolve rapidly in support of changing conditions and market innovations.[17] The underlying hypothesis is that systems that rely more on jurisprudence will be able to adapt more rapidly and, thus, will contribute to the growth and development of financial markets more so than systems that require actions by legislatures. Numerous studies support the proposition, but this view is by no means unanimous. There are many slippages that make the civil law *versus* common law divide less compelling than might otherwise seem apparent. For instance, civil law in some jurisdictions relies in part on formal jurisprudence. There are key differences as well among common law countries and civil law and common law are formally mixed in some jurisdictions (*e.g.* Scotland, Quebec in Canada and the US state of Louisiana, the French connection in the latter two jurisdictions noted). The legal tradition in each country interacts with its historical, cultural, and institutional traditions and philosophies. As these factors tend to vary, at least somewhat, from one country to the next, countries with the same historical legal tradition will tend to develop legal rules and procedures with their own distinct "national' characteristics.

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and customers.[14] The legal system influences or establishes outright who can own or manage a service provider, what information the institution must provide to its clients and shareholders, and so on. Of particular interest are company law, contract and property law, securities law, laws governing consumer and investor protection, and for when things go wrong, insolvency or bankruptcy law.[15] These bodies of law establish the basic framework within which financial institutions and markets work. They are necessary components in the development of a sound financial regulatory system. Thus, it is generally not possible to compensate for inherent weaknesses in any one component by making the other components more stringent. Imagine a chain with five fortified links, plus one weak one.

- Company law

Business organisations can take a number of different legal forms, ranging from small sole-proprietorships to partnerships to large corporate entities. It is company law that gives business organisations (financial and non-financial alike) legal personality. It regulates and facilitates the operation of business firms. Company law governs whether a particular business organisation is able to enter into contractual arrangements on its own behalf and to assume other legal rights and obligations.[18]

Of particular importance in the financial sector context is the fact that company law governs relationships along all the various axes associated with the business: shareholder-creditor, director-shareholder, shareholder-employee, and so on. Attention in this regard focuses on the corporate form whose *raison d'être* is laid out in its articles of incorporation, pursuant to the laws of the jurisdiction in which it is established. It establishes the structure of a corporation, including the rules that partition the assets belonging to the corporate entity itself from those belonging to persons affiliated with the company. The laws governing establishment of a company also typically act to prevent opportunism within the voluntary relationships between affiliated participants in the company by mandating its adherence to certain internal governance requirements, via rules on the rights and obligations of company officials, boards of directors, etc., the so-called *lex societas*. Participants are usually defined to include the company's shareholders and directors, but most include creditors to some extent and some jurisdictions – Germany, for example – also include employees.

- Contract and property law

Contracts are fundamental to finance, in all its many guises including lending, deposit taking, corporate and investment banking, trading, clearing and settling, and dealings between financial intermediaries and other entities. Contract law ensures that the rights and obligations of all the parties entering into the various

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contractual arrangements listed above are clear and enforceable. The function of contract law, however, is not to force parties to adhere to the terms of a contract. Rather, it provides a framework within which counterparties choose either to perform as required under the terms of the contract or choose instead to provide the necessary compensation for any "injuries" caused by their non-performance. Also, by providing a common set of standards, contract law helps to reduce the complexity and cost of transacting.

It is arguably the case that the framework in support of private contracts may need to be more elaborate in the case of market-based finance, given the array of financial infrastructure services that need to be provided – market information, financial research and its dissemination, credit-rating services, trading platforms, payments mechanisms, and clearing and settlement and custody services. Private parties can attempt to build all the necessary elements into their agreements, but at a cost of producing overly complex, unwieldy contracts that would be difficult to enforce and would most likely fail to foresee all relevant events anyway. The difficulty and cost of drafting contracts that cover every possible future outcome results in written agreements that are necessarily incomplete. Consequently most financial contractual agreements need to be supplemented by various other understandings and arrangements. That additional support is provided in part by securities laws and insolvency law.

- Securities law

Securities law establishes the legal framework within which financial instruments may be issued to the public and also governs the mechanisms by which securities on public offer may be traded, called, put or retired. Measures to ensure market integrity also fall under the securities law heading. The various elements of securities law are generally aimed at protecting investors, with exceptions typically made for institutions and other "sophisticated" investors. Many laws under this heading are based on the benefits of disclosure and feature the financial reporting and auditing framework, although prudential rules and laws governing fair business conduct also serve the interests of consumers and investors.

Governance and control

Business concerns in general, but especially large companies, are important entities in the communities in which they reside. Their actions as buyers and sellers in product and resource markets (both human and non-human) affect and are affected by persons internal to the company as well as persons not directly affiliated with the organisations themselves. They include the managers and the employees, the banks and other creditors who hold the company's debt obligations, and the investors who own the company's equity. Government has a stake

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as well, which reflects but is not limited to its right to tax the company's profits, as does the broader community. All these claimants on the company's value are linked through a complex web of formal contracts and side agreements. There is clearly a need for some mechanism to align the interests of these various parties, all of whom may have differing views regarding the viability of a given project, value of an asset, etc.

The most common reference in this context is to the potential mis-alignment between principals such as shareholders, creditors, and sometimes employees and other stakeholders, and an agent, who may be the chief executive officer of a company or its board of directors. At issue is the nature of the contract between the principals and the agent, in particular, whether it allows for efficient mechanisms that minimise the transactions costs involved in ensuring that the agent acts in the interests of the principals, including the costs of monitoring the agent's behaviour. The nature of the contract, the particular governance arrangement, depends not only on private arrangements but also on the legal and regulatory environment more generally and on existing institutions and corporate structures.

Effective markets in corporate control and other protections for outside minority shareholders are prerequisites for dispersed ownership of shares. Absent some means of protection, outside investors would be vulnerable to expropriation, be it from excessive compensation, transfer pricing, and asset diversion to related companies controlled by insiders, as well as to simple fraud or theft. Small investors may be particularly vulnerable to the principal-agent problems that can arise with the separation of ownership from control. Accordingly, where effective legal or regulatory protection for minority shareholders is lacking, one would not expect to find active stock markets. Rather, as empirical evidence shows, such systems tend to be characterised by relatively thin stock markets, with effective control of companies by families, financial institutions, or in some cases, by the state. That said, even when protections of minority shareholders are legally enshrined, small investors generally lack the resources and influence needed to monitor managers and encourage them to act in the best interests of the shareholders. Managerial capitalism work best when this monitoring function is performed with due diligence. Monitoring is expensive, however, and difficult to do and the returns from any improvement in performance brought about private monitoring efforts accrue to all shareholders. Given this "free-rider" problem, effective governance has typically required the presence of large investors or stakeholders, be they institutional investors, banks, or other companies that are independent of management and have the wherewithal and leverage to oblige managers to refrain from activities that are not in the best interests of the principals.

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Box 2. Corporate governance mechanisms in selected OECD countries

In the academic literature, the principal-agent problem is often linked to the separation of ownership from control in many large corporations. Many basic theoretical results in modern finance are most directly applicable to publicly owned companies whose shares are traded in efficient markets. Absent some effective governance mechanisms, it is unlikely that ownership could be dispersed across large numbers of minority shareholders. Hence, there is an emphasis on mechanisms to encourage managers to seek to maximise shareholder value. In practice, however, ownership and control are not always separated. The large, publicly held firm with diverse ownership is the dominant corporate form in Anglo-Saxon countries, but in other economically advanced (and developing) countries of continental Europe and Asia, ownership is not diffuse. Rather, it is concentrated among identifiable groups of "insiders" consisting of some combination of family interests, allied industrial concerns, banks and holding companies, which typically are supportive of the existing management. There may also be large cross shareholdings among the members of the group. Even in Anglo-Saxon countries, a large block of shares may provide effective control, although there would not strictly be a majority owner.

Across OECD countries, various market and organisational mechanisms have been devised to control the *potential* conflicts of interests between owners and managers. These mechanisms have evolved in several ways. In the so called "outside" models found largely in Anglo-Saxon countries, where emphasis is on the liquidity of shareholdings and adequate public disclosure of financial information, the protections of shareholders' interests comes from measures such as compensation-based incentives for managers, from supervision by the (sufficiently independent) board of directors, and by the threat of takeover of poorly performing companies via tender offers, proxy fights, and voluntary acquisition by which large investors gain control of the board and oust the present management. The governance arrangements are obviously different in systems where ownership interests are more concentrated.[19] Such block holding systems are widespread in both OECD and non-OECD countries. In Germany, for example, ownership of shares in large companies is often concentrated in large blocks and there may be several layers of owners. Block holders are often companies engaged in cross shareholdings, but share blocks may be held by holding companies on behalf of wealthy private investors. Universal banks may hold shares on their own behalf and typically hold proxies to vote shares held on behalf of individuals and institutions.

A particular feature of governance arrangements for large companies in Germany is the existence of two boards of directors – the supervisory board (*Aufischtsrat*) and the management board (*Vorstand*). Half of the members of the supervisory board are elected by the employees, defined to include managers, staff and labour unions. The supervisory board oversees the company's long term strategy and also elects the management board. The management board has responsibility for overseeing the day-to-day operations of the company. Given this two-tier governance structure, gaining control of a majority of the shares would not guarantee functional control of the company, as even full ownership could only guarantee control of half of the supervisory board.

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Box 2. **Corporate governance mechanisms in selected OECD countries** (*cont.*)

The corporate governance system in Japan also features cross shareholdings among groups of affiliated companies. The most notable arrangement in this regard is the keiretsu, a network of affiliated companies typically organised around a large bank or other major financial institution. There are cross shareholdings between the bank and the keiretsu member companies and also between the member companies themselves. As well, most debt financing is also provided intra group, either coming from the bank or from other companies in the group. Not surprisingly, these arrangements make gaining effective control of member companies by outsiders difficult, if not impossible, and serve to entrench existing management and its closely allied interests.

These needs notwithstanding, the evidence suggests that the majority of shareholders, including institutions, are not active monitors. In some cases, the legal environment itself inhibits monitoring activities by institutions. For example, regulations in some jurisdictions expressly prohibit certain categories of institutions from acquiring direct control or a dominant influence over the management in which they hold shares. A practical example in OECD countries is the collective investment scheme (CIS) or mutual fund sector, which generally has not been allowed to have a significant participation in the companies in which the entities invest. Other regulatory impediments are associated with voting rights. These measures can include rules against proxy voting and the requirement that shareholders must be physically present at the general meeting to vote. There may be other explicit measures to prevent large investors from "overriding" the interests of minority shareholders. In that sense, measures of the sort can serve to inhibit activism on the part of institutions to the detriment of all shareholders, which may help to insulate management and other insiders from monitoring pressure by those outside investors with the means and incentives to do so. Then again, monitoring by large institutional shareholders is sometimes impeded by their own governance problems. For example, recent corporate defaults have exposed conflicts of interest and other governance problems of financial institutions, in particular, large integrated institutions that operate in multiple sectors. With institutions operating on both the savings and investment sides of the intermediation process, the potential for conflicts is clearly present. Thus, 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.

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Financial reporting and disclosure

Good or bad, monitoring requires information and rules on disclosure exist to ensure that investors have access to the information they need. Among the conditions under which markets may be inefficient or fail are when marked differences exist in information endowments and when new information is poorly distributed. A key purpose of disclosure requirements is to correct market failures caused by incomplete or asymmetric information to ensure that investors receive the information they would require under reasonable circumstances to make informed investment decisions. Shareholders are residual claimants on the value of a company, entitled to what is left over after all other claims have been settled. Being last served entails risk. There is the normal business risk that the firm's strategy or asset mix will fail to generate an adequate return, as well as the more unusual risk of fraud or other undesirable behaviour on the part of management and other company officials. To facilitate monitoring by outside investors and to promote market discipline, disclosure rules require a display of earnings and capital, depending on the type of company involved and the jurisdiction. For instance, separate reporting rules are often applied to banking institutions. Accounting standards and a high-quality audit profession are called upon to ensure the quality of regulatory reports and public disclosures.

The same framework also helps to preserve public confidence in the integrity of financial institutions and markets, through measures such as internal audits, external audits, corporate governance, disclosure and transparency, and limits on connected lending/related party transactions. A sound and efficient financial system relies heavily on the various elements that contribute to a robust financial reporting and auditing framework. To wit, accounting standards have been included among the 12 standards identified by the Financial Stability Forum as conducive to a robust financial infrastructure. Note, however, that most rules in this area do not completely eliminate the potential for conflicts of interest to arise, but rather act to ensure that procedures are in place to properly manage them and that customers/investors are aware of their potential existence. Customer due diligence is also important.

- Insolvency law

The protection of creditor rights is also an important component of the legal framework underpinning financial services. In the case of institutional debtors, banks and other creditors typically employ restrictive covenants to protect their interests during the course of a lending agreement,[20] but sometimes things go wrong. When they do, the interests of creditors will be in conflict with those of the shareholders. Just as there are trade-offs among stakeholders in a going concern, there is a need to address the rights and conflicts of interests of among clients,

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creditors, and shareholders in the process of a failed company's winding up and exit from the market. Orderly, equitable, and transparent exit procedures are as important to the efficient functioning of markets as are minimal entry barriers. Relatively low costs for entry and exit are necessary for an efficient allocation of resources, often from older, less productive firms to newer, more innovative entities. Insolvency law (and bankruptcy law in the case of individuals) is extremely important in such distress situations, enabling financial institutions and other creditors to seek orderly restitution of the affairs of a bankrupt concern. Insolvency laws also establish a framework under which an insolvent or near-insolvent entity can be resolved. Specific options can include outright liquidation or placing the entity under the control of a receiver, conservator, or statutory administrator. Special procedures may apply in the case of banks and other financial institutions in distress. In all cases, there is a need for a clear statement of the rights of secured lenders in the distribution of proceeds from asset sales or related transactions.

The attainment of efficient outcomes depends not only on the absence of barriers to entry, but also on the freedom or need to exit. The failure of individual projects and, at times, of entire firms is a necessary aspect of a competitive economy. Economic growth requires that economic resources are reallocated from activities that are no longer profitable to more productive uses. This reallocation can be internal to a given organisation or may involve multiple entities whereby one firm disinvests while another one invests in new projects.

If firms needing to exit unprofitable lines of business fail to withdraw in time, or if otherwise profitable firms experience large, unexpected shocks, they may become insolvent in the sense that resources on hand are insufficient to satisfy all stakeholders' claims in full. There can be varying degrees of distress and different stakeholders may form different opinions regarding the distressed entity's prospects. Under a relatively mild form of distress, the firm may face a binding liquidity constraint. The present value of the cash flows from its assets exceeds the level of its debt, but for one reason or another, it has insufficient liquid resources to meet all due payments. A somewhat more serious form of distress exists when the firm's assets still generate positive cash flows, but the present value of the cash flows does not cover the value of the firm's debts. Technically, the firm is insolvent, but from a social point of view the assets themselves are still capable of generating positive cash flows. In the most severe form of distress, the net present value of the firm's assets is negative.

Regulation and supervision

Public policy toward finance is reflected or codified in the various laws, rules, and regulations promulgated by governments or regulators. Laws create incentives for proper conduct. Laws are, however, by their very nature incomplete,

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given their need to be universally applicable and to treat as "equals" all entities that are similarly situated relevant to a given issue. To be all-inconclusive requires a measure of generality. The alternative is to draft narrower, more precise rules, but the increased precision often comes at a cost of increased loopholes. The legislative process also is not free from pressures from vested interests, which may yield less than optimal results and thereby create incentives for some parties to contract around the rules. Given that legislative production of rules is expensive, there are advantages to making rules overly inconclusive as opposed to overly detailed to cover a broader swath of legal territory. The end result is that laws, as drafted, will rarely be so complete that they envisage and provide directly for every single contingency, transaction, contract clause violation, request for granting or revoking a licence, question of fairness, etc. Where law is incomplete, as it generally must be, there is a need for some source of residual or *ex post* rule making and contract enforcement.

- Regulatory powers

Evidence suggests that legislative bodies themselves may not be efficient *ex post* law makers. The typical legislative process is costly and generally does not lend itself to making speedy decisions. Legislative bodies are also not particularly good enforcers. Laws are the natural product of legislative bodies, but laws are best at creating incentives for desired outcomes, not at compelling them. It is costly to control behaviour in this fashion. Nor is it practical for legislative bodies to directly monitor and oversee all institutions, markets and industries. Rather than attempt to do so, legislative bodies in most jurisdictions pass statutes that delegate such authority to various administrative agencies, which we can term regulators. The "enabling" legislation typically outlines broad priorities and sets general guidelines governing financial institution or market conduct, but the responsibility for fleshing out the details devolves to the regulators, which in some cases are also given broad enforcement powers. A full complement of powers would consist of formal rulemaking authority, along with various supervisory powers such as authorisation/licensing, power to inspect and request information, authority to give directions or suspend operations – and, when required, appoint an administrator, conservator, or liquidator – and conduct "fit and proper" tests, and the power to remove directors, other officials, and third-parties such as auditors. Where that is the case, regulators can typically 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.[21]

Rule-making authority (and in some cases enforcement powers) over certain practices may be further delegated to private sector bodies (such as auditors, actuaries, and self-regulatory organisations or SROs), which are given responsibili-

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Box 3. Insolvency procedures

Various procedures exist for addressing problems with insolvent firms or firms experiencing other forms of financial distress. They vary in severity depending upon differences in assessments of the firms' prospects across various stakeholders and external financial market participants. For example, to address a temporary problem of illiquidity, an infusion of liquidity or rescheduling of debt may be all that is required. Debt reduction and restructuring may also be used to address cases of insolvency when the firm's assets still produce positive cash flows, although under these circumstances more fundamental restructuring measures may be employed as well, such as a change of ownership or control. For firms with obligations to banks, procedures for debt recovery are typically written into loan contract terms and may include the takeover or sale of assets that have been pledged as collateral for the loan. Insolvency procedures evolve into a formal bankruptcy process when legal proceedings are instituted to force the liquidation of an insolvent firm's assets to satisfy the claims of various creditors and other stakeholders, either in whole or in part according to the priority established under the terms of agreed contracts or under law. The involvement of all parties means that the various laws governing contractual relations among shareholders, customers, employees and suppliers of the insolvent firm interact with insolvency procedures. The state is also typically involved. To that end, a lack of certainty regarding the priority of claims can create incentives for a race to the exit at the merest hint that a firm is in trouble.

The nature of these interactions affects the ability of insolvency procedures to resolve a distress situation in the first place, not to mention the efficiency of the process measured in terms of the cost and time involved. Various factors can undermine the efficiency of the process. They include a weak legal infrastructure, governance problems in the financial system, especially problems involving banking organisations, and the existence of strong vested interests that prompt political intervention in the process. Such intervention can serve to keep loss-making firms alive too long and, thereby, hamper the shift of resources to presumably more profitable new ventures.[22] Excessively costly, drawn out and, possibly, corrupt proceedings create strong disincentives for banks and other creditors to put a firm into bankruptcy, which allows the firms to continue to accumulate losses often until problems reach crisis proportions.

In a sense, it is easier to identify inefficient aspects of the infrastructure for resolving insolvent firms than it is to identify optimal arrangements. It may well be that different legal traditions and cultural factors across countries, along with different financial systems, can result in quite different "efficient" insolvency procedures. In bank-dominated economies, for example, banks naturally are best positioned to determine the treatment of insolvent firms. Many tend to be closely involved with management. Consequently, insolvency procedures when implemented tend most often to take the form of informal workout negotiations. In the United States, by contrast, where banks can be held legally liable for giving "bad advice", banks are far less inclined to become involved in corporate decisions.[23]

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Box 3. **Insolvency procedures** (*cont.*)

The existence of a more developed market for corporate debt in the United States has resulted in a more complex financial structure for the typical US-based firm, characterised by a more diverse set of creditor groups with interests that generally do not coincide. The conflict of interest among creditors makes informal workout negotiations more difficult to agree. What matters is not so much the degree of debtor or creditor orientation of different insolvency procedures per se, but rather that concerned parties know with reasonable certainty what insolvency procedures will apply in the event of distress. Moreover, the predictability of the applicable procedures must be assured up front, at the time the various creditors and other stakeholders are contemplating entering into contracts with the firm in question.

ties relevant to their particular areas of competence under legal and operational arrangements that vary across countries. In addition, industry trade associations may also perform an important role in the regulation of some markets, although their decisions typically function as recommendations on best practice and may not be strictly legally enforceable. There are numerous exceptions, however. SROs have in many instances had formal regulatory authority granted them by national or sub-national governments. Most of these entities have operated primarily in the securities markets. The prime examples are stock exchanges, which historically have performed several regulatory functions, such as establishing listing requirements, requiring the dissemination of information, and monitoring trading practices to protect against insider trading and market manipulation.

- Regulatory regime

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. In fact, 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. 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. In most OECD countries, the enabling legislation was drafted in an era in which financial institutions were more specialised in narrow business areas. Accordingly, regulatory authorities were given a strong institutional focus at inception that reflected the perceived specificities of the different kinds of institutions. Thus, specialist regulators were given responsibility for certain types of

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financial institutions and were given mandates tailored to the traditional business mix of the particular type of financial institution. Financial supervision followed suit.

Historically, banking sector regulation in many countries developed or was subsequently modified in response to crises arising from runs by depositors who had lost confidence in their bank's ability to pay out deposit funds upon request. This scenario is the classic problem in the commercial banking business, which relies heavily on low-cost deposit funds as a major source of funding. In turn, those funds are re-invested in the mediation of various credit, market and duration risks, backed only partly by reserves. Under most circumstances, the system works well, but in times of stress and absent an external source of liquidity support, fears on the part of depositors can lead to runs that could precipitate an institution's collapse. The greater concern is that the collapse of one bank will lead to a contagious loss of confidence, threatening multiple banks, the health of the system as a whole and, thereby, the real economy. It is for this reason that a key goal of financial policy is to avoid negative consequences of financial instability. As a consequence, when problems reach crisis proportions authorities act to ensure the stability of the financial system as a whole, maintain the integrity of the payments system, as well as public confidence in the financial system.

A core component of the policy response to crises is government provision of a safety net for banks, first proposed by Walter Bagehot in L*ombard* S*treet*, in which he proposed a "lender of last resort" for banks, whose function is to provide liquidity support to enable banks to meet withdrawals by depositors, thereby averting the bank's collapse and maintaining confidence. The typical lender-of-last-resort package includes in most jurisdictions deposit insurance and procedures for failure management in addition to liquidity support. Where it exists, New Zealand being a notable exception among OECD countries,[24] deposit insurance eliminates or substantially reduces the incentives for depositors to flee an institution they perceive to be in trouble, albeit at the risk of "moral hazard".

- Regulatory practices

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 are set up to cope with the problem of asymmetric information and work to prevent fraud and other practices by which firms unfairly exploit consumers' lack of financial knowledge, their limited market access and in some cases their limited economic resources.

Prudential requirements by necessity have a strong institutional focus, as they are chiefly concerned about solvency and key differences in the risk

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characteristics of different types of financial institutions exist and likely will persist. The differences relate, in particular, to the time horizon and complexity of core business activities and liabilities. For example, lending activities are at the core of the commercial banking business, which makes credit risk their dominant concern. Most commercial industrial loans at banks are freely callable instruments, with floating rates and relatively short terms to maturity. Among the key liabilities banks use to fund their loan books are various deposits, which have their own option characteristics and give rise to considerable liquidity risk. Funding and liquidity risks are also of particular importance to investment banks, along with other market risks. In the case of both banks and securities firms, the focus tends to be on risks that exist or might develop over short time horizons. For insurers, by contrast, the dominant category of risk is technical risks, although investment risks are clearly of concern as well. Technical risks comprise two types of risks: under-pricing risk, in which premiums fail to cover expected claims, and under-provisioning, in which technical reserves prove inadequate to meet an insurer's obligations to its policyholders. An added distinction for insurers in the life segment is that the maturities of the liabilities extend to much longer horizons than those in banking (commercial and investment varieties) and the payment is upfront, so liquidity risk is far less important. So, too, is the likelihood of sudden failure. Consequently, prudential oversight in insurance has focused less on systemic stability concerns and more on policyholder protection. In banking conversely it is systemic stability that is of paramount concern.

In an ideal world, depositors and policyholders would have access at low cost and without error to complete information regarding the risks their particular service provider was incurring and would be able to demand an appropriate return on their deposits in the case of banks or portfolio insurance or other protective measure in the case of insurance that is appropriate for the level of risk observed. In a perfect capital market, deposit rates would accurately reflect banks' risk exposures and, thus, would provide proper incentives for banks to adopt prudent credit underwriting methods. By the same token, the market would appropriately price the technical and investment risks inherent in insurers' portfolios, which would have the effect of ensuring they have capital and reinsurance commensurate with their risk exposures. Similar arguments would hold in the case of other financial products and services.

In practice, of course, retail depositors and insurance policyholders either have limited information regarding their bank's or their insurer's financial status or limited ability to use the available information. Consequently, to use banks as the example, deposit rates do not reflect a bank's insolvency risk. In the case of both banks and insurers, prudential regulation addresses the information asymmetry and its attendant mispricing of risk partly by capital adequacy requirements to ensure that obligations to depositors and policyholders can be satisfied. Inas-

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Box 4. Failure management procedures

Failure management procedures typically vary depending on the perceived scope of the problem. Resolution authorities have three basic options: 1) troubled institutions can be assisted to forestall failure; 2) they can be acquired, sold or merged into healthier institutions; or 3) they can be liquidated. When problems are believed to be confined to one or more non-systemically relevant institutions, resolution activity can focus on resolving the troubled or failed institutions as expeditiously as possible and all options are on the table. Conversely, when problems are more widespread or involve a large share of total financial sector assets, liquidation is rarely chosen, because doing so would have the effect of shutting off a large volume of gross credit extension, likely damping economic activity and curtailing institutions' profit potential as a consequence. For similar reasons, the failure of large banks is often handled differently than the failure of small institutions. Under crisis conditions, authorities generally endeavour to prevent problems in the financial system from spilling over to the real economy.

Large-scale insolvency of lending institutions rarely occurs in isolation. Usually, it reflects a large non-performing loan problem owing at least in part if not in whole to extensive debt problems in the non-financial corporate sector. As a consequence, restoring the health of financial institutions in these cases normally requires some sort of measures to accelerate the operational restructuring of their corporate customers. If rehabilitation efforts focused only on financial institutions under these circumstances, the credit intermediation process still would not function efficiently, as a major source of demand would be the same troubled companies that precipitated the problems initially. Faced with these prospects, lenders might rationally refuse to extend credit and opt instead to rebuild their capital bases.

Measures to facilitate restructuring of non-financial corporations can include loan workouts and other bilateral restructuring arrangements between lenders and client firms. These arrangements can involve explicit or implicit re-contracting between the lenders, other creditors of the firm, and its stakeholders. An alternative is to draw on legal support to restructure loans through the legal redress provided by courts and insolvency laws. This choice is contingent on bankruptcy procedures being conducive to quick restructuring efforts. Where that is not the case, that is, where bankruptcy procedures are cumbersome, inefficient, and costly, lending institutions and authorities alike may prefer other restructuring approaches. Jurisdictions in which bankruptcy procedures are, in effect, liquidation procedures are one such example.

More generally, resolution options depend on the range of powers available *ex ante* to regulators and supervisors. Some authorities have a full range of powers, which include the ability to licence institutions and to withdraw licences, to give directions, the power to inspect and suspend operations as a result of the findings, and so on. If authorities lack the power to write down capital, force mergers, or close institutions, or must rely on judicial rulings by high level courts, troubled institutions may continue to operate for lengthy periods and, thus, deteriorate further. Similar outcomes can occur when troubled institutions are able to mount legal challenges to the decisions of the regulator or when regulatory personnel themselves are exposed to law suits and personal liability for damages.

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much as bank deposits generally are protected by deposit insurance schemes and as banks have access to central bank lender-of-last-resort facilities, regulators feel free to limit the type and scope of risks that banks may assume. Likewise, insurers are subject to restrictions on their investment practices as a component of measures to protect policyholders. In effect, regulatory authorities intervene in the market to establish a price for activities undertaken by financial service providers that might otherwise not be priced properly in the market.

At the market level, minimum technical standards, disclosure requirements, and rules on market making, etc. help to ensure the smooth functioning and integrity of exchanges and organised financial markets. These measures are joined by various controls applied to individual financial institutions. Chief among these measures are prudential guidelines, supported by direct supervision in order to ensure the safety and soundness of the institutions. Rules in this regard include minimum capital requirements, restrictions on connected lending, limits on undue concentration of risk, requirements regarding operational risk, and so forth. There may also be various structural controls, which are intended to prevent excessive concentration of market power and limit the potential for conflicts of interest via entry and merger controls, activity/affiliation restrictions, and asset restrictions and other limits on the range of activities of different types of financial institutions. In some areas, government guarantees provide additional support to preserve public confidence in the stability of the financial system as a whole.

III. Regulating and supervising in a changing financial landscape

"This is like déjà-vu all over again"

The foregoing discussion suggests that regulation and supervision of the financial services industry aims to achieve a set of interdependent objectives. Although financial regulations are usually introduced to achieve a particular purpose, they tend to have effects that cut across different objectives. For example, the current approach to prudential regulation and supervision, which subjects new entrants to minimum capital requirements and increasingly imposes risk-based capital requirements on all participants, may have structural effects as a by-product, a consequence of differentiating in favour of some types of institutions or activities as a result of the risk weights that are assigned to different types of assets. Financial sector entry and exit conditions can be affected as well if prudential rules have the effect of treating incumbent institutions differently than potential entrants.

Foremost among the current objectives of financial policy is to preserve the stability and integrity of the financial system as a whole and to protect the interests of unsophisticated depositors and investors. Regulations also maintain the

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integrity of trading systems and ensure that financial intermediaries in all market segments faithfully execute their fiduciary responsibilities to clients and shareholders. There may be other miscellaneous objectives as well but this group constitutes the core goals of financial policy in most jurisdictions. There is no obvious way to achieve these goals and individual countries make use of their own mix of prudential, structural and other regulations in the attempt. Nonetheless, most approaches have some common elements, including safety-net mechanisms for banks supported in most cases by some form of insurance for depositors to preserve confidence in the banking sector and guard against systemic outcomes. These measures operate alongside capital requirements and other prudential standards for sound financial behaviour on the part of individual institutions, in conjunction with requirements for effective risk management systems to address credit risk, market risk, and operations risk. In this context, protective measures are more geared to the interests of small savers, investors, borrowers, and policyholders who are non-professional users of financial products and services, while the interests of professional users are addressed by regulations regarding disclosure of information and governing market practices. A wide range of supervisory arrangements for financial services exist to ensure compliance with the rules.

The moving target – progress and evolution of the financial services industry

The financial intermediation process has been heavily influenced over time by the general ebb and flow of economic activity but also by changes in external factors such as geo-political events and public policies. In particular, the financial services industry has long been subject to significant regulation and supervision, owing in part to the fiduciary nature of some of its activities and the spill-over effects associated with the failure of institutions.

Over time, the adaptation of service providers to the rules of the game creates winners and losers, amid the search for innovation, new sources of revenue, and more effective resource deployment. Among the many possible strategic responses are horizontal combinations of financial products and services from different sectors; vertical integration of product creation, production, and distribution; and geographic combinations of various financial services or of multiple dimensions of the production or distribution of particular services. Institutions finding themselves on the losing end in this process may seek ways to bypass regulatory hurdles or put forth calls to level the playing field or seek other protections from "unfair" competition. Whatever form the regulatory response takes, it triggers a new cycle in which a bout of competition sparks innovation, which leads in turn to a reconfiguration of the financial services landscape, which eventually creates opportunities for further innovation down the road. In short, there is a complex interplay between regulation and supervision on the one hand and financial sector development on the other.

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For instance, it was common in the period prior to broad-based reform of financial services regulation for regulators and supervisors to intervene directly in the market to limit competition via controls on a broad range of financial activities. Prescriptive rules supported segmentation along distinct service lines. For example, commercial banking in that world consisted mainly of the provision of deposits, loans, and transactions services, all jointly produced and distributed through extensive branch networks. Banks earned revenues mainly from the net interest margin of their assets over the low-cost deposit funds. With a bank safety net to guard against runs, the primary risk facing the typical bank was credit risk, so supervision focused naturally on the asset side of the balance sheet with a view toward achieving a proper valuation of the assets as backing against banks' credit risk exposures. For insurance companies, by contrast, the need to protect policyholders resulted in a focus on the liabilities side of the balance sheet, in particular, to guard against under-pricing of risk and under-provisioning for claims. Within each grouping were measures intended to cover the needs of clients that own the financial assets or receivables that are the liability of the service provider, along with broader market-oriented or system-wide measures.

Competition was limited not only across sectors but also between institutions in the same sector. This regulatory approach allowed institutions limited scope to get into trouble, but left many with limited financial resilience and prolonged the existence of inefficient institutions, thereby hampering the efficiency of the financial system itself. There are stark differences between the environment this regulatory approach engendered and competition in the textbook sense. Under competitive market conditions, resources can move freely into and out of markets. With atomistic buyers and sellers, full information, and homogeneous products, producers with higher cost efficiency are able to set lower prices, and because customers are aware of the price differential between the offerings of the more efficient producers and others, rival firms are obliged to follow suit or are forced to sacrifice market share. The market mechanism works by forcing less efficient producers to either accept lower levels of profitability (possible only in the short run), improve their cost effectiveness (which is necessary for long-run survival), or exit. Prior to reforms being adopted, there were regulatory restrictions on both entry and exit.

It follows that in the days of greater financial sector compartmentalisation, financial service providers did not really engage in active competition. They had little incentive to engage in the range of behaviours grouped under the sense of the infinitive "to compete". To compete means to cut prices, advertise, invest in R&D and so forth to gain an advantage over rival producers. Competition in this sense of the word denotes a dynamic process of rivalry among firms in which only the more efficient producers survive and excel, by virtue of producing and selling new and improved goods and services. Price remains an important consideration,

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but in the absence of an assumption regarding homogeneity of the products on offer, it ceases to occupy centre stage – there being many ways in which institutions can compete other than on the basis of price alone. They include variations in product or service quality, location, or point of sale. As in the case of the competitive market structure paradigm, competition as a dynamic process of rivalry also results in the long-run expansion of output and, through innovation and the adoption of new technologies, lower prices for consumers.[25]

Much has changed, however, from the rigid compartmentalisation of the past. Dramatic improvements in technology and in the quality of telecommunications and information services, supported by the easing or removal of regulatory and other barriers to entry have paved the way for increased competition across institutions, both within and across sectors of the financial services industry. At the same time, growing economic and financial interdependence at the international level has fostered increased competition and interpenetration among national financial systems, in particular at the wholesale level.

Response of institutions to increased competition

From an economic perspective, producers face increasing competition when the products or services they offer become less differentiated (increase in the number of substitutes); because the number of competitors, actual or potential entrants, has increased; or because there is increased market power on the demand side of the market. All of these aspects of competition have been at work in financial services. On the supply side, the removal of product restrictions and other entry barriers has expanded the range of permissible activities for financial service providers, allowing in some cases for direct competition between commercial banks, insurance companies, securities firms and so forth. Financial institutions increasingly offer products (directly or indirectly) that compete against those offered by a broad range of other financial institutions. Foreign-based institutions have made competitive inroads in some markets segments and entities outside the financial services industry (*e.g.* retailers, software companies, captive financing arms of non-financial companies) have captured a share of the market for some types of financial products and services (Figure 1). On the demand side of the market, institutional investors have come to account for a rising share of total financial assets, part of an ageing-induced demand for retirement savings products. Meanwhile, non-financial corporations, themselves operating in increasingly integrated world markets for goods and services, have made demands for new financial services adapted to the global nature of their own operations and available at competitive prices.

The evolution of the financial services landscape belies trends and patterns characteristic of the usual strategic response of firms to increased competition.

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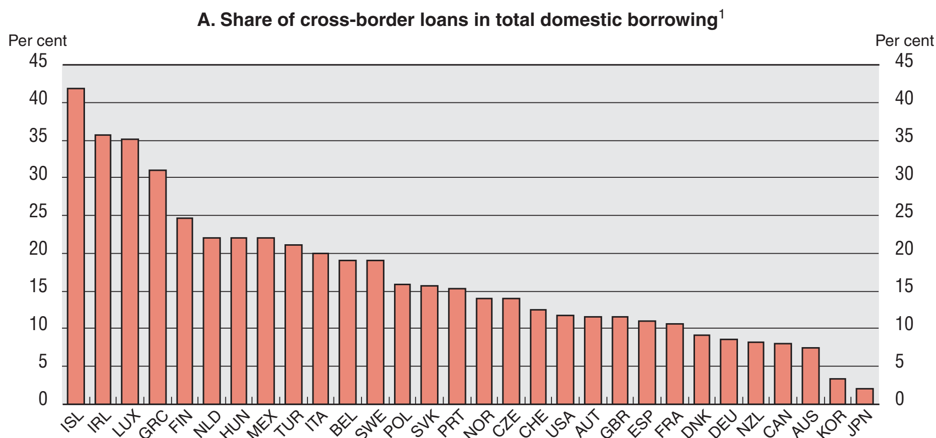
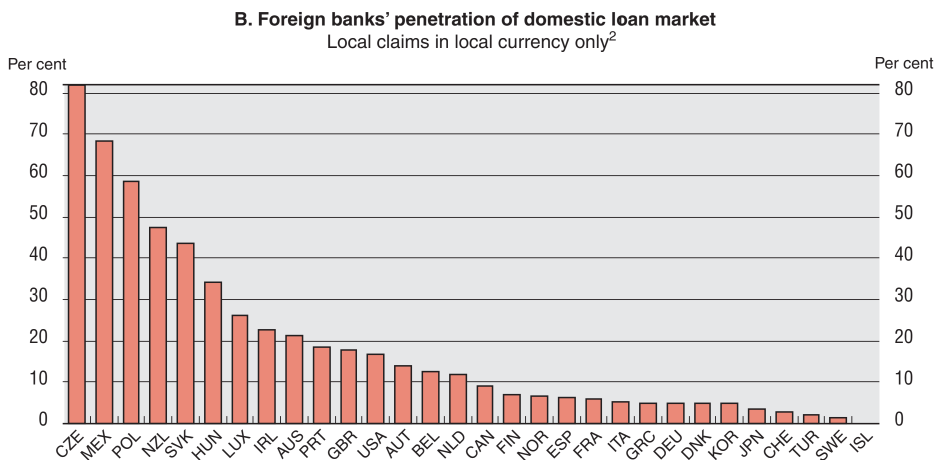
Figure 1. **International competition in banking**

Average 2000-2003





1. Measured as foreign banks' cross-border claims on non-banks as a percentage of all commercial banks' local claims on non-banks plus cross-border claims on non-banks.
2. Measured as foreign banks' local claims in local currencies as a percentage of all commercial banks' local claims on non-bank sectors (*i.e.* household, non-bank corporations and public sectors). Since the data on local claims in local currencies are not broken down by sector, they include lending to banks as well as to non-bank sectors. As a result, the measure over-estimates the underlying rate of foreign penetration of non-banks.

Source: BIS and IMF.

Technology plays a key role in the choice of strategy and the initial conditions are, of course, extremely important, as is the source of the competitive impulse. General studies of management decision-making have uncovered a few definite patterns

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in firms' strategic behaviour. If allowed by law or regulation, one of the first strategic moves a firm attempts to make is to vertically integrate within its industry. In the case of financial services, such a move entails either moving upstream along the value chain toward product creation or downstream toward distribution and the customer interface. A common example would be a securities exchange combining with a clearing and settlement operation. Firms that are already vertically integrated to some extent typically seek additional sources of revenue and profits through diversification. A market extension strategy entails a move into geographic markets the firm previously has not served. A product extension strategy involves, in contrast, adapting existing production processes to non-competing products or distributing additional products via existing channels. A conglomerate approach to diversification entails a move into unrelated lines of business and is accomplished most often by way of acquisition. Less radical is for a firm to remain in the same line of business or in a related area but to shift its focus. Practical examples would include a banking organisation shifting from an emphasis on retail banking to wholesale banking or from commercial banking to investment banking.

The responses of the various sectors of the financial services industry to these developments have covered numerous options with regard to strategies and product mix. At the institution level, the competitive response has covered a wide range of options with regard to both the types and combinations of activities in which service providers have elected to engage and the strategies they have adopted in conducting their activities. There does not appear to be one best alternative. Quite different options seem to work well in different contexts, including different production, distribution, and corporate organisation structures. It appears, for example, that some firms are more efficient at joint production, while others are more efficient when they specialise. Thus, the changing financial services landscape features at once a move by some institutions toward the horizontal integration of financial products and activities via the formation of diversified, multi-product financial groups alongside increased outsourcing, and formation of specialised institutions that exploit niches in the range of products and services. For example, back-office operations have been separated from the front-end origination of the product or service and are either processed off-site (sometimes for purposes of operational security) or completely outsourced (for reasons of cost).

In this new world, not only have large institutions with global operations had to face intensifying competition, but so, too, have smaller institutions operating essentially in their local and regional markets. Competition drives margins on standardised products down. The squeeze on revenues ups the ante on research and development activity to create new products (product innovation) and to find new ways to produce existing products at lower costs (process innovation). Trading activity may expand as well to meet the execution and hedging requirements

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for implementing the new, often more complex, product technologies. These changes must be supported by changes in the financial infrastructure, including the organisation of trading facilities, clearing and settlement systems, custody arrangements, and other operating services businesses, and the communications and information processing systems for transactions. To wit, various horizontal and vertical linkages have been formed between and across trading platforms (exchanges) and clearing and settlement entities.

In summary, the strategic responses of financial services organisations to competition stretch across numerous dimensions, including choices regarding the business mix and combinations of activities in which institutions are engaged, the production and distribution processes for the products and services, and the organisational structures of institutions and market infrastructures. In today's financial services industry, competition can be defined in terms of geography, product, sector, and customer type (*e.g.* retail *versus* wholesale). Thus, depending on the market segment or jurisdiction, competition may occur chiefly on the basis of fees and charges (price); products (range, quality, existence of substitutes); market access (availability of competitors); distribution channel (electronic, telephone or face-to-face); reputation (risk, safety); technology (economies of scale, switching costs, barriers to entry, benefits *versus* costs of large size); consumer preferences (demographics, local culture, information set, risk aversion, desire for privacy *versus* transparency); and many other factors. All told, the financial services landscape has become an increasingly complex matrix of financial instruments, institutions, and markets all interacting in myriad ways, including growing linkages between national financial systems with different legal characteristics, technical specificities, cultures, and practices.

For some financial products and services, customers have shared demands which allow for standardisation of products and mass distribution. Where that is the case, providers have sought to build or acquire economies of scale in production or in distribution. Asset management and trading and operating services are oft-cited examples. Elsewhere in financial services, new technologies, increased competition, and more assertive customers are leading financial service providers in the opposite direction, toward greater customisation of the products and services they offer. Advances in financial engineering and risk management techniques enable a variety of risks to be unbundled and sold or hedged separately or alternatively repackaged to form new instruments with risk characteristics that meet the needs of different groups of investors. Financial service providers can now manipulate the risks embedded in existing financial products with relative ease, which enables them to tailor products to cover a wide variety of risks or to satisfy a number of specific investment needs. These innovations have broadened the menu of financial products and services available to ultimate issuers of securities, ultimate savers, or other economic agents, though perhaps at a cost of less familiarity with the alternatives.

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Increased importance of conflicts-of-interest and conduct-of-business considerations

Many of the advances in product offerings suffer from the same market defect – a tremendous information asymmetry between the creators of the products and services and the end-users of those products. Even relatively straightforward financial products can seem quite complex to an unsophisticated saver/investor. Add to this fundamental lack of understanding various terms to maturity, durations, payout options and other features embedded or incorporated in new product offerings, and the non-professional investor can become overwhelmed. The lack of knowledge and understanding on the part of some individual investors often leads them to either do nothing or turn to experts and qualified professionals for advice, but that second step merely exchanges uncertainty as to which product is best for uncertainty about which advisor is best. Service providers can increase the information asymmetry by increasing the amount and complexity of the information about their products, for example, by obscuring key product characteristics through excessive advertising/marketing or product differentiation. Such steps make it more difficult for customers to compare products. Other types of switching costs that have been identified in the financial services arena include high up-front fees and charges, low surrender values, lock-in penalties, and excessive product proliferation.

The role of consumers

If consumers do not switch providers, then institutions offering relatively poor value products need not lose customers, as would happen in a competitive market with adequate consumer search. Consequently, the degree of competitive pressure on firms in the market is in effect lower than would otherwise prevail with more search and the market operates at a lower level of efficiency – with higher average prices and potentially less innovation, as the incentive for institutions to engage in R&D would be lower than under more competitive conditions. Perhaps more importantly, a component of market discipline is lost. In principle at least, the willingness, for example, of depositors and other creditors of a bank to take their funds elsewhere if they are dissatisfied with the performance of its products and services or are concerned about its risk profile serves as a check on the discretion of the bank's managers. The same type of market mechanism would presumably also operate in the case of insurance policyholders, participants in CIS, and so forth, while equity holders perform the same function in the general corporate governance context. Reality in most cases differs considerably from theory. Although regulations in most jurisdictions require financial institutions to disclose certain information to their clients, customers only have incentives to take note of and react to the information disclosed in situations in which they bear some of the risk of loss. The available evidence suggests, however, that even where depositors and retail investors are not fully insured, they appear either unwilling or unable to

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perform the monitoring function. Consumers in the life insurance market have similar difficulty observing and monitoring the financial health of insurers, both prior to actually signing the life insurance contract and during its lifetime.

In addition to the problems of information asymmetries, the complexity of the evolving financial services industry raises the potential for numerous conflicts of interest. For one, there increasingly are a number of institutional and functional overlaps between different types of financial institutions and between financial institutions and institutional investors. Insurance companies are the dominant entities in some large diverse financial groups; commercial banks are dominant in some; some are headed by investment banks, while others are financial conglomerates active in most sectors of the financial services industry. As financial institutions operate across a wider range of financial services, they are exposed to a host of conflict of interest situations.

Conflicts of interest themselves needn't be complex. A potential conflict-of-interest exists whenever a service provider has a choice between two options, one of which is preferable from its own perspective or the point of view of an affiliate, while the alternative represents a better option for the client. A conflict-of-interest situation also arises when the interests of two clients stand in opposition. A practical example concerns the securities underwriting business, which pits the interests of the issuer of the securities against those of the acquirers of the securities in the sense that a good price for one is less good for the other. The number of such conflict-of-interest situations rises with an increase in the mix of business activities in which an institution engages and also with increasing complexity of its ownership and operating structure, but even in the case of relatively simple structures, there may be numerous potential conflicts-of-interest. All financial intermediaries operate on both sides of the savings/investment relationship, using other people's money. To be sure, conglomeration and globalisation heighten the risk, but the potential for conflicts-of-interest is in some ways inherent in the process. Given the marked information asymmetry that exists between service providers and clients, potential risks may become actual risks if proper controls are not in place. Given the recent history of corporate fraud and failures, the mere suspicion that the interests of intermediaries do not coincide with the best interests of their clients or investors may be all that it takes to undermine confidence in the integrity of the financial intermediation process.

The policy response to conflicts of interest

Because the interests of financial service providers and the interests of investors may not always be perfectly aligned,[26] regulators implement rules and norms of behaviour to prevent service providers from putting their own interests or those of their affiliates ahead of those of their customers. Various types of legislative

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and regulatory requirements may be used to accomplish this goal. For example, self-dealing and certain other types of related party transactions, including transactions with affiliated parties on an arm's length basis, may be prohibited or restricted. Some jurisdictions have adopted codes of conduct to regulate the behaviour of managers. Other jurisdictions regulate conduct through legislation. Legislation may mandate, for instance, that there be an independent review of the actions of management or require the appointment of a compliance officer. In some sectors, legislation may mandate that certain company officials are subject to fiduciary duties of honesty, care, and loyalty in exercising their powers and performing their duties.

In the past, policy makers often addressed conflict-of-interest problems by mandating a certain degree of specialisation between financial institutions or between certain activities in banking and finance. Strict institutional separation is far less common today, although some degree of separation is still applied in the case of banking activities *versus* commercial and industrial activities and between banking and insurance underwriting. In particular, functional separation still exists in the sense that regulations may require that some non-core activities be carried out in separately capitalised entities.[27] Other conflict-of-interest situations are addressed by so-called "Chinese wall" arrangements inside an organisation, for example, to prevent information (of a privileged nature) known to persons in one part of an institution from being available (directly or indirectly) to those in another part of the institution. An example in this regard is the separation of an institution's credit decision-making apparatus from its securities trading or underwriting function.

As well, some forms of separation apply to the insurance business itself. For instance, the underwriting of insurance risks is restricted to licensed insurance entities, which serves the dual purpose preventing unsound entities from entering the business and maintaining strict separation between insurance underwriting and non-insurance activities. Further to that end, rules in most countries prohibit the simultaneous pursuit of life and non-life insurance business by a single entity. In fact, with few exceptions, separate licences are typically required to enter each sub-sector of the insurance business or for multiple categories of insurance grouped under a common corporate umbrella. These restrictions help ensure that the funds reserved for paying insurance claims are not endangered by risk unrelated to the insurance business, especially in the case of the life segment.[28]

More generally, where conflicts of interest are perceived to be less severe, reliance may be made on disclosure of information necessary for clients to be fully aware that potential conflict-of-interest situations do in fact exist. General guidance may take the form of institution-specific or industry-wide codes of conduct, best practice rules, or other measures of proper business conduct to impose an

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aspect of market discipline. For times when these sorts of measures fail, there may be ombudsman arrangements or other complaints procedures for customers who believe they have been victims of malpractices or abuses of conflicts of interest. Of course, prudential supervision and various other aspects of the legal and regulatory infrastructure for financial service providers address these risks.

Challenges in risk management

Another well-known problem with integrated financial institutions is that risks can migrate across different business lines, which implies a need for someone at the top of the organisation to have a view of risk for the group as a whole, whether on or off the balance sheet. A particular concern in the group-wide context is whether the risks that arise in the different lines of business are offsetting or reinforcing. The historical approach to risk management in integrated financial services organisations has been for risks to be managed locally along business lines, such as the credit function within banks and the underwriting function within insurance units, with bottom-up reporting to a centralised management unit to provide for an aggregate view. This approach has proved to be insufficient in the case of complex institutions in the sense that standard risk management tools for the constituent entities on a stand-alone basis, such as value-at-risk measures for banks or the stochastic asset-liability approach for insurers, are dependent on historical data and may fail to capture developments under so-called "tail events". Similarly, historical data may have only limited applicability to new products and new business lines. Among specific categories of risk-management, techniques for managing credit risk tend generally to be less developed than those for market risk. For example, it is not possible with existing methodologies to perform a stress test purely for credit risk. Instead, the common approach is to rely on various market stress measures, such as for particular sectors or industries. A true aggregate measure of risk, one that aggregates credit risk, liquidity and other market risks, and operational risk across all business units and sectors does not yet exist.

If a unified risk measure were developed, it is not altogether clear how it could be applied in practice. Across service sectors, there continue to be distinctions in the rules applied to different types of financial institutions as regards their solvency, the types of assets they hold and the management of their liabilities. In fact, in most jurisdictions, the various legislative acts on depository institutions, on insurance, on securities firms and on other service providers are distinct pieces of legislation, embodying rules to address the specificities of the different kinds of institutions. This description is particularly true of prudential requirements, where definitions and calculations of capital requirements differ across sectors and across borders. The effect is that similar transactions can affect a group's capital differently depending on where within the group they are conducted. Even integrated authorities often operate with institutional criteria as a secondary consideration

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for solvency and prudential oversight. Regulations can also differ across the value chain for various financial products and services, in the sense that a different treatment applies to upstream (production) *versus* downstream activities (distribution) at the customer interface.

Among the other problems an institutional approach might engender is an unnecessary duplication of regulation. Then again, there are numerous distinctions that can be drawn between different types of financial institutions and markets (*e.g.* wholesale *versus* retail, systemically important *versus* non-systemically important) and these distinctions may, in fact, warrant a different approach to regulation.

Over time, in many countries numerous changes in institutional structure 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. Note, however, that even integrated authorities tend to operate with an institutional focus. Some models preserve a role in financial supervision for the central bank, while others have removed banking oversight responsibilities from the central bank. In short, a rather wide variety of institutional structures for financial regulation may be found in practice. Moreover, inasmuch as institutional structure must reflect country-specific factors and the fact that economies and financial sectors are not all alike, it seems unlikely that any one institutional structure will ever suit each and every country. In any event, regulatory structure cannot on its own guarantee the effectiveness of regulation in achieving its objectives in an efficient manner. The regulations are, as noted before, only one component of a full complement of measures that underpin the proper functioning of financial systems.

Implications of structural developments for financial policy

Regulatory and supervisory practices must also be adapted to the new environment in which institutions increasingly make use of quantitative techniques to help manage their assets and liabilities, in some cases on a global scale. Commercial banking organisations, including their securities arms, and independent investment banks have become fairly active users of credit derivatives and other such "hedging" instruments to off-load specific credit risk exposures. Complete current data are not available, but anecdotal evidence suggests that major end-sellers of credit risk protection tend to be large commercial banks, insurance companies, the collateral managers of collateralised bond obligations, pension funds and mutual funds. Commercial banks are also on the other side of these transactions as end buyers, along with hedge funds and to a lesser extent non-financial companies, while both banks and securities firms act as intermediaries. The active

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use of derivative instruments on both sides of the balance sheets of large diverse financial organisations means in particular that their exposures can change rapidly and are certainly not amenable to being monitored and controlled by supervisors on the basis of periodic snap-shots of balance-sheet positions. An added complication is the fact that large financial institutions not only operate across sectors; they also operate across borders.

There is clearly 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. 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. Take disclosure, for example. Information is not only costly to produce; it is also costly to process and absorb. Consequently, there would be little net benefit to requiring more than some level of disclosure sufficient to enable a service provider's shareholders, investors, or clients make a proper determination regarding its prospects and risk profile. Different types of customers have different wants and needs in this regard, so a one-size-fits-all approach is likely to be unnecessary and possibly counter-productive. It may be that different disclosure standards might be appropriate for different institutions, even within the same sector, depending on their mix of business and customer make-up.

Financial reporting and disclosure

Questions concerning the "proper" amount of information to be disclosed are a major subject of debate in the market infrastructure area – exchanges and other trading platforms – where order information (price, volume, etc.) has to be transmitted from one end-trader to the appropriate receiver, either directly through the trading system itself or via agents (dealers or brokers). The different types of trading systems have rules regarding how much information is disclosed and to whom.[29] Some systems use electronic screens to display orders, while other may use open outcry (oral auctions) or post information on boards. Some markets release full pre-trade information, showing all orders and quotes, while others release only post-trade information (*i.e.* data on completed trades only). With "hard", central limit-order books, all limit orders are displayed and are processed according to a first-come, first-served rule. Other venues may display only the best bids and offers, the so-called "top" of the order book.

Different groups of traders (investors) have a preference for different attributes of trading systems including the type and quantity of information that is displayed. Whereas some investors will be most concerned about price and speed of execution, others, especially large institutional traders, may be more concerned about

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minimising any market impact of their trading activities than about strict time priority.[30] Yet others will be most concerned about overall trading costs. In short, different types of traders will have differing views as to what is meant by "best execution". Views also differ on how much transparency is enough. In the paradigm of perfect markets, more transparency results in a more efficient pricing mechanism, but more transparency may not always be better if it succeeds in discouraging some large traders from entering the market, those most likely to be concerned about minimising price effects of their trades or who simply prefer anonymity. Rules on transparency must therefore seek a balance between the benefits of more informative price information against the costs of forestalling some liquidity provision.

Policy makers are not oblivious to these issues and there have been moves towards joint or harmonised prudential standards or guidelines, both on a regional basis (as in Europe) and internationally (*e.g.* Basel Core Principles, IAIS Core Principles, etc.) As always, rules must be implemented into national legislation, which normally allows for national differences, but the general thrust remains the same. The common response by prudential authorities places increased emphasis on supervision, supported by improved risk management on the part of institutions and on market analysis and valuations, made possible by requirements for appropriate levels of disclosure. Where quantitative standards are used, authorities have increased the risk sensitivity of the standards to make them more effective. At the same time, authorities have sought where possible to avoid a one-size-fits-all approach, relying somewhat more heavily on the soundness of an institution's approach and other qualitative aspects of its risk management. As well, various measures have been implemented to strengthen the mechanisms for addressing internationally active sectors. These measures are the three Cs of international financial policy: *communication* (which means that all relevant information is shared to the extent allowable under domestic law); *co-operation* (in monitoring and other on-going supervisory efforts); and *co-ordination* (of policy responses in the event corrective action is required).

That said, the internationalisation of banking and finance has not triggered a serious push for the creation of supranational regulators, perhaps because a considerable degree of harmonisation of standards and co-ordination among regulators has already been achieved. There have been arguments in some cases for more formalised, supra-national structures, such as on an EU-wide basis, but the debate regarding cross-border arrangements is far from settled.

To reiterate a point made earlier, 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. Although the goal itself is

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straightforward, achieving it is not. There are many complications and many trade-offs. For one, there is a constant interaction over time between regulation and market practice in the sense that innovation and technological progress tend over time to undermine the effectiveness of existing rules and necessitate changes in regulatory approach. These shortcomings notwithstanding, the growing complexity of the financial services business and the rise in importance of conflict-of-interest and conduct-of-business concerns may leave policymakers with little alternative to increased reliance on the analysis of markets and valuations of risk-management systems for prudential purposes and on appropriate levels of disclosure to ensure transparency and preserve market integrity.

Note, however, that increased disclosure is no panacea. It is a means to an end and not an end in and of itself. For one, disclosure alone cannot resolve all information problems. It is up to consumers/investors to process and evaluate the information that is disclosed. The evidence suggests that many consumers of financial products lack the requisite ability. In most market segments, retail consumers show, as well, reluctance to actively search for better value and more suitable products and, armed with this information, to switch providers. Absent this behaviour, markets may depart from competitive, hence efficient, outcomes, leaving consumers with relatively high prices and fees for products that may actually not be particularly well-suited to their needs. Two, the information that is disclosed is not always the same across sectors and across borders. The creation of internationally accepted accounting standards remains an ongoing challenge. First, as with most policy changes in the finance sphere, the initial conditions matter. Financial institutions have long adjusted their business practices to the different national accounting conventions. Any change for the sake of creating common and reliable accounting standards in internationally active industries will encounter some resistance. The problems may be more severe in some sectors than in others. For example, differences in national accounting standards for insurance have tended to be greater than those in banking and areas such as re-insurance have been rather opaque. Second, across most financial sectors different reporting standards have applied for tax purposes than for financial disclosures or regulatory reporting. The notion of what is the "best" portrayal of a financial institution's condition may vary depending on which entity is going to use the information. Prudential supervisors, for instance, are more naturally inclined to favour accounting principles that are more conservative in some respects, but are more conducive to prudent financial risk management and financial stability, while financial accountants may seek what they regard as a portrayal of an institution's true "fair" market value. The tax authorities may have other interests.

The regulatory choices that are made to address these concerns are complementary to other aspects of a jurisdiction's corporate governance regime and of regulation of the broader economy, including tax, labour, competition, pension

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regulation, and so on. Harmony is good, but it may well be that different legal rules may be considered "best" for different national systems as opposed to there being a single approach that is universally regarded as best. Of course, it might help in that regard if fire walls are indeed fireproof and not just flame retardant and if entry barriers are impenetrable and not scaleable. But wait, the institutions behind those barriers could become mighty comfortable once the threat of entry were removed. That prospect would seem to suggest the need for some sort of measures to prevent a "clubby" atmosphere from degenerating into something more formal (say, a cartel). What to do? As any good chef would say, sometimes all it really takes is a pinch of salt, not too much, not too little. Is regulation any different?

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Notes

1. In finance, the notion of efficiency has a number of different dimensions. There is efficiency in production, for example, as reflected in the equality of the price charged for the product and the marginal cost of producing it. There is price efficiency, which in the financial market case, exists when the market price of an asset accurately reflects all available information about the earnings stream (both current and future) associated with the asset. There is also allocative efficiency in the sense that investors are able to assess correctly the risks of a given project and are willing to fund those that promise positive net present values.
2. See the discussion in Goodhart, C. A. E., P. Hartmann, D. Llewellyn, L. Rojas-Suaréz, and S. Weisbrod (1998), *Financial Regulation, Why, how and where now?* Chapter 8, London, Routledge, in association with the Bank of England.
3. Nothing in the discussion precludes bilateral linkages between borrowers and lenders that bypass the formal financial system architecture. Loans from family members or close relatives to the principal of a small business are examples of such transactions. In fact, many of the functions performed by the financial system can, in theory at least, be done on a bilateral basis. The feasibility of bilateral contracting is, however, another matter. An important reason for the existence of a financial system is to address agency and information problems. In the example cited, these problems are attenuated by virtue of a familial relationship between borrower and lender. In the broader context, there are, of course, many limitations of such arrangements, which explain in part why the vast majority of financial transactions are funnelled through the financial system.
4. Crane, D.B. and Z. Bodie (1996), "The transformation of banking: form follows function", *Harvard Business Review*, March-April, pp. 109-117.
5. Among studies of the link between financial sector development and economic growth, King and Levine find that indicators of financial sector depth and banking activity predict subsequent levels of economic growth. See Levine, R. and R.G. King (1993), "Finance and Growth: Schumpeter Might Be Right", *The Quarterly Journal of Economics*, MIT Press, vol. 108(3), pp. 717-37.
6. Banks and other loan originators specialise in lending to borrowers for which publicly available information about credit histories is lacking and in financing activities that are difficult to assess and contain a large measure of subjectivity. To survive in competitive markets, primary lenders must be able to distinguish better credit risks from poorer ones and set their loan terms accordingly. Banks, for example, are usually good at assessing credit quality in deciding whether or not to extend credit, but in addition to higher interest charges and other fees for risky borrowers, banks also use non-price terms to reduce the risk of default and mitigate other agency costs. Firms with a proven track record fare better, since over the course of a long-term relationship lenders may

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acquire information that helps to attenuate the information problems associated, while *de novo* borrowers or other credits deemed to be riskier typically are subject to higher charges and more stringent non-price terms. These arrangements protect the bank's interests and also help to insulate creditors of the depository from credit risk. In addition, regulators require depository institutions to maintain a buffer layer of capital that is subordinate to the claims of depositors and other providers of low cost funds and market forces compel banks to endeavour to maintain capital cushions above the regulatory minimum. These measures add a further margin of support. In contrast to depository credit arrangements, when a borrower obtains credit directly from the capital market, the investor who buys its securities has willingly accepted the credit risk involved, so there is no need for that buffer layer of capital imposed on banks to protect the saver (*i.e.* depositor) on the other side of the transaction. Rather, the securities investor relies on market-based information to evaluate performance.

7. It should be noted that the on-going stocktaking project carried out by the OECD Economics Department in co-operation with the Directorate for Financial and Enterprise Affairs for the Working Party No. 1 of the OECD Economic Policy Committee and the OECD Committee on Financial Markets seeks to examine the relationship more closely.
8. Customers only have incentives to take note of the information disclosed by their service providers in situations in which they bear some of the risk of loss, such as when they are not fully insured.
9. See, for example, the discussion on the evolution of regulation of fixed-income markets in the United States in F. B. Friedman (2004), "Regulation of Fixed Income Securities Markets in the United States", *World Bank Policy Research Working Paper* 3283, April.
10. Arguments along these lines are usually attributed to private sector participants, but competition authorities often posit an ability to trade off increased competition for direct forms of regulation.
11. Note that while some externalities are clearly negative (*e.g.* systemic failures and contagion effects), not all of the externalities that arise in financial services are. An example of the latter would be network effects, whereby efficiency and cost benefits rise with the number of participants.
12. Common references are made to moral hazard, adverse selection and free-rider problems, among others. The financial system develops as a means of addressing agency and information problems, but does not completely resolve them.
13. See the discussion by the Chairman of the Australian Prudential Regulation Authority, Jeffrey Carmichael (2000), "Financial Regulation in the 21st Century", *Journal of Banking and Financial Services* (August), pp. 32-34.
14. In common discourse, various concepts are often lumped together under the common rubric "legal and regulatory system". They include the legal system itself (*i.e.* what might be loosely termed "the law"), regulation (the establishment of specific rules of behaviour), supplemented in some areas by supervision (the more general oversight of financial institutions' behaviour to ensure that the prescribed behaviour is actually observed.
15. In that vein, La Porta *et al.* (1997, 1998) show, for example, that legal systems that rigorously protect creditors and enforce contracts encourage better functioning debt and equity markets than legal systems that are more lax in this regard. In particular, the authors conclude that poor legal institutions result in high levels of ownership concentration, limited availability of external equity financing, narrow equity markets and

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small-sized debt markets. See La Porta, R., F. Lopez-de-Silanes, A. Shleifer and R.W. Vishny (1997), "Legal determinants of external finance", *Journal of Finance* 52 (3), pp. 1131-1150; and La Porta, R., F. Lopez-de-Silanes, A. Shleifer and R.W. Vishny (1998), "Law and finance", *Journal of Political Economy* 106 (6), pp. 1113-1155.

16. For a discussion of the evolution of legal systems and the effect on financial sector development see Beck, T. and R. Levine (2003), "Legal Institutions and Financial Development", NBER *Working Paper* No. 10126, December.
17. See, for example, Ergungor, O. E. (2004), "Market- vs. bank-based financial systems: Do rights and regulations really matter?", *Journal of Banking and Finance* 28, pp. 2868-2887.
18. In the case of corporate entities, the corporation itself is for most purposes a legal resident of its jurisdiction (a notable exception is that it does not have the right to vote, at least not directly). As such, it can borrow and lend funds in its own name and it can file suit or be sued. Like most residents, it must pay taxes.
19. See OECD (2004), *Corporate Governance: A survey of OECD Countries*, OECD, Paris.
20. Loan covenants take many forms. They include affirmative covenants, which require the borrower to comply with certain basic standards of behaviour such as making timely payments of interest charges and fees, paying taxes, obeying applicable laws, etc.; negative covenants, which proscribe certain activities, such as asset sales, acquisitions, debt issuance and other transactions that could prove detrimental to the lender(s); and financial covenants, which establish performance criteria the borrower must satisfy regarding such measures as cash flow to debt service, liquidity, equity or tangible net worth, or set ceilings for leverage and levels of capital expenditures. For a more detailed discussion of these issues, see Lumpkin, S. A. (2003), "The Integration of the Corporate Bond and Commercial Loan Markets", OECD, *Financial Market Trends*, No. 85, October, pp. 51-86.
21. For example, securities markets in Canada are subject to provincial oversight, while insurance markets in the United States are regulated at the state level. As well, basic company law is state-based in the United States.
22. See, for example, Pomerleano, M. (1998), "The East Asia Crisis and Corporate Finance: The Untold Story", *World Bank Working Paper* No. 1990.
23. See Kaiser, K. M. J. (1996), "European bankruptcy laws: implications for corporations facing corporate distress", *Journal of Financial Management*.
24. There is no deposit insurance scheme in New Zealand; neither is there any explicit depositor protection objective incorporated in financial sector legislation. Instead, policy aims to provide depositors and investors with the information they need to make informed decisions and requires financial service providers to comply with general consumer protection laws.
25. See Park, D. (1998), "The Meaning of Competition", *Journal of Economic Education* (Fall), pp. 347-57.
26. Banks, for example, may give affiliated clients preferential treatment or assume risks in transactions with affiliates they would not otherwise take on in the normal course of a typical business relationship. Conflicts of interest may also arise when a bank extends credit to corporate clients, while also underwriting its securities or engaging in other business with that client. The risks may be greater in jurisdictions in which banks are controlled by powerful insiders. In some cases, the insiders may be families whose holdings may be direct, but more often are achieved through pyramid and other schemes. Opaqueness, aided by concentrated ownership, makes it easier in these

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cases for insiders to exploit outside investors and creditors, especially through connected lending and preferential treatment of affiliated parties. Other sectors of financial services may be subject to similar or additional conflicts.

27. Conflicts of interest are of particular concern when they arise in the banking sector, given banks' role in the payments system, the importance of bank credit to economic activity, their systemic importance and the need to protect depositors to prevent a contagious loss of confidence in the banking system. Episodes of widespread financial distress have often had their cause in poor lending practices at banking institutions, mainly in the form of connected lending and weak internal controls. Close links between banks and their corporate clients and sometimes government as well have been implicated in many financial sector crises.
28. Various elements of the legal and regulatory infrastructure for insurance companies address potential conflicts of interest. Some of these rules apply to all share companies in general, such as rules concerning directors' duties and restrictions against connected party transactions, while measures such as specific redress arrangements, rules on asset separation, and the separation of life insurance from non-life insurance and other non-insurance related activities are particular to the insurance business itself. In addition to formal licensing requirements, there may be requirements regarding the legal structure of the insurance entity, solvency requirements, and other technical rules regarding insurance underwriting, "fit and proper" tests for directors and other senior officers, and accounting requirements. Actuaries and auditors are required in most OECD countries, and a few countries also require asset managers, custodians, or internal control officers. Prudential supervision is carried out on an on-going basis to ensure compliance with the rules.
29. There are also regional differences as well. For instance, information on trading positions in the US is held by central clearing houses, whereas in Europe, the same information is typically held by brokers.
30. See the discussion in Gaa, C., R. Ogrodnick, P. Thurlow and S. A. Lumpkin (2001), "Future Prospects for National Financial Markets and Trading Centres", *Financial Market Trends*, No. 78, March, pp. 37-72.

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Résumé : Tour d'horizon conceptuel de la politique financière

Cet article examine différents aspects de la formulation de la politique financière dans un paysage des services financiers en pleine mutation. Les tendances et évolutions récentes observées dans le secteur des services financiers, ainsi que quelques problèmes de plus longue date, placent les autorités de tutelle et de contrôle devant un certain nombre de défis. Certains de ces défis peuvent être reliés à des évolutions technologiques et aux progrès correspondants de l'ingénierie financière ; d'autres tiennent à l'internationalisation croissante de certaines catégories de services financiers – le terme de « mondialisation » est peut être mieux choisi ici ; certains problèmes trouvent enfin leur origine dans les évolutions démographiques. Dans les pays de l'OCDE, on constate une certaine évolution des objectifs fondamentaux de la politique financière (par exemple, la stabilité systémique, la protection du consommateur et de l'investisseur et la conduite des affaires), mais les régimes et pratiques de réglementation présentent tout de même de grandes disparités, car les divers pays membres et observateurs officielles définissent les objectifs de leur politique financière en fonction de la cartographie de leur appareil de réglementation et de contrôle.

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Box 2. The need for a single standard for calculating and reporting pension fund performance

Preliminary work initiated by the OECD Task Force on Pension Statistics shows that a vast amount of thinking and data gathering, work and research has gone into understanding the various methodologies applied by OECD countries to calculate the investment performance of pension schemes. While the individual efforts that have gone into creating methodologies for individual countries have borne fruit in their national context, it is still extremely difficult to compare the performance of one country's pension funds to those of another, due to the different algorithms used by different countries. Preliminary work undertaken by the OECD Task Force on Pension Statistics suggests that there is no single method that is demonstrably better than the rest. When different groups examine the same questions with a view to creating and endorsing a methodology for evaluating complex sets of financial instruments, it comes as no surprise that they may come up with different recommendations.

Exactly the same problem has been confronted by the world of fund management, which, of course, is closely related to the topic of pension funds. Over a number of years, experts from every part of the market and representing 17 different countries met in a sub-committee. As a result of their work, a set of standards was created. The standards were called Investment Performance Standards (GIPS). Part of the GIPS "vision statement" explains why this standard would be extremely relevant to this discussion: "A global investment performance standard leads to readily accepted presentations of investment performance that present performance results that are readily comparable among investment managers, without regard to geographic location". GIPS provide the investment community with a set of standards for investment management firms to follow when presenting their performance results to potential clients. It would therefore be relevant to examine how official pension authorities could draw on this standard, thus allowing potential improvement not only for national performance to be comparable and analysable over time, but also internationally across nations.

Prior to further examination of existing standards and harmonisation in performance measurement, the OECD work is critical for a better understanding of concepts. Therefore, the follow-up of this work undertaken by the OECD is welcome in order to get an in-depth knowledge of methodologies and calculation methods used in OECD countries.

Source: Chris Golden, Chairman of European Federation of Financial Analysts Societies, European Bond Commission (EFFAS-EBC), unpublished mimeo.

total assets under management in 2004 grew by 6.5 percentage points in Norway, 2.1 in Sweden, 1.5 in New Zealand, 1.4 in Canada, 1.1 in Ireland and Spain, 0.7 in Finland and 0.5 in the United States. In Japan, on the other hand, social security reserve funds decreased by half a percentage point.

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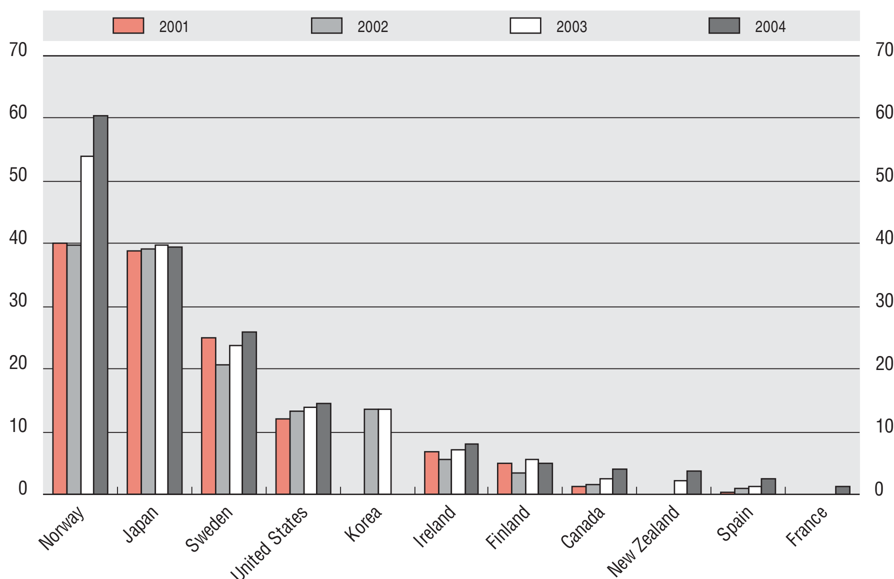
Figure 3. **Social security reserves for selected OECD countries, 2001-2004**
In per cent of GDP



Source: OECD, Global Pension Statistics.

There were also some important portfolio reallocations. The recently established New Zealand reserve fund increased its allocation to equities to over 70 per cent of total assets as investments in Treasury Bills and cash were cut back drastically. On the other hand, the Canadian reserve fund (CPP) reduced its allocation to equities from about 90 per cent to less than 70 per cent.

VIII. Focus on pension funds in selected non-OECD countries

Pension fund growth also continued unabated in Latin America and Asia, two regions where mandatory funded pension systems are common.

Few countries in these two regions are OECD members but their experience in pension reform is worth examining. Another region with a rapidly growing pension fund sector is Eastern Europe. Many non-OECD countries in this region have introduced pension funds during the last five years, including Bulgaria, Croatia, Estonia, Latvia, Lithuania, Russia, Slovenia, and the Ukraine. Macedonia will join this group in January 2006 when the new pension fund system is expected to start operating. The funded pension system is

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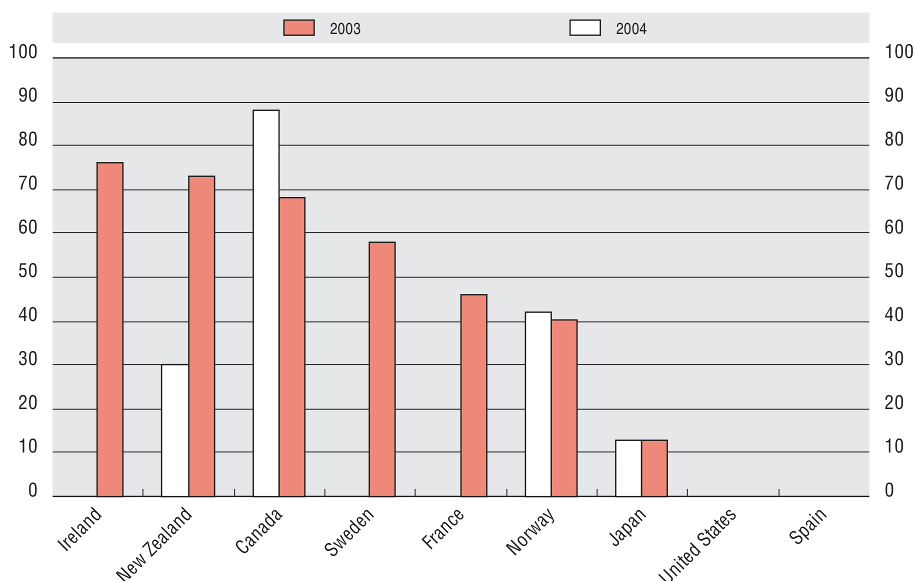
Figure 4. **Social security reserve fund equity investment for selected OECD countries, 2003-2004**

In per cent of total assets



Source: OECD, Global Pension Statistics.

mandatory for new entrants to the labour force in all these countries except Lithuania. While assets under management in non-OECD Eastern European countries represented less than 3 per cent of GDP in 2004, it is expected that they will grow rapidly over the coming years as a result of the mandate to save. Outside these three regions (Asia, Latin America and Eastern Europe), only a few countries such as Kenya (23 per cent of GDP), South Africa (33.9 per cent of GDP) and Israel (29 per cent of GDP) have large pension fund systems (Figure 5).

Low pensions coverage is a key concern in Asian countries

Asian countries, where 60 per cent of the world population live, face the most impressive demographic changes in the world. The average old-age dependency ratio is expected to triple in Asia from 10 per cent today to 24 per cent by 2050, with some countries facing dependency ratios of nearly 70 per cent.

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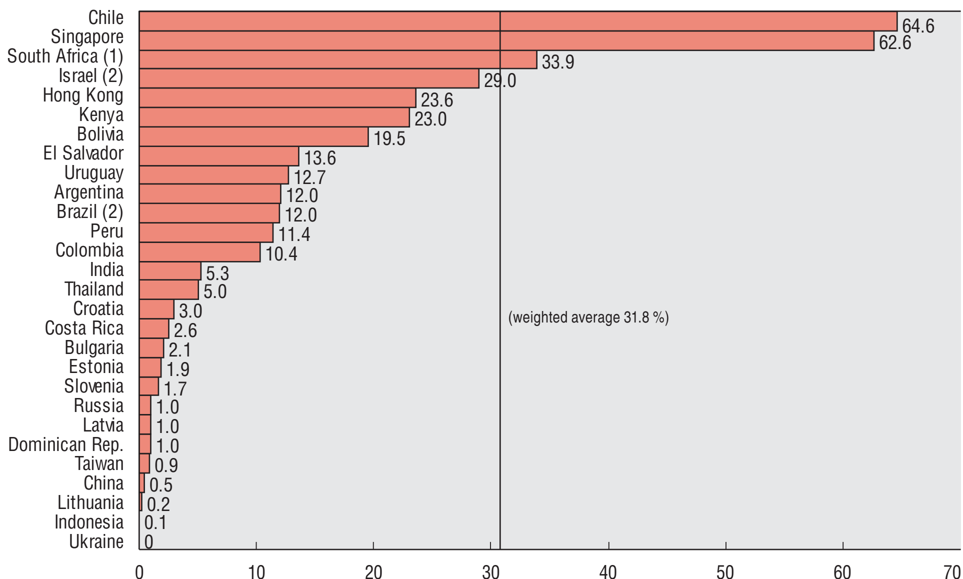
Figure 5. **Pension fund assets in selected non-OECD countries, 2004**

In per cent of GDP



Source: OECD compilation (see notes in the Annex).

With a view to addressing the impending problem that will occur from population ageing, most countries in the region have started to implement measures to increase pension coverage and to provide adequate replacement rates. However, countries are at different stages of pension reform and demographic developments vary.

These countries range from highly industrialised ones to those resembling more a developing country than an emerging market. These variations in development are reflected by huge differences in their pension systems. While more developed economies, like Singapore, have almost universal coverage of the population, other countries like China and India still reach only a minority of the population.

Despite the differences in coverage, most Asian countries share one feature in common: they rely to an increasing extent on funded pensions in order to help securing retire-

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ment income for the elderly. In particular, both China and India will experience rapid growth in defined contribution pension arrangements now that the legislation for these plans has been put in place.

Portfolio choice arrives to Latin American individual account pension systems

As a first laboratory in structural pension reform, Latin America has accumulated a large pool of pension fund savings. Total assets under management by Latin American pension funds amounted to USD 146.5 billion in 2004, only 0.9 per cent of the OECD total, but 32.1 per cent of the region's GDP.

All major countries in the region, except Brazil, have mandatory or substitutive fully-funded individual accounts held at pension funds. In Brazil, pension funds are largely employment based though open pension funds (similar to those in other Latin American countries) have been growing rapidly in recent years.

The region has recently experienced a second-wave of reforms of individual account systems, involving the introduction of member choice of portfolio (known as "multifunds" in the region). Chile introduced a five-portfolio model in 2002, while Peru did so earlier this year. The Chilean system has been the most successful, as nearly 30 per cent of all affiliates had selected a portfolio by December 2004. On the other hand, the recently introduced three-portfolio arrangement in Peru has met little popularity. Fewer than one per cent of members had made an active choice by October 2005.

Portfolios remain relatively conservative in most Asian and Latin American countries

As in 2003, pension fund portfolios in non-OECD countries (those that participated in the official OECD data collection exercise, see Table 5) were much more conservative than those in the OECD area, cash and deposits being a major asset class in Brazil, Thailand and Indonesia (respectively accounting for 44.2, 70.9 and 41.4 per cent of total assets). Investment in equities also tends to be much lower than in OECD countries.

Pension fund asset allocation in Latin America is largely concentrated in domestic government securities and bank instruments. There are some exceptions, however. Peruvian pension funds had over 45 per cent of their assets invested in the corporate sector, while nearly 30 per cent of Chilean pension fund assets were invested abroad (Table 10).

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Table 10. **Asset allocation of selected non-OECD countries, 2004**

	State Sector	Corporate Sector	Financial Sector	Foreign Sector	Other Assets
Latin American countries					
Argentina	62.3	14.7	11.1	10.3	1.6
Bolivia	67.5	24.4	5.6	1.4	1.1
Chile	18.7	24.4	29.5	27.3	0.1
Costa Rica	77.2	11.3	11.5	n.a	..
El Salvador	83.5	0.3	10.5	5.5	..
Peru	24.5	45.2	20.0	10.2	0.1
Dominican Republic	n.a	n.a	100.0	n.a	n.a
Uruguay	79.0	5.2	7.5	n.a	8.3
Other countries					
Kazakhstan	50.6	30.4	9.0	7.2	2.8

1. Total may not add up due to rounding or to negligible value.
Source: International Federation of Pension Fund Administrators.

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List of official sources used under the OECD Global Pension Statistics Project

Statistical source(s) by country	
OECD countries	
Australia	Australian Prudential Regulation Authority
Austria	FMA Financial Market Authority
Belgium	Commission Bancaire, Financière et des Assurances
Canada	Statistics Canada
Czech Republic	Ministry of Finance
Denmark	Danish Financial Supervisory Authority
Finland	Insurance Supervision Authority
France	Ministry of Finance
Germany	Federal Financial Supervisory Authority
Hungary	Hungarian Financial Supervisory Authority
Iceland	Financial Supervisory Authority
Italy	Commissione vigilanza fondi pensione (COVIP)
Japan	Ministry of Foreign Affairs
Korea	Korea Life Insurance Association
Mexico	CONSAR
Netherlands	Statistics Netherlands
New Zealand	Ministry of Economic Development
Norway	Kredittilsynet
Poland	Insurance and Pension Funds Supervisory Commission of Poland
Portugal	Instituto de Seguros de Portugal
Spain	Banco de Espana
Spain (1)	Ministry of Economy
Slovak Republic	Ministry of Finance of the Slovak Republic
Switzerland	Office fédéral de la statistique
Sweden	Finansinspektionen (the Swedish Financial Supervisory Authority)
Turkey	Directorate general of Insurance, Department for Private Pensions
United Kingdom	National Statistical Office (ONS)
United States	Department of Treasury
United States	Federal Reserve
United States	Department of Labor
Non-OECD countries	
Argentina	International Federation of Pension Funds Administrators
Bolivia	International Federation of Pension Funds Administrators
Brazil	Ministry of Finance - SUSEP (Open funds)
Brazil	Ministry of Social Security (Closed funds)
Bulgaria	Financial Supervision Commission
Chile	International Federation of Pension Funds Administrators
Colombia	Superintendencia Bancaria de Colombia
Costa Rica	International Federation of Pension Funds Administrators
El Salvador	International Federation of Pension Funds Administrators
Estonia	Financial Supervision Authority
Hong Kong	Mandatory Provident Fund Schemes Authority
Indonesia	Ministry of Finance of the Republic of Indonesia
Kazakhstan	International Federation of Pension Funds Administrators
Peru	International Federation of Pension Funds Administrators

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List of official sources used under the OECD Global Pension Statistics Project (*cont.*)

Statistical source(s) by country	
Non-OECD countries	
Singapore	Monetary Authority of Singapore
Slovenia	Slovene Insurance Supervision Agency
Slovenia	Slovene Security Market Agency
South Africa	Financial Services Board
Thailand	Securities and Exchange Commission
Uruguay	International Federation of Pension Funds Administrators

1. Data coming from a secondary source was used to estimate investments by mutual pension entities.
Source: OECD, Global Pension Statistics.

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Annex

Notes to be taken into consideration when interpreting the data

Data includes pension funds per the OECD taxonomy.[11] All types of plans are included (occupational and personal, mandatory and voluntary). Pension funds include also some personal pension arrangement like the Individual Retirement Accounts (IRA) in the United States as well as funds for government workers (Box 2).

Assets pertaining to reserve funds in social security systems are excluded.

General notes

- G10 includes Belgium, Canada, France, Germany, Italy, Japan, the Netherlands, Sweden, Switzerland, the United Kingdom and the United States.
- Euro Area includes 12 countries: Austria, Belgium, Germany, Greece, Finland, France, Italy, Ireland, Luxembourg, Netherlands, Portugal, and Spain.
- OECD countries exchange rates to Euro used: 1.12 in 2001; 1.06 in 2002, 0.89 in 2003, and 0.80 in 2004.
- All OECD countries exchange rates from OECD, Main Economic Indicators.
- Non-OECD countries' exchange rates and GDP data from the International Financial Statistics Yearbook, IMF.
- Data for Luxembourg are confidential.
- Data for Greece are close to zero.
- Conventional signs: "n.a", not applicable; "..", not available.

Common notes to **Table 1**, *Figure* **1**, *Figure* **2**, *Table* **3**, *Table* **4** *and Table* **6**

(1) 2003 data used for 2004;

(2) Includes mandatory pension plans for 2004, but not for previous years.

(3) OECD staff calculation; total assets for pension funds based on total liabilities.

(4) Source: Irish Association of Pension Funds (IAPF).

(5) Data does not include Mutual Aid Associations; 2004 data includes Personal Pension Plans and 2003 data on Occupational Pension Plans.

(6) Includes Mutual Pension Entities for 2004.

(7) Includes assets from the Premium Pension System for 2004.

(8) 2003 data are preliminary estimates.

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(9) 2002 data are 2001.

(10) Includes State and Local Government Retirement Funds as well as Federal Government Retirement Funds.

(11) Source: Bank of Israel, Annual Report, 2003.

Specific notes

Figure 1 and Table 1:

- Life Insurance data from OECD Insurance Statistics Yearbook, 2005 edition; 2002 and 2003 data used for 2003 and 2004 figures, respectively.
- Weighted average for total as a percentage of GDP using pension fund assets as weights.

Table 3 and Figure 2:

- GDP (at current prices) is from OECD Main Economic Indicators.
- Weighted average for totals as a percentage of GDP using pension fund assets as weights.

Table 5:

- Total may not add up due to rounding or to negligible value.
- Some substantial variations in the figures presented in Table 5, as compared to the same table exhibited in the issue 1 of this newsletter, can be explained by the efforts of countries to reallocate the "other investments" category. This is the case for Finland, Italy and United States. The high level of this category ('other investment') in other countries (*e.g.* Spain) can be explained by the inclusion of alternative investments under this category. To address this issue, as of 2006, a new investment category, 'alternative investments', will be created.

(1) 2003 data.

(2) For Portugal, the values shown under "other investments" include short term payable accounts to the fund managers (commissions), payable loans and the amount relative to the partial transfer of one pension fund, transferred to social security, worth about 1 billion Euros.

(3) 2002 data.

Figure 3:

- The data for Korea is related to 31 June 2003.
- The data for Japan is related to the end of the fiscal year, 31 March. The data includes the Mutual Aid Associations.
- In the chart, data point at 'zero' means data is not available for France and Korea but not applicable in the case of New Zealand.
- The data for Sweden includes AP1, AP2, AP3, AP4, AP6 as well as two temporary funds.

Figure 4:

- The data for Japan is related to the end of the fiscal year, 31 March 2004. In the case of the asset allocation for National Pension and Employees' Pension Insurance, 2003 data is used.
- In the chart, data point at 'zero' means data is not applicable in the case of USA and Spain.
- The data for Sweden includes AP1, AP2, AP3, AP4, AP6 and two temporary funds.

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Figure 5:

- Source for Latin American countries: International Federation of Pension Fund Administrators
- Source for Asian countries: Allianz Global Investors.
- Source for Bulgaria, Colombia, Estonia, Mexico, Slovenia, South Africa, and Thailand: OECD Global Pension Fund Statistics.
- Various sources used for other non-OECD countries.

(1) 2004 data are preliminary estimates.

(2), (3) 2003 data.

Notes

1. Life insurance company assets include both the traditional life insurance business and pension insurance contracts. The OECD is working to separate out the two forms of life insurance in the statistics.
2. Pension funds, life insurance companies and social security reserve funds.
3. A new mandatory individual account system was introduced on January 1st, 2005.
4. Korea became the latest OECD country to introduce an occupational pension system with the passing of the "Employee Retirement Income Security Act" on December 29, 2004. Implementation is set for 1 December 2005 for employers with five or more employees; smaller firms will have to comply by 2010.
5. 9 per cent of employee's salaries to privately run pension funds.
6. In local currency, growth in Norwegian pension fund assets stood at 59 per cent, followed by Australia, Hungary and Poland at 39 per cent, the Czech Republic at 24 per cent, and Iceland at 20 per cent.
7. Non-OECD countries that participate in the Global Pension Statistics project are included in this section.
8. See also: Schich, S. and M. Weth "Potential pension fund demand for high-quality long-term bonds: Quantifying 'scarcity' of suitable investments", in this issue of Financial Market Trends (Vol. 2006/1, No. 90).
9. Pension Benefit Guaranty Corporation (PBGC): "Performance and Accountability Report, Fiscal Year 2005", (November 15, 2005).
10. Cash Flow = [Total contributions + Net investments income + Other income] – [Benefits + Operational expenses + Other expenses].
11. *Private Pensions*: OECD *Classification and Glossary*. The Glossary is available at *www.oecd.org/daf/pensions/*.

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Résumé : Le projet de l'OCDE sur les statistiques des pensions dans le monde – Aperçu du patrimoine financier accumulé dans le cadre de régimes de retraite par capitalisation

Un indicateur de substitution utile du total des actifs accumulés dans les régimes d'épargne et de retraite à long terme réside dans la somme des investissements des fonds de pension et des sociétés d'assurance vie. Cet indicateur couvre en effet la grande majorité des régimes de retraite professionnels et individuels des secteurs public et privé qui ont recours à la capitalisation. En 2004, le total des actifs détenus par les fonds de pension et les sociétés d'assurance vie a progressé de plus de 3 300 milliards USD, soit l'équivalent de 1.5 point du PIB total des pays de l'OCDE. Le volume des actifs accumulés par les fonds de pension est dans une large mesure lié à leur échéance et à l'importance de la couverture du marché du travail. Dans la zone de l'OCDE, les fonds de pension ont connu une expansion spectaculaire ces dix dernières années, passant de 5 900 milliards USD en 1994 à 15 600 milliards USD en 2004. Bien que la plupart des pays aient affiché une augmentation substantielle du ratio des actifs des fonds de pension à leur PIB de 2003 à 2004, il existe certaines exceptions à cette règle. En 2003, ce sont les pays qui sont partis d'un niveau relativement bas qui ont enregistré une croissance rapide des actifs des fonds de pension. On a aussi pu observer en 2004 un mouvement de diversification internationale plus marquée des portefeuilles de ces fonds. En outre, les règles de capitalisation qui visent aussi à améliorer la sécurité des prestations de retraite, sont susceptibles de provoquer des modifications de la répartition des actifs.

Cet article fait le point sur le projet de l'OCDE sur les Statistiques des pensions dans le monde. Il s'appuie sur la deuxième livraison de la lettre d'information de l'OCDE *Pension Markets in Focus* et donne un aperçu des tendances récentes de l'épargne à long terme et de l'épargne retraite. Il examine notamment les tendances des retraites par capitalisation dans les pays de l'OCDE et il s'attarde plus précisément sur la répartition des actifs et des caractéristiques particulières concernant les flux de trésorerie des fonds de pension, leurs performances financières, les fonds de réserve des administrations de sécurité sociale ainsi que les actifs des fonds de pension dans quelques pays hors OCDE.

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Abstract: Highlights of OECD Financial Outreach Activities in 2005

In the late 1980's the OECD began co-operation (*i.e.* policy dialogue with non-member economies) with the Asian Newly Industrialising Economies, and when the Berlin wall fell in 1989 it launched a programme with the Central and East European countries in transition. Today, the co-operation extends to some 100 non-members. These "Outreach" activities have of course included financial sector reform, as the financial sector is often considered one of the key sectors in assisting these economies' developments. The OECD's efforts in this area have focused on, and continue to give primary attention to, financial market reform (including corporate governance) as well as insurance and pension market policies and reform on a regional basis; they have been recently targeting Asia, as this region is the most dynamically growing among the emerging economies. This note describes the general background for the financial "Outreach" activities as well as highlighting the activities conducted in 2005 in Asia and elsewhere.

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Highlights of OECD Financial Outreach Activities in 2005

In the late 1980's the OECD began co-operation (*i.e.* policy dialogue with non-Member economies) with the Asian NIES (Newly Industrialising Economies*) and when the Berlin wall fell in 1989 it launched a programme with the Central and East European countries in transition. Today, the co-operation extends to some 100 non-members.

These "Outreach" activities have of course included financial sector reform, as the financial sector is often considered one of the key sectors in assisting these economies' developments. The OECD's efforts in this area have focused on, and continue to give primary attention to, financial market reform (including corporate governance) as well as insurance and pension market policies and reform on a regional basis; they have been recently targeting Asia, as this region is the most dynamically growing among the emerging economies.

The paragraphs below describe the general background for the financial "Outreach" activities as well as highlighting the activities conducted in 2005 in Asia and elsewhere.

All conference materials are available at: *www.oecd.org/daf/financialmarkets* (Non-member Activities).

I. Financial markets

Background

While Asia has shown significant economic growth over the past four decades, it continues to hold strong potential to remain the fastest-growing region in the world, indicating the continuance of very large and promising investment opportunities in this area. However, the Asian Financial Crisis in 1997-1998 swept away, albeit momentarily, this optimism that had been ubiquitous not only in the region but also in other parts of the world. Although this renewed pessimism proved to

* South Korea, Chinese Taipei, Hong Kong, China and Singapore.

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be rather short-lived owing to the region's well-coordinated response and generous assistance from the international community, a consensus opinion seems to have emerged during the past several years, both in policy and academic circles, recommending Asian economies to become less reliant on bank financing that had traditionally been very dominant in Asia, while placing more emphasis on developing capital markets.

This approach is seen as a better means to mobilise regional savings for long-term financing and to spread risks and absorb the shocks of any possible future contingencies. As often mentioned, Asian countries as a whole have a large pool of savings. For example, gross savings ratios of many Asian countries are around 30 to 50 per cent, while world-wide averages have hovered at about 20 per cent. Thus it is important that domestic and regional savings should be mobilised within the territory or region, especially to reduce currency and maturity mismatches in the balance sheets, which have been pointed out as one of the "triggers" of the financial crisis. The development of Asian capital markets that are resilient to external shocks is thus critical, and to that end, it is of critical importance to pursue transparent disclosure regimes, more investor empowerment and thus better functioning capital markets for the purpose of sustainable economic growth in this region, in light of the lessons learned from the economic turmoil.

Activities

OECD-China Forum on Public Debt Management and Development and Government Securities Markets in China

Pursuant to a request from the Chinese authorities for the OECD to work with the Ministry of Finance (MOF) on key issues in public debt management and the development of Chinese debt markets, in 2004 the OECD Secretariat contacted the Treasury Department of the Chinese Ministry of Finance to successfully organise with them a multi-year program in this field under the aegis of the OECD Working Party on Debt Management.

The second event under this framework was held on September 2005 in Xian, and highlighted such topics as the role and responsibility of the Ministries of Finance in developing government bond markets, and regulation and supervision of public bond markets.

The current medium-term programme with China will enter its third year in 2006, and possible expansion of the programme to include other Asian countries will be explored to respond to the regional initiatives on bond market development.

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Roundtable on Capital Market Reform in Asia

The OECD, together with the Asian Development Bank Institute (ADBI), established *the Roundtable on Capital Market Reform in Asia* in 1999 to provide a regional forum to discuss the challenges that securities market regulators and policy makers should address in the aftermath of the Asian financial crisis in 1997-1998. In particular it has met the regional demands for policy discussion to lessen reliance on bank finance and to introduce structural reform into capital markets in order to make the economies more resilient to possible external or internal shocks. High ranking representatives participate in the Roundtable, including senior officials from securities market regulators, policy makers and international organisations as well as academics and business. The Roundtable covers almost all economies from East Asia such as China, Hong Kong, Chinese Taipei, alongside with the ASEAN countries to South Asia such as India, Pakistan, Sri Lanka and Bangladesh, apart from Japan, Australia, New Zealand and South Korea and other OECD countries.

The Seventh Roundtable was held at the ADBI in Tokyo in October 2005. About 50 people participated in the Roundtable including senior officials from securities regulators, policy makers, capital market experts and academics from Asia and the OECD countries, and representatives from the ADB (including the ADBI), the World Bank, and the IMF. Mr. Andrew Sheng, former Chairman of the Hong Kong Securities and Futures Commission, chaired this conference.

Although considerable developments have been made in the capital markets in this region since the crisis, there remain a lot of challenges to be addressed for further developing sound and efficient markets. Against this backdrop, the 2005 Roundtable covered several topical issues with the following agenda items: 1) Financial Policy Landscape; 2) Integration of Capital Market in the Asian Region; 3) Investor Education; 4) Developments in the Venture Capital and Private Equity since the end of the "Tech Bubble", and 5) Governance Issues Related to Securities Markets.

Capital market reform will provide continuous policy challenges for the Asian region in the foreseeable future. The Eighth Roundtable is planned to be held in late 2006 with an agenda based on the discussion in the relevant OECD Committees as well as reflecting the current policy needs in the region. The Roundtable will continue to be designed and managed in a way to meet the regional demands and to attract high ranking officials and business/academic leaders in the region so as to ensure utmost policy impacts.

OECD Global Forum on Public Debt Management and Emerging Government Securities Markets

This forum was initially established 14 years ago as a programme to assist the transition economies in Central and Eastern Europe (similar to the Japanese pro-

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gramme with the OECD Directorate for Financial and Enterprise Affairs in the mid-90's), but with specific focus on their public debt management and the development of their government securities markets. The Forum introduces to non-Members OECD conclusions and best (or good) practices developed through a "peer review" process in the Working Party on Public Debt Management.

The 15th Forum (the first time the Japanese voluntary contribution supported this event) was held in December 2005, highlighting such topics as cash management, performance management, and auction theory and practice. The meeting attracted about 80 delegates, consisting mostly of debt managers from OECD countries and emerging markets, including those from China, Indonesia, Turkey, Mexico, Brazil, Hungary, South Africa, and Israel. The IMF and the World Bank also participated in the discussions.

Seminar on Capital Markets in Indonesia

Following the agreement between the OECD and the BAPEPAM (Capital Market Supervisory Agency of Indonesia) the seminar for policy dialogue between the OECD and Indonesia preceding the Asian Roundtable on Corporate Governance meeting was held in Bali. Several speakers from the OECD member countries and the Secretariat attended to discuss with participants from Indonesia.

The morning session of the seminar discussed how to further develop markets for government bonds based on the OECD experiences and for corporate bonds based on Japan's experiences. The afternoon session focused on how to improve corporate governance in terms of, amongst others, the role of the board as well as the governance in groups of companies. The seminar tried to seek the applicability of best or good practices of the OECD countries to Indonesia in those policy areas.

II. Insurance

Background

As an important part of the financial sector, the insurance sector may affect overall financial stability. The financial crises which fell upon emerging economies in the late 1990's, while affecting the insurance industry in those economies to a lesser extent than would have been expected, also generated a momentum for regulatory and supervisory reforms in this sector from various angles. Thus, the development of an adequate insurance regulatory and supervisory framework has been promoted by the OECD, in co-operation with other relevant international bodies such as the International Association of Insurance Supervisors (IAIS).

Insurance markets have also been increasingly integrated globally, underpinned by market liberalisation; concomitantly, emerging economies are seeing devel-

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opments, challenges and problems similar to those pertinent to OECD countries. For example, in recent years, the demographic changes and renewed economic growth have allowed for the development of new markets, such as health insurance products.

These issues have been the focus of intensive OECD study and work over the recent years. The policy dialogue and exchanges supported through the organisation of conferences, on the one hand, assist these emerging economies in meeting current and particular insurance risks and in appropriately regulating and supervising developing insurance markets, and on the other hand, provide OECD members with new experiences and points of view on these issues as well as ensure stability in the insurance and financial markets of these economies in general.

Activities

Conference on Insurance Regulation and Supervision in Latin America

The sixth OECD-IAIS-ASSAL Conference on Insurance Regulation and Supervision in Latin America was held in Cochabamba, Bolivia in March 2005 in co-operation with the local sponsor (Pensions, Securities, and Insurance Superintendent of Bolivia (SPVS)), the ASSAL (Association of Latin American Insurance Supervisors) and IAIS (International Association of Insurance Supervisors).

This conference was held on the occasion of the 16th Annual Meeting of ASSAL and preceded the ASSAL-IAIS Training Seminar on insurance supervision. It was held against the backdrop of ongoing changes in insurance markets in Latin America, addressing such issues as Governance of Insurers, Solvency, and Catastrophic Risk Insurance in respective panels. The conference was attended by about 60 participants consisting of ASSAL members (including senior level supervisors), as well as the private sector. Mr. Kawakami and Ms. Messy from the OECD Secretariat attended the conference and chaired as well as spoke in a session on "Catastrophic risk management and insurance" and "Governance of Insurers". Professor Monti of Bocconi University spoke on behalf of the OECD on "Catastrophic risk management and insurance".

Conference of Pan-European Insurance Supervisory Services

The 18th Conference of European Insurance Supervisory Services was held in Prague, the Czech Republic in May 2005 in co-operation with the local sponsor (Office of the State Supervision in Insurance and Pension Funds, Czech Ministry of Finance), IAIS (International Association of Insurance Supervisors), and the IIF (International Insurance Foundation), as co-sponsors along with the OECD. The conference was attended by approximately 130 participants from the supervisory side and the private sector, including approximately 40 European insurance

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supervisors (some at senior level), as well as about 70 local participants. Mr. Schneiter, Chair of the OECD's Insurance Committee, represented the OECD, while Mr. Kawakami from the OECD Secretariat also attended the conference as one of the organisers. Professor Monti of Bocconi University spoke again on behalf of the OECD on "Catastrophic risk management and insurance".

The first day discussed such issues as: 1) developments in the Czech insurance system; 2) changes in the European insurance market subsequent to the new members' accession in May 2004; 3) risk-based supervision, and 4) role of professional entities. On the second day, a "Workshop on International Developments of Prudential Supervision and Insurance Core Principles" was held, addressing issues as how to coordinate international accounting rules with prudential regulation and solvency.

OECD-ASEAN *Reinsurance Seminar*

The OECD co-sponsored this event with the AITRI (ASEAN Insurance Training and Research Institute) in November 2005 in Kuala Lumpur, Malaysia, with the co-operation also of the IAIS. The OECD was responsible for organising the second day of discussions, which focused on catastrophe risk management and insurance.

About 30 participants from eight ASEAN countries as well as Macao SAR, Australia, and Canada attended. While the participants remained in general rather quiet and passive, seven participating ASEAN countries (except Singapore that was self-financed) did make presentations on their respective CatRisk management systems. AITRI was generally pleased with the co-operation and assistance that the OECD was able to provide for this seminar, and requested follow-up on possible future co-operation in 2006.

III. Private pensions

Background

Private pension provision is generally at an early stage in the Asian-Pacific region. However, many of these countries have well developed funded, publicly managed saving and retirement systems, and family support networks have also traditionally provided an important source of retirement income for the elderly. Private sector involvement in the management of pension assets is already permitted or envisioned in some of these countries, while opportunities for individual choice are being introduced. Hence, private pensions are likely to become an important component of the retirement system of these countries.

The objectives of policymakers in the majority of countries in the region include expanding coverage of pension plans, raising the relatively low retirement

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age, increasing rates of return to pension funds and, most importantly, securing the benefits by proper regulation and supervision. In order to secure the benefits, funding and investment regulations are critical to ensure that pension schemes are well managed. Moreover, these policies must be coupled with reforms to improve the financial infrastructure, including custody and depository services, risk rating and pension fund corporate governance.

The OECD Working Party on Private Pensions has been working in this field, focusing its efforts on regulatory and policy issues related to private pension systems. Private pensions have appeared as a key issue for some time in the OECD countries, and recently in emerging economies as well. Given the growing importance of private pension funds from both social as well as economic policy perspectives, this Working Party has concentrated its efforts on assisting countries to developing effective infrastructures and policies for supervision and regulation of private pensions, by means of regular policy dialogue between policy makers, as well as standard-setting, analytical and statistical activities.

Activities

Conference on Private Pensions in Asia

The OECD/IOPS Conference on Private Pensions in Asia took place in April 2005 in Bangkok, Thailand. The Conference was held under the auspices of the OECD Insurance and Private Pensions Committee and was organised in co-operation with the International Organisation of Pension Supervisors (IOPS).

The conference was hosted by the Securities and Exchange Commission of Thailand (SEC) with additional sponsorship provided by the Government of Japan and the IOPS. The conference brought together 120 experts in the private pension area from 11 OECD member countries (Australia, Germany, Ireland, Italy, Japan, Korea, the Netherlands, Spain, Turkey, the United Kingdom and the United States); 10 Asian-Pacific economies (Bhutan; China; Hong Kong, China; Indonesia; Kazakhstan; Malaysia; Singapore; Sri Lanka; and Thailand); as well as experts from Bulgaria, Croatia, Kenya, South Africa and Jordan. In addition, the representatives of several international organisations, namely the World Bank Institute and the Asian Development Bank (ADB), also participated in the conference.

The key objective of the conference was to provide an international forum for a discussion on specific policy issues and challenges in the implementation of pension reforms in Asia. Particular focus was laid on the reform process in Thailand and on "best practice" regulatory mechanisms used in the OECD countries to ensure efficient and appropriate pension provision under diversified approaches in the design of the retirement schemes. The issue of financial education of investors and fiduciaries was another crucial policy concern for the Asian-Pacific region that was addressed during the conference.

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Résumé : Le point sur les activités d'ouverture de l'OCDE en 2005 dans le domaine financier

A la fin des années 80, l'OCDE a entamé une coopération (c'est-à-dire un dialogue sur les politiques à suivre avec des économies non membres) avec les nouvelles économies asiatiques en voie d'industrialisation, et à la suite de la chute du mur de Berlin en 1989, avec les pays en transition d'Europe centrale et orientale. Actuellement, cette coopération concerne une centaine d'économies non membres. Ces activités dites « d'ouverture » se sont bien entendu intéressées à la réforme du secteur financier, car ce secteur passe souvent pour l'une des branches essentielles si l'on veut favoriser le développement de ces économies. Les efforts de l'OCDE dans ce domaine se sont attachés et continuent d'accorder une attention prioritaire à la réforme du marché des capitaux (y compris le gouvernement d'entreprise). Mais ils portent aussi sur l'action des pouvoirs publics sur les marchés de l'assurance et des retraites ainsi que sur les réformes menées à l'échelle régionale ; ces efforts ont récemment ciblé l'Asie car cette région connaît la croissance la plus dynamique parmi les économies émergentes. Cet article décrit le contexte général des activités « d'ouverture » dans le domaine financier en mettant plus particulièrement l'accent sur les activités réalisées en 2005 en Asie et ailleurs.

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