



Policy Framework for Effective and Efficient Financial Regulation

GENERAL GUIDANCE AND HIGH-LEVEL CHECKLIST



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ORGANISATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT

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Foreword

The structure and operation of financial systems have undergone marked changes in the past couple of decades, driven by dramatic improvements in technology, product innovation, integration, competition, and policy, regulatory, and trade reforms.

These developments have led to a dynamic, sophisticated, and global financial services arena that can foster economic growth. Yet, the financial and economic crisis has revealed many shortcomings in our approach to financial regulation.

The *Policy Framework for Effective and Efficient Financial Regulation: General Guidance and High-Level Checklist* is a tool that can support ongoing efforts by policymakers, regulators, and supervisors to achieve stronger, more resilient financial systems. It is the product of the joint work of the Committee on Financial Markets and the Insurance and Private Pensions Committee and was the subject of a broad public consultation.

The *Policy Framework* is not meant to substitute for the more focused standards and guidelines of international standard-setting bodies in the financial sector. Its purpose is instead to guide strategic thinking and promote governmental leadership and action so that the financial system can play its vital role in the functioning of the economy.

The *Policy Framework* challenges policy makers to think about the fundamentals of financial regulation in a globalised financial system. I hope that you will put it to good use both in setting national policy and in underpinning international co-operation.



Angel Gurria
Secretary-General

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GENERAL GUIDANCE ON A POLICY FRAMEWORK FOR EFFECTIVE AND EFFICIENT FINANCIAL REGULATION

Introduction

The structure and operation of the financial system have undergone marked changes in the past couple of decades, encouraged by dramatic improvements in technology, rapid product innovation, ongoing global financial system integration, competition in financial services, and policy, regulatory, and trade reforms. These developments have led to a dynamic, sophisticated, and global financial services arena and fostered economic growth; at the same time, however, problems of confidence and trust have beset the financial system, with sometimes severe consequences, as demonstrated by the recent crisis. Given ongoing questions about the effectiveness and efficiency of financial regulation, and its use as a potential instrument for reform, governments have continued to assess, and reassess, the policy and regulatory framework for the financial system, with a view to ensuring public confidence in the system and its safety and soundness, but also retaining its flexibility and innovative character.

In this context, the Committee on Financial Markets (CMF) and the Insurance and Private Pensions Committee (IPPC) had, in recent years, a number of discussions on the effectiveness and efficiency of financial regulation. The CMF had discussions on a broad range of topics, including mergers and acquisitions and other structural developments, competition in financial services, prospects for exchanges and national financial centres, consolidation and other changes in the structure of supervisory and regulatory agencies, and arrangements to ensure regulatory effectiveness and efficiency. Input from CMF delegates has contributed to the discussions. The IPPC had, for its part, discussions on the effectiveness and efficiency of regulation, particularly in the insurance sector, and conducted a stocktaking of country initiatives to improve regulatory effectiveness and efficiency, based on delegate input.

The CMF and IPPC decided to conclude this work by developing general guidance for the development of a sound policy framework for effective and efficient financial regulation that would incorporate “good” regulatory approaches and practices synthesised from their respective stocktaking efforts and discussions. This general guidance is aimed at legislators, policymakers, regulators, supervisors, as well as relevant stakeholders, including industry and consumers. The general guidance incorporates the existing *OECD Reference Checklist for Regulatory Decision-making* and adopts a number of the principles and themes of the *OECD Guiding Principles for Regulatory Quality and Performance*.

While the general guidance is based largely on regulatory initiatives and discussions that preceded the current financial crisis, and thus may not offer specific solutions, it may nonetheless have relevance to current efforts to reconsider, from a longer-term perspective, the framework for financial sector intervention and regulation. The guidance contains a checklist of principles that should be adopted or considered as a general means of furthering the attainment of an effective and efficient framework for government intervention and regulation in the financial system. The guidance is neither sector specific nor focussed exclusively on financial regulation. In this respect, the general guidance is not meant to

substitute for the more focussed, micro-prudential principles and guidelines of international standard-setting bodies or codes of international financial institutions (though there may be some overlap), but is rather intended to operate at a higher level and address the policy framework as well as financial regulation at a general level.

The general guidance proposes that a sound ***policy framework*** provides the basis for effective and efficient financial regulation. Financial regulation cannot be understood in isolation, but must be comprehended in the context of the financial landscape, the policy objectives that have been elaborated for the financial system, and the policy instruments and system of institutions that are in place to meet these objectives. This policy framework should reflect the key features of the financial system (some of which are becoming increasingly prominent), including:

- The primary role played by the financial system in financial intermediation in the economy and in the pooling, management, and transfer of risks;
- The close interlinkages between the financial system and the macroeconomy and the global and integrated nature of financial and economic systems; and,
- The complex and rapidly evolving nature of the financial system, the continued convergence of products, institutions, and markets, and the growth of globally active financial conglomerates.

Before financial regulation is developed, there must first be a good ***understanding of the features of the financial system***, both in terms of how it ought to operate, and of how it does operate in practice, including any problems that may affect its operations or its participants, including consumers. Establishing adequate transparency in the financial system is essential for developing this critical understanding.

As elaborated in the general guidance, the framework for government intervention and financial regulation is based on the ***elaboration of policy objectives***, which define the outcomes to be expected from addressing identified problems or specified needs in the financial system and possibly more broadly. Government intervention and regulation should strive to achieve these objectives, and their ***effectiveness*** is measured by the extent to which these efforts are successful. At the same time, intervention and regulation in the financial system carries costs, so that it should be done as ***efficiently*** as possible without sacrificing the achievement of policy objectives -- unless indeed the overall costs of intervention exceed the benefits.

Financial regulation is among a number of ***policy instruments*** at the disposal of governments, and its potential uses, features, and effects should be examined alongside these other instruments. At the same time, financial regulation has its own specificities as a policy instrument, with the result that the general guidance offers some insight as to what might be good principles for financial regulation specifically. Finally, policy instruments depend on an ***institutional system*** for their implementation, another question addressed by the general guidance. Finally, the framework for intervention and financial regulation should, given rapid innovation in the sector, be subject to ***review*** on a periodic basis in order to ensure the continued effectiveness and efficiency of the policy and regulatory framework for the financial system, and financial regulation in particular.

The general guidance is structured in line with this sequencing of considerations, which should be taken into account in the development of the policy framework. An important cross-cutting element addressed throughout the general guidance is the need for enhanced international collaboration, cooperation, and

coordination, essential in a world with, on the one hand, highly integrated and sophisticated financial systems and interconnected economies, and, on the other, nation-based systems of intervention and regulation with potentially different and conflicting objectives.

The general guidance is addressed to OECD member countries. Non-member economies are invited to take due account of these good practices. The general guidance should help to promote the fundamental objectives of the OECD, which are to achieve the highest sustainable economic growth and employment and a rising standard of living while maintaining financial stability, contribute to sound economic expansion in member and non-member countries, and contribute to the expansion of world trade on a multilateral, non-discriminatory basis in accordance with international obligations.

I. Financial Landscape

Understanding the operation and functioning of the financial system is an essential step in the development of a sound policy and regulatory framework. This should involve an understanding of the essential attributes of a well-functioning financial system so that its role in the economic system is well understood and the boundaries of the financial system are clear. Financial system transparency is essential for this understanding, as it makes the operations of the system more visible and supports the identification of risks; in addition, it facilitates the identification of possible problems and needs. Market failure analysis can be an instrument in this respect. International collaboration and cooperation is needed for the establishment of transparency and for the effective monitoring and analysis of the financial system.

A. Define attributes of a well-functioning financial system

Identifying the attributes of a well-functioning financial system provides the foundation for the development of financial regulation. Whether it reflects generalised empirical observation or economic theory, the conceptualisation of an “ideal” financial system establishes a normative reference point, defined in terms of outcomes. These “ideal” outcomes serve to anchor expectations regarding the operation of the financial system and its outputs, and thus provide a benchmark for analysis and evaluation.

This process involves identifying: (i) the scope and functions of the financial system; (ii) interlinkages with the economy and the broader international financial and economic system; (iii) expected outcomes; and (iv) the underlying foundations of the system, without which the system could not function.

Scope and functions: The role and functions of the financial system within the broader economy must be properly defined. A key function of the financial system is *financial intermediation*, by which savings and investments, public or private, are transformed into productive investments. This intermediation function may take place through financial institutions such as banks or may take place directly between parties through capital markets. Another key function of the financial system is the *pooling, management, and transfer of risks*. The financial system also *facilitates private and public transactions* by supporting the existence and circulation of money (e.g., demand deposits), providing related payment mechanisms, offering financial advisory services, and purchasing and trading securities. In addition, the financial system plays a key role in the promotion of financial disclosures and the general *pricing of risk*. The rapid evolution of the

financial system and its growing complexity may make the precise identification of the scope and functions of the system difficult and quickly outdated.

Linkages: The macroeconomic and international linkages of the financial system should be defined and highlighted. The financial system plays a critical role in supporting the operation of the monetary system and ensuring an effective and efficient transmission of monetary policy; the linkages between the financial and monetary system should therefore be elaborated. Linkages with the real economy also deserve attention as the financial system has a significant and direct economic impact through its central role in the allocation of credit and capital and in the pooling and management of risks. With free movement of capital among OECD economies, recognition must, furthermore, be made of the footloose nature of financial institutions, markets, and capital, and the high level of global financial integration.

Expected outcomes: The expected outcomes of a well-functioning financial system should be specified. As outcomes, one might expect, under ideal conditions, the following: an efficient allocation of liquidity and capital; efficient pooling, management, and transfer of risks; market liquidity; correct pricing of risk; the ability of the system, through its risk management capabilities, to withstand shocks and self-correct; the facilitation of monetary policy; competitive market functioning, both domestically and internationally, and innovation; consumer choice and confidence in the system; and, more generally, a general confidence in the functioning of the financial system and trust in its players and institutions. These outcomes provide an important benchmark for analysis and evaluation.

Foundations: Finally, the foundations of a well-functioning system should be carefully identified. These might include: a sound macroeconomic environment; a competitive market structure in the financial sector and, more broadly, a competitive market economy; high-quality information flows and disclosures; a sound legal infrastructure and regulatory and supervisory framework; sound corporate governance practices; a well-aligned tax system; and ethical and prudent risk-taking behaviour.

These attributes should have sufficient precision to permit an understanding of the nature of the financial system and to distinguish clearly its activities from other economic activities. Moreover, these attributes should take into consideration potential country-level factors that may alter the anticipated scope and functions of the financial system, affect perceived macroeconomic and international linkages, influence expected outcomes, and affect the foundational elements of the financial system.

The attributes of a well-functioning financial system are often described in OECD countries, be it in government policy papers, central banker speeches, and press communiqués. Such public communication provides an opportunity for the authorities to articulate their conception of the financial system and elaborate expected outcomes, and thereby establish a benchmark for discussion, analysis, and reform. In general, governments should communicate a “benchmark definition” of the financial system when and as appropriate. It is particularly recommended in the context of any proposed comprehensive policy or regulatory reform intended to affect the structure and operation of the financial system. More specific benchmark definitions could be developed for segments of the financial system given potentially different audiences and the possible need for tailored messages.

I.A. Financial system: benchmark definition

- a) The attributes of a well-functioning financial system should be identified, taking into consideration the stage of development of the economy and other relevant country-specific factors. In this respect, there should be specification of:
 - i) the functions and scope of activities of a well-functioning financial system;
 - ii) anticipated macroeconomic and international linkages;
 - iii) expected outcomes; and,
 - iv) supporting foundations.

These attributes should have sufficient precision to permit an understanding of the nature of the financial system and to distinguish clearly its activities from other economic activities.
- b) This benchmark definition should be communicated publicly, in a manner, form, and frequency appropriate to the context and target audience. It should be updated as appropriate in light of the evolution of the financial system.

B. Establish transparency to elucidate the actual functioning of the financial system

The operations of the financial system and its participants should be sufficiently transparent, both to facilitate a proper empirical understanding of the functioning of the system, its features, and evolution, and to promote the efficiency of the system, given the value of high-quality and accurate information for its functioning. In this context, it is desirable to promote the availability of general information on: (i) products, services, processes, transactions; (ii) institutions; (iii) markets; (iv) supporting infrastructures; (v) participants; and (vi) interlinkages (e.g., macroeconomic, international).

This information could be made available through statistics, indicators, and descriptive information, and should, to the extent possible, be timely, relevant, comprehensive (across sectors, institutions, and transactions), high-quality, and internationally comparable. Given the rapid evolution of the financial sector, and the development of new products across industry and market lines, timeliness, comprehensiveness, and consistency of data and information are critically important; moreover, there may be a need for information to be obtained, and possibly disseminated, on private vehicles, institutions, and transactions, as often these represent the first steps in financial innovation and need to be understood. Data and information that is disseminated should, to the extent possible, be freely available or available at low cost. Governmental authorities should have the legal powers to compel, if necessary, the collection and, if appropriate, dissemination of data and information to ensure that proper transparency is achieved.

The collection and, where appropriate, dissemination of information on the financial system should have benefits for the financial industry and markets, consumers, academics, and public authorities. For instance, the availability of such information can facilitate the development of sound modelling and risk management systems at financial institutions. Some considerations should, however, be kept in mind:

- *Costs versus expected benefits:* The costs of data and information collection must be carefully considered, and weighted against expected benefits. The availability of low-cost information and communication technologies should lessen the cost burden of data and information

collection. A challenging problem, however, is achieving appropriate comparability and harmonisation of collected data and information, as these affect the benefits to be gained from such information and the costs for financial products and institutions offered or operating across jurisdictions.

- Confidentiality: Some information may be confidential and commercially sensitive in nature. There may be, in this context, some specific types of information that require protection against disclosure. However, there may be public interest considerations that warrant making such information available (at least to public authorities, with appropriate safeguards).
- *Stability*: The public dissemination of certain types of information may affect confidence in financial institutions and markets, and thus threaten financial stability. This information should be kept confidential unless there is an overriding public interest to release it.
- Security: Some information may relate to the physical security and operational activities of institutions, markets, and infrastructures. Disclosure of such information is likely unnecessary for the general public, though it may be needed by public authorities.

Industry groups and private-sector data providers may provide useful support in the collection and dissemination of financial data and information, in addition to governmental authorities. Collaboration between the public and private sectors may facilitate data collection and dissemination. International organisations such as the BIS, OECD, ECB, and IMF have an important role to play in ensuring the transparency of financial systems, and should coordinate their efforts in this respect.

I.B. Transparency

- a) The operations of the financial system should be transparent, permitting the identification and delineation of its features, its operations, and their evolution over time.
- b) Micro- and macro-level data and information on the financial system should be available to promote transparency. In this respect:
 - i) comprehensive, relevant, up-to-date, and internationally comparable sets of statistics and indicators for the entire financial system should be collected and disseminated; and,
 - ii) comprehensive and timely information on products, services, transactions, institutions, systems, and markets connected with the financial system (including private and off-balance sheet vehicles), should be collected and, to the extent possible, disseminated.
- c) The collection and, where appropriate, dissemination of information on the financial system should have benefits for relevant stakeholders. Due consideration should be given to costs, confidentiality, financial stability, and security as relevant in the collection or dissemination of data and information.
- d) Governmental authorities should have the legal powers to compel, if necessary, the collection and, if appropriate, dissemination of data and information to ensure that proper transparency is achieved.
- e) Industry groups should be encouraged to promote a high level of transparency in the financial system, possibly in collaboration with government.
- f) International organisations should work to ensure transparency in the financial system, domestically and internationally, and coordinate their efforts in this respect.

C. Understand the financial system

Both theoretical considerations, as well as empirical data and findings, can enrich one's understanding of the financial system and its workings. In particular, they may help in understanding the processes of financial intermediation and the pooling, management, and transfer of risks in the financial system, as well as elucidate other features of the system. They may also help to clarify and understand the linkages between the financial system and the broader macroeconomy and the international economic and financial system. Especially important is the development of an understanding of the dynamics of the financial system and of possible market failures, and the risks that these can engender. Understanding the financial system, and how it deviates from the "ideal" state, are of critical importance for policymaking.

In this respect, there are two key steps for enhancing understanding:

Surveillance: The development of surveillance mechanisms and capacity is a necessary condition for gaining a full understanding of the financial system. Surveillance should involve the monitoring of products, services, transactions, institutions, systems, markets, and participants (including consumers) and of their interrelationships, and the development of analytical methods and tools to interpret observed phenomena. For instance, early warning systems can be developed to highlight heightened risks to the financial system. Surveillance should also involve the monitoring of macroeconomic developments and developments in other financial systems, including the monitoring of possible macroeconomic impacts of financial regulation, such as pro-cyclicality, and possible cross-border impacts of domestic and foreign regulatory measures. Surveillance may involve the establishment of consultative channels with industry and other stakeholders, and the development of other systems for the solicitation of views on the operation of the financial system. Surveillance should be distinguished from possible ex ante supervisory reviews of products or transactions.

The conduct of surveillance depends on the existence of timely, comprehensive, high-quality data and information on the financial system. There must also be the requisite expertise and resources to monitor and interpret this information, and draw conclusions for policy and regulation. In addition, the outputs generated by surveillance should be timely, have relevance, and be conveyed in a format that is intelligible, so that it is understood and actionable by policymakers and regulators.

Analysis: The undertaking of analysis is obviously a critical element to the understanding of the financial system. This analysis should be focussed not only on the operation of the financial system and its broader macroeconomic and international linkages, but also on the outcomes of the system, both from the perspective of efficiency and equity. A number of analytical methods may be employed for understanding the financial system and its outcomes; however, as demonstrated in a number of OECD countries, market failure analysis is a central analytical tool as it helps to identify problems in systematic fashion and possible policy and regulatory responses.

Market failure analysis starts with the consideration of possible market failures that may upset the efficient operation of financial systems. These failures may include:

- **Asymmetric information:** Asymmetric information arises from imbalances in information that make it very costly if not impossible to monitor perfectly the behaviour or situation of others, or to have one's own behaviour or situation perfectly monitored. Asymmetries of information exist between buyers and sellers of financial services and products; indeed, the complexity of financial information, of financial products, services, and transactions, and of the operations of financial institution,

accentuates information asymmetries that can bedevil economic transactions.

Asymmetric information explains some of the key risks in the financial intermediation process (e.g., credit risk) and accounts for the role of financial institutions in intermediation. It can also provide the basis for undesirable incentive effects, such as moral hazard and adverse selection (e.g., possible excessive risk taking by borrowers in the case of the former; possible decision to not pool risks in insurance markets in the case of the latter, which may lead to incomplete markets), which are observable in the financial system. Finally, it provides scope for conflicts of interest, another key risk in the financial system given the nature of the financial intermediation process – the entrusting of one's savings and investments to financial institutions, brokers, and capital market vehicles. In light of these considerations, financial systems could be considered to be intrinsically imperfect given the prevalence and extent of information asymmetries.

- *Negative spillovers:* Negative spillovers arise when the costs of individual actions do not incorporate potential broader social costs that may be imposed on others from those actions. These spillovers may cause affected parties to initiate their own actions which could cause, in turn, further spillovers and thus aggravate the problem and lead to a sub-optimal outcome. In a world of information asymmetries, negative spillovers may be informational in nature, with negative information on one person or institution potentially casting doubt on other persons or institutions, in possibly indiscriminate fashion. Negative spillovers are particularly important in the financial sector as they help to explain the potential instability of financial systems and markets, whereby confidence in financial products and institutions can quickly evaporate and lead to a panic and a rush for the exits, amplifying costs for all concerned.
- *Market power imbalances:* As with other economic sectors, excessive concentration in the financial system may lead to market power abuses and sub-optimal economic outcomes, with excessive pricing for financial services and products, and a possible inefficient allocation of capital. Market power may be accentuated in the financial system due to network effects caused by the use of common financial infrastructures (e.g., payment and clearing systems), which may make it difficult for alternative infrastructures to emerge and for those outside the system to create competing products. It may also be accentuated due to information asymmetries, which may place financial institutions at an informational advantage compared to the customers, which could lead to inappropriate products being sold, excessive pricing, or agreement on unfair contractual terms.
- *Market abuse:* The financial sector, like other sectors, may be characterised by market abuse, whereby individuals may be taken advantage of and deprived of savings and investments or find themselves with grossly unfair and abusive contractual terms and pricing. This could occur, for instance, through deceptive marketing practices, inappropriate use of funds in segregated accounts at brokerage firms, and market manipulation of share prices. Market abuse creates particular problems for the financial sector since the financial system relies fundamentally on trust and confidence; if, due to market abuses, trust and confidence are lost, they are difficult to rebuild. In this way, market abuse can, if sufficiently problematic, cause widespread and long-term reputational damage and thus undermine the functioning of the financial system.

I.C. Surveillance and analysis

- a) The functioning of the financial system and its broader macroeconomic and global linkages should be well understood, as should the products, services, institutions, systems, and markets connected with the financial system.
- b) Surveillance tools and mechanisms should be established to ensure a comprehensive, on-going monitoring of domestic and international financial system developments, macroeconomic trends, and emerging risks.
- c) Market failure analysis should be conducted to assess the efficiency of the financial system and, in particular, understand the risks to which the financial system and related participants may be susceptible. The potentially global and dynamic nature of these risks should be considered as part of this analysis.
- d) Governmental authorities should have the requisite expertise and resources to conduct appropriate surveillance and analysis on a timely basis and formulate sound policy and regulation.
- e) Given the complexity and rapid evolution of the financial system, the international nature of the financial system and global macroeconomic linkages, and the related challenges associated with effective surveillance and analysis, there should be continuous:
 - i) information-sharing within and across jurisdictions, through formal and informal channels, subject to professional secrecy standards applicable to governmental authorities in the context of any exchange of confidential information;
 - ii) collaborative analysis and discussion of the financial system and related developments, risks, and possible contagion channels, domestically and internationally;
 - iii) research and analysis, conducted at the domestic and international level, and effective mechanisms to promote such collaboration and information-sharing.

Market failure analysis then examines the risks and negative effects resulting from these failures; these may include credit and liquidity risks, moral hazard, adverse selection, conflicts of interest, crises of confidence, mispricing, and abuse of a dominant position. Incentive effects deserve close attention given their potential for the generation and build-up of risks. Factors that may be aggravating market failures also need to be considered (e.g., weak supervision, poor corporate governance practices, inappropriate tax rules, poorly designed insolvency rules). Empirical substantiation is then pursued to help validate (or not) any identified problems, through such tools as market data, studies and surveys, and comparisons with other countries. The global and dynamic nature of the risks and problems must also be assessed. For instance, might identified problems have an international as well as domestic origin? Might problems be self-correcting? Finally, there should be ongoing risk analysis to ensure a continued understanding of market failures and their evolution.

Given the challenges of effective surveillance and analysis, the considerable amount of expertise and resources needed for them to be done properly, the similarity of problems across countries, and an international dimension to some market failure problems through contagion channels, collaboration and information-sharing, both domestically and internationally, should be strongly encouraged, subject to professional secrecy standards applicable to governmental authorities in the context of any exchange of confidential information.

II. Policy Objectives

The articulation of government policy objectives is of paramount importance in the establishment of a policy framework and in the elaboration of financial regulation, as these objectives define the beneficial outcomes that government intervention is expected to achieve, identify the trade-offs (if any) that may have to be made in policy and regulatory decisions, and anchor the expectations of regulated institutions and other stakeholders. These objectives also have an important role in establishing an accountability framework for governments, regulators, and supervisors.

A. Identify problems and establish the case for intervention

The elaboration of policy objectives must be based on a global identification and analysis of the range of actual or potential market failures and, if relevant, broader economic and social needs. Government intervention is intended to address actual or potential market failures and possibly broader needs, and therefore should be properly oriented toward achieving these goals; if successful, the intervention should yield the benefits to be expected from correcting these problems or satisfying these needs.

This analysis should primarily involve a broad market failure analysis, but may also incorporate other forms of economic and social analysis given potentially broader public interest considerations. Broader economic analysis could, for instance, incorporate elements of development policy, industrial policy, and competition policy. For instance, to the extent that a country considers that being a financial centre reflects an important economic need, possibly due to expected knowledge spillovers and high-quality employment growth, then such needs will be factored into the broader analysis surrounding government intervention. Similarly, social analysis may be considered and suggest that attention be paid to considerations of access, equity, social solidarity, health and income protection, and the promotion of long-term savings.

While there may a large number of economic and social reasons for government intervention, the case for intervention needs to be firmly established. In general, the operation of the financial system suffers from a sufficient number of material problems – such as asymmetric information and spillovers -- so as to warrant government intervention. Although the case for intervention may be compelling *prima facie*, there should nonetheless be a considered analysis of the nature of the problems, the potential benefits and costs of intervention (based on a realistic assessment of effectiveness), the international dimension to the problems (if any) and whether a coordinated international response might be more effective in addressing them, whether the identified problems might be self-correcting, and whether there might be alternatives to intervention. The possible problems, complications, unintended consequences, or unexpected costs of government intervention should be carefully considered, including the possibility that certain policies or approaches may be unsustainable or lead to a build-up of risks (i.e., conduct of regulatory failure analysis).

The combined general analysis of market failures and broader economic and social needs, on the one hand, and the case for intervention, on the other hand, permits the ranking of problems in terms of gravity and impact on welfare, and the identification of problems that can in fact be addressed by intervention and of expected outcomes. This ranking and triage exercise permits the targets and outcomes of government intervention to be clearly defined, and thus provides a basis for the elaboration and prioritisation of policy objectives.

II.A. Identification of problems and the case for intervention

- a) Actual and potential market failures and broader economic and social needs in the financial system should be clearly identified and analysed, and these problems and needs ranked in terms of gravity and impact on welfare.
- b) The case for government intervention in the financial system should be established, including an assessment of potential benefits versus costs, the international dimension, and possible alternatives to intervention, and the targets of intervention and related expected outcomes should be clearly identified.

B. Articulate policy objectives

Policy objectives for the financial system should be clearly defined, and should correspond to the beneficial outcomes anticipated from government intervention. Policy objectives provide the anchor for the policy and regulatory framework, as they define the goals of government intervention and provide a roadmap for the more specific elaboration and implementation of intervention measures, including financial regulation.

Policy objectives should be elaborated at a general level, applicable to the entire financial system and defining the broad policy framework. That said, they may also be elaborated at a more micro level if there is a strong case for differentiation according to particular sectors, institutions, and products. General policy objectives for the financial system may include the following:

- *Confidence in the financial system*: Public confidence in the financial system is maintained, so that the key functions of the financial system can operate, such as financial intermediation.
- *Systemic stability*: The financial system as a whole is resilient against external shocks and is not susceptible to a systemic breakdown, for instance where the failure of one or more financial institutions causes the collapse of other, otherwise safe, financial institutions.
- *Safety and soundness of financial institutions*: Financial institutions involved in the intermediation process and in the management, pooling, and transfer of risks are managed prudently, with the scope for failure of poorly managed and weak institutions.
- *Market integrity and transparency*: The financial system operates in a fair and transparent manner, with the absence of fraud and market abuse, and fair, accurate, and timely disclosures.
- *Market conduct and consumer protection*: The providers of financial products and services in the financial system interact with their customers in a fair, transparent, and professional manner, and the interests of consumers are adequately safeguarded and their needs addressed.
- *Efficiency*: The financial system generates efficient outcomes, with capital allocated efficiently to the most productive uses, the pricing of financial services reflecting costs, and the expected return on financial securities, products, and instruments appropriately reflecting risks.

A clear hierarchy should be established for the policy objectives; they should be prioritised and weighted, reflecting the scope and scale of the underlying problems. In this respect, top priority should be given to maintaining confidence in the financial system and systemic stability. In addition, there should be consideration of the extent to which the policy objectives may conflict with one another, or be

mutually reinforcing. This may require a specific analysis of how policy instruments might interact with one another (see below). Developing a sense of priorities in selected policy objectives and understanding their possible interaction should help in identifying trade-offs that may have to be made in government decision-making and intervention, and highlight the risks associated with failure to achieve these objectives.

More specific – and potentially different -- policy objectives for particular sectors, institutions, and products may need to be elaborated if there are material differences in market conditions, practices, and participants in different parts of the financial system. Such differences in policy objectives should be based on market failure analysis and possible broader economic and social considerations. If micro-level policy objectives are adopted, these should be clearly linked to the broader hierarchy of policy objectives governing the financial system as a whole.

II.B.1. Policy objectives: framework for financial regulation

- a) Clear policy objectives should be elaborated to govern the framework for government intervention and financial regulation.
- b) Policy objectives should be based on sound policy analysis and correspond to the beneficial outcomes to be expected from addressing identified market failures and other identified broader economic or social needs.
- c) Policy objectives should be directed at the financial system as a whole, going beyond particular sectors, institutions, and products.
- d) Policy objectives should be appropriately prioritised; given the importance of the stability of the financial system, top priority should be given to promoting confidence in the financial system and addressing systemic risks.
- e) Any trade-offs or mutual reinforcement among policy objectives should be carefully analysed.

II.B.2. Policy objectives: micro-level

- a) More specific – and potentially different – policy objectives for particular sectors, institutions, and products may need to be elaborated given differences in market conditions, practices, and participants in different parts of the financial system.
- b) To the extent that there are differences in policy objectives at the micro-level, these should be:
 - i) linked to conclusions from market failure analysis and potentially broader economic and social analysis; and,
 - ii) linked to the broader hierarchy of policy objectives established at the macro-level (as per II.B.1 above).

C. Ensure an accountability framework

Policy objectives provide a yardstick for measuring the effectiveness of government intervention and financial regulation and, as such, provide a framework for accountability. By specifying the expected outcomes of intervention, they help to measure the extent to which government and its administrative institutions have been successful in addressing identified market failures and identified broader economic and social needs. They may thus facilitate the identification of any failures of understanding regarding the financial system or of deficiencies in policy approaches and regulation (including any deficiencies at the international level in terms of coordination), and contribute to more effective policy and regulation.

Public disclosure of clearly articulated policy objectives ensures an appropriate level of transparency for the policy framework and reinforces accountability, as governments will be expected to explain any significant failure in meeting stated policy objectives. Policy objectives should, where and as appropriate, be explicitly incorporated into the mandated objectives of governmental authorities and bodies having a role in government intervention. Even non-governmental bodies indirectly involved in the regulation of the financial system or its participants (e.g., due to mandated membership) should have clearly defined objectives. Disclosure of objectives should also help to guide the expectations of industry and consumer stakeholders.

Mechanisms should be established to promote public articulation of policy objectives and accountability. For instance, relevant governmental authorities and bodies should publish annual reports in which they outline their objectives, describe the general framework for intervention and regulation and (if relevant) supervisory methods and tools, identify risks, and review progress in meeting these objective. In this context, relevant governmental authorities (including supervisory authorities) should describe the application of the regulatory framework and any related methods and tools, and provide aggregate statistical data on key aspects of such implementation so that the priorities and activities of the governmental authority can be better understood. These annual reports should also provide an overview of relevant developments in the financial system.

In addition, internal governance mechanisms within government should be established to ensure ongoing review and reporting by relevant administrative bodies. These mechanisms may facilitate disclosure and discussion of sensitive issues (e.g., failure resolution efforts and interventions) that, if released publicly, might undermine confidence and potentially destabilise the financial system. In addition, indicators should be developed that could help measure progress toward the achievement of policy objectives. Finally, remedies should be available within government to address any serious failure of governmental authorities to meet mandated objectives. These remedies may be positive in nature (e.g., mandating an increase in resources and expertise) or negative (e.g., in the extreme, removal of appointed authorities for cause), but should be applied judiciously so as to ensure proper independence of regulatory or supervisory functions.

II.C. Accountability

- a) Policy objectives should be publicly disclosed.
- b) Mechanisms to promote accountability should be in place, such as:
 - i) annual reports by governmental authorities to the public, including:
 - a. *a description of objectives, an overview of the regulatory framework and relevant developments in the financial system, an identification of key risks, and information on how the regulatory framework is addressing these risks and achieving stated objectives;*
 - b. *aggregate statistical data on key aspects of such implementation so that the priorities and activities of the governmental authority can be better understood;*
 - ii) internal governmental mechanisms for reporting and review;
 - iii) development of indicators measuring progress toward the achievement of policy objectives; and,
 - iv) remedies within government to address any serious failure of governmental authorities to meet mandated objectives.

III. Policy Instruments

Identifying appropriate policy instruments for achieving policy objectives is a key task for government, and is particularly challenging in the financial sector given the complexity of the financial system, the rapid-moving and global nature of capital, the linkages between the financial system and monetary policy and linkages between the domestic and international economic and financial systems, and the related potential for policy spillovers among countries. Understanding the nature of each of policy instruments, and their expected effects, both on the domestic and international financial and economic system and on other domestic policy instruments (and, in particular, financial regulation) and other countries' policies, can help in designing effective intervention measures and sound financial regulation.

A. Identification of financial sector policy instruments

Governments should identify the range of policy instruments and methods at their disposal that are capable of affecting the operation of the financial system, the conduct of its participants, or its outcomes. Briefly stated, a policy instrument is a tool used by government to achieve its goals, and thus can be broadly conceived. A number of policy instruments are available to government, namely:

- *Surveillance*: The surveillance of the financial system is a critical instrument of policy as it ensures continued awareness and understanding of the financial system and its evolution, and permits a precise and measured response to identified problems. Moreover, active and ongoing surveillance of the financial system by government may influence, positively, the behaviour and perceptions of participants in the system, and deter misconduct and abuse.
- *Moral suasion with market-based solutions*: The government may play the role of facilitator and engage in moral suasion to guide market-based solutions and help ensure that desired outcomes are achieved. Market-based solutions in this context can take on a wide range of forms, depending on the nature of the problem, extent of private-sector coordination, and degree of moral suasion exercised by the government. These solutions can be industry-wide in nature, involving, for instance, self-regulatory organisations actively overseen by government and industry codes of conduct driven, in part, by governmental expectations. These solutions can be also participant-based such as sound corporate governance and risk management practices. This policy instrument should be distinguished from pure market-based solutions where there is no government involvement or signalling of such potential involvement.
- *Regulation*: Financial regulation is a powerful instrument and has traditionally been a key instrument of policy in the financial sector. Financial regulation can set out, in clear, pre-determined fashion, certain outcomes for participants in the financial system (e.g., special rights for policyholders in an insolvency), or can seek to influence the behaviour and actions of participants through compulsion, the alignment of risks and incentives, and the establishment of governmental expectations (e.g., prudential regulation).
- *Guarantees*: The provision of guarantees by government, or an imposed requirement on industry to provide guarantees, can be a potent instrument of policy. Deposit insurance schemes, policyholder protection funds, and reinsurance guarantees for industry losses in the context of large-scale insurance risks are examples of guarantees.

- *Lending*: The provision of liquidity (i.e., very short-term funding) and possibly longer-term lending support to participants in the financial system is another important instrument of government.
- *Subsidies, grants, and programmes*: The government may seek to achieve policy objectives through direct subsidies, grants, and programs to targeted individuals and firms. These may include subsidies provided through the tax system, such as income tax deductions for insurance company provisions or for insurance premiums paid by individuals and firms.
- *Government ownership and control*: Governments may establish, with public funds as capital, special government enterprises that participate in the financial system or may, in the context of a financial failure, take control of an existing financial institution.

These policy instruments, by their nature, differ markedly in terms of their operation, transparency, flexibility, costs, and effects. In practice, their features are likely to be affected by the precise design and implementation of the policy instruments.

In selecting policy instruments, the direct, or primary, impact on the financial system, its participants, or outcomes needs to be understood and evaluated. This evaluation needs to consider the extent to which the identified market failures or possible broader economic and social problems will be directly addressed or guarded against by the proposed instruments, and thus yield benefits; the related costs also need to be evaluated. In addition, secondary impacts need to be analysed as they may reduce the effectiveness of the chosen policy instrument(s) and affect the need for, and impact of, other policy instruments as well as the need for international coordination; these impacts include incentive effects and policy spillover effects.

The implementation of some policy instruments may, for instance, create negative incentive effects, such as moral hazard, if the activities of participants cannot be fully monitored. For instance, the provision of deposit insurance may, while promoting confidence in the banking system, create incentives for banks to increase the riskiness of their activities and reduce the incentive of depositors to monitor banks. These impacts may reduce the overall impact of the guarantee and require a strengthening of financial regulation (and related to supervision) to help counter such possible negative incentive effects on bank management. The adoption of special measures in the context of a financial crisis may provide necessary financial stability but may create large adverse incentive effects. Proper exit strategies should therefore be devised as part of the implementation of policy instruments linked to special crisis measures.

Given the strong financial and economic interlinkages among countries, the international spillover effects of policy instruments also need to be taken into account. The adoption of policy instruments may have positive or negative financial or economic effects on other countries, which may lead to a policy response in these other countries; the resulting combined set of country policies may be positive or negative for the global financial and economic system as a whole. Such policy spillovers may lead to policy conflicts among countries, but may also provide the basis for coordinated, welfare-improving international responses. For instance, it is understood that international agreement on a common capital framework for banks is necessary in order to avoid the prospect of uncoordinated domestic rules that may tend to focus on national competitiveness, heightening risks for the global financial system. In light of possible spillovers, the need, and scope for, international cooperation and coordination should be identified in respect of each of the policy instruments.

III.A. Identification of policy instruments and their impact

- a) The range of policy instruments capable of affecting the operation of the financial system, the conduct of its participants, or its outcomes, and at the disposal of government, should be identified; in this respect, financial regulation should be considered as a key policy instrument, but by no means the only one.
- b) The features and possible impacts of each policy instrument should be identified and understood, particularly in terms of costs, incentives, and international spillover effects.
- c) Consideration should be given to assessing how any negative incentive or spillover effects could be addressed, for instance by varying the use of other instruments or through international coordination. These effects should be addressed *ex ante* through appropriate policy actions. In particular:
 - i) Any negative incentive effects arising from the use of policy instruments – such as moral hazard – should, to the extent possible, be controlled *ex ante* with appropriate risk mitigation measures.
 - ii) The need and scope for international cooperation and coordination should be specified in advance with respect to each policy instrument.

B. Matching policy instruments to policy objectives

Based on expected direct impacts, and in consideration of possible secondary effects such as incentive and spillover effects, the identification of the proper policy instruments, and their appropriate combination (if any), for each policy objective should be carefully considered and explored by governments. There are a number of considerations in this respect:

- A combination of policy instruments is generally required to produce effective government intervention and thus achieve the desired outcomes defined by policy objectives. It is unlikely, given the likely breadth of policy objectives, the potentially large number of areas in the financial system (including its underlying foundations and possibly the broader economic system) where intervention may be needed to address each policy objective, the possible contributions of several policy instruments, and possible secondary effects that may cut across policy instruments, that a simple one-to-one mapping will exist between a policy instrument and a policy objective.
- The chosen combination of instruments should be designed to address as precisely as possible the identified market failure(s) or broader economic and social need(s) underlying each policy objective; moreover, this combination should be the least-cost approach – that is, without sacrificing effectiveness, it is the approach that imposes the lowest costs.
- The selected combination of instruments, and their design, should reflect the priority attached to the particular objective and the related risk tolerance for policy failure. For instance, the achievement of systemic stability is likely to rely, to a great degree, on policy instruments whose outcomes are more certain – for instance, strong surveillance, prescriptive regulation, and the provision of emergency liquidity – and less emphasis on instruments whose outcomes may be less certain, thus minimising the extreme and costly downside risk of systemic failure.
- As policy instruments may be used to support more than one objective, the potential conflicts among policy objectives also need to be considered in selecting and designing the combination of policy instruments.

- The design and combination of instruments should be adjusted to take into consideration possible incentive effects that may affect, and cut across, policy instruments. This may require the establishment of offsetting risk controls (e.g., risk mitigation techniques) in the instrument causing the effects and an adjustment to other policy instruments. The provision of lending and guarantees are policy instruments where special consideration needs to be given to incentive effects and designing appropriate *ex ante* risk mitigation techniques and controls. For instance, controls are normally placed on the provision of central bank liquidity in order to ensure that lending is provided only to solvent, but illiquid, financial institutions, thus helping to minimise inappropriate use of lending facilities and minimise the government's fiscal exposure. This consideration suggests that the instrument of regulation may often need to be combined with other policy instruments as it provides a framework for the establishment of appropriate risk controls.
- It may be desirable for the design and combination of instruments chosen for each policy objective to vary according specific factors, such as the nature of the product, service, institution, sector, system, market, or participant. For instance, distinctions could be made on the basis of industry sector, quality of an institution's risk management, and type of consumer (e.g., retail versus institutional). Caution must be exercised in deciding on specificity versus uniformity in the application of a policy instrument since identified market failures and other problems may be left inadequately addressed or unattended, giving rise to a potentially damaging policy failure.
- The choice, design, and implementation of instruments needs to consider, in light of the globalised financial and economic system, policy spillovers among countries. International coordination should take place in those areas where spillovers are the greatest, with due recognition to the limits to coordination in nation-based systems of government.

The choice and design of policy instruments, and their mapping to policy objectives, should be transparent to the public and be publicly justified. This level of transparency should foster an understanding of the policy framework for the financial sector and provide appropriate context to government interventions. It may also help to support public confidence in the financial system; for instance, public awareness and knowledge of deposit insurance is essential for stability. Transparency should include information on the nature, amount, and costs of any government intervention to rescue a financial institution or, in a crisis context, safeguard the financial system (e.g., guarantees, lending, capital injections). Transparency is especially necessary in the context of any major policy or regulatory reforms, where the rationale for reforms should be presented.

The use of policy instruments should be made transparent where possible. However, it is recognised that, in some specific contexts, such disclosure may be inappropriate or counterproductive, and possibly endanger the stability of the financial system. There may be merit, for instance, in maintaining constructive ambiguity in respect of certain specific policies, in order to ensure the proper alignment of incentives in the financial system. In some circumstances, there may also be a need to maintain confidentiality, in order to prevent any panic behaviour; however, there should be appropriate accountability mechanisms in place within government in place to ensure proper oversight of actions.

Finally, given the commonality of problems in financial systems across countries, the extensive linkages and spillovers across countries, and the possible need for international coordination, international policy analysis and discussion

should be reinforced. Such collaboration should be focussed in nature, identifying areas that require particularly close international policy coordination and implementation. It should involve the monitoring of relevant risks as well as policy analysis and development. Appropriate governance and reporting mechanisms should be in place to ensure sustained collaboration. The Financial Stability Board and the OECD provide platforms for possible enhanced collaboration on financial sector policy.

III.B. Matching policy instruments to policy objectives

- a) Based on expected impacts, and in consideration of possible incentive and spillover effects, the identification of the proper policy instruments, and their appropriate combination, for each policy objective should be carefully considered and explored by governments. In this respect:
 - i) The chosen combination of instruments should address as precisely as possible the identified market failures or broader economic and social needs underlying each policy objective.
 - ii) The selected combination of instruments, and their design, for each objective should reflect the priority attached to the particular objective and the related risk tolerance for policy failure.
 - iii) As an instrument may be used to support more than one policy objective, potential conflicts among policy objectives should be identified and addressed accordingly.
 - iv) The choice and design of instruments should be adjusted to take into consideration possible incentive effects that may affect, and cut across, policy instruments. This may require the establishment of proper ex ante risk controls in the instrument causing the effects and an adjustment to other policy instruments.
 - v) Specific factors, such as industry sector, type of institution, and type of consumer should, in some circumstances, be considered in the choice and design of instruments for each policy objective. Such specificity should be well justified and not inadvertently increase the risk of policy failure.
 - vi) While priority should be given to ensuring effectiveness, due attention should be given to the costs of adopting instruments; in this respect, the least-cost approach should be adopted.
- b) The choice of instruments, and their mapping to policy objectives, should be made transparent and publicly justified, particularly in the context of any significant policy or regulatory reforms or any special crisis intervention measures. The use of instruments should, in addition, be made transparent; however, in some specific contexts or under certain circumstances, there may be a need for:
 - i) constructive ambiguity, in order to ensure the proper alignment of incentives; and,
 - ii) confidentiality, in order to ensure continued public confidence; however, there should be appropriate accountability mechanisms in place within government to ensure proper oversight of actions.
- c) The choice, design, and implementation of instruments should consider, in light of the globalised financial and economic system, policy spillovers among countries. International collaboration and discussion of financial sector policy should be reinforced and be appropriately focussed on those areas requiring close international coordination.

C. Specification and principles of financial regulation

Financial regulation is one of the key policy instruments available to governments. As with any other policy instrument, financial regulation should, if adopted, be designed to address identified problems as effectively as possible and in the least costly manner as possible. There should also be recognition of its potential adverse incentive effects, and any international spillovers should be considered; both should, if possible, be addressed, as well as any other possible secondary effects.

Financial regulation is, however, a distinct policy instrument. The operation and features of financial regulation therefore need to be carefully considered; in this respect, it is important to define and properly understand “regulation”. Strictly speaking, regulation is an instrument or mechanism by which the state (or a state agency) or legislature compels an entity or individual to comply with specified requirements. Regulation can be elaborated through policies, legislation, decrees and other types of instruments of the state or legislature. Regulation should, however, be viewed broadly and can be considered to include:

- Any rules or principles imposed on, or directed to, entities or individuals that require them to undertake an action or prohibits them from undertaking an action;
- Any rules or principles that are intended to affect the behaviour – not just actions -- of entities or individuals, including rules or principles that establish expectations regarding their conduct or that affect the risks or incentives facing these entities and individuals;
- Any rules that directly specify rights or outcomes for entities or individuals, such as the priorities of creditors in insolvency regimes or access to public goods; and,
- The mechanisms and systems that are used or relied upon for the implementation and enforcement of rules or principles or for the achievement of expected behaviours and outcomes – this can include systems of cooperation and oversight among governmental bodies, systems of corporate monitoring mandated by legislation (e.g., auditors), and self-regulatory bodies to the extent that membership is mandatory and these bodies are subject to government oversight.

Regulation, in short, involves the establishment of rules or principles and associated mechanisms and systems that: (i) seek, through various means of influence, to affect or control the behaviour and actions of entities and individuals, with the overall objective of achieving desired outcomes; or (ii) directly specify rights or outcomes for entities and individuals. This definition is very broad and serves to capture all of the key elements and specificities of financial regulation.

With this concept of regulation in mind, the key elements of financial regulation that differentiate it from other financial sector policy instruments can be identified, namely:

- *Directive*: Financial regulation seeks to dictate outcomes in the financial system, or control or guide the behaviour and actions of its participants in order to achieve desired outcomes. Moreover, financial regulation contains, within itself (as a policy, legislation, regulation, decree), the directive order it seeks to impose on the financial system and its participants; this feature, indeed, provides financial regulation with a level of inherent transparency.

Unlike regulation in many other economic sectors, financial regulation is particularly concerned with influencing or controlling the *behaviour* of certain classes of participants in the financial system in order to ensure prudence, safety, integrity, and transparency of the core actors, institutions, systems, and markets of the financial system. For instance, capital regulation of financial institutions and broader financial groups not only impose minimal solvency buffers but can affect the behaviour of these institutions and groups by affecting the cost of capital for different types of financial activities.

- *Compulsion:* Financial regulation will, in most cases, have the force of law or be backed up by the threat of state sanction and, in respect of regulation aimed at affecting behaviour, have penalties for non-compliance. Administrative penalties and sanctions may be complemented by civil law provisions in legislation as well as by criminal code provisions. At a minimum, there is an expectation that there will be legal or reputational consequences from non-compliance.
- *Supervision:* Where financial regulation is specifically directed toward behaviour and actions as opposed to dictating specific fixed outcomes, there is typically a level of supervision to ensure compliance. Therefore, financial regulation tends to imply state monitoring (thus, for the purposes of this *Guidance*, regulation is deemed to include supervisory measures and actions). In this respect, it is very important that the system of supervision is capable of promoting effective compliance; for instance, supervisors should have the proper legal authorities, have a strong level of expertise and level of staffing, and have effective techniques of supervision. Moreover, accountability mechanisms should be place to help ensure that supervisors meet their objectives.

These differentiating elements provide an indication of some of the specific design and implementation issues for financial regulation, which can have a bearing on its effectiveness and efficiency. Choices have to be made about the nature and content of the directive order(s), the nature and degree of compulsion needed to encourage desired behaviours or specify outcomes and, if relevant, the nature and extent of supervision required for affected participants.

Given the importance of behaviour in financial regulation, a key issue in financial regulation relates to the orientation, and degree of precision, in the directive order for affected participants – that is, the choice of principles versus rules. A principles-based approach to financial regulation sets out general, high-level expectations of behaviour, leaving it to affected participants to decide on the means by which they are to achieve these standards of behaviour. By contrast, prescriptive rules require the adoption of specific behaviours or actions or impose prohibitions on specific behaviours or actions.

By being focussed on high-level behavioural outcomes -- which find expression in the principles themselves and essentially reflect policy objectives -- a principles-based approach provides a flexible framework of regulation capable of adapting to structural and institutional changes in the financial system, as the desired behavioural outcomes are likely to remain stable over time insofar as the underlying policy objectives remain the same. Such an approach also seeks to align incentives with desired behaviours in order to promote adherence; amongst other means, it does so by: (a) providing transparency on expected behaviours and thus making it potentially risky for those subject to the principles to initiate actions that will result in outcomes that deviate from these norms; (b) providing those subject to the principles with the opportunity to seek the most effective and efficient ways to adhere to the principles; and (c) relying on market forces and related reputational pressures as disciplinary mechanisms. These incentive effects may become so powerful that firms establish excessively detailed rules to ensure compliance with the principles and become overly risk averse. A principle-based regulatory approach would appear to be better suited for such areas as governance, risk management, and internal controls where behavioural outcomes are largely expected and a qualitative or judgemental approach is needed to assess compliance. A key risk with principles-based regulation is that there may be scope for differing interpretations of the principles, which may lead to a wide range of regulatory outcomes.

By contrast, a rules-based approach seeks to achieve desired outcomes through more concrete measures, either by directly specifying the specific actions or

behaviours to be undertaken (or avoided) or specifying the means (direct or indirect) by which actions or behaviours are to be achieved (or avoided). An example of the former are solvency rules that establish minimum levels of capital, which provide a buffer against unexpected loss events and thus enhance the safety and soundness of a financial institution; an example of the latter are governance rules that specify a minimum number of independent directors on a board, and which are intended to promote better decision-making and risk management practices, and thus contribute to enhanced safety and soundness. Rules have greater certainty in their application, and thus may be usefully applied where rule-based actions can be expected to lead directly to the achievement of policy objectives and where the tolerance for policy failure is low. As a rule-based approach facilitates compliance assessments by supervisors and regulated institutions and markets, and facilitates quantitative comparisons, it would appear to be better suited for such areas as capital rules where level playing field considerations are particularly relevant. However, rules may be applied inconsistently, lack comprehensiveness, become outdated in the face of rapid innovation, and encourage “ticking-boxes” exercises. At the extreme, there may be rule-avoidance and regulatory arbitrage across sectors and markets.

Given the high-level nature of principles, a principles-based approach tends to rely on supervision to ensure proper compliance instead of compulsion, since penalties can apply only when there is clear evidence of a breach in principle. An active and sophisticated level of supervision is needed in order to monitor behaviour properly, identify breaches of principle, and be credible if sanctions need to be applied. By contrast, a rules-based approach can rely more easily on compulsion, as transgressions are clearer-cut, while at the same time rely on supervision. While a rules-based approach may make compliance reviews more straightforward for regulated institutions and markets and for supervisors, it could be very costly if there is a large body of rules, and could lead to unnecessary conflict or burden if there are multiple, overlapping sets of rules within a country or internationally. Overall, each approach has its advantages and disadvantages, and the precise mixture of principles and rules will depend on the specific context, policy objectives, and risk tolerance for policy failure, as well as on the level of development of the financial system in a country and other possible country-specific factors.

In formulating financial regulation, the experiences of OECD countries suggest that a number of general principles should be respected – ten key principles for effective and efficient financial regulation are set forth below. These principles relate to the proper orientation of financial regulation, the process by which financial regulation should be developed and implemented, and the international dimension. These general principles are as follows:

Nature of regulation

1. **Precognition:** Theory and experience suggest that the operation of the financial system suffers from a number of significant problems, some carrying potentially very high costs. Accordingly, a pre-cautionary approach is warranted in financial regulation, reflecting the importance of maintaining confidence in the financial system and systemic stability (see section II.B), without which other policy objectives cannot be sought. Policymakers should pro-actively anticipate and address emerging risks and problems (including through active monitoring of the financial system and macroeconomic developments) and not initiate reforms solely in response to the onset of a crisis¹. This approach suggests that the benefits

¹ This principle should not be equated with the “precautionary principle” found in law and regulation in other policy fields.

of financial regulation – often hard to define quantitatively absent a crisis – should be given proper weight and consideration in any cost-benefit analysis. Moreover, it suggests that costs should, to a large extent, be borne upfront in the form of ex ante risk mitigation measures instead of ex post responses, the latter likely involving costlier governmental intervention. A precautionary stance could include, for instance, counter-cyclical measures in regulation governing bank provisioning and solvency, or requirements for proper risk margins in the determination of technical provisions at insurers. The importance of these ex ante measures increases with the priority attached to the related policy objective(s). Finally, it suggests that intervention and failure resolution frameworks should be in place ex ante to provide governmental authorities with the proper legal authorities to deal swiftly with problems.

2. **Risk-based:** Among the policy instruments available to government, financial regulation is arguably the instrument most able to manage and control risks in the financial system in a comprehensive and systematic way. These risks are linked to the actual or potential occurrence of market failures (see section I.C) and are thus capable of compromising the achievement of policy objectives. Financial regulation (and its related supervisory component) should be properly oriented to these risks and give priority to those risks that, due to their nature or impact, have the greatest potential of compromising the achievement of policy objectives (e.g., public confidence, systemic stability, safety and soundness, appropriate market conduct and consumer protection).

A risk-based approach requires an assessment of the nature, scope, and scale of the different types of risks to which financial system participants (including consumers) are exposed and of the capacity of participants to absorb and manage these risks, be it on an individual, institutional, sectoral, market, or system-wide level. Risk-based regulation seeks to establish a coherent, consistent approach to underlying system risks and risk capacities. This approach may lead to differentiated regulation and supervision of products, services, institutions, systems, and markets in light of differing types of risks, probabilities of their occurring, and scope and scale of their impacts, and differing capacities of system participants to absorb or manage these risks. A risk-based approach does not impose a uniform system of regulation where differences in risks and risk capacities are material.

A risk-based approach does not necessarily seek to eliminate all risk from the financial system (though, for some risks, full risk-control may be an appropriate objective), but recognises that risk-taking is a core feature of the financial system and seeks to manage and reduce those risks that truly threaten the achievement of policy objectives. Risk-based regulation, while prioritised, does not ignore lower probability, lower impact, or certain types of risk as these risks may be material from perspective of some system participants, be cumulative in nature, or be newly emerging, and lead to regulatory failure.

Risk-based regulation and related supervision should be aligned with, and promote, sound risk management in the financial system and strengthen incentives for prudent and proper behaviour. Since risk-based regulation may, due to potential linkages with broader macroeconomic variables, lead to pro-cyclical outcomes and thus inadvertently lead to a build-up of risks, a forward-looking, pre-cautionary element may need to be embedded in such regulation.

The extent to which a risk-based approach can be adopted depends on the level of development of the country's financial system, the sophistication of its products, institutions, systems, and markets, and supervisory capacities. Where financial regulation is developed to address broader economic or social objectives, and not only market failures, the impact of such regulation on risks in the financial system should be properly taken into account and addressed to the extent possible.

3. **Sound incentives:** Unlike regulation in many other economic sectors, financial regulation is particularly concerned with influencing or controlling the behaviour of participants in the financial system. Directly controlling behaviour may in practice be difficult to achieve, however, placing limits on the ability of financial regulation to achieve desired outcomes; moreover, regulation, along with other policy instruments, may create adverse incentive effects (e.g., moral hazard), which need to be addressed. Financial regulation should therefore seek, directly or indirectly, to align the *incentives* of participants with policy objectives by carefully adjusting the nature, form, and strength of directive authority, compulsion, and supervision as appropriate, and using other policy instruments where necessary and justified as reinforcement. For instance, the promotion of proper policies on compensation in financial institutions may establish a basis for sound incentives, and provide a complementary means to promote prudent risk-taking. Incentives should be aligned *ex ante* since incentive problems, once installed, may be difficult to overcome. Effective enforcement of financial regulation and appropriate deterrence through properly tailored penalties for breaches of regulation provide an important basis for sound incentives.

A powerful means to promote aligned incentives is to ensure that financial institutions and other relevant market participants are aware of the possibility of their failure and therefore of the need to manage risks properly. Such recognition of failure can serve to reinforce market discipline. It is important, in this respect, for the regulatory and supervisory framework to indicate that the board of directors of financial institutions, along with senior management, are responsible for the proper management of their business operations and for the effective management of risks. The goal of regulation is not to seek the prevention of the failure of an entity at all costs, but to focus on failure prevention while facilitating orderly failure resolution and ensuring the protection of retail customers should failure occur. If the number of customers affected by the potential failure of an institution or a participant is large and the potential losses severe, the behaviour of the entity and its customers may become distorted; these potential effects merit explicit *ex ante* attention in the regulatory and supervisory system and failure resolution framework.

Financial regulation may, in addition, seek to harness market forces to promote sound incentives. Competitive markets, coupled with adequate disclosure and transparency, may help to ensure a proper alignment of incentives and thus may be explicitly factored into the design of financial regulation. These pressures may operate through one or more channels, including: the actions of competitors in terms of pricing, supply, and innovation; the pressures placed by customers, both retail and institutional, who may have the option of switching to a competitor; the demands of investors who may, if dissatisfied, punish the equity value of the financial business; and the possible role played by third parties, such as rating agencies and intermediaries, who may have an influential role and some sanctioning power. That said, any reliance placed on market forces in financial regulation needs to be carefully assessed, as it is

possible that market forces may yield the same negative outcomes that the regulatory intervention sought to address. Market failure analysis should be conducted to determine the appropriate role for market forces in regulation.

4. **Comprehensiveness:** Financial regulation should be comprehensive in nature, in terms of ensuring that all identified problems (market failures and broader economic and social needs) are properly addressed, both at a domestic and global level, and that all necessary regulatory and supervisory tools and mechanisms are being used to achieve policy objectives, including through the combination of regulation with other policy instruments. Comprehensiveness means that all financial system participants and related products, services, institutions, systems, and markets are subject to appropriate regulatory and supervisory frameworks and oversight. Comprehensiveness also means that interconnected components of the financial system, be it in terms of financial groups, sectors, systems, or markets, as well as broader macroeconomic conditions, are appropriately subject an integrated, global view so that interrelated risks and contagion channels can be appropriately identified and, as necessary, addressed, at both a micro and macro level. Comprehensiveness requires that all appropriate policy tools and mechanisms be used to ensure a global, integrated approach to the regulation and supervision of relevant participants, institutions, systems, and markets in the financial system.
5. **Consistency and competitive neutrality:** Financial regulation should be applied in a consistent, “functionally equivalent” manner (*i.e.*, neutral from a product, institutional, sectoral, and market perspective, so that similar underlying risk factors and problems are treated equivalently and in a coordinated and integrated fashion by regulation); otherwise, there may be competitive inequalities and scope for regulatory arbitrage, and regulatory gaps may be created. Market failure problems do not respect - but indeed may be accentuated by - boundaries of regulation and supervision, and thus should be addressed in a consistent manner.

This principle is taking on increased importance as boundaries between products, services, institutions, and markets disappear and financial conglomerates grow. Indeed, the growth of financial groups and conglomerates, and the convergence of financial sectors (particularly banking and insurance) in terms of products offered and risk management practices, suggest that more coordinated and consistent forms of legislation, regulation, and supervision should be adopted across financial sectors and markets. Consideration should be given to developing a well coordinated, integrated, and consistent view of risks across a financial institution or group engaged in different financial activities, developing consistent rules and guidelines on corporate governance, risk management, and internal controls across financial sectors, developing consistent market conduct rules for products with similar characteristics, and encouraging the convergence of solvency rules within and across sectors. A similarly coordinated, integrated, and consistent approach should be adopted across financial markets and related systems and infrastructures. In this respect, the principles of consistency and comprehensiveness are complementary.

Regulatory process and enforcement

6. **High-quality, transparent decision-making and enforcement:** Regulatory quality depends on a sound process for the formulation and implementation of financial regulation. In this respect, the 1995 *OECD Reference Checklist for Regulatory Decision-making* (see annex) provides a useful guide for regulation-making in the financial sector in OECD countries. The *Reference Checklist* provides a basis for the formulation and implementation of financial regulation; it sets out ten elements, both procedural and substantive: (1) proper definition of the problem; (2) justification of government intervention; (3) assessment of use of regulation in comparison with other policy instruments; (4) determination of the legal basis for regulation; (5) assessment of the appropriate level of government; (6) weighing of benefits versus costs; (7) provision of transparency regarding distributional effects of a regulation across society; (8) clarity, consistency, comprehensibility, and accessibility of regulation to users; (9) open and transparent regulation-making involving adequate consultation; and (10) effective compliance mechanisms.

The multi-layered nature of financial regulation should be given due attention in any application of the Reference Checklist. The development and implementation of financial regulation often evolve in stages, starting with a legislative framework that may outline broad principles of regulation, to be followed by more detailed implementation regulation and then specific rules and possible guidance. The Reference Checklist may apply at any stage, depending on where the substance of the regulation lies. However, as regulation moves from development to implementation, some elements of the Reference Checklist may no longer be applicable, while others continue to be. The principle of consultation (element 9) should, especially, continue to apply at every level of implementation.

While the 1995 Reference Checklist is relevant and applicable to financial regulation, variation in some of its elements may need to be considered by governments. In particular:

- *Justification for government action (element 2):* As noted above, financial regulation should, in general, adopt a pre-cautionary approach. Financial regulation may not always be based on precise and clear evidence of a problem, but may need to rely on theoretical considerations and hypotheses about potential damaging problems in the financial system, including possible intangible impacts on public confidence.
- *Cost-benefit analysis (element 6):* Given the breadth and depth of financial regulation, and the difficulty in measuring benefits in many instances, it may not necessarily be appropriate or possible to conduct a full cost-benefit analysis of every regulation. The use of cost-benefit analysis should be proportionate to the regulation under consideration and its impact.
- *Consultation (element 9):* In special, very limited circumstances, advance consultation may not be possible or appropriate. Some regulatory decisions may have to be made quickly, confidentially, and without full consultation, for instance in the context of a financial crisis, or in response to a rapidly escalating risk that may have potentially important consequences. Public disclosure of, and consultation on, proposed regulatory interventions may, in some cases, hamper rapid, efficient, and effective responses and undermine

public confidence in the financial system or its products, services, and institutions.

In addition, consultations should take into consideration that financial regulation is, to a considerable extent, being conducted at the international level within international standard-setting bodies. There should be appropriate scope for public consultation on the principles and rules developed by these international bodies, whether through consultation mechanisms developed by these bodies or through domestic consultation mechanisms, or both.

As part of the regulatory process, governments should consider the use of cross-governmental quality reviews of proposed regulations (where they exist) to strengthen regulatory quality and allow those involved in financial regulation to learn best practices from other policy sectors.

As recommended by the Reference Checklist, financial regulation should be complemented by effective compliance and enforcement mechanisms in order to ensure adherence. These mechanisms may include soft tools (inducing appropriate behaviour and actions through persuasion, deterrence, market forces, and other means) or hard tools (enforcing desired behaviour and actions through compulsion), or some combination of both (e.g., supervision). Enforcement is ultimately obtained through compulsion by means of administrative directives and penalties, proceedings under civil law (e.g., civil liability), or prosecutions under criminal law. Enforcement by administrative bodies should be timely in nature, transparent, and consistently and effectively applied.

7. **Systematic review:** The quality, implementation, and impact of regulation should be assessed after a sufficient length of time has passed since its adoption. This assessment should evaluate whether the regulation achieved its specific objective(s), whether it did so in a cost-efficient manner, and whether the decision-making process could be improved. This assessment should be conducted at least internally within government. Regulatory impact assessment is a critical element of the regulatory process, both *ex ante* and *ex post*, and provides an opportunity to make any necessary adjustments to financial regulation that has been implemented. This process of follow-up complements and reinforces the review of the framework for government intervention and regulation that should be undertaken on a continuous basis, as outlined in section V.

International dimension

8. **International coordination, convergence, and implementation in policy and regulation:** International financial regulation is becoming increasingly the norm, as witnessed by the activities of international standard-setting bodies. As with other policy instruments (see section III.A), countries should decide on the need and exact scope for international cooperation and coordination in the development and implementation of financial regulation and related supervision. This specification is particularly important for financial regulation given the potential for policy spillovers among countries and related risk of policy and regulatory conflicts, and the impact of domestic regulation on cross-border trade.

The principles of comprehensiveness and consistency should extend to the international level where possible. The global nature of the financial system, and the activities of internationally active financial institutions, groups, and intermediaries, suggest that national regulation and supervision across countries should, to the extent possible, be

comprehensive and consistent, with effective coordination where relevant and gradual convergence over time insofar as policy objectives and their relative ranking are broadly shared.

Enhanced coordination in policy and rule-making requires further developing, among governmental authorities, shared understandings of the nature and scale of market failures and of appropriate regulatory approaches to address them. It requires that consideration be given to the timing and content of policy and regulatory initiatives on similar issues in different countries in order to avoid unnecessary duplication, burden, or conflicts and promote convergence.

Where financial regulation is developed internationally, coordination in implementation is important since compliance mechanisms and supervisory functions are largely organised at a national level. Any material inconsistencies in implementation could further aggravate the potential problems of regulatory duplication, burden, conflict, and barriers, and create opportunities for regulatory arbitrage between countries.

9. **International coordination in the regulation of internationally active financial firms and groups:** The growth and size of internationally active financial firms, which straddle national borders and engage in a broad range of financial activities, and the special challenges they pose for nation-based systems of regulation and supervision and insolvency, suggest that close international coordination and cooperation is required in relation to their regulation and supervision, cross-border crisis management, and failure resolution. Such international coordination requires that the legal and regulatory framework provide governmental authorities with the necessary tools and mechanisms to achieve a comprehensive and consistent approach to oversight and control of these firms and groups; it also requires integrated supervisory mechanisms to ensure a consolidated view of activities, for instance through supervisory colleges or common reporting forms and processes across jurisdictions.
10. **Promotion of open, competitive, and safe markets through the establishment of a level playing field and removal of unnecessary duplication, burdens, conflicts, and barriers across countries:** Given the potential for international policy spillovers, the risk of countries seeking to promote the competitiveness of their financial institutions and financial systems without due regard to the effects on other jurisdictions, and the possible ramifications for the stability and integrity of the international financial system, countries should seek to ensure a level playing field for products, services, institutions, systems, and markets that are sold or operate internationally. Establishing a level playing field requires the international adoption of the principles of *competitive neutrality* and *international coordination, convergence, and implementation in policy and rule-making*, with a particular focus on those aspects of regulation that have an important impact on the competitive position of institutions and systems (e.g., solvency). In addition, efforts should be made to eliminate unnecessary regulatory duplication, burden, conflict, or barriers, and thereby promote the efficiency of the international financial system and domestic markets. Strengthened international coordination in policy and regulation-making should help to identify unnecessary duplication, burdens, and barriers. Mutual recognition may be a means to promote open and competitive markets.

III.C. Principles of financial regulation

Nature of regulation

- a) **Precaution:** A pre-cautionary approach is warranted in financial regulation; policymakers should proactively anticipate and address emerging risks and problems and not initiate reforms solely in response to the onset of a crisis.
- b) **Risk-based:** Financial regulation should be oriented to the risks in the financial system and give priority to those risks that, due to their nature or impact, have the greatest potential of compromising the achievement of policy objectives. Risk-based regulation should be aligned with, and promote, sound risk management in the financial system and strengthen incentives for prudent and proper behaviour.
- c) **Sound incentives:** Financial regulation should seek to align the incentives of participants with policy objectives by adjusting the nature, form, and strength of directive authority, compulsion, and supervision as appropriate, and using other policy instruments where necessary and appropriate. Effective enforcement and appropriate deterrence provide a basis for sound incentives. Financial regulation should clarify that financial institutions may fail and should specify orderly failure resolution procedures. As appropriate, financial regulation may make use of market forces to promote the alignment of incentives.
- d) **Comprehensiveness:** Financial regulation should ensure that all identified market failures and broader economic and social needs are properly addressed, at a domestic and global level, and involve the full use of all regulatory tools and mechanisms to achieve policy objectives, including through the combination of regulation with other policy instruments. Comprehensiveness means that:
 - i) all financial system participants and related products, services, institutions, systems, and markets are subject to appropriate regulatory and supervisory frameworks and oversight;
 - ii) interconnected components of the financial system, be it in terms of financial groups, sectors, systems, or markets, as well as broader macroeconomic conditions, are appropriately subject to an integrated, global view so that interrelated risks and contagion channels can be appropriately identified and, as necessary, addressed, at both a micro and macro level; and,
 - iii) all appropriate tools and mechanisms are used to ensure a global, integrated approach to the regulation and supervision of relevant participants, products, services, institutions, systems, and markets.
- e) **Consistency and competitive neutrality:** Financial regulation should be applied in a consistent, "functionally equivalent" manner (i.e., neutral from a product, institutional, sectoral, and market perspective so that similar risks are treated equivalently by regulation). With the growth of financial groups, and convergence of financial sectors and markets, more consistent, coordinated, and integrated forms of regulation should be adopted across: (i) products, services, sectors, systems, and markets; and (ii) financial firms and groups.

Regulatory process and enforcement

- f) **High-quality, transparent decision-making and enforcement:** A high-quality and transparent decision-making process for regulation-making should be established, with effective mechanisms for enforcement. The 1995 "OECD Reference Checklist for Regulatory Decision-Making" provides a useful guide; however, due recognition should be given to the specificities and exigencies of financial regulation.
- g) **Systematic review:** The quality, implementation, and impact of financial regulation should be assessed in due course following its adoption. This assessment should evaluate whether the regulation achieved its specific objective(s) and did so in a cost-efficient manner, and whether the decision-making process could be improved.

International dimension

- h) **International coordination, convergence, and implementation in policy and rule-making:** Financial regulation should, to the extent possible, be comprehensive and consistent internationally, with effective coordination where relevant and gradual convergence over time insofar as policy objectives are shared. Where financial regulation is developed internationally, coordination in implementation should be encouraged to ensure consistency in application and prevent regulatory arbitrage.
- i) **International coordination in the regulation of internationally active financial firms and groups:** The growth and size of internationally active financial firms, and the special challenges they pose for nation-based systems of regulation and supervision and insolvency, suggest that close international coordination and cooperation is required in relation to their regulation and supervision and failure resolution.
- j) **Promotion of open, competitive, and safe markets through the establishment of a level playing field and removal of unnecessary duplication, burdens, conflicts and barriers across countries:** Financial regulation should ensure a level playing field and not lead to unnecessary duplication, burden, conflict, or barriers across countries, and thereby promote open, competitive, and safe markets.

IV. System Design and Implementation

Government intervention is particularly challenging in the financial sector: there are multiple policy objectives, some of which may be conflicting; there are multiple policy instruments, whose effects may cause them to work at cross-purposes and which may require some level of international coordination for their optimisation; and there may be multiple institutions in government implementing the policy instruments (e.g., treasury, supervisors, central banks, deposit insurers), and possibly at different levels of government within a jurisdiction, which may raise issues of coordination in the use of policy instruments. Moreover, some policy and regulatory functions may, explicitly or implicitly, be delegated to designated self-regulatory organisations, which, while providing possible benefits to the regulatory system, may raise an additional layer of complexity for its governance.

The organisation and design of the institutional system involved in the development and implementation of government intervention and regulation are key considerations in the effectiveness and efficiency of financial regulation. How institutions responsible for the development and administration of policy and regulation are constituted, what their functions and responsibilities are, and how they are coordinated, have an important impact on government intervention and regulation. There are two key decisions in institutional design: (a) matching policy objectives and instruments to administrative institutions; and (b) devising appropriate system(s) for coordination, oversight, and control of instruments and institutions.

A. Matching policy objectives and instruments to institutions

Designing the institutional framework for government oversight and regulation of the financial system is a key challenge. Decisions need to be made on the number of institutions involved in the system, the assignment of objectives, the roles and responsibilities to institutions, the interrelationships among institutions, and the accountability framework. These decisions need to take into account the possible role of other levels of government in financial system oversight and regulation.

There are special challenges in the financial sector that are highly relevant for institutional design, and which should be taken into account in the institutional setup:

- *Close linkages with macroeconomic policy:* Although the purpose of monetary policy is to manage the supply of money with a view to controlling macroeconomic variables, and in particular inflation, and thus promoting sound and sustainable economic growth, the financial system supports the operation of the monetary system and provides the transmission mechanism through which monetary policy operates. The establishment of institutions, and assignment of policy objectives and instruments to these institutions, for monetary policy and financial sector policy therefore need to be done in a coordinated and integrated fashion. For instance, the institutional setup for the conduct of monetary policy may, due to synergies (*i.e.*, mutual reinforcement) in policy objectives, may provide a platform for the pursuit of specific policy objectives in the financial system.
- *Implicit and explicit financial exposure of the government:* Unlike other areas of economic policy (through sharing similarities with social policy), the government has a potentially very large fiscal exposure to the operation of the financial system, be it explicitly through the use of specific policy instruments such as the provision of lending facilities (*e.g.*, liquidity) and guarantees, or implicitly due to damage a financial crisis might impose on the real economy, whose costs may in large part -- perhaps unavoidably -- have to be covered by the government.
- *Rapid evolution of the financial system and convergence of institutions and products:* The complex and rapidly evolving nature of the financial system, and the continued convergence of financial institutions, markets, and products, mean that pressures will continuously be placed on the institutional framework for it to evolve and reflect emerging realities in the financial system. Yet there is often a lag, creating a mismatch between the operational reality of the financial system and the framework for intervention and regulation and potentially leading to new risks. The institutional framework should be consistent with the financial system and expected trends.
- *Global linkages:* The integrated nature of financial systems in OECD countries, and the existence of policy spillovers, suggest that consideration should be given, in terms of institutional design, to international cooperation and coordination, and possible related international institutional frameworks. For instance, the legal mandates of national supervisors could be broadened to take into account the international dimension in light of potential negative policy spillovers among countries and the need for effective and efficient oversight and regulation of internationally active financial institutions and of international financial markets. Nation-based legal frameworks and systems of accountability, in addition to potential country-specific circumstances, are important considerations that need to be taken into account in assessing the feasibility of developing integrated regulatory, supervisory, and intervention systems at the international level; however, in an area characterised by a high degree of financial integration, some regulatory and supervisory functions may need to be attached to a centralised, supranational structure.

The first step in developing a sound institutional system for government intervention and regulation - assigning policy objectives and policy instruments to institutions - is no simple task, as the debates regarding optimal regulatory structure attest. Questions abound in this respect: should the regulatory structure be institution-focussed, *i.e.*, on the main types of financial institutions, systems, and markets? Should the structure instead reflect core financial activities, and thus be

purely functional in approach? Alternatively, should the regulatory structure be based on policy objectives, with each institution focussing on one key policy objective? Or should it be based on some mixture of the above?

A proper analysis and discussion of designing an appropriate institutional system for government intervention and regulation in the financial system likely warrants a separate paper. However, a number of key principles are offered regarding appropriate institutional design, namely:

- *Maximise synergies:* Synergies should be exploited to the extent possible and with due consideration given to other system design factors (see III.B. below). These synergies might operate at a number of levels, including:
 - **Policy objectives:** Any strong mutual reinforcement among policy objectives should be exploited in institutional design. Such reinforcement exists where beneficial outcomes achieved in the pursuit of one policy objective support the achievement of one or more other objectives. For instance, it can be expected that the successful pursuit of systemic stability will lead to conditions favourable to the safety and soundness of financial institutions. These synergies might be explicitly considered ex ante, such as in macro-prudential supervision.
 - **Policy instruments:** The use of two or more instruments together may have positive, reinforcing effects that exceed the contribution of each instrument. Given the informational benefits of surveillance for the sound development and use of any policy instrument, the assignment of a surveillance function to each institution, in combination with other assigned instruments, should be a minimum requirement for all institutions.
 - **Information:** Specific information may be generated that could have use beyond its immediate application and purpose, and thus support the use of other policy instruments or serve in the achievement of a broader array of policy objectives. Institutional design should take into consideration such information flows if they are significant. For instance, business conduct problems linked to a financial institution may throw up red flags regarding the corporate governance practices of the institution, and thus raise questions about its safety and soundness, given the importance of corporate governance in assuring sound prudential management. Similarly, information obtained in the pursuit of systemic stability may support the supervision of financial institutions, and vice versa; in addition, the promotion of market integrity and consumer protection in securities markets may yield information that is valuable for efforts to minimise systemic risks.
 - **Expertise:** Expertise acquired in the development and implementation of policies and regulation may have a broader use than its original purpose. For instance, supervisory expertise in asset-liability management in the banking sector may be applicable to the insurance sector. The institutional framework can facilitate or impede such synergies.
 - **Administration:** Administrative synergies may be realised by combining administrative functions.
- *Ensure consistency and coherence in the use of policy instruments:* As with financial regulation, policy instruments equivalent in nature and

sharing the same policy objective(s) should be used in similar manner across institutions, and be applied in a consistent and comprehensive fashion across the financial system. Unnecessary overlap and duplication should be avoided, unless justified by broader institutional design reasons (see IV.B below). Achieving coordinated or integrated financial sector supervision may take the form of a single, fully integrated supervisory institution; alternatively, it may take the form of close regulatory and supervisory cooperation and coordination arrangements among relevant institutions (see section IV.B below).

- *Align incentives and minimise potential conflicts:* The incentives of institutions charged with developing and implementing measures should be aligned with the policy objectives assigned to them. However, information asymmetries may cause incentives to become misaligned and conflicts of interest to arise, leading to the possible misuse of a policy instrument (e.g., regulatory forbearance) if the institution does not fully bear the costs of its mistakes.

These incentive issues become important to consider in the context of policy instruments involving large direct or contingent financial exposures – namely, lending facilities and the provision of guarantees – that may be assigned to an institution but whose costs may not be fully absorbed by that institution. Tight *ex ante* controls may need to be imposed on the use of these instruments, and on mandates of the relevant institution(s), in order to ensure proper risk management. These considerations suggest that a degree of *specialisation* may be desirable in respect of financial tools, and in respect of the institutions that have been assigned these tools, particularly if such tools are intended to address high-priority policy objectives.

There may also be external influences (e.g., political interference) that could affect incentives and cause actions to deviate from the objectives established for the institution. If the risk of interference is high, and if the impact on the achievement of policy objectives is significantly important, then the institution in question may need a degree of *independence*. Such independence needs to be balanced against the need for proper accountability.

- *Promote accountability:* Given the importance promoting the effectiveness of government intervention and regulation, and aligning incentives, each institution established within the institutional framework should have clear objectives that are linked to the overarching policy objectives for the financial system, and should be assigned policy instruments that permit each institution to meet these objectives. These objectives provide a framework for accountability, and thus permit not only an assessment of the performance of each institution, but also allow for a recognition of the need for adjustments in policy approaches, policy instruments, and possibly even the institutional framework.
- *Minimise risks for the taxpayer:* Given the potentially large implicit and explicit financial risks to governments in intervening in the financial system, the institutional setup should seek to minimise these risks for governments (and ultimately for taxpayers), unless the public interest dictates otherwise. Minimising taxpayer exposures should serve to ensure that costs are properly absorbed and managed *ex ante* by the financial system, and prevent the “socialisation” of risk. This principle may affect the extent to which, and the way in which, policy instruments, particularly those financial in nature, are delegated to separate

institutions. It may also affect systems of coordination, conflict, oversight, and control in the institutional setup, as described below in section IV.B. (e.g., assigning oversight and challenge functions to some institutions).

The operationalisation of these principles will depend on country contexts and preferences, and will be influenced by the current design of the institutional system. Trade-offs will have to be made in the design of the institutional framework, and decisions on the appropriate structure will ultimately reflect: (a) the structure and operation of the financial system and expected trends over the medium to longer term; (b) the overarching policy objectives for the financial system and the prioritisation of these objectives; and (c) considerations of efficiency and the proper alignment of incentives. At a minimum, in order to promote the sound development and use of policy instruments, and an effective and responsive set of institutions, instruments, and objectives, a strong surveillance function should be assigned to each institution in order to monitor developments, identify risks, and consider implications for policy and regulation. The contours of the surveillance function of each institution should be carefully drawn to avoid gaps and ensure a comprehensive governmental view.

IV.A. Matching policy objectives and instruments to institutions

- a) Institutions connected to the framework for government intervention and regulation (e.g., treasury, financial supervisors, central banks, deposit insurers) should be established with a clear set of objectives and instruments in order to permit them to meet their objectives in an effective and efficient manner.
- b) The objectives of these institutions should, in part or whole, correspond to the policy objectives for the financial system and provide a basis for the accountability framework for these institutions.
- c) The assignment of policy objectives and policy instruments to these institutions should:
 - i) maximise available synergies;
 - ii) ensure consistency and coherence in the use of policy instruments;
 - iii) align incentives and minimise potential conflicts of interest;
 - iv) promote accountability; and,
 - v) minimise risks for taxpayers.
- d) As a minimum requirement, a surveillance function should be attached to each of the institutions with responsibilities for the intervention framework. The contours of the surveillance function of each institution should be carefully drawn to avoid gaps and ensure a comprehensive governmental view.

B. Systems for coordination, oversight, and control

A second layer of considerations regarding institutional design relates to internal governmental systems for the coordination, oversight, and control of institutions. Ultimately, institutions responsible for intervention and regulation are part of a broader framework of government oversight and intervention, and must be integrated and coordinated through a stable pattern of interrelationships and information flows so as to promote the achievement of policy objectives.

Coordination and integration: The activities and functions of each of the institutions should be coordinated and properly integrated in order to ensure adequate information flows, encourage collaborative analysis, discussion, and policy development, and effective and consistent and coordinated implementation of policy instruments. Coordination and integration should take place through regular

meetings among the concerned institutions, which should be given appropriate legal foundations in order to ensure adequate information flows and protect the confidentiality of information and discussions. Institutions from different levels of government should be included where relevant in these coordination mechanisms. The degree of coordination and integration may vary according to the situation, with greater coordination, for instance, taking place under emergency conditions.

Oversight: Some degree of oversight should be established among the institutions implicated in intervention and regulation in order to provide a challenge function and strengthen accountability. This oversight should include reviewing the actions of institutions in the aftermath of a financial failure or crisis as the details of any intervention may never, for confidentiality reasons, be made public. This oversight can be mutual and informal in nature, with each of the institutions permitted to oversee, and potentially challenge, the behaviour and actions of other institutions. Alternatively, oversight could be entrusted with certain institutions with overarching responsibilities, such as the treasury, or with specific emergency duties in the event of a crisis, such as deposit insurers.

To gain effective force, the challenge function may need to have legislative backing (e.g., giving the deposit insurer closure powers over deposit-taking institutions). Formalising the challenge function could create conflicts but may help to align incentives and promote discussion of alternative approaches to intervention and regulation. Downside risks include unproductive inter-institutional conflict that may hamstring efficient responses to rapidly evolving problems, and a potential clouding of responsibilities and accountability that may be disincentivising and lead to untimely or inappropriate decisions and actions.

Control: The ultimate sources of authority and control should be clearly established, both to ensure efficient functioning of each institution, but also to ensure effective coordination and accountability for the system as a whole. In effect, this involves determining which institution gets a final say, and when, in respect of interventions and regulatory measures. This determination should be outlined for a gradation of scenarios, ranging from ordinary circumstances to emergency conditions necessitating crisis management.

IV.B. Coordination, oversight, and control of institutions

- a) The activities and functions of each of the institutions should be coordinated and properly integrated in order to ensure adequate information flows, encourage collaborative analysis, discussion, and policy development, and ensure effective and consistent implementation of policy instruments. In this respect:
 - i) formal committees and other mechanisms should be established to ensure proper coordination, and should include institutions from different levels of government if relevant; and,
 - ii) legal foundations for these mechanisms should be established in order to ensure adequate information flows and protect the confidentiality of information and discussions.
- b) Some degree of oversight should be established among the institutions implicated in intervention and regulation in order to provide a challenge function and strengthen accountability.
- c) The allocation of responsibilities and authorities for final decision-making under different circumstances, including crisis management, should be clearly established to ensure effective coordination and accountability for the system.

V. Review

The framework for government intervention and regulation in the financial system should be consistent with and responsive to the rapid evolution of the financial system and its integration with the international economic and financial system. This framework should, moreover, be adjusted to ensure: (a) the continued relevance and appropriateness of stated policy objectives and the weightings attached to them; and (b) the effectiveness and efficiency of the policy instruments and system of institutions used to achieve them.

Accordingly, the framework for government intervention and regulation in the financial sector should be reviewed and evaluated on a continuous basis and amended as necessary. At a minimum, a comprehensive review of the framework should be conducted on a periodic basis (e.g., every 5-8 years). Such a comprehensive review should attempt to review of the evolution of the financial system in synthetic fashion and draw conclusions for government policy and regulation, including any implications for policy objectives, the use and design of policy instruments, and the institutional setup. Lessons learned from the actions (or inactions) of governmental authorities, and possible implications for the design of the institutional setup, should be included in this review if relevant. This review could advance proposals for reform as well as respond to policy proposals put forward by governmental agencies as well as those advanced by stakeholders, including industry and consumers. The review could include cross-country consultations in order to identify issues for policy consideration. The comprehensive review therefore does not need to involve a painstaking line-by-line review of the entire corpus of financial regulation, or a re-evaluation of every policy instrument or institution. The key is to identify pressure points and ways to improve the effectiveness and efficiency of government intervention and regulation.

In addition, international review and peer pressure, such as the IMF and World Bank Financial Sector Assessment Program and related Reports on the Observance of Standards and Codes, can help in the review of a government's policy and regulatory framework and promote accountability.

V. Review

- a) The framework for government intervention and regulation should be consistent with and responsive to the rapid evolution of the financial system and its integration with the international economic and financial system, and should be adjusted and amended as necessary to ensure: (i) the continued relevance and appropriateness of stated policy objectives and the weightings attached to them; and (ii) the effectiveness and efficiency of the policy instruments and system of institutions used to achieve them.
- b) At a minimum, the framework for government intervention and regulation should be subject to a comprehensive review on a periodic basis (e.g., every 5 to 8 years).
- c) Domestic reviews of the policy and regulatory framework should be supplemented by international review and peer pressure.

Appendix

OECD Reference Checklist for Regulatory Decision-Making

1. Is the problem correctly defined?	The problem to be solved should be precisely stated, giving clear evidence of its nature and magnitude, and explaining why it has arisen (identifying the incentives of affected entities).
2. Is government action justified?	Government intervention should be based on clear evidence that government action is justified, given the nature of the problem, the likely benefits and costs of action (based on a realistic assessment of government effectiveness), and alternative mechanisms for addressing the problem.
3. Is regulation the best form of government action?	Regulators should carry out, early in the regulatory process, an informed comparison of a variety of regulatory and non-regulatory policy instruments, considering relevant issues such as costs, benefits, distributional effects, and administrative requirements.
4. Is there a legal basis for regulation?	Regulatory processes should be structured so that all regulatory decisions rigorously respect the “rule of law”; that is, responsibility should be explicit for ensuring that all regulations are authorised by higher level regulations and consistent with treaty obligations, and comply with relevant legal principles such as certainty, proportionality, and applicable procedural requirements.
5. What is the appropriate level (or levels) of government for this action?	Regulators should choose the most appropriate level of government to take action, or, if multiple levels are involved, should design effective systems of coordination between levels of government.
6. Do the benefits of regulation justify the costs?	Regulators should estimate the total expected costs and benefits of each regulatory proposal and of feasible alternatives, and should make the estimates available in accessible format to decision-makers. The costs of government action should be justified by its benefits before action is taken.

7. Is the distribution of effects across society transparent?

To the extent that distributive and equity values are affected by government intervention, regulators should make transparent the distribution of regulatory costs and benefits across social groups.

8. Is the regulation clear, consistent, comprehensible, and accessible to users?

Regulators should assess whether rules will be understood by likely users, and to that end should take steps to ensure that the text and structure of rules are as clear as possible.

9. Have all interested parties had the opportunity to present their views?

Regulations should be developed in an open and transparent fashion, with appropriate procedures for effective and timely input from interested parties such as affected businesses and trade unions, other interest groups, or other levels of government.

10. How will compliance be achieved?

Regulators should assess the incentives and institutions through which the regulation will take effect, and should design responsive implementation strategies that make the best use of them.

HIGH-LEVEL OECD CHECKLIST

I. Financial Landscape

A. Benchmark reference

Have the attributes of a well-functioning system been identified?

- Have the principal functions of the financial system been identified? Have the features of these functions been properly identified?
- Have the boundaries of the system been defined? Have the expected linkages between the financial system and the broader economy been identified?
- Has the relationship between the financial system and the monetary system, including the conduct of monetary policy, been clarified?
- Have the anticipated linkages between the domestic financial system and the international financial system been identified?
- Have the expected outcomes of a well-functioning financial system been identified?
- Have the essential foundations (e.g., legal, behavioural, institutional) of a well-functioning financial system been identified?
- Have possible country-specific features regarding the operations of the financial system been identified?
- Has this vision of a well-functioning financial system been communicated to the public? If so, how and when? Has this vision been updated to reflect changes in the financial system?

B. Transparency

Is the functioning of the financial system, its features, and evolution transparent?

- Is comprehensive, relevant, and timely information currently being collected and, to the extent possible, disseminated on:
 - i) Products, services, processes, and transactions in the financial system?
 - ii) Institutions?
 - iii) Private and off-balance sheet vehicles?
 - iv) Markets?
 - v) Systems and supporting infrastructures?
 - vi) Participants (including consumers)?
 - vii) Interlinkages (e.g., macroeconomic, international)?

- What are the expected benefits of collecting and disseminating such information? Has the relevance of this information been assessed? Who will be the users of this information?
- Are comprehensive, relevant, up-to-date, and internationally comparable sets of statistics and indicators for the entire financial system being collected and disseminated? What are the expected benefits of collecting and disseminating these statistics and of producing related indicators? Who will be the users of these statistics and indicators?
- Have considerations of cost, confidentiality, financial stability, and security been properly assessed in determining the appropriate level of transparency?
- Do governmental authorities have the legal powers to compel, if necessary, the collection and, if appropriate, dissemination of data and information?
- Are timely, relevant, comparable, international data and information available to permit comparisons and foster an understanding of the international financial system?
- Is there scope for the private sector, possibly in collaboration with government, to improve further the relevance, quality, timeliness, comprehensiveness, and comparability of data and information?
- Are relevant international organisations supporting domestic and global efforts to promote greater transparency of the financial system?

C. Surveillance and analysis

Are domestic and international financial system developments and macroeconomic trends being properly surveyed? Are emerging risks consistently being identified and monitored closely?

- Have effective surveillance tools and mechanisms been established? Is there adequate monitoring of financial products, services, transactions, institutions, systems, markets, and participants (including consumers) and of their interrelationships?
- Is there adequate expertise to properly understand risks, conduct analyses, identify policy options, and formulate a policy response?

Has market failure analysis been conducted to better understand the operations and efficiency of the financial system and define the key problems?

- In this respect:
 - i) Have relevant markets and participants been identified?
 - ii) Has the source of the market failure been identified (e.g., asymmetric information, spillovers, market power, market abuse)?
 - iii) Has the materiality of the market failure been assessed?
 - iv) Have the risks and effects of the failure been identified?
 - v) Has the market failure been substantiated empirically?
 - vi) Have the possible global and dynamic nature of the market failure been assessed, including whether the failure might be self-correcting?

Is there collaborative information-sharing, discussion, and analysis among relevant governmental authorities, both domestically and internationally?

- In this respect:
 - i) Are professional secrecy standards applicable to governmental authorities in relation to the exchange of confidential information?
 - ii) Are there discussions and analysis of the financial system and related developments, risks, and possible contagion channels, domestically and internationally?
 - iii) Are there effective mechanisms to promote continued collaboration and information-sharing?

II. Policy Objectives

A. Identification of problem and case for intervention

Has the case for intervention been established?

- Have the expected benefits of the government intervention to address these problems and needs been identified?
- Have the direct and indirect costs of intervention been assessed? Have the unexpected possible problems, complications, intended consequences, or unexpected costs of government intervention been carefully considered, including the possibility that certain policies or approaches may be unsustainable or lead to a build-up of risks (i.e., regulatory failure analysis)? Has consideration been given to whether identified problems might worsen in the absence of intervention?
- Has the international dimension been considered, in particular whether the identified problem(s) might be more effectively addressed by a coordinated international response?
- Have the alternatives to government intervention been assessed (including non-intervention)?
- Overall, does the intervention appear to be justified?

B. Policy objectives

If government intervention in the financial system appears to be justified: have clear policy objectives been elaborated?

- Do the objectives correspond to the anticipated beneficial outcomes of intervention?
- Are they sufficiently general to be applicable to the entire financial system?
- Have they been prioritised? Do they give top priority to promoting confidence in the financial system and addressing systemic risks?
- Have the trade-offs or mutual reinforcement among policy objectives been identified and carefully analysed? Has consideration been given to the extent to which policy objectives may be conflicting?
- Do more specific objectives need to be elaborated for particular sectors, institutions, or products? Why? How are they linked to the general objectives?

C. Accountability

Have policy objectives been publicly articulated?

- Are they sufficiently transparent to assess the effectiveness of intervention?

Have accountability mechanisms been established?

- Have they been explicitly incorporated, in part or whole, into the mandated objectives of governmental authorities involved in intervention?
- Do relevant governmental authorities publish annual reports in which they outline their objectives, provide an overview of the regulatory framework and relevant developments in the financial system, identify key risks, and provide information on how the regulatory framework is addressing these risks and achieving stated objectives? Are aggregate statistical data provided on key aspects of such implementation so that the priorities and activities of these governmental authorities can be better understood?
- Have internal governance mechanisms been established within government to ensure ongoing review of, and reporting by, relevant authorities?
- Have indicators been developed to help monitor progress toward the achievement of policy objectives?
- Are remedies available within government to address any serious failure by governmental authorities to meet mandated objectives?

III. Policy Instruments

A. Identification of financial sector policy instruments

Have the range and features of policy instruments available to address the problem been identified and are they well understood?

- Policy instruments include:
 - i) Surveillance
 - ii) Moral suasion with market-based solutions
 - iii) Regulation
 - iv) Guarantees
 - v) Lending and liquidity support
 - vi) Subsidies, grants, and programmes
 - vii) State ownership and control
- Have the impacts of each policy instrument been identified, particularly in respect of costs, incentives of affected parties, and international spillovers?
- Has consideration been given, in particular, to addressing how any expected negative incentive effects or international spillover effects can be reduced?
 - i) Have ex ante risk mitigation measures been adopted to help control the effects of negative incentives? Has consideration been given to adjusting the use of other policy instruments to reduce these risks?
 - ii) Has the need and scope for international cooperation and coordination been specified to optimise the impact of policy instruments?
- In the case of the use of regulation as a policy instrument, has its proper nature and form been considered? To what extent does it meet the ten principles of financial regulation (see III.C below)?

B. Matching policy instruments to policy objectives

Are the selected combinations of policy instruments appropriate for the identified problems or needs in the financial system? Are they the least-cost approach?

- Has the mix of policy instruments been carefully considered? What is the role, if any, of financial regulation in this mix?
- Do the instruments, taken together, address the identified market failures or broader economic and social needs underlying each policy objective?
- Have potential conflicts in policy objectives been taken into account in the choice of policy instruments?
- Has the choice and design of policy instruments taken into consideration possible negative incentive effects that may affect, and cut across, policy instruments? Have possible international policy spillovers also been considered?
- Have specific factors, such as industry sector, type of institution, and type of consumer been explicitly considered in the choice and design of instruments for each policy objective? Has such specificity been well justified?

- Has the possibility of international policy spillovers been considered in the choice, design, and implementation of policy instruments?
- Do the selected combinations of instruments represent a cost-efficient approach to addressing the policy objectives?
- Has the choice of policy instruments, and their mapping to policy objectives, been made transparent and publicly justified?
- Once made operational, has the use of policy instruments been made transparent to the extent possible and appropriate?
- Has international coordination been established, where necessary and possible, to maximise the impact of domestic policy instruments?

Has the choice and design of policy instruments been made transparent and publicly justified?

- Is the level of transparency sufficient to foster an understanding of the policy framework for the financial sector and provide appropriate context to government intervention?
- Has transparency been provided on the nature, amount, and costs of any government intervention to rescue a financial institution or, in a crisis situation, to safeguard the financial system (e.g., guarantees, lending, capital injection)?

C. Specification and principles of financial regulation

Financial regulation is a policy instrument designed to induce certain behaviours and actions or specify certain fixed outcomes – in this context, has consideration been given to the nature and content of the “directive order” in question, the degree of compulsion, and (if relevant) the extent of supervision?

- Regarding the nature and content of the directive order in regulation, has careful thought been given to the appropriate mix of principles and rules?
- Is the system of compulsion appropriate?
 - i) Adequacy of administrative penalties and sanctions?
 - ii) Extent of civil law provisions?
 - iii) Relevance and extent of criminal law provisions?
- Is the system of supervision (if relevant) adequate?
 - i) Proper legal authorities?
 - ii) Adequate expertise and level of staffing?
 - iii) Effective techniques of supervision?
 - iv) Accountability mechanisms in place?
 - v) Complementary role of criminal law prosecution?

To what extent have the following ten principles for effective and efficient financial regulation been met?

- A *pre-cautionary* approach has been adopted in financial regulation; policymakers pro-actively anticipate and address emerging risks and problems (including through active monitoring of the financial system and macroeconomic developments) and do not initiate reforms solely in response to the onset of crises.
- Financial regulation is *risk-based* and is thus oriented to the risks in the financial system and gives priority to those risks that, due to their nature or impact, have the greatest potential of compromising the achievement of policy objectives. Regulation is aligned with, and promotes, sound risk management in the financial system and strengthens incentives for prudent and proper behaviour.
- Financial regulation promotes *sound incentives* (i.e., incentives that are aligned with policy objectives) and, to do so, includes effective enforcement of financial regulation and appropriate deterrence, clarifies that financial institutions may fail and specifies orderly failure resolution procedures for them, and may harness market forces as appropriate.
- Financial regulation is *comprehensive* and ensures that all identified problems (market failures and broader economic and social needs) are properly addressed, at a domestic and global level, and involve the full use of all regulatory tools and mechanisms to achieve policy objectives, including through the combination of regulation with other policy instruments. In this context:
 - i) all financial system participants and related products, services, institutions, systems, and markets are subject to appropriate regulatory and supervisory frameworks and oversight;
 - ii) interconnected components of the financial system, be it in terms of financial groups, sectors, systems, or markets, as well as broader macroeconomic conditions, are appropriately subject to an integrated, global view so that interrelated risks and contagion channels can be appropriately identified and, as necessary, addressed, at both a micro and macro level; and,
 - iii) all appropriate tools and mechanisms are being used to ensure a global, integrated approach to the regulation and supervision of relevant participants, products, services, institutions, systems, and markets.
- Financial regulation is *consistent and competitively neutral* and is applied in a consistent, “functionally equivalent” manner (i.e., neutral from a product, institutional, sectoral, and market perspective so that similar risks are treated equivalently by regulation). Consistent, coordinated, and integrated forms of regulation and supervision have been adopted across: (i) products, services, sectors, systems, and markets; and (ii) financial firms and groups.

- A high-quality and transparent decision-making process for regulation-making is in place, including consultations with relevant stakeholders and effective mechanisms for enforcement (see below for further questions regarding the regulatory process and enforcement, from the *OECD Reference Checklist for Regulatory Decision-Making*).
- Financial regulation is subject to systematic review and is assessed with respect to quality, implementation, and impact in due course following its adoption. This assessment evaluates whether the regulation achieved its specific objective(s) and did so in a cost-efficient manner, and whether the decision-making process could be improved.
- Financial regulation is involving international coordination, convergence, and implementation in policy and rule-making: Financial regulation is, to the extent possible, comprehensive and consistent internationally, with effective coordination where relevant and gradual convergence over time insofar as policy objectives are shared. Where financial regulation is developed internationally, efforts are made to coordinate implementation to ensure consistency in application and prevent regulatory arbitrage.
- There is international coordination in the regulation and supervision of internationally active financial firms and groups. The growth and size of internationally active financial firms, and the special challenges they pose for nation-based systems of regulation and supervision and insolvency, suggest that close international coordination and cooperation is required in relation to their regulation and supervision, cross-border crisis management, and failure resolution.
- Open, competitive, and safe markets are being promoted through the establishment of a level international playing field and the removal of unnecessary duplication, burdens, conflicts and barriers.

In the context of the development of specific financial regulations, has a sound, open, transparent, process been followed?

- Have the following steps been taken, as outlined in the *OECD Reference Checklist for Regulatory Decision-Making*?
 - i) Define the specific problem in question
 - ii) Assess whether government action is justified (see also II.A), whether regulation is the most appropriate policy instrument (see also III.A and III.B), and whether there is a legal basis for regulation
 - iii) Assess the appropriate level of government for implementation and establishing effective coordination if there are multiple levels
 - iv) Assess the costs and benefits of regulation in a manner proportionate to the importance of the regulation and its impact
 - v) Ensure that any distributional impacts are transparent

- vi) Conduct consultations with interested parties in an open and transparent manner, and ensure adequate time for responses
- vii) Assess and ensure effective implementation and compliance mechanisms
- Has consideration been given to possible, limited circumstances (e.g., supervisory interventions, emergency and crisis management) where an open, transparent process may not be possible or appropriate? On what criteria would such a decision be based?
- Has consideration been given to the international dimension of regulation-making? Are appropriate domestic or international consultation mechanisms in place, involving all relevant stakeholders?
- If applicable, has the regulation been reviewed by central governmental agencies charged with reviewing governmental regulations?

IV. System Design and Implementation

A. Appropriate institutional setup

Is the institutional setup for government intervention and financial regulation effective and efficient?

- Does the institutional setup reflect realities in the domestic and global financial system?
- Do the government institutions (“administrative institutions”) responsible for intervention and regulation have clear, mandated objectives? Do they have sufficient authorities and adequate tools for implementation? Does each institution have a surveillance function to ensure that it can properly monitor relevant developments and meet its mandated objectives? Does the government as whole, through its administrative institutions, have a proper, comprehensive view of developments in the financial system?
- Have available synergies been maximised in terms of the assignment of policy objectives and instruments to these institutions? Synergies include:
 - i) Policy objectives
 - ii) Policy instruments
 - iii) Information and expertise
 - iv) Administration
- If more than one administrative institution is involved in the use of a policy instrument and policy objectives are shared, have effective coordination mechanisms been established to ensure consistency and coherence?
- Are the interests and incentives of relevant administrative institutions aligned with their objectives? What external pressures exist? Has the institutional setup accounted for these factors?

- Are appropriate accountability mechanisms in place for these institutions?
- Have the linkages with macroeconomic policy – specifically monetary policy -- been properly taken into account in the design of the institutional setup?
- Have the financial exposures of government been properly considered in the institutional setup?
- Have global linkages been considered in the design of the institutional setup? In this respect, has consideration been given to the establishment of enhanced international coordination and institutional mechanisms, as appropriate?
- Where self-regulatory organisations (SRO) are directly or indirectly involved in government intervention and regulation, is this setup appropriate? Is the public interest being served in an effective and efficient way? Is government oversight over the SROs clearly established and adequate?

B. Systems for coordination, oversight, and control

Is there an effective system of coordination, oversight, and control in the institutional setup?

Coordination

- Have mechanisms been established to ensure adequate information flows, collaborative analysis, discussion, and policy development, and effective and coordinated implementation of policy instruments?
- Do these mechanisms include other relevant levels of government?
- Do these mechanisms have a legal foundation to ensure their effectiveness and continuity?

Oversight

- Have elements of oversight (informal or formal) been integrated into this system to ensure a degree of checks and balances?

Control

- Is it clear which institution gets a final say, and when, in respect of interventions and regulatory measures? Has this allocation of responsibilities and decision-making been determined for different types of scenarios, ranging from ordinary circumstances to emergency conditions involving crisis management?

V. Review

Has the framework for government intervention and financial regulation been reviewed and evaluated on a regular basis?

- Is the framework for intervention and regulation keeping pace with the evolution of the domestic and international financial system?
- Is the policy framework reviewed periodically (e.g., every 5 to 8 years) to:
 - i) Reassess previously identified problems and needs?
 - ii) Identify new problems and needs?
 - iii) Adjust policy objectives and their weightings?
 - iv) Assess the effectiveness and efficiency of policy instruments and the institutional setup for implementation?
 - v) Assess the processes for regulation-making and implementation?
- Have mechanisms for international peer review been fully exploited? Has use been made of the IMF and World Bank Financial Sector Assessment Program and of a related Report on the Observance of Standards and Codes?

RECOMMENDATION OF THE COUNCIL ON A POLICY FRAMEWORK FOR EFFECTIVE AND EFFICIENT FINANCIAL REGULATION

THE COUNCIL,

Having regard to Articles 1(a), 2(c) and 5(b) of the Convention on the Organisation for Economic Co-operation and Development of 14 December 1960;

Considering the primary role played by the financial system in financial intermediation in the economy and in the pooling, management, and transfer of risks;

Considering the close interlinkages between the financial system and the macroeconomy and the global and integrated nature of financial and economic systems;

Considering the complex and rapidly evolving nature of the financial system, the convergence of products, institutions, and markets, and the growth of globally active financial conglomerates;

Considering the potentially devastating economic and social consequences of financial crises and the length of time that may be needed to restore public confidence in the financial system;

Considering the importance of establishing a sound policy and regulatory framework for the financial sector that addresses market failures and any broader economic or social needs;

Considering that governments in OECD Member and non-Member countries may benefit from high-level international guidance on financial sector policy and regulation;

Recognising previous work of the OECD in promoting effective and efficient regulatory systems through instruments such as the *OECD Reference Checklist for Regulatory Decision-making* and *OECD Guiding Principles for Regulatory Quality and Performance*;

Recognising the role of other international organisations in developing regulatory standards for sound financial systems and supporting peer reviews of national financial systems;

Noting the *General Guidance on a Policy Framework for Effective and Efficient Financial Regulation* and the related *High-Level Checklist* developed by the Committee on Financial Markets and the Insurance and Private Pensions Committee;

Noting that the principles set out in the present Recommendation are drawn from the above-mentioned *General Guidance on a Policy Framework for Effective and Efficient Financial Regulation*;

On the proposal of the Committee on Financial Markets and the Insurance and Private Pensions Committee;

RECOMMENDS that Members develop a policy framework for effective and efficient financial regulation and, for this purpose, take due account of and implement the principles for a Policy Framework for Effective and Efficient Financial Regulation that are set out in the Annex to this Recommendation, of which they form an integral part.

RECOMMENDS that Members also take account of the *General Guidance on a Policy Framework for Effective and Efficient Financial Regulation* and related *High-level Checklist*, as they may be modified from time to time.

INVITES non-Members to adhere to this Recommendation.

INSTRUCTS the Committee on Financial Markets and the Insurance and Private Pensions Committee to exchange information on progress and experiences with respect to the implementation of this Recommendation, review that information, and report to the Council within three years from its adoption.

ANNEX

PRINCIPLES FOR A POLICY FRAMEWORK FOR EFFECTIVE AND EFFICIENT FINANCIAL REGULATION

I. Financial Landscape

A. *Financial system: benchmark definition*

- a) The attributes of a well-functioning financial system should be identified, taking into consideration the stage of development of the economy and other relevant country-specific factors. In this respect, there should be specification of:
 - i) the functions and scope of activities of a well-functioning financial system;
 - ii) anticipated macroeconomic and international linkages;
 - iii) expected outcomes; and,
 - iv) supporting foundations.

These attributes should have sufficient precision to permit an understanding of the nature of the financial system and to distinguish clearly its activities from other economic activities.

- b) This benchmark definition should be communicated publicly, in a manner, form, and frequency appropriate to the context and target audience. It should be updated as appropriate in light of the evolution of the financial system.

B. *Transparency*

- a) The operations of the financial system should be transparent, permitting the identification and delineation of its features, its operations, and their evolution over time.
- b) Micro- and macro-level data and information on the financial system should be available to promote transparency. In this respect:
 - i) comprehensive, relevant, up-to-date, and internationally comparable sets of statistics and indicators for the entire financial system should be collected and disseminated; and,
 - ii) comprehensive and timely information on products, services, transactions, institutions, systems, and markets connected with the financial system (including private and off-balance sheet vehicles), should be collected and, to the extent possible, disseminated.
- c) The collection and, where appropriate, dissemination of information on the financial system should have benefits for relevant stakeholders. Due consideration should be given to costs, confidentiality, financial stability, and security as relevant in the collection or dissemination of data and information.

- d) Governmental authorities should have the legal powers to compel, if necessary, the collection and, if appropriate, dissemination of data and information to ensure that proper transparency is achieved.
- e) Industry groups should be encouraged to promote a high level of transparency in the financial system, possibly in collaboration with government.
- f) International organisations should work to ensure transparency in the financial system, domestically and internationally, and coordinate their efforts in this respect.

C. Surveillance and analysis

- a) The functioning of the financial system and its broader macroeconomic and global linkages should be well understood, as should the products, services, institutions, systems, and markets connected with the financial system.
- b) Surveillance tools and mechanisms should be established to ensure a comprehensive, on-going monitoring of domestic and international financial system developments, macroeconomic trends, and emerging risks.
- c) Market failure analysis should be conducted to assess the efficiency of the financial system and, in particular, understand the risks to which the financial system and related participants may be susceptible. The potentially global and dynamic nature of these risks should be considered as part of this analysis.
- d) Governmental authorities should have the requisite expertise and resources to conduct appropriate surveillance and analysis on a timely basis and formulate sound policy and regulation.
- e) Given the complexity and rapid evolution of the financial system, the international nature of the financial system and global macroeconomic linkages, and the related challenges associated with effective surveillance and analysis, there should be continuous:
 - i) information-sharing within and across jurisdictions, through formal and informal channels, subject to professional secrecy standards applicable to governmental authorities in the context of any exchange of confidential information;
 - ii) collaborative analysis and discussion of the financial system and related developments, risks, and possible contagion channels, domestically and internationally;
 - iii) research and analysis, conducted at the domestic and international level;
 - iv) and effective mechanisms to promote such collaboration and information-sharing.

II. Policy Objectives

A. Identification of problems and the case for intervention

- a) Actual and potential market failures and broader economic and social needs in the financial system should be clearly identified and analysed, and these problems and needs ranked in terms of gravity and impact on welfare.

- b) The case for government intervention in the financial system should be established, including an assessment of potential benefits versus costs, the international dimension, and possible alternatives to intervention, and the targets of intervention and related expected outcomes should be clearly identified.

B.1. Policy objectives: framework for financial regulation

- a) Clear policy objectives should be elaborated to govern the framework for government intervention and financial regulation.
- b) Policy objectives should be based on sound policy analysis and correspond to the beneficial outcomes to be expected from addressing identified market failures and other identified broader economic or social needs.
- c) Policy objectives should be directed at the financial system as a whole, going beyond particular sectors, institutions, and products.
- d) Policy objectives should be appropriately prioritised; given the importance of the stability of the financial system, top priority should be given to promoting confidence in the financial system and addressing systemic risks.
- e) Any trade-offs or mutual reinforcement among policy objectives should be carefully analysed.

B.2. Policy objectives: micro-level

- a) More specific – and potentially different – policy objectives for particular sectors, institutions, and products may need to be elaborated given differences in market conditions, practices, and participants in different parts of the financial system.
- b) To the extent that there are differences in policy objectives at the micro-level, these should be:
 - i) linked to conclusions from market failure analysis and potentially broader economic and social analysis; and,
 - ii) linked to the broader hierarchy of policy objectives established at the macro-level (as per II.B.1 above).

C. Accountability

- a) Policy objectives should be publicly disclosed.
- b) Mechanisms to promote accountability should be in place, such as:
 - i) annual reports by governmental authorities to the public, including:
 - a. a description of objectives, an overview of the regulatory framework and relevant developments in the financial system, an identification of key risks, and information on how the regulatory framework is addressing these risks and achieving stated objectives, and,
 - b. aggregate statistical data on key aspects of such implementation so that the priorities and activities of the governmental authority can be better understood;
 - ii) internal governmental mechanisms for reporting and review;

- iii) development of indicators measuring progress toward the achievement of policy objectives; and,
- iv) remedies within government to address any serious failure of governmental authorities to meet mandated objectives.

III. Policy Instruments

A. Identification of policy instruments and their impact

- a) The range of policy instruments capable of affecting the operation of the financial system, the conduct of its participants, or its outcomes, and at the disposal of government, should be identified; in this respect, financial regulation should be considered as a key policy instrument, but by no means the only one.
- b) The features and possible impacts of each policy instrument should be identified and understood, particularly in terms of costs, incentives, and international spillover effects.
- c) Consideration should be given to assessing how any negative incentive or spillover effects could be addressed, for instance by varying the use of other instruments or through international coordination. These effects should be addressed *ex ante* through appropriate policy actions. In particular:
 - i) any negative incentive effects arising from the use of policy instruments – such as moral hazard – should, to the extent possible, be controlled *ex ante* with appropriate risk mitigation measures; and,
 - ii) the need and scope for international cooperation and coordination should be specified in advance with respect to each policy instrument.

B. Matching policy instruments to policy objectives

- a) Based on expected impacts, and in consideration of possible incentive and spillover effects, the identification of the proper policy instruments, and their appropriate combination, for each policy objective should be carefully considered and explored by governments. In this respect:
 - i) The chosen combination of instruments should address as precisely as possible the identified market failures or broader economic and social needs underlying each policy objective.
 - ii) The selected combination of instruments, and their design, for each objective should reflect the priority attached to the particular objective and the related risk tolerance for policy failure.
 - iii) As an instrument may be used to support more than one policy objective, potential conflicts among policy objectives should be identified and addressed accordingly.
 - iv) The choice and design of instruments should be adjusted to take into consideration possible incentive effects that may affect, and cut across, policy instruments. This may require the establishment of proper *ex ante* risk controls in the instrument causing the effects and an adjustment to other policy instruments.
 - v) Specific factors, such as industry sector, type of institution, and type of consumer should, in some circumstances, may be considered in the choice

- and design of instruments for each policy objective. Such specificity should be well justified and not inadvertently increase the risk of policy failure.
- vi) While priority should be given to ensuring effectiveness, due attention should be given to the costs of adopting instruments; in this respect, the least-cost approach should be adopted.
- b) The choice of instruments, and their mapping to policy objectives, should be made transparent and publicly justified, particularly in the context of any significant policy or regulatory reforms or any special crisis intervention measures. The use of instruments should, in addition, be made transparent; however, in some specific contexts or under certain circumstances, there may be a need for:
 - i) constructive ambiguity, in order to ensure the proper alignment of incentives; and,
 - ii) confidentiality, in order to ensure continued public confidence; however, there should be appropriate accountability mechanisms in place within government to ensure proper oversight of actions.
 - c) The choice, design, and implementation of instruments should consider, in light of the globalised financial and economic system, policy spillovers among countries. International collaboration and discussion of financial sector policy should be reinforced and be appropriately focussed on those areas requiring close international coordination.

C. Principles of financial regulation

Nature of regulation

- a) **Precaution:** A pre-cautionary approach is warranted in financial regulation; policymakers should pro-actively anticipate and address emerging risks and problems and not initiate reforms solely in response to the onset of a crisis.
- b) **Risk-based:** Financial regulation should be oriented to the risks in the financial system and give priority to those risks that, due to their nature or impact, have the greatest potential of compromising the achievement of policy objectives. Risk-based regulation should be aligned with, and promote, sound risk management in the financial system and strengthen incentives for prudent and proper behaviour.
- c) **Sound incentives:** Financial regulation should seek to align the incentives of participants with policy objectives by adjusting the nature, form, and strength of directive authority, compulsion, and supervision as appropriate, and using other policy instruments where necessary and appropriate. Effective enforcement and appropriate deterrence provide a basis for sound incentives. Financial regulation should clarify that financial institutions may fail and should specify orderly failure resolution procedures. As appropriate, financial regulation may make use of market forces to promote the alignment of incentives.
- d) **Comprehensiveness:** Financial regulation should ensure that all identified market failures and broader economic and social needs are properly addressed, at a domestic and global level, and involve the full use of all regulatory tools and mechanisms to achieve policy objectives, including through the combination of regulation with other policy instruments. Comprehensiveness means that:
 - i) all financial system participants and related products, services, institutions, systems, and markets are subject to appropriate regulatory and supervisory frameworks and oversight;

- ii) interconnected components of the financial system, be it in terms of financial groups, sectors, systems, or markets, as well as broader macroeconomic conditions, are appropriately subject to an integrated, global view so that interrelated risks and contagion channels can be appropriately identified and, as necessary, addressed, at both a micro and macro level; and,
 - iii) all appropriate tools and mechanisms are used to ensure a global, integrated approach to the regulation and supervision of relevant participants, products, services, institutions, systems, and markets.
- e) ***Consistency and competitive neutrality.*** Financial regulation should be applied in a consistent, “functionally equivalent” manner (i.e., neutral from a product, institutional, sectoral, and market perspective so that similar risks are treated equivalently by regulation). With the growth of financial groups, and convergence of financial sectors and markets, more consistent, coordinated, and integrated forms of regulation should be adopted across: (i) products, services, sectors, systems, and markets; and (ii) financial firms and groups.

Regulatory process and enforcement

- f) ***High-quality, transparent decision-making and enforcement.*** A high-quality and transparent decision-making process for regulation-making should be established, with effective mechanisms for enforcement. The 1995 *OECD Reference Checklist for Regulatory Decision-Making* provides a useful guide; however, due recognition should be given to the specificities and exigencies of financial regulation.
- g) ***Systematic review.*** The quality, implementation, and impact of financial regulation should be assessed in due course following its adoption. This assessment should evaluate whether the regulation achieved its specific objective(s) and did so in a cost-efficient manner, and whether the decision-making process could be improved.

International dimension

- h) ***International coordination, convergence, and implementation in policy and rule-making.*** Financial regulation should, to the extent possible, be comprehensive and consistent internationally, with effective coordination where relevant and gradual convergence over time insofar as policy objectives are shared. Where financial regulation is developed internationally, coordination in implementation should be encouraged to ensure consistency in application and prevent regulatory arbitrage.
- i) ***International coordination in the regulation of internationally active financial firms and groups.*** The growth and size of internationally active financial firms, and the special challenges they pose for nation-based systems of regulation and supervision and insolvency, suggest that close international coordination and cooperation is required in relation to their regulation and supervision and failure resolution.
- j) ***Promotion of open, competitive, and safe markets through the establishment of a level playing field and removal of unnecessary duplication, burdens, conflicts and barriers across countries.*** Financial regulation should ensure a level playing field and not lead to unnecessary duplication, burden, conflict, or barriers across countries, and thereby promote open, competitive, and safe markets.

IV. System Design and Implementation

A. Matching policy objectives and instruments to institutions

- a) Institutions connected to the framework for government intervention and regulation (e.g., treasury, financial supervisors, central banks, deposit insurers) should be established with a clear set of objectives and instruments in order to permit them to meet their objectives in an effective and efficient manner.
- b) The objectives of these institutions should, in part or whole, correspond to the policy objectives for the financial system and provide a basis for the accountability framework for these institutions.
- c) The assignment of policy objectives and policy instruments to these institutions should:
 - i) maximise available synergies;
 - ii) ensure consistency and coherence in the use of policy instruments;
 - iii) align incentives and minimise potential conflicts of interest;
 - iv) promote accountability; and,
 - v) minimise risks for taxpayers.
- d) As a minimum requirement, a surveillance function should be attached to each of the institutions with responsibilities for the intervention framework. The contours of the surveillance function of each institution should be carefully drawn to avoid gaps and ensure a comprehensive governmental view.

B. Coordination, oversight, and control of institutions

- a) The activities and functions of each of the institutions should be coordinated and properly integrated in order to ensure adequate information flows, encourage collaborative analysis, discussion, and policy development, and ensure effective and consistent implementation of policy instruments. In this respect:
 - i) formal committees and other mechanisms should be established to ensure proper coordination and should include institutions from different levels of government if relevant; and,
 - ii) legal foundations for these mechanisms should be established in order to ensure adequate information flows and protect the confidentiality of information and discussions.
- b) Some degree of oversight should be established among the institutions implicated in intervention and regulation in order to provide a challenge function and strengthen accountability.
- c) The allocation of responsibilities and authorities for final decision-making under different circumstances, including crisis management, should be clearly established to ensure effective coordination and accountability for the system.

V. Review

- a) The framework for government intervention and regulation should be consistent with and responsive to the rapid evolution of the financial system and its integration with the international economic and financial system, and should be adjusted and amended as necessary to ensure: (i) the continued relevance and appropriateness of stated policy objectives and the weightings attached to them; and (ii) the effectiveness and efficiency of the policy instruments and system of institutions used to achieve them.
- b) At a minimum, the framework for government intervention and regulation should be subject to a comprehensive review on a periodic basis (e.g., every 5 to 8 years).
- c) Domestic reviews of the policy and regulatory framework should be supplemented by international review and peer pressure.

Policy Framework for Effective and Efficient Financial Regulation

GENERAL GUIDANCE AND HIGH-LEVEL CHECKLIST

The *OECD General Guidance on a Policy Framework for Effective and Efficient Financial Regulation* offers a set of high-level, policy-oriented principles that can be used by legislators, policy-makers, and supervisory authorities as they consider reforms to their systems of financial regulation and intervention. The *General Guidance* can also help decision-makers ensure that these systems continue to meet public policy objectives in a rapidly evolving, complex, and globalised economic and financial system. The financial crisis has demonstrated the importance of getting regulatory systems right so that the financial system can fulfil its vital role in the functioning of the economy, domestically and globally. A *High-Level Checklist* serves as a reference tool for the implementation of the *General Guidance*. For any comments, questions, or suggestions regarding the *OECD General Guidance on a Policy Framework for Effective and Efficient Financial Regulation* and *High-Level Checklist*, please contact the Financial Affairs Division of the OECD at: daf.contact@oecd.org. For more information on the OECD's work in the financial sector, visit: www.oecd.org/daf/fin.

