



Recommendation of the Council on a Policy Framework for Effective and Efficient Financial Regulation

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Background Information

The Recommendation on a Policy Framework for Effective and Efficient Financial Regulation was adopted by the OECD Council on 26 November 2009 on the proposal of the Committee on Financial Markets and the Insurance and Private Pensions Committee. It represents an element of the OECD Strategic Response to the Financial and Economic Crisis. The Recommendation calls on Adherents to abide by a comprehensive set of principles set out in Annex 1 when designing financial regulation to help achieve stronger, more resilient financial systems. The Recommendation is based on the General Guidance on a Policy Framework for Effective and Efficient Financial Regulation in order to ensure that the principles contained therein are given due consideration by Adherents -- particularly in light of the recent financial crisis and its severe financial and economic impacts, and given the need for countries to develop appropriately considered reforms.

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 [C(95)21/FINAL] and OECD Guiding Principles for Regulatory Quality and Performance [C(2005)52 and CORR1];

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 [C(2009)125/ADD1] and the related High-Level Checklist [C(2009)125/ADD2] 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.
- 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.

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. *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 co-ordinate 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;
 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 co-ordination. 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 co-operation and co-ordination 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, 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 co-ordination.

C. *Principles of Financial Regulation*

Nature of Regulation

- a) **Precaution:** A precautionary 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, co-ordinated, 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 co-ordination, convergence, and implementation in policy and rule-making:** Financial regulation should, to the extent possible, be comprehensive and consistent internationally, with effective co-ordination where relevant and gradual convergence over time insofar as policy objectives are shared. Where financial regulation is developed internationally, co-ordination in implementation should be encouraged to ensure consistency in application and prevent regulatory arbitrage.
- i) **International co-ordination 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 co-ordination and co-operation 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. Co-ordination, Oversight, and Control of Institutions

- a) The activities and functions of each of the institutions should be co-ordinated 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 co-ordination 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 co-ordination 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 five to eight years).
- c) Domestic reviews of the policy and regulatory framework should be supplemented by international review and peer pressure.

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