ORGANISATION DE COOPÉRATION ET DE DÉVELOPPEMENT ÉCONOMIQUES

A regulatory approach to innovative financial products

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A few remarks about innovative products

- "… the securitisation of hard-to-trade assets gave rise to the notion that credit risk could be reduced if instruments became marketable"
- "financial conglomerates have conflicts of interest that interfered with effective credit allocation and also led to a change in the perception of liquidity"
- "if there is no liquidity, market assets have no value"
- "there is a strong case for intervening more aggressively when financial innovation spawns instruments with undesirable characteristics"

True or false?

- financial innovations create new opportunities to allocate capital across space, time, and types of risk;
- financial innovations can make some business models and structures non-viable and obsolete;
- financial innovations can lead to improved efficiency and thereby help to increase overall economic welfare;
- financial innovations can create higher costs for consumers via exposure to increased financial risks;

True or false?

- financial innovations can lead to increased concentration of risk;
- financial innovations can lead to improved allocation of risk;
- financial innovations can boost financial stability;
- financial innovations can lead to increased financial fragility;

The answer: they all are true

- Some innovative products have resulted in increased choice for consumers and greater flexibility for other economic agents.
- But other innovative products have undesirable side effects that raise cause for concern.
- For example, episodes of financial instability have often followed in the wake of a change in the structural regime that often reflected some form of market innovation that altered the nature of competition.

Exploring some difficulties

Usually, despite changes in the nature of competition, the system functions as intended…

… but there are periodic episodes of instability …

…which tend not to be as rare as might be expected.

Rather, boom and bust cycles are all too common and tend to occur in the wake of innovations.

Various factors account for these outcomes, which include the behaviour of individuals and institutions…

… and the fact that market participants do not face market pressure to internalise external costs needed to protect the system as a whole.

Differences between the private and social costs of financial activities are one of the major imperfections in financial markets.

The existence of market failures interferes in the proper functioning of markets, including by impeding market discipline.

In short, “liberalisation and innovation are important for financial development, but often have hidden flaws, which can prove problematic when they emerge”.

Measures needed to prepare the financial system for innovative activities

Step 1: ensure that the framework conditions necessary for markets to function properly are in place

- sound and sustainable macroeconomic policies;
- well-developed public infrastructure, including reliable accounting, auditing, and legal and judiciary systems;
- appropriate monetary controls to support sustainable aggregate economic activity and constrain major internal and external imbalances;
- sound regulation and proper enforcement

Measures needed to prepare the financial system for innovative activities

Step 2: acknowledge that there is no one policy measure that can be considered optimal in all circumstances

- It is not a choice between two polar cases of exclusive reliance on competition and market discipline on the one hand versus complete reliance on regulation and supervision on the other;
- Both sets of instruments have their place in the policy repertoire;
- The success of regulation as a policy instrument depends to a significant extent on encouraging proper behaviour;

Measures needed to prepare the financial system for innovative activities

Step 3: ensure that the policy instruments to achieve incentive-compatible objectives are in the toolkit

- Clarify what is meant by maintaining systemic stability (i.e. does not imply zero failures);
- Properly address exit problems for large institutions;
- Establish a proper macro-prudential framework;
- Establish a proper framework to ensure adequate protection for consumers (i.e. against fraud, malpractice, and market misconduct, but not against errors of judgment)

Measures needed to prepare the financial system for innovative activities

Step 4: ensure regulators and supervisors have the requisite skills and experience, and proper mandates

- Must have skills and expertise in the appropriate use of regulatory instruments in order to apply them in an effective manner, which may require a proactive approach;
- Staffs of experienced, well-trained supervisors must exist in all inter-connected jurisdictions, otherwise the weakest among them becomes the port of entry for subsequent problems;
- Establish a proper coordination mechanism to address cross-border issues;

Measures needed to prepare the financial system for innovative activities

Step 5: ensure a proper balance between regulation and governance

- The relationship between regulatory policy and broader governance is critical ;
- It is not the purpose of policymakers to substitute for boards and senior management;
- But it is the purpose of policy to ensure that institutions internalise all costs, including the social costs associated with their own operations, their market conduct, and their behaviour vis-à-vis clients and customers, which requires proper internal controls.

Measures addressed to innovative activities

Step 6: ensure appropriate monitoring of new products, markets, and processes

- Authorities need to develop a thorough understanding of financial innovations;
- One of the highest principles to be observed in this context is the need for *precaution* – oversight needs to be risk-based;
- There need be no presumption that specific action is necessary, but a failure to adapt regulation and supervision to changed market circumstances can be problematic;

Measures addressed to innovative activities

Step 7: adapt the regulatory system as necessary to the market environment it is intended to regulate

- The decision to intervene, either to modify existing rules or to introduce new ones, should be based on a systematic analysis of the relevant issues:
  - Intended target of the innovation;
  - Core purpose of the innovation (regulatory avoidance is probably a no-no);
  - What are the key assumptions (e.g. abundant liquidity, continued low or high interest rates, inflation, or volatility);
  - What is the timing of the innovation (has the product been tested under conditions of stress)?

Summing up

Step 7: adapt the regulatory system as necessary to the market environment it is intended to regulate

- The ideal approach is to find an appropriate balance between preserving safety and soundness of the system and allowing financial institutions and markets to perform their intended risk management functions:
- That approach entails establishing a proper structure for reviewing innovative products;
- Different thresholds may be involved for different policy objectives;
- All objectives must be considered;

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THANK YOU

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