European Bank
for Reconstruction and Development

International Practices and Experiences on Regulation of NBFIs

NBFIs International practices

- NBFIs have an important role to play in economic and financial development.
  - In Mongolia, as in general in the Asian region banks still dominate, but NBFIs are emerging at a very rapid pace.
- NBFIs can be a potential positive influence on the economy, but also a source of risk.
  - That risk is heightened when growth is very rapid.
- Rapid growth not only takes pressure off inefficient firms to be competitive but might serve to hide the results of poor decisions behind growing balance sheets.
  - As soon as growth slows, the problems are revealed, and the impact felt.

NBFIs and regulatory system

- In most countries, the financial system extends beyond traditional banking institutions to include non- banking financial institutions.
- There has been tremendous growth worldwide in the mobilization of financial resources outside traditional banking systems.
- Channeled mainly through capital markets, such rapid financial diversification is posing new challenges for regulators in many emerging markets.
- NBFIs provide services that are not necessarily suited to banks, serve as competition to banks, and specialize in sectors or groups.
- Having a multi-faceted financial system, which includes non-bank financial institutions, can protect economies from financial shocks.

Getting the risk balance right

- One of the main ways of controlling risks is through regulation.
- The challenge for regulation is to balance the risks against the positive contributions that NBFIs can make to growth and community welfare.
- On the one hand, too little (or misguided) regulation can lead to crises.
- On the other, overly intrusive (or inappropriate) regulation can negate their potential positive contribution.
- Getting this balance right is made more difficult by the fact that many areas of non-bank regulation are still very embryonic.

Key elements of the regulatory framework

- The regulatory framework has 3 main elements:

- Regulatory objectives
  - why we regulate and what we hope to achieve through regulation.

- Regulatory structure
  - the structure of agencies that carry the delegated regulatory responsibilities of the community; and

- Regulatory effectiveness, which can be broken into two subcomponents:
  - regulatory backing - political, legal and financial backing available to regulators to enable them to carry out their duties effectively; and,
  - regulatory implementation - the instruments, tools and techniques used by the regulator to implement regulatory oversight.

Contributions associated with NBFIs

- NBFIs complement banks by providing services not well suited to banks.
  - NBFIs fill gaps in financial services that otherwise occur in bank-based financial systems.

- There is no reason why banks can't provide all services, to an extent they do.
  - The problem is that banks are extremely inefficient in providing some services or conflicting incentives in providing all services.
  - The way in which banks provide their core services means that they cannot provide all services equally efficiently.

- NBFIs provide competition for banks in the provision of financial services.
  - NBFIs unbundle bank services and compete with them as providers.
  - They specialize in particular sectors and target particular groups.
  - They overcome legal and tax impediments and they enjoy informational advantages arising from specialization.

- There is a growing body of hard evidence to suggest that:
  - The development of financial intermediaries contributes strongly to economic growth;
  - That contribution is increased where intermediation is provided through a balanced combination of NBFIs and banks.

What about risks?

- While NBFIs can contribute to the economy, they also bring risks and the only way to control these risks are through proper regulation.
  - Risk will vary depending upon the economic functions performed by NBFIs.
- NBFIs can be used as a means of circumventing the intent of regulations imposed on banks.
  - This effect has been clearest where NBFIs have been either totally or largely unregulated and have thereby gained a competitive advantage in competing with regulated banks on their own territory.
- On the one hand, too little or no regulation can lead to crisis and severely impact the vulnerable and the economy.
  - This has been a major attribute to the Asian crisis in the late 90s – finance companies in Thailand and merchant banks in Korea.
- Challenge for regulation is striking the balance between risks and benefits.

Experience in Asian region

- The fallout from this type of behaviour was widely experienced in the Asian region in the late 1990s.
- In Thailand, finance companies issued high-yielding promissory notes and borrowed offshore, then loaned the funds in local currency to high-risk borrowers who could not meet banking standards – when the crisis hit in mid-1997, the Government was forced to close 69 insolvent finance companies.
- Malaysia experienced similar problems with finance companies that had extended hire-purchase loans.
- In Korea, NBFIs grew very strongly in the pre-97 period precisely because they competed directly with banks, but with a regulatory advantage; merchant banks which borrowed offshore engaging in risky leverage with problem.
- China has also had problems associated with Investment Trust Companies.

Competition is healthy

- Competition between NBFIs and banks in providing financial services is healthy.
  - But competition based on lax regulation is unhealthy – with consequences that may affect economic growth and financial stability for years.

- The best incentive regulators can provide for the healthy, long-run development of a stable NBFI sector is to provide a sound regulatory framework that eliminates the shady players, recognizes institutional differences, does not interfere with the provision of the full range of risk products - but which does not create regulatory arbitrage.

- The business in which NBFIs are permitted to engage is ultimately a matter of choice.
  - To illustrate the point, following the crisis in 1997, the Korean Authorities accepted that Merchant Banks in Korea effectively are in the same business as banks and have changed their regulatory requirements so that their merchant banks face essentially the same capital, provisioning, liquidity, large exposure and foreign exchange requirements as banks.

Regulation of NBFIs

- There is a need to have a coherent regulatory framework that covers the whole of the financial system.
    - regulate similar risks in similar ways, regardless of which institutions offer the particular services.
- The regulatory framework should have an appropriate structure and it should also support regulatory effectiveness where market conduct and prudential duties of regulators converge and support each other.
- Prudential regulation involves but is not limited to:
    - developing standards of prudential behaviour for regulated institutions;
    - monitoring compliance with those policies, and,
    - enforcing remedial action to protect the interests of customers where there are concerns about either compliance or financial sustainability.

Various practices on regulatory powers

- The primary building block of regulatory effectiveness is legislation.
- In various countries, there are different legislation practices, under which different regulators operate.
  - The importance of legal heritage in determining what will work in different countries should not be under-estimated.
  - Countries with a common law heritage can usually work with a much more flexible law than countries with a civil law heritage, where greater detail and precision is required if the law is to be interpreted consistently over time.
- The relevance of the heritage aspect is that what works well in one legal framework cannot necessarily be transplanted to another country with a different legal environment.
  - How these principles are implemented in any country will depend on the particular legal constitution and environment.
- The fundamental powers that are needed for effective regulation of NBFIs can be divided into relevant to both prudential and market conduct regulation, and those that are more relevant to prudential.

Powers common to market conduct and prudential regulation

- Power to license (remove licenses, to limit licenses and to put conditions on licenses etc.)
  - power to determine that an entity should be regulated or to exempt it from regulation).
- Power to request information
  - including from related parties (members of a conglomerate and service providers).
- Power to conduct routine on-site examinations without needing an invitation – more relevant to prudential but also relevant in some areas of conduct regulation.
  - includes having power to request and copy documents without notice).
- Power to investigate suspected breaches of financial laws
  - fundamental to market conduct regulation.

Powers common to market conduct and prudential regulation

- Power to issue prudential standards (or regulations or simply rules)
  - the issue here is substance rather than form
  - who controls the process of determining the rules and how flexible the process is.
- Power to issue administrative sanctions and to levy fines.
- Power to issue directions (including to freeze assets, to comply with standards, to divest certain activities or subsidiaries, to act or not act in a certain way – e.g. to stop writing particular types of business or to stop new business all together and to obtain enforceable undertakings.
  - These are all critical enforcement powers.
- Power to prosecute suspected breaches of financial laws.

Powers more particular to prudential regulators

- Power to impose rules on ownership and control of licensed entities

fit and proper rules as well as rules on concentration and conglomerate relationships.

- Power to appoint an external expert for the purpose of valuation or review.

could be accompanied by the power to require an institution to change the value of its assets or liabilities.

- Power to require individuals to report an institution in financial difficulty
  - “whistleblowing” especially useful when it applies not only to Boards and management of financial institutions but also to market professionals such as actuaries and auditors.

- Power to appoint a statutory manager or inspector
  - this is the first step in the winding up process for troubled financial institutions. Ideally, the statutory manager should take over the powers of the Board and management and be able to sell assets and liabilities and close out contracts to protect the interests of policy holders, pension investors or depositors.

Examples of other countries

- Indonesia illustrates some of the tricky issues involved with regulating ownership and control of financial institutions.
- Indonesia suffered immensely in the 1990s from the improper use of moneys by banks, essentially to finance the business activities of their owners.
- To prevent these problems from surfacing in the future, legislation was drafted that enables the application of stronger fit and proper rules for controllers of supervised bodies.
- The fit and proper rules have been recognized as financial sector issues, rather than simply banking issues.
- Ownership control. The law contains a comprehensive definition of controllers, which catches, among others, major shareholders (10% or more), and controllers of a regulated institution's parent.
    - The definition includes anyone who can influence the financing or operations of the institution, directly or indirectly, and applies on an individual basis.

Regulatory policies

- How to increase effectiveness?
  - If the laws under which a regulatory agency (FRC Law of 2005 and other laws) operates give it the power to set standards, regulations or rules, the question is how these might be shaped to increase effectiveness.
- The importance of taking a risk-based approach to setting prudential standards for NBFIs.
- Risk-based supervision could mean different things and it has relevance to both regulatory policy and its implementation.
- In respect of prudential policy, it means that:
  - capital and other prudential requirements should be determined by assessed risk – rather than by absolute levels.
  - This is particularly relevant in non-bank regulation, where risk-related capital is still fairly embryonic in its application.

Practices and Processes

- This is simultaneously the easiest and yet the most difficult area of effectiveness where most failures occur.
    - It is the easiest because it doesn't require legislative reform.
    - It is the hardest because changing the culture and attitude of a regulatory institution can be extremely daunting.
- The greatest problem faced by all regulators is how to change what has in most cases been a compliance focused culture into an enforcement focused one.
- Processes to ensure that high-risk institutions help to determine the amount and nature of supervisory and enforcement activity that each institution warrants.
- Procedures to ensure that management of high-risk institutions is escalated to senior levels within regulator.
- Procedures to ensure that information about high-risk institutions is circulated more widely within regulator.
- Formalised procedures for dealing with material provided by various parties.
- Policies to foster a greater enforcement orientation within the regulator's culture.
- Good practices ultimately come from good governance and our new law has a chapter dedicated to that.

Thank for your attention!