Chapter 6

Assessing the Supervision of Other Financial Intermediaries

6

6.1 Overview

This chapter focuses on issues in the regulation of a range of non-bank financial institutions (NBFIs), categorized as Other Financial Intermediaries (OFIs). OFIs refer to those financial corporations that are primarily engaged in financial intermediation—that is, corporations that channel funds from lenders to borrowers through their own account or in auxiliary financial activities that are closely related to financial intermediation—but are not classified as deposit takers (IMF 2004a).[1] OFIs include insurance corporations; pension funds; securities dealers; investment funds; finance, leasing, and factoring companies; and asset management companies. This chapter discusses considerations in assessing the regulation and supervision of OFIs (other than insurance companies and security market intermediaries) generally, with a focus on specialized finance institutions, leasing and factoring companies, and pension funds.

Although OFIs are often dwarfed by commercial banks in terms of volume of business and size of assets, OFIs should receive adequate attention during the assessment process for various reasons. OFIs play an important developmental role through their activity in areas and markets where the presence of commercial banks is not fully felt. Moreover, the development of OFIs could increase bank competition, which could lead to greater access to finance. In many countries, pension funds are major contractual savings institutions with a significant effect on financial markets and the macroeconomy.

Specialized financial institutions (such as thrifts, building societies, and mortgage institutions) have emerged in many countries to carry out real estate finance. However, in many countries, other than their specialization in housing finance, those institutions are

indistinguishable from deposit-taking institutions such as banks, and they require attention from both the stability and the development perspectives.

Leasing companies engage in relatively simple transactions where the lessee (a business owner) uses the asset (owned by the leasing company) for a fixed period of time, while making payments on a set schedule. At the end of the lease, the lessee buys the asset for a nominal fee, giving the lessee the opportunity to make a capital investment. Leasing companies can serve as a significant source of finance for small firms wanting to invest in equipment, and that investment in leasing companies can yield attractive returns if conditions are right.

Factoring companies are financial institutions that specialize in the business of accounts receivable management. Factoring is an important source of external financing for corporations and small and medium enterprises (SMEs), which receive credit based on the value of their accounts receivables. Under this form of asset-based finance, the credit provided by a lender is explicitly linked on a formula basis to the value of a borrower's underlying assets (working capital), not to the borrower's overall creditworthiness. In developing countries, factoring offers several advantages over other types of lending. First, factoring may be particularly useful in countries with weak secured-lending laws, inefficient bankruptcy systems, and imperfect records of upholding seniority claims, because factored receivables are not part of the estate of a bankrupt SME. Second, in a factoring relationship the credit is primarily based on quality of the underlying accounts, not on the quality of the borrower. Thus, factoring may be especially attractive to high-risk SMEs (Bakker, Klapper, and Udell 2004).

The development of OFIs such as leasing and factoring companies (especially if they were operated by groups that were independent of large banks and insurance companies) increases lending to smaller borrowers. Some practitioners argue that stand-alone OFIs tend to compete more vigorously. For that reason, the International Finance Corporation prefers to finance stand-alone leasing companies despite their disadvantage when competing with leasing subsidiaries of commercial banks, which can tap into low-cost depositors' funding from their parent companies) (International Finance Corporation 1996).

While the small size of the OFI sector in some countries may limit OFI's systemic effect on the rest of the financial sector in case of crisis, stress in OFIs could have systemic effects in specific circumstances. In particular, difficulties in OFIs may have some systemic effect, insofar as they trigger a loss of confidence in deposit-taking activities. For instance, a crisis of confidence can spread from one subsector of the financial system to another subsector, owing to perceived ownership or balance-sheet linkages. Moreover, the lack of effective regulations for OFIs can exacerbate the fragility of the overall financial system through regulatory arbitrage (Herring and Santomero 1999).

In many countries, pension funds are a major source of contractual savings, providing a stable source of long-term investment to support growth and at the same time playing a key role in financial markets through their investment behavior. National pension systems provide retirement income from a mixture of government, employment, and individual savings. Pension funds affect the stability of financial markets and the distribution of risks among different sectors of the economy by their investment behavior and the way they manage their risk.

6.2 Objectives of the Legal and Regulatory Framework for OFIs[2]

Against this background, the assessment of the regulation and supervision of OFIs should not only account for their effectiveness in meeting the traditional objectives of financial supervision, but should also consider whether the regulatory framework helps build a sound environment that fosters the development of those institutions. For instance, an inadequate regulatory framework that promotes regulatory arbitrage in the OFI sector could restrict the potential developmental role of OFIs and at the same time could lead to the buildup of substantial undetected vulnerabilities and risks.

While both competition regulation and conduct of business (including market integrity) regulation apply to all sectors and institutions in the financial system, assessing which type of OFIs warrants prudential regulation is, in practice, a difficult exercise. Three characteristics of financial institutions are critical in judging the scope of prudential regulation: (a) the difficulty of honoring the contractual obligations, (b) the difficulty faced by the consumer in assessing the creditworthiness or soundness of the institution, and (c) the adversity caused by a breach of contractual obligations (see Carmichael and Pomerleano 2002). For instance, banks are subject to systemic liquidity risks that may lead to the breach of obligations, financial conglomerates have complex structures whose soundness and creditworthiness are difficult to assess, and the failure of a large bank or insurance company is likely to generate great adversity. Each group of institutions could be ranked using those characteristics to judge the desirability and scope of prudential oversight.

An appropriate regulatory environment is required to foster the development of OFIs as recognized legal entities that are well integrated with the rest of the financial system. In many emerging economies, the legal and regulatory framework for finance, leasing, and other specialized financial institutions is ambiguous, fragmented, and incomplete. Assembling and analyzing the laws and regulations governing the operations of each group of institutions to ensure clarity and completeness is an important step in the assessment of OFIs. While repressive regulation can retard the growth of OFIs, an inappropriate and poorly designed regulatory structure can create incentives for regulatory arbitrage. However, even when high-quality legislation exists, enforcement is sometimes poor. Those factors are all impediments to the development of the financial system in general, but the impediments become more pronounced in the case of OFIs that, in many emerging economies, are often not supported by a clear legal framework.

Legislation should permit effective enforcement. The legal framework for financial system supervision could be somewhat prescriptive, spelling out specific prudential rules within the scope of the governing law, or could be general, thereby providing guidelines and principles while conferring broad regulatory powers on the regulator. The guidelines approach could provide more discretion and flexibility to the regulator, which may be particularly important for OFIs, because separate laws governing specific types of OFIs and markets often overlap, which gives rise to conflicts and ambiguity regarding the applicable rules. If, however, the regulator's lack of operational independence hampers the effective use of discretion, a more-prescriptive law, if well designed, could provide a workable alternative.

6.3 Assessing Institutional Structure and Regulatory Arbitrage

The appropriateness of the institutional structure for supervising OFIs should consider the overall institutional framework for financial supervision and the scope of the OFIs' activities within that framework. The number and size of OFIs (individual and aggregate), as well as their links to banks and other players in the financial system, are major factors influencing the appropriate institutional structure for supervising OFIs. The stage of financial development, the legislative environment generally, and the range of regulators' skills available would also affect the appropriate institutional structure for supervising OFIs.

An institutional structure that is sectorally focused rather than focused on the nature of functions to be regulated may result in gaps in the regulation of OFIs. In some country circumstances, therefore, bringing the regulation and supervision of all types of financial institutions, including OFIs, under a unified supervisory framework would help reduce the possibilities of regulatory arbitrage and regulatory gaps and allow for more-efficient oversight. A unified structure facilitates the adoption of a common set of standards for institutions with the same profile of risk—for instance, uniform application of conduct of business and financial integrity regulations, and adjustments in the scope of prudential regulations according to risk profile. However, under a structure with more than one regulatory body involved in institutional regulation and supervision, special attention should be given to the definition of the legal power of responsible bodies, the identification of conflicting areas of jurisdiction, and the extent of regulatory duplication. This sectorally focused structure is a source of inconsistencies and ambiguities that have created weaknesses in the regulatory and supervisory process in many countries. For instance, this structure's inability to undertake "fit-and-proper" tests and impose minimum capital requirements or other specific guidelines creates loose regulatory and supervisory regimes that allow OFIs to develop their business recklessly and get involved in banking activities.

In countries with separate, sectorally focused regulators, the assessment should focus on verifying the differences in the types of risk posed by various categories of service providers, since the application of different rules to products and services that are functionally equivalent can give rise to increased incentives for regulatory arbitrage (OECD 2002). For instance, institutions assuming the main banking functions should be considered banks and regulated and supervised as such. In some countries, OFIs became an important segment of the financial system as a result of efforts to circumvent prudential norms and exploit loopholes in the banking sector.

Table 6.1 compares the regulatory features of banks and OFIs. Raising the following four questions when completing table 6.1 can help regulators verify the differences in the rules applied to different group of institutions (Carmichael and Pomerleano 2002):

- Can institutions subjected to different regulation provide similar products?
- Is a financial institution capable of choosing among different regulators by altering its corporation form, regulatory jurisdiction, or institutional label? For example, is a parent institution able to reduce its regulatory burden by shifting business into an unregulated subsidiary?

Table 6.1. Main Regulatory and Prudential Aspects of Different Groups of Financial Institutions[a]

Regulation	*Commercial banks*	*Deposit-taking institutions*			*Non-deposit-taking institutions*	
Main regulator/supervisor						
Restriction on loans						
Participation in the clearing/settlement system						
Issuing deposits						
Subject to onsite supervision						
Subject to offsite supervision						
Minimum paid-up capital						
Minimum risk weighted capital/asset ratio						
Liquidity ratio						
Cash reserve requirements						
Required provisions						
Limit to a single borrower						
Insider lending						

a. This table can be adapted to individual country situations.

- Can new OFIs offer banking-type products under a different banner to remain outside the jurisdiction of the main regulator?
- Is there a regulatory structure in which at least one regulator has overall responsibility for financial conglomerates?

In a unified supervisory structure where the number of OFIs is significant but OFIs operate independently from the main players in the financial sector (i.e., banks and insurance companies), establishing a separate department that is exclusively dedicated to the supervision of OFIs is a common practice. In such structure, there are cases where the same regulators are responsible for both onsite supervision and offsite supervision for a group of OFIs, or cases where there is separation between the responsibility for onsite and offsite functions. On the one hand, having the same regulators be responsible for both onsite and offsite functions helps ensure continuity in monitoring events in the sector, as well as coherence in supervision. On the other hand, separating offsite and onsite functions provides a certain degree of specialization in the related processes and procedures. In either case, the regulators' skill levels should be adequate to avoid having inexperienced and unqualified regulators be systematically assigned to supervising OFIs.

In a unified structure where the links between OFIs and banks are significant through investment and ownership, regulators with responsibility for a group of related institutions (including banks and OFIs) help monitor development in related sectors in a consolidated manner. Moreover, specialization helps enhance the regulation and supervision of OFIs. Regulators in charge of supervising banks can usually supervise OFIs, provided they receive adequate training and guidance to specifically deal with OFIs. As stressed in the Basel Core Principles (BCPs) for Effective Banking Supervision, an essential element

of banking supervision is regulators' ability to supervise the banking organization on a consolidated basis, which includes their ability to review both banking and non-banking activities conducted by the bank.

6.4 Assessing Regulatory Practice and Effectiveness

The regulatory regime for OFIs should help meet regulatory objectives—effective competition, good conduct of business and financial integrity, and prudent operations—while ensuring that regulations reflect the specific operational characteristics of the OFIs and promote their development. From this perspective, many core principles of effective bank supervision and regulation also apply to OFIs. The general rule is that financial institutions that do not have deposit-like liabilities to the general public do not need to be regulated and supervised as closely as those that do. The tools and techniques for deposit-taking OFIs would follow the standards contained in the BCPs. Financial institutions that are banklike in all but name should also be just as closely regulated and supervised. In several countries, OFIs that were (formally or informally) taking deposits from the general public and were either not required to conform to banking regulations or did not come under the supervision of the main supervisory authority have faced difficulties that necessitated the intervention of the government (World Bank 1999).

Given the diversity of institutions that make up the group of OFIs, certain additional principles and considerations can complement the BCPs and help adapt them to the supervision of OFIs. Such principles and considerations, regardless of the institutional structure (unified or segmented), include modifying prudential rules to accommodate the operational characteristics of OFIs; ensuring consistency in decision making; recognizing the unique risks of OFI; ensuring that supervision is proportionate and consistent with costs and benefits; and maintaining resources and skills sufficient and adequate to face the growth of the OFIs sector. Those principles are similar to those applying to banks, and are further explained in Annex 6.A. Their implementation can be a challenge. For example, housing finance institutions, including building societies, often offer deposit services (not necessarily checking accounts) and may need to be regulated as banking institutions (see box 6.1). In many cases, tailoring regulations to the specific operational characteristics of the OFIs and avoiding overregulation is important for the development of the sector.

For the majority of OFIs where retail deposits and systemic issues are not involved, competition and market conduct regulations—such as entry and disclosure requirements and monitoring association with other institutions—should be sufficient. With regard to entry requirements, the regulator would encourage low barriers to entry into these sectors by ensuring that there are minimal restrictions on the corporate form and ownership structure of OFIs, freedom of entry for foreign firms, and strong antitrust conditions to prevent excessive concentration in the industry. Disclosure of correct and timely information to market participants complements supervision.[3] Regarding the association of OFIs with other institutions, particular attention should be given to OFIs established as subsidiaries of regulated institutions as a means of circumventing the regulation. The dangers of excessive growth in unregulated subsidiaries were highlighted in a number of crises (see World Bank 2001).

Box 6.1 The Case of Financial Institutions Providing Housing Finance

In the housing sector, banks and other specialized financial institutions such as thrifts, mortgage societies, primary mortgage institutions, or mortgage banks often offer the same products. Those institutions face similar risks, including credit risk exposure to the borrowers, liquidity risk from the possible loss of short-term funding, and market risk at the time of maturity.

The conditions under which deposits can be withdrawn from those institutions are often mentioned as differentiating factors between banks and specialized housing finance institutions and are viewed as justification to impose different prudential rules (such as on liquidity). The general rule, however, is that when specialized housing finance institutions solicit deposits directly from the public and when those institutions' deposits are guaranteed implicitly or explicitly by the government, those institutions must be regulated at least to the standards of banks.

Given that the risks of specialized housing finance institutions are sometimes greater than those of banks, which have more diversified balance sheets, there is even a case for stricter regulation of those institutions. The concentration in housing and real estate finance means that their risks may be highly concentrated, and a large overconcentration can be the source of systemic failures. However, in some countries, the availability of a mortgage-backed securities market may help those institutions manage their risk profile and minimize the concentration of exposures.

In some countries, building societies—which are very similar to banks in terms of the range of financial services offered—are grouped together with other nonbank financial institutions (NBFIs) and are supervised separately, even though they need to be regulated with standards similar to those of banks. More generally, the heterogeneity of other financial institutions often results in inappropriate regulation and supervision of some financial institutions providing housing finance.

When corporate laws are still evolving, however, additional conditions in financial regulation can support the good market conduct and prudent operation of OFIs. Those additional conditions could cover the following:

- *Licensing requirements*. As with any financial institution, the purpose of licensing OFIs should be to ensure adequate capitalization and sound management, not to limit entry or restrict competition. Regulators should have the authority to screen potential owners and managers to prevent those lacking professional qualifications, financial backing, or moral standing from obtaining a license. An OFI license should not become a simple alternative for applicants who could not meet the requirements to be granted a commercial bank license. Liberal entry into the financial system should not mean unqualified entry. Countries with easy entry have often experienced problems with insufficiently regulated, undercapitalized, and poorly managed institutions.

  In some countries, once an OFI has been licensed, it conducts activities that are normally not permissible under the range of activities specified in its license. The balance sheet restrictions for each group of financial institution should, therefore, be closely monitored (e.g., limits on assets and liabilities, prohibition on particular classes of assets or liabilities, restrictions on the types of assets held, and mandated maximum or minimum holdings of particular assets).
- *Minimum capital requirements*. With regard to minimum capital requirements (and all the main rules for the conduct of the institution), the requirements for banks

should not be applied to OFIs when not adequately justified. The minimum capital requirement is usually part of the financial institution's licensing requirements, but should not inhibit the start-up of new institutions or act as barrier to competition. The amount of capital appropriate for a group of OFIs or an individual institution is a function of the institution's potential to incur unexpected losses. A higher than necessary limit could restrict the industry's growth.

- *Accountability requirements.* In many countries, accountability requirements, including accounting and auditing practices by OFIs, are inadequate.[4] This deficiency increases the chance that misleading information could cause market instability. Facilitating market discipline and sound practices for accounting and auditing helps reinforce supervisory efforts to encourage OFIs to maintain sound risk management practices and internal controls. As with any financial institution, OFIs need sound accounting standards to achieve satisfactory transparency—public disclosure of reliable information that enables market participants and other users of that information to make an accurate assessment of the institution's financial condition and performance, its business activities, and the risks related to those activities.
- *Risk management practices commensurate with the risk profile in the industry.* Measuring, monitoring, and controlling risks are often issues of concern with OFIs, especially in countries where licenses were granted too liberally. It is important that the OFI put in place a risk management process adequate for the size and the nature of its activities. Regulators should ensure that such a risk management system is not static, but rather adjusted to the OFI's risk profile (concentration, credit, currency, or tax-related risks). This process is not only helpful in identifying potential systemically important OFIs, but also in setting priorities for allocation of limited supervisory capacity, for instance, to determine the frequency of reporting and the depth and focus of onsite supervision.

Building supervisory capacity does not mean that all OFIs need to be supervised, and when they do, they usually do not require the same level of supervision and resources as banks. The supervisory authority must establish priorities for the allocation of regulators' supervisory capacity. There is sometimes little benefit in trying to regularly visit small, dispersed OFIs that, with modest change in regulation (e.g., licensing, minimum capital, accounting, auditing, and disclosure requirements), could present negligible risk.

After establishing supervisory priorities, regulators should also ensure that OFIs (particularly small non–deposit-taking institutions) are not overwhelmed by excessive reporting requirements when they do not present major variations in their portfolios from one period to the other. In most cases, quarterly or even semiannual returns (instead of monthly returns) would be appropriate. For those institutions accuracy and completeness are far more important than frequency. At the same time, more attention should be given to OFIs with substantial assets whose reporting should be more frequent. Other recurrent issues relate to the following:

- Deficiencies with offsite supervision, which weaken early warning systems to identify weak OFIs

- Unreliable and rudimentary working methods, which prevent regulators from efficiently and accurately assessing the OFI's exposure to various risks and, for the most part, its soundness and financial performance
- The lack of internal guidelines or manual for onsite and offsite supervision, which are important to determine the examination procedures and policies for OFIs

An adequate information system and a guideline or manual are useful tools to help address the specific risks inherent to OFIs.

6.5 Selected Issues on the Regulation and Supervision of Leasing Companies

In some circumstances, a separate legal and regulatory framework for leasing companies can be helpful to create a suitable environment for leasing and promote confidence in the industry. Many developed countries, despite their long history of leasing, do not have a separate leasing law (Amembal, Lowder, and Ruga 2000). Those countries usually have well-developed common and civil laws that provide an adequate basis to support leasing transactions. In countries where the leasing industry is still in the very early stages of development, a new legal and regulatory framework could help promote confidence in the efficiency and fairness of the market. Specialized leasing laws may not be necessary, however, provided that existing regulations designed to deal with financial institutions do not discriminate against the industry.[5] When the industry develops, however, it will be important that the fundamental elements of an efficient financial leasing law be put in place. Those elements include the following (see International Finance Corporation 1998):

- Freedom of contract
- Recognition of the three-party structure of the modern financial lease
- Duties consistent with party's role in the transaction
  - Lessee's duty to pay after acceptance
  - Lessor's lack of equipment responsibilities
  - Lessee's recourse against the seller
  - Equipment not liable to other creditor's claims
  - Transfer freedom and restraint
- Default remedies, including the right to accelerate the remaining lease payments
- Expedient repossession and recovery

The rights and duties of the lessor as legal owner of the asset and the rights and duties of the lessee as user of the asset should be clearly stated. The legal owner needs a clear, simple, workable, timely process to reclaim an asset if the terms of the lease are breached by the user, including the automatic right of repossession without lengthy court proceedings and the right to claim payments due and other damages. The lessee must have the right to use the asset unimpeded and gain the full productivity of the asset. In some countries, it may be necessary to clarify that the lessee does not have the right to create a lien on leased assets (International Finance Corporation 1996). One advantage of the leasing

Box 6.2 Measures to Develop a Favorable Regulatory Environment for Leasing

Legal Framework

- *Lessor's ownership.* Ownership should be clearly stated, with simple, effective, and timely procedures for repossession if lessee defaults.
- Lessee's rights. Rights should be clear—uninterrupted use of leased asset for the lease period if the lease payments are current.

Regulations

- *Licensing.* Regulation should recognize the existence of leasing. Restricting leasing to licensed institutions (and requiring commercial banks to set up separate subsidiaries to write leasing contracts) may help the industry develop aggressively. Leasing companies should be allowed to mobilize term deposits only.
- *Prudential requirements.* Regulations may have lower minimum capital requirements than many other financial institutions. Other prudential requirements may be less strict than for deposit-taking institutions.

Tax Treatment

- *Lessor.* The lessor should be allowed to depreciate the asset, with lease payments taxed as income and asset depreciation computed over life shorter than or equal to lease contract.
- *Lessee.* The lessee should be allowed to treat lease payments as an expense for tax purposes.
- *Sales tax.* The postcontract sale of the asset should be exempt from sales tax.
- *Capital allowances.* Allowances should be given to lessor or lessee, with equal treatment compared to other financing.

Source: International Finance Corporation (1996).

companies over banks is that they own the leased asset. However, physical repossession can still prove difficult. For instance, the mobility of the leased asset has made repossession even more difficult. In its lessons of experience, International Finance Corporation (1996) has identified a set of measures to develop a favorable regulatory environment for leasing (box 6.2).

In many countries, leasing companies are not regulated and supervised because they do not take deposits. However, many leasing companies are bank subsidiaries, and regulators should be interested in such companies for the purpose of consolidated supervision. Moreover, as previously stated, even for NBFIs where retail deposits and systemic issues are not involved and where corporate laws are still evolving, additional conditions—including licensing requirements, minimum capital requirements, accountability requirements, and risk conditions consistent with the risk involved in the industry—can support market conduct.

6.6 Selected Issues on the Regulation and Supervision of Factoring Companies

Factoring companies are financial institutions that specialize in the business of accounts receivable financing and management. If a factoring company chooses to purchase a firm's receivables, then it will pay the firm a prenegotiated, discounted amount of the face value of the invoices (Sopranzetti 1998). A moral hazard problem develops when the seller's credit management efforts are unobservable to the factoring company: Once the entire

Box 6.3 Factoring as a Sale and Purchase Transaction Rather Than as a Loan

A key issue for factoring is whether a financial system's commercial law views factoring as a sale and purchase transaction rather than as a loan. If it is a sale and purchase transaction, creditor rights and loan contract enforcement are less important for factoring because factors are not creditors—that is, if a firm went bankrupt, its factored receivables would not be part of its bankruptcy estate because they would be the property of the factor.

Still, creditor rights and loan contract enforcement are not irrelevant to factoring for at least two reasons. First, they define the environment in which the factoring company engages in collection activities. The strength of the regime for creditor rights will affect underwriting standards because factors must consider the anticipated cost and efficiency of their collection activities when they make credit decisions about which invoices to purchase. Second, under recourse factoring, the factoring company has a contingent claim against the borrowing firm if there is a deficiency in the collection of a receivable. This contingent claim can be secured or unsecured, depending on whether the factoring company filed a security interest in some or all of the firm's assets as a secondary source of repayment.

Source: Bakker, Klapper, and Udell (2004).

receivable is sold (factored), the seller has no incentive to monitor that receivable, as the seller no longer bears any credit risk. Factoring is not one homogeneous product. Most factoring companies do not simply provide immediate cash services; they also offer a range of other professional services such as collecting payments, pursuing late payers, providing credit management advise, and protecting clients against bad debts. Factoring companies typically fall under three categories: banks, large industrial companies, or independent factoring companies.

One fundamental issue with factoring resides in recognizing the commercial status of the industry, which in turn determines the oversight structure. In some countries, factoring is recognized as a commercial activity and is, therefore, regulated by commercial law, but it is not unusual in certain countries to see factoring companies undertake the functions of financial intermediation without authorization (see box 6.3 for further details).

The regulatory environment has an important effect on the factoring industry. In some countries, factoring operates entirely outside the purview of any regulatory structure or authority, and in others it is regulated along with other financial services such as banking and insurance. In most countries, however, the level of regulation falls somewhere in between (Bakker, Klapper, and Udell 2004). For countries where factoring is developing, a law setting out minimum standards for the management of factoring companies and specifying the tools to be used to manage key risks in factoring operations could be envisaged. Some countries simply restrict market entry to formally registered financial institutions such as banks or other specialized financial institutions. However, those restrictions could hinder competition by excluding the emergence of independent factors. To address the potential lack of discipline in some markets, International Finance Corporation (1998) recommends that governments consider requiring minimum capital and prudential guidelines as a barrier to entry into the market.

6.7 Selected Issues on the Regulation and Supervision of Pension Funds

National pension systems are typically characterized as multipillar structures that are defined in many ways, depending on the purpose of analysis.[6] From the perspective of analyzing financial stability and development, it is useful to distinguish between (a) state-provided pension schemes, which are a combination of a universal entitlement and an earnings related component; (b) occupational pension funds, which are funded by and organized in the workplace as Defined Benefit (DB), Defined Contribution (DC), or a hybrid; and (c) private savings plans, which are often tax advantaged. As a result of increasing longevity and rising dependency ratios, the funding of promised retirement benefits (in DB plans) has become a challenge in many countries. This funding challenge has led to pension reforms that reduce benefits, increase contributions (i.e., taxes to pay state pensions), redefine risk sharing between sponsors and beneficiaries, and raise retirement age. Increased funding of pension obligations (by both the private and public sectors) and greater retirement savings by individuals are increasingly part of the solution.

While funded pension plans' size and importance vary greatly among countries, in many countries pension funds are among the largest institutional investors. As a result, pension fund asset allocations could affect financial markets and the flow of investment funds quite significantly. As pension funds became increasingly underfunded and shift toward DC and hybrid plans, the issues of appropriate asset liability management and asset allocation have become pressing. As a result, both pension fund management and the approaches to its regulation have changed. The regulatory framework for pension funds is increasingly focusing on risk management, in addition to the traditional focus on protection of pensioner and employee benefits and rights.[7] Key issues in assessing pension funds' regulatory framework from a financial sector perspective and the emerging practices are covered in appendix H.

Annex 6.A Regulation and Supervision of OFIs: A Few Guiding Principles

As one puts in place a regulatory framework for Other Financial Intermediaries (OFIs), some regulations common in traditional banking must be adjusted to accommodate those institutions. The challenges facing a given country's supervisory agency—and the realistic obstacles to meeting those challenges—must be weighted seriously when examining proposals for the regulation of OFIs.

A. The regulatory framework should minimize adverse effects on competition and encourage competition.

1. Repressive and inappropriate regulation can have a negative influence on the development of OFIs. Examples of repressive regulation include restrictive licensing and pricing and investment regimes. Excessive regulation of banks can stimu-

late the growth of non-banks or the establishment of non-bank subsidiaries as a means to circumvent regulation. Discriminatory tax treatment is an example of inappropriate regulation.

B. The regulatory framework should clearly define the power of the regulator and the permissible activities of OFIs.

2. The regulatory framework should be clear with regard to (a) the establishment and powers of the regulator and (b) the legal existence and the behavior of the entities being regulated. The regulatory frameworks also should be supported by adequate infrastructure such as accounting and disclosure rules, property rights, and contract enforcement.
3. The regulatory framework should define the permissible activities of OFIs, including the regulatory distinction between banks and non-banks, as well as the activities retained solely for banks. There should be no ambiguity as to the meaning of "bank," "lease," "factor," or "deposit" or to what constitutes the illegal acceptance of deposit without a license.

C. Similar risks and functions should be supervised similarly to minimize scope for regulatory arbitrage.

4. "Banklike" financial institutions should be supervised like banks. The supervisory authority should also ensure that no new activity is undertaken without the prior consent of the regulator (e.g., taking deposits).

D. The links between OFIs and other players in the financial sector should be closely monitored.

5. Exposition to risks through investment and ownership linkages (particularly with banks) should be evaluated, because those linkages make each sector vulnerable to adverse development in other sectors.

E. The unique risks of OFIs should be recognized within the supervisory structure and when defining prudential norms.

6. There should be a dedicated focus within the institutional framework to recognize those unique risks of the regulation and supervision of OFIs, whether financial institutions are under a unified or a separate supervisory framework.
7. When appropriate, prudential norms ought to be specifically defined for OFIs. The following set of regulations will commonly require reexamination: minimum statutory capital, capital adequacy ratio, asset classification, provisioning, liquidity, acquisition, and investment.

F. Supervision should be proportionate and consistent with costs and benefits.

8. Simple and less-risky institutions should not be burdened by the full regulatory requirements imposed on more-complex and riskier institutions.

G. Resources and skills should be targeted to the higher-impact and more-complex OFIs.

9. The frequency of offsite supervision and the depth of onsite supervision should consider the scale of the institution to avoid having scarce supervisory resources be wasted or institutions be saddled with unnecessary compliance burdens.
10. Staff members responsible for supervising OFIs should have the resources and skills to understand the specific risk related to those institutions. The methodology used should help identify sources of risks (credit, market, liquidity, operational, legal, and reputation), as well as risk management practice.
11. Supervisory staff members should have guidelines to provide direction to reach appropriate conclusions on a consistent basis.
12. Staff members should have access to training for upgrading their skills to ensure that regulatory and supervisory frameworks meet the industry's needs.

H. There should be a strengthening of the self-regulatory capacity.

13. Associations can play an important role in representing the OFIs' views on appropriate regulatory and supervisory frameworks. They can also voice the opinions of the market participants to government authorities, particularly when there is no regulatory body directly involved with the regulation. Moreover, they can provide educational, promotional, legal, financial, and other services tailored to the needs of the OFIs.

Notes

1. See IMF (2004a) for the definition of deposit taker and Other Financial Corporation (OFC). This Handbook uses the term Other Financial Intermediary (OFI) instead of OFC to avoid confusion with references to Offshore Financial Centers. IMF (2004a) uses the term deposit takers as units that engage in financial intermediation as a principal activity and that have liabilities in the form of deposits payable on demand, transferable by checks, or otherwise used for making payments. Or they have liabilities in the form of instruments that may not be readily transferable such as certificates of deposits, but that are close substitutes for deposits and are included in measures of broad money.
2. This section is partly drawn from Carmichael and Pomerleano (2002).

3. Where the institutions are the beneficiaries of government tax incentives, subsidies, or other privileges, there is a case for imposing reporting requirements, additional disclosures, and even inspections and audit requirements to ensure that the incentives and privileges are not subject to abuse.
4. Comprehensive standards addressing financial instruments are essential if an accounting standards regime is to be credible. The International Accounting Standard (IAS) Board provides guidance for all financial instruments not only on disclosure and presentation (IAS 32), but also on recognition and measurement (IAS 39) at fair value or at amortized cost. See http://www.iasplus.com/standard/ias39.htm and chapter 10, section 10.2.
5. In some countries, the leasing industry is one part of the financial system that is not burdened by heavy government regulations. In the absence of a leasing law, however, leasing regulations are usually fragmented and unclear. Many countries have opted for a separate leasing law to avoid confusion and to clearly define the rights and obligations of the various parties (see International Finance Corporation 1996).
6. World Bank (1994) describes Pillar 1 as noncontributory state pension; Pillar 2, mandatory contributory; and Pillar 3, voluntary contributory. This classification is useful to the discussion of the social safety net, the redistribution of income, and the fiscal aspects of pensions.
7. For a discussion of risk management issues in the pension fund industry, see IMF (2004b).

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