

Governance, Executive Compensation and Excessive Risk in the Financial Service Industry

Achieving regulatory coherence in financial sector regulation: the potential for regulatory quality tools and strengthened public governance

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The views are the author's responsibility

The OECD added value

- *The OECD's strategic response to the financial crisis:*
 - ✓ *Interconnecting macroeconomic and structural aspects*
 - ✓ *State of the art experience in policy areas*
- *Multidisciplinary work, specific issues of interest*
 - ✓ *Corporate governance and the financial crisis*
 - ✓ *Policy Framework for Effective and Efficient Financial Regulation*
 - ✓ *Implementing Regulatory Quality Practices in Financial Sector Regulation*
 - ✓ *Public governance aspects: transparency in lobbying, revolving doors*
- *Value of intergovernmental cooperation and coordination to address externalities and global issues to ensure sustainable economic development*

Introduction

- *Financial Sector: Need for “Cycle Proof” Regulation, Rajan*
 - *Comprehensive*
 - *Contingent*
 - *Cost effective*
- *Avoid under and over regulation*
- *Sectoral vs. global codes of good practice: food safety, scientific risk assessment, vs risk in financial sector*
- *Whole of government perspective, financial sector regulation and risk management.*
- *Some countries did weather the crisis better than others: Australia/Canada, (institutional memory in banks).*

Does Regulation matter?

Some results from cross country analysis

- Ahrend, Arnold and others (2009)
- Financial market information, policy indicators for eight areas of prudential banking regulation
- Indicators do correlate with different measures of financial stability (bank share prices, 322 banks, 32 countries), cost of rescue package, financial soundness
- No clear trade off between stability oriented regulatory policies and competition: strong banking supervisor often associated with greater competition in banking (net interest margins)

Effective and Efficient Financial Regulation

- OECD work on the efficiency of financial regulation : e.g., transparency, analysis, proper policy tools and institutions, and smart regulation
- Institutional understanding: leverage ratio on all bank assets, capital buffer over the minimum requirement, separation of certain investment banking activities (Secretary General, Berlin address to Chancellor Merkel, 20 May)
- Implementation: follow up to Policy Framework – e.g., institutional design for regulation



The Policy Framework for Effective and Efficient Financial Regulation

- **10 key principles for financial regulation**
 - Precautionary and proactive approach, risk based
 - Sound incentives (e.g., remuneration guidelines) – essential given limits of regulation
 - Comprehensiveness (all participants covered)
 - Consistency across markets and borders, and competitive neutrality
 - Use of Better Regulation Tools and ex post review
 - International coordination, and convergence
 - Open competitive and safe markets



Transparency and Better Regulation

An analysis of 5 countries (Before 2009)

- Collaborative work with Prof. J. Black (LSE)
- An analysis of sets of principles
 - OECD general principles for better regulation (1995-2005), and more recent PFEEFR
 - Basel, IOSCO, IAIS core principles
 - 12 Key standards for sound financial systems of the Financial Stability Forum
 - IMF Code of Good Practices on Transparency in Monetary and Financial Policies
- Analysis of : independence, accountability, powers of financial sector regulators, potential for risk based approaches
- Better Regulation arrangements (next)



Better Regulation and Management of Conflicts of Interest

- Ex Ante and Ex Post Regulatory Impact Assessments and Burden Reduction evaluations
- Transparency and communication
- Coordination mechanisms
- Review and dynamic approach to improving the regulatory system over time
- Ethics codes, conflicts of interest and confidentiality provision

Some results

- Regulatory shortcomings: Lack of coordinated information on macro financial flows, and micro-prudential supervision of individual banks
- Insufficient coordinated action by supervisors nationally and internationally
- Delineation of regulatory boundaries (black holes)
- Incentives structures created by regulation: bank moving assets onto the trading book
- Issues in risk assessment and risk management (included but not limited to the regulators)

Some results

- Regulatory philosophy of self correcting markets: too much reliance on the ability of self regulation
- Central body in US, UK, Canada, Australia, not in France at that time
- But in the US independent regulatory agencies subject to only part of the orders), Pildes Sunstein 2002. (FR, SEC, CFTC, but not the OCC)
- APRA, ASIC, FSA, OSFI (Canada), subject to the review
- FSA, OSC, CFTC, and to an extent SEC: statutory obligation of CBA.

Some results

- Transparency: generally exists about regulatory matters, with or without requirements
- Coordination: Council of Financial Regulators in Australia, Financial Institution Supervisory Committee (Canada), Collège in France, Tripartite agreement in the UK,
- US: fragmented structure, FFIEC, some bilateral coordination arrangements, President's working group on financial Markets (blocked CFTC proposal to regulate the Over the Counter derivatives in 1997-99)
- Periodic reviews of regulation: very uneven

A public governance perspective

Lobbying and Integrity

➤ Lobbying:

- Major impact on the financial sector. 3.4 B USD between 1998 and 2008. 344 millions in the first three quarters of 2009.
- IMF study: A Fistful of Dollars: Lobbying and the Financial Crisis, Igan et al 2009, links lobbying with high-risk lending practices.
- Lobbying cessation when public ownership (Fannie Mae)
- Prevention of future crisis might require closer monitoring of lobbying activities.
- 10 OECD Principles for Transparency and Integrity in Lobbying: monitoring implementation

Revolving doors, work in progress

- The issue of regulatory capture is not new
- Heightened concerns in the context of the crisis
- Usual requirement for senior positions in regulatory field: (cooling off period, seniority at nomination, formal and informal practices)
- OECD : stocktaking of concerns, assessment of practices in financial sector
- Options to provide guidance to help remain open, need to build consensus as work is progressing.

Conclusions, restoring trust

- Safeguarding the public interest
- Attention to the regulatory dimension:
 - Ex ante assessment
 - Coordination
 - Transparency
 - Risk management
- Specific governance issues pending
 - Lobbying , agreement to identify the issue and frame principles
 - Work in progress on revolving doors
- Dynamic policy debate: need to keep a long term perspective