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’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
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:**
  - 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
R很有 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