DEVELOPING A POST-FINANCIAL CRISIS REGULATORY AND TAX ENVIRONMENT FOR FINANCIAL MARKET STABILITY

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Executive Summary

1. The world has entered into the most severe financial crisis since the Great Depression, and now has a proportionate policy response: involving massive actual and/or contingent costs for taxpayers. The response to the crisis will proceed along many fronts. With respect to the financial sector itself, 2 phases can be identified:

   • Crisis management: This involves: (a) liquidity management by central banks broadening collateral and maturities (to keep the interbank and related markets open) and loan guarantees by governments (to raise confidence to lend); and (b) dealing with the solvency and bank runs issues which always have 3 basic requirements: (i) Guarantee liabilities to prevent runs on banks. (Some countries have been acting in a manner that distorts markets). (ii) Separate out the bad assets (the TARP is designed to do this, but nationalisation of individual institutions is also an option). (iii) Recapitalise the banks with sound assets (via investments, earnings/dividend policy, and injections of capital).

   • Longer-run structural reform of the workings of the global financial system to ensure that a crisis like this does not happen again—this reform needs to recognize that the premises on which financial policies have been based have not been borne out by events, and that partial reforms focused on recent failures will likely not be sufficient. Policy makers must also protect market principles in the reform process. The great progress made in recent decades in establishing open and competitive markets as the fundamental driver of economic activity needs to be maintained against calls for protection and competition-reducing or distorting measures.

2. The OECD role is to focus on the longer-run structural reform of the system: Reform of the international monetary system (exchange rate regimes and better coordination in the era of globalised financial markets) is critical in this process, and will involve a large number of international organisations and inter-governmental cooperation. At the institutional level, to avoid periodic asset bubbles, excess leverage and gross policy and corporate governance failures, it will also be necessary to focus on improving incentive structures through re-regulation, self-regulation, improved competition, and better governance, education and taxation structures.

3. The OECD proposes to focus on these latter structural issues. The focus will be on ‘smarter’ rather than (necessarily) more regulations. The key priority will be balancing the costs and benefits of regulations and supporting risk control and competitive level playing fields between institutions and countries.
4. Previous responses to crises have been partial in nature, focusing on problems directly associated with the most recent events. This has been followed by new crises in different locations, sectors or products (e.g. Latin American debt, junk bonds, the S&L crisis, the Japan bubble, the Asia crisis, the tech bust, corporate scandals such as Enron and Parmalat, and subprime). In addition to macro policy errors, this suggests problems with the incentive structures within firms and the broader financial system.

5. There is a strong need for:
   1. A more holistic culture of risk management in financial firms and companies in respect to leverage, longer-term strategy, compensation issues;
   2. Responsible and accountable management;
   3. Effective and re-enforcing regulations;
   4. Consistent regulatory and tax policies;
   5. Implementation of agreed international standards for corporate governance, such as the OECD Principles of Corporate Governance, and their improvement through better international co-operation and coherence between national frameworks, and bringing more ‘teeth’ to the enforcement of ‘soft rules and guidelines’;
   6. Better education and incentives for prudent due diligence within the household sector; and
   7. More ‘teeth’ for enforcement of soft rules such as self regulation and codes of conduct.

6. A summary of the issues and interrelationships that need to be addressed is shown in Figure 1. By drawing together a broad range of policy communities (financial market, insurance and pension regulation, competition and taxation policy, corporate governance policy and financial education policy) OECD can help policy makers achieve a more integrated understanding of these complex incentive structures in order to achieve a well-functioning and sustainable financial system. On many issues OECD committees will have responsibility to develop recommendations for solutions. Operational responsibility for other issues will lie with other organisations.

7. The rest of this report focuses on the 3 key institutional areas that will require change and vigilance:
   1. To ensure the role of government and its organisation is coherent and consistent.
   2. To reform incentive structures within the financial system to create a more holistic culture of responsibility and risk awareness through better regulations and tax incentives, as well as improved governance, while maintaining competitive conditions.
   3. To protect and educate the consumers of financial products so they can assume greater responsibility for doing their own due diligence.
Figure 1.

OECD FINANCIAL MARKETS, CORPORATE GOVERNANCE, INSURANCE & PENSIONS, COMPETITION, TAX & ECO COMMITTEES COVER THE COMPLEX INTERRELATIONSHIPS

Current Crisis
- Mispricing of risk
- Asset bubble
- Excess leverage
- Credit Crunch/Recession

Future Outcome
- Consistent reg. & tax drivers
- Correct pricing of risk
- Adequate cost of capital
- Sustainable Assets & Debt

Risk Factors
- Asset Prices
- Leverage
- Securitisation
- Transparency

Agents
- Rating Agencies
- Banks
- Pension Funds
- Investment Banks
- Insurance Co's
- Hedge Funds
- Consumer
- Auditors
- Regulator

Incentive Structure

Cost of Capital

Inconsistent Macro
- American Dream
- Equity Montgages
- Low Interest Rates
- Tax Cuts
- Budget deficits
- Asian surplus recycling
- and excess global liquidity

Taxation
- Tax advantaged structured products
- Tax haven SPV location
- Tax treatment exec. pay
- Tax treatment M&A
- Interest deductibility

Regulations
- Basel bank capital rules & pro-cyclical issue
- Other Capital Rules & reg.
- Treatment of Investment Banks in mergers & cap. rules
- Short selling bans
- Voluntary codes/mandates
- Underwriting/audit/accounts

Structure of Firms
- Too big to fail banks
- Holding Co includes an investment bank
- Glass-Steagall issues
- Concentration, state role, multiple regulators, multiple operations & cross selling/ internal trading

Board Structure
- Independence directors
- Risk sub-committee?
- Chair of Risk on Board?
- Holistic risk focus including bank long-run strategy & leverage issues
- Fiduciary responsibilities & charter

Fees/Executive Pay
- Cash versus equity & links to the share price
- Share vesting period
- Use of options & accounting

Competition
- Consistent objectives with regulators
- Oligopoly structure impact on costs, disclosure
- Role of State (owner, regulator)
- Integration of independent operations
- Foreign competition

Education/Safety Net
- Codes of conduct
- Awareness campaigns on risk, costs, terms.
- Disclosure rules on costs of credit & terms
- Extent to which households take responsibility for due diligence
- Deposit insurance
Introduction: Incentives & Structural Problems

- In the 1990s the culture of banking changed as financial liberalisation and regulatory change, globalisation, and innovation proceeded. Banks’ focus shifted towards earnings expansion and share price growth and away from the old on-balance sheet deposit taking and lending-at-a-spread model. If banks could grow fee and trading revenue and avoid balance sheet capital charges, the return on capital would rise and the share price would expand. Compensation packages of executives came to depend more on growth performance and the share price (shares/options). In the US, commercial banks sought to compete with investment banks, which were less regulated. This was achieved in part by lobbying for the removal of Glass Steagall and by concentrating on earnings activities that did not attract regulatory capital charges.

- The incentive to grow revenue by taking advantage of regulatory loopholes (such as off-balance sheet activity that escaped the Basel rules) and tax loopholes (such as off-balance sheet structured products and use of tax havens) led to a commensurate rise in risk taking and related leveraged special purpose vehicles (SPV’s), collateralised debt obligations (CDO’s), and derivative products (such as CDS contracts).

- As risk and leveraged positions grew, the corporate governance that could have helped institutions contain the process failed (though not everywhere), with boards either unqualified to assess risks, or information on risk not being presented to the board in a consistent and digestible way.

- The incentive structures in banking began to influence the way credit rating agencies, insurers, derivative writers and lending underwriters worked to facilitate the desire and (to some) the imperative to continue to grow earnings.

- Regulatory change actually facilitated greater risk taking: (a) The anticipation of Basel II (e.g. reduced weights for mortgages) encouraged portfolio concentration and allowed banks greater scope to operate with less capital (when more would prove to be needed); (b) the Glass Steagall act was removed in 1999; (c) The Office of Federal Housing Enterprise Oversight (OFHEO) quantitative and capital requirement changes allowed banks greater mortgage securitisation scope; and the surge in bank activity in this area was not matched by containing action by bank regulators.¹

- Consumers of financial products did not have sufficient information or capacity to understand the riskiness of new products or of institutions issuing them; nor could they assess how their financial positions might evolve under different scenarios (such as interest rate resets, recession, etc).

As the crisis unfolded, governments have been thrust into the role of becoming new owners of distressed financial institutions, guarantors of loans, taking over the risk implicit in poor collateral (with contingent liabilities for the taxpayer), and making regulatory adjustments on the run.

I. The Role of Government

A new global financial architecture

- The OECD supports open markets with an appropriate role of government, that requires better and not necessarily more regulation. The role of government itself includes macro policy, ownership of financial firms, regulation, tax structures and education. All of these areas need careful reconsideration—in particular, what balance should there be between self-regulation and private ownership versus a stronger role for government; what balance between consumer protection and greater due diligence for investors, and how should the role of government adjust in crisis versus periods of normal activity?

- The global system needs a new international financial architecture that does not have a bias towards excess liquidity creation through beggar-thy-neighbour monetary policy and exchange rate regimes that fix against the dollar, forcing onto the United States a choice between accommodating easy policy or recession.

- Monetary, fiscal, and lender-of-last-resort policies need to be consistent globally and focused not only on low-inflation growth, but also the avoidance of bubbles and excess leverage that portend problems in the future.

- Domestic policies also need to be consistent. For example, the Bush Administration’s “American Dream” policy that promoted zero-equity housing finance; the use of government-sponsored agencies to facilitate housing credit; tax policies that allow excessive deductions for home mortgage interest payments; tax provisions that favour highly structured products; and low interest rate policies related to financial pressure; all had individual merit in terms of the specific objectives they addressed but combined to provide a very strong incentive for excessive borrowing to purchase homes.

Better regulation

- The OECD has long been running a program of work on efficient and effective financial regulation with a focus on balancing benefits and costs. The current crisis should lead to better regulation, not over regulation. Regulation and lender-of-last-resort provisions lead to

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2 See “General Guidance for Effective and Efficient Financial Regulation”, DAF/CMF(2008)18, for a detailed exposition, that will be the starting point for work on better regulation. It will be extended by collaborative work with other OECD directorates and a number of Committees.
cheaper funding for the affected institutions, but this carries with it the need to avoid moral hazard and excessive risk taking. The unregulated sector has a higher cost of capital balanced against greater risk taking, and consumers of their products should be more aware of the risks and the need for their own due diligence. Improved bankruptcy resolution mechanisms will be required for this sector. Where these lines are drawn between regulated and unregulated will be critical in defining the competitive landscape and in the avoidance of future crises.

- The provision of regulations consistent with competition, tax, and corporate governance policies are essential; and soft rules implicit in self regulation will need to be better enforced, if crises are to be avoided.

- Consumer protection, and improved financial and risk awareness and education will also be essential to restore confidence. To some extent governments will need to increase the responsibility assumed by households for due diligence with respect to their financial situation.

II. Better Incentives for Prudent Behaviour

A. Financial Structure and Regulation

- There are strong interrelationships between regulations on capital, deposit insurance, tax structures, corporate governance frameworks, competition policy, accounting rules, executive compensation and the like, that produce the overall environment in which risk taking occurs. The current framework has resulted in a major crisis. The OECD aim is to look at all of the relevant issues in a holistic way, so the interactions can be better understood. In some of these areas the OECD will not be the place to recommend new operational rules (e.g. accounting, derivatives and bank supervision). In others where the OECD has leadership, such as corporate governance, competition, tax, pensions, and education, as well as in the overall consistency and efficiency of reforms taken together, more prescriptive outcomes should follow.

Financial regulations

- Capital rules aim to ensure that banks have enough capital to absorb losses without causing systemic problems. The present approach has resulted in rules that have left banks with too little capital, and with capital variation over the cycle that is pro-cyclical. The issues that have contributed most to the build up of excess risk taking, interacting with tax and governance factors, are (a) coverage (e.g. on and off-balance sheet), (b) incentives that encourage excess risk taking in certain products and off-shore locations—for example, rules that encourage economising on capital charges via the design of new leveraged products, and (c) uneven treatment of financial institutions, depending on how sophisticated they are, in which sector they operate (e.g. banking, investment banking, hedge funds etc), or the jurisdiction in which they reside.
The underpinnings of the Basel model in pillar 1 have well-known problems (e.g. the assumptions of portfolio invariance and the absence of regional and sector-specific concentration risk), and it is highly procyclical. The system is complex, and the most sophisticated choice within it for setting capital levels, the internal ratings based (IRB) approach, relies on individual firm’s risk modelling and assumptions. These features interact with corporate objectives for business strategy and earnings growth: including location, business structure, choice of products and tax minimisation.

The range of policies that bear on these issues go well beyond financial markets, to pensions, tax, competition and corporate governance.

Size concentration and mergers with investment banks

Part of the crisis management has seen M&A activity with stronger firms taking over weaker or failed high-risk and previously under-regulated investment banks. This is leading to the formation of more large systemically important financial institutions that are ‘too big to fail’. It is not clear that this will be the best solution in the long-run (e.g. it is more difficult for capital regulations to affect the cost of capital in intra-firm capital allocation processes; oligopolies are less transparent and are associated with less competitive pricing).

There are tax issues also in this respect, in particular as regards the use of pre-acquisition losses. For example, in a series of recently issued notices, the IRS has expanded the possibility of acquirers to use the pre-acquisition losses of the acquired entity. It has been widely reported in the financial press that the release of these IRS Notices helped persuade Wells Fargo & Co. to pursue its $15 billion acquisition of Wachovia Corp., despite the latter's previously announced deal with Citigroup, because an ownership change would not affect the ability of Wachovia (or, depending on the facts and circumstances, Wells Fargo) to deduct almost $72 billion in Wachovia's book losses for federal income tax purposes and potentially produce, over time, almost $25 billion in federal income tax savings.

The high risk and highly cyclical investment banking part of the financial sector, including those within bank holding companies, grew rapidly through the 90s and played a key causal role in the crisis. It grew in an opaque manner with sophisticated products that had poorly-arranged asset and liability structures. This led to mispricing of risk and extreme price volatility that proved to be systemically important and in the end destabilized retail banking and the economy. Now, as investment banks deleverage and shrink, they pose a strong potential danger to the real economy. One key question is the extent to which this segment should be allowed to re-expand, and how the cost of capital might be better used to influence this volatile business in the future. Should this be left up to the governance of the institutions themselves? Should some form of Glass-Steagall come back into play later on, and stronger capital requirements be held in relation to exposures to investment banks? Or
are there other ways for policy to influence funding policy within a bank non-operating holding company structure?

- Does a more concentrated financial system act to reduce competition and increase the cost of credit and other financial services to consumers and businesses? What policies can improve the competitive environment of financial markets?

- Hedge funds lie outside the regulatory net and have (so far) not played any causal role in the crisis, though there are some examples of short selling by hedge funds that push the limits of responsibility. Causal factors in the crisis have come from inside the regulated sector. What lessons should be learned from this for the re-regulation debate? Do efficiency and level playing field issues require that they be brought into the regulatory net? Or has the higher capital cost they face led to greater risk awareness.

- The interaction of financial rules with tax, corporate governance, competition and financial education will be important here.

**Competition policy issues**

- Risks to competition arising from the crisis include mergers, state ownership and aid, and quite possibly protectionist sentiment and measures. During the Great Depression, economically harmful restrictions on competition were encouraged as part of the policy response. How can policy makers avoid being stampeded into adopting competition reducing policies in the financial sector and the real economy in the current crisis?

- Financial regulation/policy and competition principles sometimes come into conflict. For example EU competition rules limit mergers that would harm competition and the provision of competition distorting state aid, but state aid was provided to individual banks and merger activity was encouraged as a part of the crisis resolution process. To what extent are the longer-run objectives consistent? (b) If the objectives are inconsistent, how can policy makers handle inconsistencies between the regimes? (c) What approaches can be used to improve the interrelationships between financial regulatory regimes and competition regimes?

- What are the efficiencies and risks from integrating within one institution potentially independent operations including consumer banking, SME lending and investment banking?

- Should international mergers of banks in crisis be advocated in preference to intra-national mergers to limit the anti-competitive effects of bank restructuring? This can also have important taxation implications.
If concentration increases in financial markets, what countervailing policies can be implemented to restore or improve competitive conditions?

Can competition policy help improve transparency by reducing switching costs between like products and by also reducing information asymmetries?

Is there sufficient competition between credit rating agencies? (a) Does the structure of the credit rating markets yield sufficient competition over ratings? (b) Are there regulatory barriers to entry? (c) What measures could be undertaken to enhance beneficial competition?

The interaction between competition and taxation policy makers, as well as the investment policy community will be very important.

Pensions and insurance funds

The role of pension funds as automatic market stabilizers (e.g. portfolio rebalancing) has been weakened over the last decade by the implementation of fair-value accounting standards, and - in a few countries - by quantitative risk-based solvency rules. These reforms have contributed to making pension funds in some countries forced net sellers of equities during the downturn.

Pension funds are passive investors that are called upon to exercise their shareholder rights to help corporate governance to adjust in the face of changes in the business environment, in the use of derivatives (e.g. to gain voting power) and to adjust to pressures from new private pools of capital. The fiduciary responsibilities of pension fund and insurance boards needs to be reconsidered in this light. The crisis calls for more work on the regulatory framework and governance structures of these key investor groups.

The OECD has called for the strengthening of pension fund governance since the publication of a set of guidelines in 2001 (currently being revised). Small pension funds are more prone to weak governance (and they are much more expensive to manage). This raises the question as to whether policy makers should seek to consolidate the pension fund sector in some countries. A more concentrated pension fund sector would also facilitate more regular supervision by the relevant authorities.

The OECD has also issued a broader set of Core Principles for Occupational Pension Regulation (2004, currently being revised), which among other things deal with funding/solvency and investment regulations. For example, the funding principle calls for avoiding pro-cyclical regulations. The implementation of these principles in member countries should be assessed.
• Products for long-term investments to fund pensions have been in short supply, and incentives for long-term investment and saving have not been sufficiently strong. Should such products be encouraged to foster longer-run saving and investment?

• Collaboration between financial policy makers and corporate governance will be crucial here.

Transparency issues and OTC markets

• There is a need for more standardisation of securitisation procedures and better underwriting standards for loan collateral.

• Mark-to-market accounting has contributed to systemic problems by causing losses resulting from price volatility in securitised products and OTC derivatives trading in illiquid markets (sometimes caused by credit rating downgrades) to be reflected immediately in extreme changes in company income statements. Bankruptcy can follow where these exceed regulatory capital requirements. Does the role of auditing require greater scrutiny?

• There has been massive uncertainty about the operational characteristics of OTC derivatives, particularly credit default swaps (CDS), leading to market distrust and liquidity problems. This requires better standardisation of documentation and cash settlement obligations. To solve these problems requires better clearing and automated trade processes to avoid crisis backlogs. Clearer, dealer and investor standards for netting, reconciliation and valuation of trades are required. Migration to exchange traded instruments should be encouraged.

• Processes need to be in place to monitor new derivative products that emerge, counterparty exposures and attendant risk controls.

• The OECD may not be the best place in which to centre the technical aspects of this work, but policy makers need to understand the issues and problems fully to ensure effective solutions.

• There is an opportunity for collaboration between tax authorities and financial market and accounting policy and rule makers.

B. Better Incentives: Corporate Governance

• In Corporate Governance, the OECD will focus on 3 key areas:
  – The quality of the institutional structure that supports effective implementation of agreed standards;
  – Improving weak corporate governance practices, and;
  – Application of regulatory cost-benefit analysis in the area of corporate governance.
Strengthening the Regulatory Framework

- The widespread corporate governance failure in the crisis seems largely due to weak policy implementation and monitoring, rather than problems with the quality of standards, laws and regulations. This may to some extent be explained by fragmentation of the regulatory framework – both at international and national level.

- How can international co-operation among institutions, including private sector bodies, be improved to ensure better coordination and implementation of agreed international corporate governance standards, especially the OECD Principles of Corporate Governance? Consultation with relevant institutions, non-member countries, private sector organisations and other stakeholders can establish the extent of current efforts to co-ordinate actions and agree on a roadmap for improving weak corporate governance practices.

- Consistency and coherence among laws, regulations and codes at the international level is a prerequisite for effective implementation at the national level. Based on the Principles, the OECD can advise on how countries can achieve a more efficient national regulatory structure for corporate governance, including voluntary standards.

Remedies to Weak Practices

- On the basis of the Principles, the OECD will address areas where weak corporate governance practices directly contributed to the crisis:

  **Risk Management**: Corporate governance aspects of risk management systems have been weak and partial. A review of existing risk management practices and standards will help increase awareness and improve implementation. How to give ‘teeth’ for better compliance with soft rules such as the OECD Principles and board-room guides is a key issue.

  **Board Composition and Competence**: Failure of risk management systems, important in some banks, also points to potential board failure. For listed companies in general, the competence and integrity of the board of directors is essential for the quality of corporate governance. During the last decade responsibilities of boards have increased. The financial crisis governance failures raise the question as to whether the quality and competence of boards has been sufficient to meet these new demands. This may involve weak understanding and implementation of the “independent directors” aspects of the Principles. It may also mean that bank boards did not have appropriate risk systems and procedures in place, or had an insufficiently-holistic approach to risk management. A report on weak practices is required to review the nuances of this issue and suggest improvements. This too might require better enforcement.

  **Remuneration and Incentive Systems** are supposed to align the interests of corporate officials with the long-term interest of the company and the shareholders. Distortions in these structures may lead to a too ‘short-term’ focus of financial and non-financial firms. The Principles can inform current plans and
actions of some countries and how to achieve cost efficient solutions. The role of tax incentives is also an important element to explore.

The Role of Institutional Investors: An important aspect of the financial crisis has been the absence of shareholders as a disciplining force, and in particular the large institutional shareholders. For many years there has been hope that institutional investors would make a significant contribution to monitoring companies, effectively look after their own interests, and take a more long-term approach. The track record of institutional investors has been disappointing. Their generally passive attitude may have several explanations, including legal and tax arrangements, together with internal incentive systems, fee structures, conflicts of interests, etc. Ways to improve corporate monitoring, with shareholders better meeting their corporate responsibilities, is an important underpinning of the regulatory framework for financial and non-financial firms.

C. Taxation

Did tax contribute to the crisis?

- The current crisis has been partly caused by the fact that financial markets have become less transparent and more opaque in many different dimensions. The development of new and exotic financial instruments that are hard to value and price, the fact that many of these instruments trade over the counter, the lack of information about such instruments and who is holding them, the fact that new financial players are opaque and work under little or no regulation, have all contributed to an astonishing lack of transparency. This lack of transparency made it more difficult to assess the true extent of the risks involved and undermined the integrity of the system.

- Tax is a driver in encouraging financial institutions to develop highly sophisticated products and to move their activities off-shore. Consequently, it should be an integrated part of the longer-run structural solution.

Integrating tax into the new regulatory environment

- There are four main factors which should inform the integration of tax into the new regulatory environment: tax havens must be brought into the international regulatory and tax framework; tax must reinforce regulatory requirements; tax must provide the right signal to markets; and it should contribute to ensuring the transparency of the system.

1. The need to ensure the transparency of the system

- Politicians are increasingly drawing the link between tax havens and the crisis. Tax havens play an increasing role in the international financial system. For example, the Cayman Islands is now the fifth largest banking centre in the world and The Bahamas plays a key role in the reinsurance business. Over the last two decades the offshore world has grown from a small player into an
industry which is estimated to hold $5-7 trillion in assets, often in a lightly-regulated and opaque environment. Because of the opaqueness of these centres it is difficult for regulators to gain a clear idea of the transactions that take place there.

- While tax is not the sole driver for activities going offshore, it is certainly one of the most important. OECD could develop a methodology to arrive at a reliable estimate of the size of the offshore industry in aggregate and vis a vis each country, thereby providing a firmer basis for the political debate. It could also identify how to minimize the tax incentives to move offshore and ensure proper compliance by taxpayers.

- Tax authorities must have powers to obtain information on ownership, identity and accounting books. Anonymous bank accounts and bearer shares should be prohibited. Furthermore, access to ownership, identity and accounting information should be the rule: countries should have powers to access accounting records from any person within their jurisdiction who has possession of, or has the control of, or has the ability to obtain such information.

- In 2002 the OECD laid down a set of principles which were intended to improve the transparency of the financial sector. However, implementation, particularly in financial centres, remains patchy. It is necessary to make sure that these principles are consistently applied in order to ensure the transparency of the system.

2. Tax and corporate governance

- There are important areas of interaction between corporate governance and taxation issues. Good corporate governance should cover the corporation’s attitude towards its tax structuring and liabilities. Boards need to take responsibility for their tax position. There needs to be a clear setting out in the accounts of tax liabilities and assets since these can affect the overall rating of financial institutions.

- Possible manipulation of tax and financial accounting and income reporting rules also raise corporate governance issues. Accounting and mark-to-market may have contributed to the systemic problems we are facing today. Thus it is important that the interaction between tax and financial accounting rules be examined in the context of any review of corporate governance.

- Strengthening the relationship between tax and governance issues is a vital step in getting corporate boards to adopt more responsible attitudes and to correctly assess the reputational and financial risk attached to aggressive behaviours. In this context, corporate tax returns include important information about corporations beyond
that available in financial statements. Making corporate tax returns available to the wider public (which is already the case in a number of OECD countries) could provide a useful tool for analysts and rating agencies to better evaluate corporate risks. Furthermore, if corporate tax returns became public, non-governmental players would be able to analyze outcomes and quickly report back to lawmakers, speeding and heightening their understanding of legislation’s effects.

3. The role of banks and financial institutions

- The OECD is developing a high-level understanding of how banks and financial institutions operate, with particular emphasis on structured financing and the key roles banks play in the operation of tax systems. The project is a follow up to the OECD “Study into the Role of Tax Intermediaries”, and is being developed with input from industry experts.

- The study is likely to address (i) the planning, design, review and implementation of complex structured financing transactions, including those which are the tax drivers of sophisticated financial products; (ii) identification and description of prevention, detection and response strategies applied by different revenue bodies; (iii) the benefits revenue bodies and banks could mutually achieve by enhancing their relationship through greater disclosure and transparency.

- OECD work in this area could be speeded up and will contribute to a better understanding of the role of banks, both as taxpayers and as developers of structured financial products, and to ensure that tax reinforces the regulatory signals.

III. Consumer Protection and Education

- Financial risks are being transferred more and more to individuals. The shift to defined contributions pension schemes transfers both investment and (increasingly) longevity risks to households. The development of adjustable interest-only mortgages also transfers interest rate risks to households. More and more households also have to bear part of their health costs. The problem is that individuals are ill-equipped to face these risks and make proper financial decisions. This calls for a new regulatory approach, with a focus on access, competition, consumer protection and (in particular) financial education and awareness.

- Consumers need to be made aware of major developments in finance, pensions and healthcare; their current and expected financial situation; and ways to deal with weaknesses and risks.

- There is a need for better international codes of conduct, awareness campaigns and regulatory standards. Information disclosure on basic issues such as the true cost of credit is essential. Current mortgage
disclosures failed to convey key mortgage costs and loan terms to many consumers, and studies show that recognition of costs and terms improve with better disclosure—particularly where terms are complex.

- Financial education helps individuals to understand financial risks and products and thus take decisions better adapted to their personal circumstances. This also helps prudential supervision, as it is more difficult to mislead better educated citizens.

- The OECD is working on these issues (with major priority projects on risk transfer to households) and is leading international work on financial education.

**Deposit Insurance**

- The reform of deposit insurance to deal with inconsistencies between countries which can exacerbate liquidity problems in a crisis.

- To what extent does deposit insurance reduce competition between banks and increase the risk of increased moral hazard in portfolio decisions?

- OECD structural perspectives examining interactions between different financial safety net provisions complements that of the International Association of Deposit Insurers, which focuses on the design of national systems.

- This is an opportunity for collaboration between financial market, competition and consumer policy makers.