Risk and Regulation: The Challenges across Sectors Including Financial Services

1-2 December 2008
OECD Conference Center

This note was prepared to support the second thematic session on regulatory reform and the management of risks: reflections on risk-based approaches to the financial sector regulation.

For further information, please contact Josef Konvitz. Tel: 33 1 45 24 97 47. Email: josef.konvitz@oecd.org.
RISK AND REGULATION: CHALLENGES ACROSS SECTORS
INCLUDING FINANCIAL SERVICES

NOTE FOR DISCUSSION

1. This note was prepared to support discussion on the link between the more general discussion on risk and regulation and the financial sector. The focus is on the challenges of integrating risk in regulatory and supervisory designs and on achieving a coherent and consistent approach.

Risk-based regulation: an institutional focus

2. The financial crisis coincides with a trend marked by rising concerns about risks of many kinds. Governments are facing increased public expectations for protection and safety. Policy responses to the financial crisis should be understood in the context of ongoing public concerns about the ability of government to plan for and to manage risks, and about the sharing of burdens and responsibilities between the public and private sectors.

3. When a crisis occurs, the political response to media and electoral pressures has often been reactive regulation, quickly adopted, and without adequate scrutiny of its potential effectiveness and efficiency. This may result in unnecessary burdens, without proper consideration of alternatives and impacts. In 2005, as part of the Guiding Principles for Regulatory Quality and Performance, the OECD called on governments to “assess risk to the public and to public policy in a changing environment as fully and transparently as possible, thereby contributing to a better understanding of the responsibilities of all stakeholders.” Regulatory policy in recent years, and in several sectors, has had to integrate risk management and risk-based regulation as part of strategies for better regulation. This remains a priority as part of a wider effort to build confidence that good regulations meet the public interest.

4. Regulatory policy and practice calls for institutions capable of assessing and managing risks. Many regulatory bodies cope with risk to determine whether or not an activity should be regulated, or what level of preventive measures firms or others should take on issues affecting health, safety, energy supply and the environment. When there is a crisis or failure, the analysis of causes routinely examines organisational and institutional factors, and often finds a lack of clarity in the rules and objectives of the organisation, poorly designed regulation, a lack of adequate oversight, insufficient technical capacity, weak incentives to take risk seriously, and/or inadequate response which aggravated the initial problem.

5. Risk-based regulation refers to the use of systematized frameworks of inspection or supervision which are primarily designed to manage regulatory or institutional risk: risks to the agency itself that it will not achieve its objectives. In this sense, risk-based regulation involves the development of decision making frameworks and procedures to prioritise regulatory activities and deploy resources, principally relating to inspection and enforcement, based on an assessment of the risks that regulated firms pose to the regulator’s objectives. Risk-based frameworks require regulators to identify the risks to be managed, not the rules to be enforced. The selection should be explicit, and provide a framework of analysis in which they can be made. This should include the type of risk that the authorities are prepared to tolerate, as well as an assessment of probabilities of a hazard or adverse event. Statutory objectives may provide the starting point, but a highly complex legislative framework can get in the way.
Sectoral aspects

6. Risk-based regulation matters significantly to the way enforcement and supervisory tasks are conducted by sectoral regulators. It should be of particular relevance as the financial crisis may renew interest in better regulation approaches, given the shortcomings observed in recent years which contributed to the crisis, and given the critical role for regulatory supervision and oversight in the future. Research highlights how difficult it is to:

- Combine simplicity with the wide range of risks to be covered;
- Get the right data, and make better use of it;
- Set the right level of administrative burdens;
- Ensure that the assessment of firms is forward-looking, not just short-term;
- Assess risks for a sector and not just for a specific firm;
- Balance the need for speed and responsiveness with the time it takes to ensure accuracy and consistency of assessments;
- Embed the risk-based approach in the culture of the regulatory body;
- Ensure internal compliance with the risk-based regime, and to manage blame when there is a failure;
- Allocate resources according to risk priorities.

7. Research on risk-based regulation in selected sectors, including financial services, has produced some insights and lessons for implementation (SG/GRP(2008)4). To help, the authorities need to:

- Ensure that regulatory bodies have sufficient powers of intervention;
- Allow sufficient time to design and implement a risk-based framework, and take account of the organisational challenges involved;
- Anticipate teamwork to function in a crisis;
- Target enforcement and inspection resources where they are likely to make the biggest difference;
- Develop, evaluate and improve communication;
- Accept that risk-based processes require regulators, and politicians, to take risks.

Risk, policy coherence, and coordination

8. The interconnected nature of risks in many sectors, and in the financial sector in particular, affect how governments ensure the quality of the regulatory structure. The agenda for reforming regulation of the financial sector covers taxation, corporate governance, capital rules, the treatment of financial institutions by sector or jurisdiction, competition, and consumer protection and education. Consistency and coherence are vital if the new regulatory framework is to be functional in an interconnected, global economy. How various regulatory institutions interact, and how the regulations themselves fit together, will determine the extent to which international co-operation will be reinforced. Mapping and analysing the linkages in the new regulatory system will be critical to risk assessment, to transparency, and to accountability.
9. It remains to be seen how consistency and coherence can be achieved:

- The disciplines and techniques that bring the separate parts of a regulatory system into focus, are often the responsibility of a body close to the centre of government which ensures consistency in better regulation approaches across various departments, agencies and regulators.

- But the system of decentralised or multiple regulatory bodies makes it difficult to ensure that central oversight can cover the widest possible range of risks, and their inter-connectedness.

10. Better regulation can be enhanced by deliberate efforts to bring policy makers from across the spectrum together, including from core bodies close to the center of government, the financial sector, and policymakers in related fields such as competition and trade.

11. The transition to a new, improved regulatory framework will itself pose challenges for risk regulatory management, for which few countries are prepared. Efforts to tackle the regulatory stock, to identify and remove obsolete regulations, should be linked to efforts to tackle the regulatory inflow, as new regulations are needed in response to technological innovation, changing priorities and social demand. Managing the regulatory stock and the regulatory flow are two phases of what should be a single cycle. Connecting them to enhance regulatory certainty is still a challenge.

12. A restoration of trust and confidence should be a major outcome of current efforts to cope with the financial crisis. But success is not a foregone conclusion. The process by which governments design a more robust yet transparent regulatory framework is a critical variable. Good governance is essential both to the design of better regulations, and to their implementation. A well-functioning regulatory management system should make a difference. Policies for better regulation and regulatory management do not substitute for substantive rule-making in specific sectors. They can however make the rule-making process more transparent, and contribute to regulations that are “fit for purpose”, efficient and effective.

**Key issues**

13. Delegates and participants may wish to reflect on the following:

1. Regulatory management for coherence

   1. Risk assessment is frequently the privileged domain of experts. How can risk-based regulation be designed in an open and transparent manner, addressing all relevant viewpoints?
   2. Who will take responsibility for the coherence of the regulatory framework for financial services?
   3. When international co-operation is essential to share information and enforce regulations, how can regulatory institutions be designed to assure this function? What lessons from other sectors may be relevant?

2. Making reform happen

   1. Training and institution-building should proceed at the same time as the new regulatory framework is put in place. Will two years be enough?
   2. Will there be enough consistency across economic and electoral cycles to make reform sustainable? How can governments promote responsible regulation while coping with public pressures for short-term action?
   3. What lessons might be drawn about the political economy of reform from the reform process underway?
ANNEX 1

Regulation needs to be built on a sound understanding of the area it seeks to regulate, and responsive to that context whilst seeking to modify it.

1. **Institutional settings and forms**
   a. Structure of regulator and its powers
   b. Patterns of control over the regulator – is it independent, who can veto it,
   c. Extent of political support,
   d. Location within a broader network of regulators – e.g., position in EU which limits its ability to initiate policies;
   e. Organisational structure of the market – can be relevant to extent to which regulator is prone to ‘capture’

2. **Organisational cultures, skills and capacities**
   a. For firms: understanding of where (and perhaps how) firms are likely to try to avoid regulation, and which ones are likely to do so
   b. Firm’s attitude to regulation & reasons for that attitude
      − Their internal culture and orientation
      − Their own internal capacity to regulate and the level of resources they can devote to compliance, often related to market position
   c. For regulators
      − Culture of regulator, e.g. prefers tough enforcement approach, or negotiation
      − Its own regulatory capacity, resources and skills
      − Impact of past successes and failures on its regulatory style

3. **Logics and languages**
   a. Degree of coherence of policy assumptions and responses across regulator or network of regulators; for example
      − ensuring modes of evaluation do not contradict the achievement of desired outcomes;
      − ensuring that policies are formed on the basis of consistent assumptions;
      − ensuring that different regulatory regimes do not impose conflicting requirements on firms

4. **Performance sensitivity**
   a. Evaluation of outcomes over defined periods of time
   b. Anticipation, recognition and evaluation of unintended consequences and side effects
5. **Adaptability**
   a. Adaptability of the regulatory regime to changes in market structure, firm’s patterns of behaviour
   b. Adaptability of the regulatory regime to performance evaluations and unintended consequences
   c. Degree to which barriers to adaptability exist, for example
      - Lack of feedback / data
        - Lack of clarity as to cause – effect relationships, particularly where a number of different regulators are involved
        - Lack of powers by the regulator to instigate change
        - High number of veto points.

Source: Prof. Julia Black.