Introduction

Mitigating Capture in Financial Regulation

Stefano Pagliari
University of Waterloo; International Centre for Financial Regulation

Introduction

The interaction between policymakers and market participants in the regulation of financial markets is marked by a paradox. In a dynamic and technically complex environment such as the financial markets, regulatory authorities are required to develop a constant and close interaction with the market participants under their surveillance in order to stay abreast of rapidly changing financial markets, to monitor the build-up of risks, and to understand the impact of their regulatory policies. However, the same proximity between regulators and market actors that is required for regulators to effectively perform their responsibilities has also been described as opening the regulatory process to the risk of unduly favouring narrow industry interests at the expense of the public. This distortion in the regulatory process is commonly defined as "regulatory capture".

The problem of regulatory capture in financial regulation has attracted renewed attention in the aftermath of the global financial crisis. Different academic works, journalistic accounts, as well as official inquiries have all emphasized the impact that the undue influence of special interests has played in causing a relaxation of regulatory constraints in the period preceding the crisis.[1] The Governor of the Bank of England, Mervyn King, described regulatory capture as 'one of the major problems leading up to the crisis'.[2]
However, despite references to regulatory capture having permeated much of the discourse on financial regulation and a significant body of

About the Author: Stefano Pagliari is a Ph.D. Candidate at the University of Waterloo and a Research Associate at the International Centre for Financial Regulation. His work focuses on the political economy of the regulatory response to the global financial crisis. His published work appears in International Organization, Journal of European Integration, Journal of European Law and he is the Co-Editor (with Eric Helleiner and Hubert Zimmerman) of 'Global Finance in Crisis: The Politics of International Regulatory Change' (Routledge, 2009).

[1] See for instance FCIC (2011). The Financial Crisis Inquiry Report. *Final Report of the National Commission on the Causes of the Financial and Economic Crisis in the United States*. Washington, DC, The Financial Crisis Inquiry Commission; Johnson and Kwak (2010). *13 Bankers*. New York, Pantheon Books;

[2] Cited by Masters (2011). 'King calls for discretionary powers'. *Financial Times*. London. 3 November.

academic studies and commentaries dissecting the regulatory process in finance and the relationship between policymakers and the financial industry, only a minority of these works has ventured into systematically discussing policy solutions to mitigate capture in financial regulation. As Carpenter and Moss have argued in an important recent contribution to the subject, 'all too often, observers of regulation are quicker to yelp about capture than to think hard about how it might be prevented or mitigated. Analyses stop at diagnosis without venturing to the matter of cure.'[3] This tendency also applies to the same regulators and regulated institutions that have been the targets of criticism. These have been reluctant to publicly discuss what deficiencies or conflicts emerge from their interaction and what measures could strengthen the integrity of the policymaking process in finance. As a result, a debate regarding how to structure the interaction between the financial industry and regulatory agencies has struggled to emerge in the public policy sphere, and that of capture has remained a subject that 'generates more heat than light'.[4]

This report aims to make a contribution towards addressing this gap in the academic literature and public policy debate by identifying a set of realistic policy solutions to mitigate the risk that the process through which financial rules are designed and implemented may be captured by special interests. In order to achieve this objective, this report departs from the existing analysis of regulatory capture in finance in two important ways. First, it draws on a variety of perspectives, combining the contribution of academics with the experience of regulators and former regulators, financial industry practitioners, as well as other stakeholders such as consumer groups and non-financial end users. Second, rather than looking at finance in isolation, this report will also include the perspective of different academics and policymakers whose primary experience and research extends to sectors outside of the financial realms, such as the regulation of the telecommunication industry, energy markets, and the automobile industry. Concerns regarding undue special interest influence are not unique to financial policymaking, and a close look at the experience of these sectors offers important insights into possible policy responses to the problem of capture in the financial regulatory arena.

This introductory chapter will summarize the main findings of these different contributions. The first part of this chapter (Section 1) will discuss how different authors have conceived the problem of regulatory capture in finance. This section will discuss four aspects of the policymaking process that been identified as conducive to diverting the content of regulatory policies away from the interest of the public and in favour of special interests: 1) the asymmetrical participation of the financial industry and other stakeholders in the formulation of regulatory policies; 2) the institutional context within which financial regulatory policies are designed and implemented; 3) the ideas, beliefs and mind-sets guiding the work of regulators; and 4) the broader political context in which the financial regulatory process takes place.

The acknowledgement of the multiple channels and mechanisms that may lead regulation to unduly favour narrow interests have led different commentators in the past to discount the possibility of effectively countering this phenomenon. Contrary to this perspective, this report argues that the risk that regulatory policies will divert from the public interest and favour special interests can be mitigated through different strategies to balance the impact of the factors driving regulatory capture. The wide range of mitigating strategies discussed by the different contributors to this report and the broader literature will be divided into three broad agendas, based on the respective points of intervention in the regulatory policymaking process.

A first set of proposals (Section 2.1) focuses on the engagement of different stakeholders in the regulatory process and seeks to mitigate capture

[3] Carpenter and Moss (forthcoming). Draft chapter of 'Introduction'. In: *Preventing Regulatory Capture: Special Interest Influence, and How to Limit It*, by Carpenter and Moss (forthcoming), Cambridge, Cambridge University Press, p.5.
[4] Strachan (this volume).

by promoting greater balance and diversity among the groups competing to influence the content of regulatory policies. Some of the different solutions discussed to achieve this objective include the creation of participatory mechanisms that favour the engagement of a broader range of groups, measures to strengthen the position of consumer groups and other groups with a diffuse membership in the policymaking process, and approaches to foster the emergence of countervailing forces against the risk of capture within the same financial industry.

A second set of proposals (Section 2.2) focuses on the institutional context within which regulatory policies are designed and implemented and seeks to mitigate the risk of capture by reforming by those elements that may bias the action of regulators in favour of certain stakeholders. These measures include reforms in the mandate of regulatory agencies, changes in the internal decision making procedures, reforms in the staffing and recruitment practices, as well as changes in the level and sources of funding.

Finally, a third set of proposals (Section 2.3) seeks to mitigate the risk of capture by subjecting the regulatory process to a greater external scrutiny. These recommendations include measures to increase the transparency of the regulatory process, increasing the legal system's scrutiny of the regulatory process, the creation of expert review bodies to monitor the integrity of the regulatory process, as well as measures seeking to strengthen the reciprocal oversight against the risk of capture from other regulatory agencies within the same country and at the international level.

Section 1: Understanding Regulatory Capture

1.1 What is Regulatory Capture?

The origins of the concept of regulatory capture are frequently associated with the work of the Nobel Laureate George Stigler four decades before the outbreak of the crisis. Stigler argued that concentrated producer groups are able to systematically exercise a disproportionate influence over the conduct of their regulators to the point of shaping regulation to suit their interests rather than their mandate to maximize social welfare.[5] Since Stigler's pioneering work, an important scholarly tradition known as the "special interest" theory of regulation has analysed what dynamics could lead regulatory agencies to unduly favour the industry they had responsibility for regulating and to deviate from the public interest.[6]

While the analysis of regulatory capture has developed primarily to shed light on distortions in the regulation of other industries outside of finance, this 'theory of private distortion of public purpose' [7] has become a privileged lens to interpret financial regulatory policymaking. Most attempts to theorize and analyse the process of capture in financial regulation have emerged from the US experience.[8] However, references to the undue influence of special interests have also informed different analyses of financial policymaking in other industrialized countries,[9] at the European level [10] in emerging market countries,[11] as well as within international bodies such as the Basel Committee and the International Organization of Securities Commissions, where the influence of financial industry groups over the international regulatory initiatives has led different authors to developed the concept of "transnational regulatory capture".[12] Indeed, the

[5] Stigler (1971). 'The Theory of Economic Regulation.' *Bell Journal of Economics and Management Science*, 2: 3-21.

[6] See Peltzman (1976). 'Towards a More General Theory of Regulation.' *Journal of Law and Economics*, 19: 211-48; Laffont and Tirole (1991). 'The politics of government decision making. A theory of regulatory capture.' *Quarterly Journal of Economics*, 106: 4. For a review of the literature see Dal Bó (2006). 'Regulatory Capture: A Review.' *Oxford Review of Economic Policy*, 22(2): 203-25.

[7] Baxter (this volume).

[8] Johnson and Kwak (2010), *op. cit. in footnote* 1.

[9] See Ridley (this volume) for the UK experience

[10] Mügge (2010). *Widen the Market, Narrow the Competition*. Colchester, ECPR Press.

[11] Walter (2008). *Governing Finance: East Asia's Adoption of International Standards*. Ithaca, Cornell University Press

[12] Underhill and Zhang (2008). 'Setting the rules: private power, political underpinnings, and legitimacy in global monetary and financial governance.' *International Affairs* 84(3): 535-54; Lall (2011). 'From failure to failure: The politics of international banking regulation.' *Review of International Political Economy*; for a critique see Young (2012). 'Transnational regulatory capture? An empirical examination

fact that the analysis of regulatory capture has developed primarily from the US experience has often led analysts to often overlook how the nature and the extent of regulatory capture may vary considerably across these contexts.

The concept of regulatory capture has been associated also with different phases of the financial regulatory policymaking process. Most attention has been paid to the rulemaking phase. In this area, undue influence of the regulated sector is most commonly associated with the absence of regulatory measures that would impose costs on the regulated entity or in the introduction of rules that fail to adequately defend broader societal preferences. However, regulatory capture could also manifest itself in the development of more stringent regulations that allow the market leaders to eliminate present and future competition.[13] Moreover, the concept of capture has also been used as an analytical lens to explain failures in other phases of the regulatory policymaking process in finance, such as in the supervision of financial firms, [14] or in the enforcement[15] and implementation phase[16]. In this phase, pressures from the regulated institutions have been presented as conducive to a lack of tough enforcement and investigations, or conducive to episodes of regulatory forbearance where regulation is not fully enforced. Indeed, as Walter suggests in this volume, the more ‘opaque, extended, and complex’ nature of the implementation phase provides a more fertile terrain for the influence of organized interests than the rulemaking process, since a trade-off may exist between the intensity of the pressures exercised by these interests during the rulemaking and implementation phases.[17]

The popularity of regulatory capture as one of the main analytical lenses to explore failures in financial regulatory policymaking also reflects some of the limitations of this concept, starting from its ambiguity. Different works have frequently restrained from seeking to define regulatory capture or provided very different definitions of this phenomenon. A more analytically precise definition of regulatory capture comes from Carpenter and Moss, who have described regulatory capture as ‘the result or process by which regulation (in law or application) is, at least partially, by intent and action of the industry regulated, consistently or repeatedly directed away from the public interest and towards the interests of the regulated industry’.[18] However, the application of this definition to the financial policy realm relies on the capacity to clearly define where the “public interest” resides in a given regulatory issue and to identify when a policy shift away from this solution is the result of the action of special interests with clearly delineated and divergent interests. The uncertainty surrounding the impact of financial regulatory policies and the presence of at times competing objectives, such as ensuring stability and a stable flow of credit to the economy, make the task of identifying the public interest ex-ante often challenging. The definition of capture presented by Baxter bypasses the problem of identifying what is in the public interest, since he argues that regulatory capture is present ‘whenever a particular sector to the regulatory regime has acquired influence disproportionate to the balance of interests envisaged when the regulatory system was established’.[19]

A second limitation of the concept derives from the fact that, as Baxter argues, regulatory capture is ‘at once a theory of legislative and regulatory motivation *and* a vituperative accusation levelled at results unfavourable to one of the contesting groups’.[20] As a result, this allegation is likely to be raised even if the regulation strikes the right balance among competing interests. However,

of the transnational lobbying of the Basel Committee on Banking Supervision.' *Review of International Political Economy*.

[13] Mattli and Woods (2009). 'In Whose Benefit? Explaining Regulatory Change in Global Politics.' In: *The Politics of Global Regulation*, by Mattli and Woods, eds (2009), Princeton, NJ, Princeton University Press.

[14] Baxter (2011). 'Capture in Financial Regulation: Can We Channel It Toward the Common Good?' *Cornell Journal of Law and Public Policy* 21(1): 175-200, p. 187.

[15] Sheng (this volume).

[16] Walter (2008), *op. cit. in footnote* 11.

[17] Walter (this volume).

[18] Carpenter and Moss (forthcoming), *op. cit. in footnote* 3; Carpenter, Moss, Wachtell Stinnett (this volume).

[19] Baxter (2011), p. 176, *op. cit. in footnote* 14.

[20] Baxter (this volume).

claims regarding the extent of this phenomenon are frequently supported by only weak empirical evidence. Carpenter and Moss argue that analysts have often inferred capture from episodes in which regulators partially rely upon the firms, from patterns of regulatory advantage granted to certain groups, or simply 'on the basis of observations of undesired regulatory outcomes, even though those outcomes might be caused by a number of things besides capture' such as 'regulators' incompetence, inefficiency, or randomness'.[21]

Given these difficulties in defining and assessing capture, it comes as no surprise that disagreements persist among different commentators regarding the extent of this phenomenon, including the contributors to this volume. For some authors, undue influence exercised by financial industry groups remains a structural distortion in the regulatory process in finance, which limits the possibility of achieving effective policies.[22] In their review of the broader literature, Carpenter and Moss find little support among empirical researchers for this kind of extensive influence by special interests leading to regulation detrimental to the broader public. Instead, they argue that capture seems to manifest itself in degrees, in some cases having no discernible effects on regulation, and more commonly limiting a regulator's efforts to serve the public interest, but not to the point of compromising the regulatory policy.[23] For others, capture remains more an issue of "perception" than reality, which could still undermine the confidence in the rulemaking process if left unchecked.[24] Moreover, different authors in this report argue that undue or inappropriate influence over the financial regulatory process could come from a plurality of stakeholders besides the largest financial services firms or the financial sector targeted by the regulation. From this perspective, capture from the industry directly targeted by the regulation is only a subset of different captures, and a multitude of actors within or outside finance are capable to 'exercise an influence that knocks the regulator off its original balance', which may include large consumers[25], NGOs,[26] or politicians following their own electoral considerations.[27]

However, the most important source of disagreement among the different scholars and commentators in this collection of papers concerns the mechanisms through which regulatory policies come to diverge from the public interest and unduly favour narrow interest. Building upon the taxonomy introduced by Baker,[28] it is possible to identify four aspects of the financial policymaking process that make financial regulatory policymaking particularly prone to be captured.

1.2 The Asymmetrical Nature of Stakeholders' Participation in the Regulatory Process

A first element identified by the literature as influencing capture is to be found in the asymmetric participation of different stakeholders in the financial regulatory process**.** The central premise underlying theories of regulatory capture is the notion that the action of regulators is significantly influenced by the mobilization of different organized interests and stakeholders

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[21] Carpenter and Moss (forthcoming) op. cit. in footnote 3. See also Carpenter (2004). 'Protection without Capture: Product Approval by a politically Responsive, Learning Regulator.' *American Political Science Review* 98(4); Baxter (2011), *op. cit. in footnote* 14; Young (2012), op. cit. in footnote 12.

[22] Johnson and Kwak (2010), *op. cit. in footnote* 1.

[23] Carpenter, Moss, and Wachtell Stinnett (this volume).

[24] Strachan (this volume).

[25] Mogg (this volume) argues that in the world of gas and electricity, the risk of undue influence on the regulatory process comes not only from the producers such as power generators and suppliers, but also from the same group that regulators are duty-bound to protect, that is, consumers, in particular large corporate consumers.

[26] The US Environmental Protection Agency (EPA) has sometimes been criticized for being captured by environmental groups rather than the industries it regulates. See Kwak (forthcoming). 'Cultural Capture and the Financial Crisis.' In: *Preventing Regulatory Capture: Special Interest Influence, and How to Limit It*, by Carpenter and Moss (forthcoming). Cambridge, Cambridge University Press.

[27] See Mogg, Briault, Ridley, Green, and Strachan (this volume).

[28] This taxonomy draws upon Baker (2010). 'Restraining regulatory capture? Anglo- America, crisis politics and trajectories of change in global financial governance.' *International Affairs*, 86(3): 647-663

deploying an array of financial and technical resources in the attempt to influence the content of regulatory policies. However, different commentators have argued that in financial regulatory policymaking this competition among stakeholders, to influence the content of financial regulatory policies, is characterized by a concentration of resources in the hands of a restricted range of financial firms.

Much attention has been directed towards the financial resources that these groups are capable of harnessing in the policymaking process.[29] This is particularly the case in the US context, where in the period from 1999 to 2008 the financial sector spent $2.7 billion in reported federal lobbying expenses[30] and the $1.4 million spent daily by financial industry lobbies during the financial crisis to lobby Congress.[31] However, the greater imbalance among societal actors is not in terms of financial resources, but rather in terms of technical information, what Mogg describes as the 'fuel' that regulators require to regulate complex policy environments.[32] Regulatory capture theorists have highlighted how "capture" is more likely when regulation is highly complex and information asymmetries between the regulated industry and the regulators are greater (Laffont and Tirole 1991). The complexity inherent in financial regulatory policies and the built-in advantage that the financial firms targeted by specific regulation have in terms of knowledge and information vis-à-vis other stakeholders are factors that increase the dependence on industry for expertise.

Moreover, many analysts have lamented the lack of engagement with financial regulatory debates from other stakeholders such as deposit holders, investors, and consumers of financial services. Besides being disadvantaged vis-à-vis financial industry groups in terms of financial resources and technical expertise, these groups' voices remain hindered by their diffuse nature and the resulting 'collective action problems'.[33] While the financial groups who are the primary target of the regulation will have strong incentives to constantly monitor and seek to steer the action of regulators, other stakeholders face greater challenges in coordinating and in mobilizing the organizational and informational resources required to compete with the financial industry groups in the marketplace for influencing regulation.[34] Moreover, the survey of respondents to financial consultations conducted by Pagliari and Young find that less than 10% of the private actors responding to financial regulatory consultations belong to trade unions, consumer protection groups, non-governmental organizations, and research institutions.[35]

However, the tendency to aggregate figures regarding the participation of different financial interest groups and the money spent by these groups to lobby policymakers often mask the fact that the interests and demands of different financial groups frequently diverge and in some cases counteract each other. Moreover, also the presence of "consumers" of financial regulatory services in financial regulatory debates is more diverse than most regulatory capture theorists assume. For instance, Mogg suggests that, in the case of energy, regulation is important to differentiate between the millions of households who pay the bills but do not engage in regulatory debates over the energy markets and the large corporate energy consumers who are instead better positioned to solve collective action problems, engage with regulators and resist decisions going against their interests.[36] This insight also applies to the case of financial regulation. Pagliari and Young argue that while

[29] Igan, Mishra and Tressel (2009). A Fistful of Dollars: Lobbying and the Financial Crisis. IMF Working Paper, WP/09/287. Washington, DC; Johnson (2009). "The Quiet Coup." *The Atlantic*, May 2009.
[30] FCIC (2011), p. xviii, *op. cit. in footnote* 1.
[31] Americans for Financial Reform (2010). *Wall Street Influence, By the Numbers*.
[32] Mogg (this volume).
[33] Olson (1965). *The Logic of Collective Action: Public Goods and the Theory of Groups*. Harvard University Press
[34] Stigler (1971), *op. cit. in footnote* 5; Wilson (1980). *The Politics of Regulation*. Wilson. New York, Basic Books; and Mattli and Woods (2009), *op. cit. in footnote* 13. See Farnish (this volume) for the experience of consumers groups.
[35] Pagliari and Young (this volume). See also Pagliari and Young (2012). 'Leveraged Interests: Financial Industry Power and the Role of Private Sector Coalitions'. Available at www.stefanopagliari.net
[36] Mogg (this volume).

NGOs and consumer organizations are proportionally less active in response to financial regulatory policies than in other sectors, non-financial business groups that represent the large end users of financial services are instead active participants and their impact over the design of regulatory policies has indeed increased in the aftermath of the crisis.[37] In other words, debates surrounding financial regulatory policies do not always present the sort of frontal and asymmetrical clash between competing producers' and consumers' interests described by some regulatory capture theorists, but rather they often involve a greater plurality of actors and heterogeneous coalitions comprising both financial and non-financial stakeholders.

1.3 The Institutional Context

A second factor identified by the literature as influencing the possibility that regulatory policies will be captured is the institutional context within which the societal participation discussed above is channelled. Unlike other areas analysed by theories of regulatory capture, financial regulatory policies are seldom designed and implemented by the politicians themselves. Instead, this task is delegated in normal times to independent regulatory agencies that are not part of the executive branch of government.[38] While this delegation of regulatory functions to independent agencies has been an attempt to protect the regulatory process from short-term pressures from politically influential stakeholders, the institutional design of independent regulatory agencies may still tilt the playing field in favour of certain stakeholders.

Despite the statutory autonomy of independent regulatory agencies, financial industry groups continue to maintain a preferential access to regulators and to interact with them in an often opaque and discretionary environment, with many discussions occurring behind closed doors. Other institutional features of environment in which this interaction takes place may lead regulators to unduly favour the financial industry groups under their surveillance.

One of these is the formal mandate of regulatory agencies. In some cases, regulatory agencies have often been granted an explicit mandate to promote the interests of certain groups over others.[39] For instance, certain regulatory agencies such as the US Office of the Comptroller of the Currency are statutorily directed to promote the interests of the banks under their oversight.[40] Similarly, the mandate of the UK Financial Services Authority (FSA) includes a clause to "have regard to" the competitiveness of the financial services industry, an element which has been described as skewing the incentives of regulators, and increasing the risk they will prioritize the role of the international champion of the City of London over other statutory duties.[41]

Others incentives to favour financial industry groups may be embedded in the governance of regulatory agencies. In particular, different regulatory agencies rely on levies applied to the financial industry as the primary source of funding. Financial industry representatives in some cases have a direct representation on the board of regulatory agencies, thus potentially influencing key decisions and the selection of executives.[42] In particular, the governance of the Federal Reserve system has come under the spotlight in recent years, since executives of banks that are regulated by the Fed and that have

[37] Pagliari and Young (this volume); see also Raeburn (this volume) on the experience of corporate end users in the regulatory response to the crisis.

[38] Masciandaro, Quintyn and Taylor (2008). Financial Supervisory Independence and Accountability – Exploring the Determinants. IMF Working Paper, WP/08/147. Washington, DC, International Monetary Fund.. For a theory of capture accounting for the delegation of regulatory power, see Spiller (1990). 'Politicians, Interest Groups, and Regulators: A Multiple-Principals Agency Theory of Regulation, or "Let Them be Bribed".' *Journal of Law & Economics*, 33(1): 65-101.

[39] Hardy (2006). 'Regulatory Capture in Banking.' IMF Working Paper, WP/06/34, January 2006.

[40] Baxter (this volume).

[41] Warwick Commission on International Financial Reform (2009). *In Praise of Unlevel Playing Fields. The Report of the Second Warwick Commission*. Coventry, University of Warwick; Baker (2010), *op. cit. in footnote* 28.

[42] For the governance of central banks with regulatory responsibilities, see Frisell, Roszbach and Spagnolo (2008). 'Governing the Governors: A Clinical Study of Central Banks.' Sveriges Rikbank Working Paper, Series 221.

received emergency loans during the crisis often serve on its board of directors.[43]

Moreover, much attention has been paid towards the hiring practices of regulatory agencies and in particular the "revolving doors" that exist between the financial industry and regulatory agencies. This term points towards the fact that regulators often find that their best working opportunities lie with the firms they regulate, but the reverse trend is also true, that is, the flow of individuals from the industry to regulatory positions.[44] Debates regarding the relationship between revolving doors and regulatory capture have primarily emerged in the US context, where the flow of people between regulators and the financial industry have remained a defining feature of the main regulatory institutions since their creations. European regulatory bodies have instead been characterized by career silos with bureaucrats spending most of their career in the state sector and different restrictions discouraging the transition. However, a shift towards a more US-style flow of individuals between regulatory agencies and the financial industry is noticeable in many jurisdictions such as the UK, where the FSA has in recent years deliberately sought to hire lawyers from the private sector in order to strengthen its enforcement division.[45]

Theories of regulatory capture have held that revolving doors may distort regulatory policies in favour of the financial industry. Firms that hire former regulators have been described as having an unfair advantage over other groups due to insider knowledge and preferential access to the regulatory agency.[46] Most importantly, given regulatory authorities often find in the firms they regulate and supervise the most common source of future employment, this could create incentives to be lenient towards prospective future employers. The academic literature has presented only mixed evidence of this sort of inter-temporal conflict of interest, and some authors have argued that those regulators more likely to be hired by industry are often those that are tougher in their supervisory activity.[47]

1.4 Intellectual Capture

While the traditional concept of regulatory capture in the academic literature has focused on material incentives between regulators and different stakeholders, the recent financial crisis has led a number of authors to broaden this concept and to investigate how the possibility that regulatory policies will favour a narrow set of special interests could be influenced by the regulators' ideas, beliefs and mind-sets. Terms such as "intellectual capture", "cognitive capture", "cultural capture have been used to signal instances where, as Kwak argues, special interests are able to 'shape policy outcomes through influences other than material incentives and rational debate'[48].

For instance, Buiter has argued that in the period before the crisis the Federal Reserve displayed 'excess sensitivity … not just to asset prices but also to the concerns and fears of Wall Street more

[43] GAO (2011a). *Federal Reserve Bank Governance. Opportunities Exist to Broaden Director Recruitment Efforts and Increase Transparency*. United States Government Accountability Office. GAO-12-18. The notion that these banks may benefit from the appointment of their representative on the Federal Reserve boards is supported by the tendency of their stock price to rise in the aftermath of this announcement, while recent research has provided evidence that banks with Fed directorships were more likely to receive public funding during the financial crisis. See Adams (2011). 'Who Directs the Fed?' ECGI - Finance Working Paper, No. 293/2011; Duchin and Sosyura (2010). 'TARP Investments: Financial and Politics.' Ross School of Business Working Papers.

[44] Woodward (2001). 'Regulatory Capture at the U.S. Securities and Exchange Commission.' In Barth, Brumbaugh and Yago, eds (2000). *Restructuring Regulation and Financial Institutions.* Milken Institute Press

[45] Masters (2012). Enter the revolving regulators. *Financial Times*. London. 23 April 2012. For the case of Japan, see Walter (this volume).

[46] Lall (2012), *op. cit. in footnote* 12.

[47] DeHaan, Koh, Kedia and Rajgopal (2011). 'Does the Revolving Door Affect the SEC's Enforcement Outcomes?' Unpublished manuscript. GAO (2011b). 'Securities and Exchange Commission. Existing Post-Employment Controls Could be Further Strengthened', United States Government Accountability Office. Report to Congressional Committees. POGO (2011). 'Revolving Regulators: SEC Faces Ethics Challenges with Revolving Door', Project on Government Oversight. Currie (this volume).

[48] Kwak (forthcoming), *op. cit. in footnote* 26.

generally'[49]. For Dorn, in the period preceding the crisis, 'regulators found it "natural" to utilize models and datasets developed by private interests, so sidelining questions of systemic risk and public interest'.[50] This diagnosis of pre-crisis regulatory failures has been acknowledged by regulators and former regulators and the same Chairman of the FSA, Lord Adair Turner, argued that before the crisis regulatory authorities were prone to 'regulatory capture through the intellectual zeitgeist', which enabled the influence of banking lobbies to hold sway.[51]

However, different views remain regarding what factors determine this form of capture. Several analyses have acknowledged the importance of the broader intellectual climate of the period, in particular the ascendancy within the academic community and many regulatory authorities of ideas highlighting the efficiency of financial markets at understanding and allocating risks, their self-stabilizing nature, and the benefits of financial innovations for the real economy.[52] This change in the dominant paradigm provided the intellectual basis for several important pieces of legislation in the period before the crisis, from Basel II to a greater reliance on disclosure and market discipline, as well as a broader reassessment of the purpose of regulation and a scaling down in the ambitions of regulatory action.[53]

Other authors have identified the sources of intellectual capture inside the regulatory process, and discussed how the repeated interaction between regulators and the financial industry could contribute to align the way in which regulators think about problems with the view of the industry they regulate. Building upon the insights coming from psychological studies on the importance of group identities, Barth, Caprio, and Levine have argued that 'even well-intentioned, incorruptible officials might be subject to the same human psychological factors that induce referees and umpires in sport to conform to the interests of the home crowd'.[54] In the case of financial regulators, the home crowd is represented by the financial services firms with whom they interact on a daily basis in order to perform their regulatory and supervisory duties.

Kwak has further broken down the sources of this bias in favour of the financial services industry and argued that regulators are more likely to trust and to adopt positions advanced by 1) 'people whom they perceive as being in their in-group', 2) 'people whom they perceive to be of higher status in social, economic, intellectual, or other terms', and 3) 'people who are in their social networks'[55]. According to Kwak, financial regulators often identify themselves as 'economically sophisticated steward[s] of efficient financial markets' and are more likely to side with the financial institutions which enjoy a higher prestige because of their technical knowledge and with whom they share more social networks than with consumer groups and other stakeholders. According to Kwak, the potential for this sort of capture increases with the complexity of the problem: 'faced with uncertainty deciding between competing theories of the world and the public interest, people are more likely to fall back on the signals communicated by identity, status, or relationships'.[56]

From a similar perspective, different scholars have argued that the major impact of the revolving doors phenomenon and the repeated interaction between regulators and regulated firms as described above is not the conflict of interests which may result, but rather the nurturing of a kind of 'consanguinity'[57] in the policymaking

[49] Buiter (2009). Central Banks and Financial Crises. *Maintaining Stability in a Changing Financial System*, Federal Reserve Bank of Kansas City.
[50] Dorn (2010). 'The Governance of Securities. Ponzi Finance, Regulatory Convergence, Credit Crunch.' *British Journal of Criminology*, 50(1): 23-45.
[51] Turner (2009). 'Roundtable: How to tame global finance.' *Prospect*, 162,August 27. See also Briault (this volume).
[52] Sheng (this volume); Baker (2010), *op. cit. in footnote* 28.
[53] Warwick Commission on International Financial Reform (2009), *op. cit. in footnote* 41. FSA (2009). *Turner Review: A regulatory response to the global banking crisis*. London, Financial Services Authority
[54] Barth, Caprio and Levine (2012), p. 38, *op. cit. in footnote* 1.
[55] Kwak (forthcoming), *op. cit. in footnote* 26.
[56] Ibid.
[57] Baxter (2011), p. 184, *op. cit. in footnote* 14.

process, supporting a process of intellectual convergence between like-minded individuals across the public and private sector, socialization, and, ultimately, "intellectual capture".[58]

1.5 Capture through the Political Process

Finally, while the different faces of capture described above pertain to the interaction between regulators and the regulated firms, different commentators have broadened this analysis to account for the role of the politicians (governments and legislative bodies) defining the responsibilities that independent regulatory agencies need to follow and granting them the resources and powers to perform these tasks. The relationship between regulators and their political masters creates additional venues for regulatory capture, as different stakeholders will often seek to change the course of action of regulators indirectly through the political process.[59]

The literature has identified different factors influencing the potential that elected politicians will pay heed to the demands of certain special interests and interfere in regulators' actions. First, in countries such as the United States, the financial industry remains one of the major contributors to politicians' electoral campaigns across the political spectrum and it is therefore able to exercise a significant influence over the voting behaviour of Congress on certain regulatory issues. Second, given the significant externalities that certain financial regulatory issues may have on the rest of the economy, politicians may interfere in the actions of regulators in order to achieve key political objectives such as economic growth, employment, social and economic stability. Different authors have therefore highlighted the risk that politicians may pressure regulators in order to achieve short-term political objectives by pleasing powerful electoral constituencies or special interest groups, regardless of changes in the legislation.[60]

This sort of interference is particularly likely in the context of booms. The critical role that the supply of credit plays in ensuring the growth of the economy creates strong incentives for politicians to avoid regulatory policies that may interfere with 'the (apparently) successful prevailing machinery of growth' [61] and jeopardize their chances of re-election. At the same time, the low political salience that financial regulatory issues have during financial booms makes it more likely that arguments regarding the risks generated by inadequate regulatory policies will not resonate with elected politicians.[62] As a result of this political climate, during boom times regulatory agencies are likely to face pressures to be accommodating in the implementation of financial rules, thus hindering their capacity to "remove the punchbowl from the party" – particularly in areas such as prudential supervision and macro-prudential regulation which are more susceptible to economic and electoral considerations.[63]

At the same time, the pressures upon regulators coming from the political sphere may be reversed in the aftermath of crises or scandals. These events are likely to increase the political salience of financial regulatory policies among the broader electorate and can create incentives among elected politicians to be tough on the industry in order to extract electoral rewards.[64] According to different commentators, the financial reforms introduced after the crisis have not been immune from this sort of dynamics.[65] However, a crisis

[58] Tsingou (2008). Transnational private governance and the Basel process: banking regulation, private interests and Basel II. *Transnational Private Governance and its Limits*. Nolke and Graz. London, Routledge. Seabrooke and Tsingou (2009). 'Revolving Doors and Linked Ecologies in the World Economy: Policy Locations and the Practice of International Financial Reform.' CSGR Working Paper, 260/09; Warwick Commission on International Financial Reform (2009), *op. cit. in footnote* 41.

[59] Fullenkamp and Sharma (2012). 'Good Financial Regulation: Changing the Process is Crucial.' *ICFR-Financial Times Research Prize*. Green (this volume). Sheng (this volume).

[60] Sheng (this volume). See also Green (this volume).

[61] Cross (this volume).

[62] Warwick Commission on International Financial Reform (2009), *op. cit. in footnote* 41.

[63] See also Viñals and Fiechter (2010). 'The Making of Good Supervision: Learning to Say "No" '. IMF Staff Position Note SPN/10/08.

[64] Walter (this volume).

[65] According to different commentators, crisis-time regulatory politics may still introduce distortions in the regulation and supervision of financial markets by frequently leading to the

causing a severe deterioration of the economic conditions is likely to increase rather than weaken the influence of the financial sector over the timing and nature of the rules implemented. Periods of slow economic growth may reinforce concerns that regulation may be preventing small businesses from accessing credit and damaging the recovery of the economy.[66] In particular, in those circumstances where an apparent trade-off exists between the mandate of regulatory agencies to bolster financial stability and the goal of promoting economic growth (e.g. defining appropriate capital requirements for banking institutions), then political incumbents as well as a number of societal stakeholders are more likely to support financial industry groups in demanding a watering down of the regulatory measures introduced in the middle of the crisis.[67]

In sum, as a result of the influence that the broader electoral and economic cycles have over the regulatory process, the possibility of financial regulation will be captured by special interests must be regarded as cyclical rather than static phenomenon, alternating between periods of crisis and boom.[68]

Section 2: Towards a Policy Agenda Against Regulatory Capture

This diagnosis of the different determinants of capture in financial regulation reveals how this represents a more multifaceted and complex phenomenon than is portrayed in many journalistic and scholarly accounts. The potential that a piece of regulation will unduly favour certain special interests is influenced by a multitude of factors, such as the kind of mobilization this will raise among different stakeholders, the institutional context, the dominant ideas, as well as the broader political and economic context surrounding the policymaking context.

These different channels and mechanisms make the potential for regulatory capture a partly inevitable aspect of the financial regulatory process, given the information-intensive nature of financial regulatory policies and the proximity with market participants which is required for regulators to stay abreast of market developments. At the same time, while it is implausible that this risk may be eliminated from the regulatory process, the attempts of financial industry groups and other stakeholders to influence the content of regulation towards their interests and the other mechanisms of capture described above can be channelled through mechanisms designed to mitigate their impact.[69]

The rest of this paper will present a wide range of different safeguards and mitigation strategies that could reduce the potential that regulation will diverge from the public interest and unduly favour specific interests These strategies will build upon the academic literature that has examined the making of good regulation, but also from the direct experience of different contributors to this volume in the financial regulatory policymaking, as well as from the experience of other sectors besides finance. For the sake of clarity, these measures will divided across three broad policy approaches to mitigate the risk of capture: 1) measures promoting greater balance and diversity in the competition among different stakeholders; 2) reforms of the institutional context within which regulators operate; 3) opening up the regulatory process to different external checks and balances.

2.1 Rebalancing the Participation of Stakeholders in the Regulatory Process

Different proposals to mitigate capture have therefore focused on redressing one of its main determinants, that is, the imbalance between the

possibility of an excessive tightening of regulation in the moment when it is least desirable ("regulatory overkill"). For a discussion of the distortions in the content of regulations that characterize the policymaking in a crisis, see Green, Ridley (this volume).

[66] Green (this volume).

[67] Walter (this volume).

[68] Warwick Commission on International Financial Reform (2009), *op. cit. in footnote* 41; Baker (2010), *op. cit. in footnote* 28; Johnson and Kwak (2010), *op. cit. in footnote* 1; Helleiner and Pagliari (2011). 'The End of an Era in International Financial Regulation? Towards a Post-Crisis Research Agenda". *International Organization* 65(3).

[69] Baxter (2011), p.188, *op. cit. in footnote* 14.

capacity of financial groups to have their voice heard in the policymaking process and those of other stakeholders, such as depositors, investors, and consumers, whom the proposed rules are designed to protect. While for authors such as Johnson and Kwak this goal requires the breaking up of too big to fail institutions to constrain also their political influence,[70] others have focused on balancing the influence of these financial industry groups by strengthening the plurality of voices in the regulatory process.

The experience of other sectors reveals how the involvement of a plurality of stakeholders besides the producers targeted by the regulation in the regulatory process, such as other business groups, non-governmental organizations and consumer movement organizations, can play a crucial role in keeping the influence of the regulated industry in check and limiting the potential for capture for different reasons. First, in a complex policy environment such as finance, strengthening the plurality of voices and perspectives in the regulatory process is important to reduce the risks that regulators find themselves exposed to one-sided evidence from the regulated financial sector.[71] Second, as Kroszner and Strahan argue, 'competition among rival interest groups can increase the likelihood of beneficial reform. Rival groups have an incentive to battle each other in addition to battling the consumer. If they dissipate their efforts against each other, they are less likely to be able to support narrow special interest regulation.' [72] Third, measures seeking to strengthen the plurality of groups in the regulatory process may also be an important counter to the risk of groupthink and intellectual capture, to the extent that these groups are capable of bringing different ideas and perspectives into the regulatory process.[73]

Three broad views remain among the authors regarding what measures could be introduced to achieve this goal: first, the creation of participatory mechanisms; second, tripartism and proxy advocates; and third, strengthening the diversity of views within the financial industry

2.1.1 Creating participatory mechanisms

Mattli and Woods have argued that regulatory policies are less likely to deviate from the public interest when they are developed through 'participatory mechanisms that are fair, transparent, accessible and open', thus favouring the participation of those stakeholders that are less well connected to the regulators.[74] The main mechanism through which this principle has been translated into the financial regulatory process is by subjecting regulatory policies to public consultations. This approach is increasingly being accepted by most regulatory agencies, although this varies significantly across bodies.

However, as different contributors have argued, public consultations by themselves are unlikely to be sufficient to ensure that a plurality of stakeholders will be capable of having their share of the input into the regulatory process. On this note, different adjustments have been suggested to avoid the risk that consultations may be being conducted solely to discharge formal obligations, such as granting different stakeholders sufficient time to digest the implications of the rules proposed, publicly summarizing the position of the different stakeholders, and justifying how these positions have been treated in respect to the final decision.[75]

Moreover, in order to compensate for the informational advantage of the financial industry insiders participating in these consultations, different authors have also suggested that regulators should grant full access to the information available to them, including, for

[70] Johnson and Kwak 2010, *op. cit. in footnote* 1.
[71] See Carpenter, Moss, Wachtell Stinnett (this volume).
[72] Kroszner and Strahan (2000). 'Obstacles to optimal policy: the interplay of politics and economics in shaping bank supervision and regulation reforms.' Center for Research in Security Prices, Working Paper 512, February 2000), p. 38.
[73] See Carpenter, Moss, Wachtell Stinnett (this volume); Farnish (this volume)
[74] Mattli and Woods (2009), *op. cit. in footnote* 13.
[75] Mogg (this volume). For a discussion of the limits of existing consultations, see Ridley (this volume).

example, their internal data and analyses.[76] Along the same lines, a regulatory agency may be given the power to generate and disseminate information to remedy the public's information disadvantage vis-à-vis the industry. According to Barkow, regulators must be given the power to 'make the public aware of pending issues so that industry is not the only one who knows about them', as well as 'the authority to study and publicize data that will be of interest to the public and help energize the public to overcome collective action problems and rally behind the agency'.[77]

These and other measures to generate and disseminate information and enhance transparency in the consultation process are described not only as prerequisites to allow an informed debate among different stakeholders, but also as tools allowing 'the smaller, less well-funded interests (notably consumer interests and SMEs) to engage in the issues, possibly against the deep pockets of the incumbents'[78].

2.1.2 Tripartism and Proxy Advocates

The introduction of participatory mechanisms is in itself however unlikely to be effective in levelling the playing field and achieving an adequate participation from a plurality of stakeholders. In a highly technical area such as financial regulation, the financial industry groups with the greatest technical expertise continue to be best positioned to take advantage of these mechanisms, while those stakeholders with diffuse membership are constrained in their capacity to take advantage of the channels of access to the policymaking process.

Other authors have therefore discussed the creation of alternative mechanisms to empower the mobilization of groups with a diffuse membership such as the consumers, investors and other groups by granting these groups a privileged position within the regulatory process, what Ayres and Braithwaite call tripartism.[79] Within the context of financial regulatory policymaking, Raeburn has called for a 'form of affirmative action' on the part of regulators to strengthen the voice of those real economy interests whose representative is more fragmented.[80] Farnish has stressed the need to create the conditions for a more proactive engagement of regulators with consumers groups, for instance by investing in processes to gather real-time intelligence from groups, designing consultations in ways that makes better use of consumer representatives' limited resources, and creating direct routes for designated consumer groups to present complaints to which regulators need to respond within a defined timeframe.[81]

However, the capacity of consumer groups and NGOs to effectively engage in the policymaking process continues to be constrained by the fact that most of these bodies active in financial regulatory policymaking are too small, disperse, and underfunded. For other commentators, however, the objective of redressing the imbalance of power between consumers' and firms' resources and strengthening the voice of the former in the policymaking process requires a more direct intervention of policymakers. One mechanism would be that of policymakers' subsidizing the creation of consumer groups. This is for instance the approach adopted in the case of Finance Watch, an organization comprising different consumer groups, retail investor associations, housing associations, trade unions, foundations, think tanks, and NGOs, whose creation has been sponsored by the European Parliament during the crisis with the objective of establishing a more effective counterweight to industry lobbying in regulatory debates.

Another solution relies instead on the creation of "proxy advocates" within the same regulatory institution. These are internal agencies tasked to provide regulators with expertise and information

[76] Ayres and Braithwaite (1991). 'Tripartism: Regulatory Capture and Empowerment.' *Law & Social Inquiry*, 16(3): 435-96. Ridley (this volume); Currie (this volume).

[77] Barkow (2010). 'Insulating Agencies: Avoiding Capture Through Institutional Design.' *Texas Law Review*, 89(1): 15-79, p.59.

[78] Currie (this volume).

[79] Ayres and Braithwaite (1991), *op. cit. in footnote* 76.

[80] Raeburn (this volume).

[81] Farnish (this volume).

from a consumer perspective, to challenge regulatory policies, and to represent the public interest at large in the decision making process.[82] This mechanism is common outside of finance, where different utilities regulators have established standing panels of consumer representatives to provide expert consumer input.

Similar mechanisms have also been established within finance by different US insurance regulators, the European Commission (the Financial Services User Group), and the British FSA (Consumer Panel). However, the capacity of these bodies to truly represent consumer perspectives in the regulatory process is constrained by different factors such the limited resources allocated, as well as their location within the organization. For this reason, Farnish has called to supplement internal proxy advocates with independent external consumer bodies that may benefit from a greater independence, capacity to set their own agenda, and capacity to speak out publicly if they disagree with the decisions of regulators.[83]

2.1.3. Strengthening Competition within the Financial Industry

While the strategies described above seek to mitigate capture by increasing the capacity of consumers of financial services and other non-financial parties to act as counterweights to the producers' interests, this strategy is less applicable in the case of those markets where the counterparties are not retail consumers but rather other financial groups, such as in the case of wholesale markets.[84] Different authors have therefore advocated the introduction of measures to encourage the emergence of countervailing forces against the risk of capture from within the same financial industry and to promote a greater engagement of those financial groups with a material incentive in stronger regulation.[85]

Different industry practitioners have argued that it is in the long-term interest of the financial industry to promote a strong regulatory infrastructure capable of achieving stability and restoring confidence in the financial system. However, short-term competitive concerns, rather than the long-term interests in a more stable regulatory environment, seem to have dominated in different circumstances the engagement of financial groups in the policy arena. For instance, in the case of banking regulation, the capacity of investors in bank debt to act as a countervailing force to the management of banks is constrained by the disperse nature of the investor community, the short-termism of part of it, and factors constraining market discipline such as deposit insurance schemes or the moral hazard created by "too big to fail" institutions.[86] Similarly, in the case of the regulation of hedge funds, the incentives for banks that provide these investment vehicles with leverage to lobby in favour of safer standards may be affected by the fact that many of the same banks also sponsor hedge funds. Moreover, the mobilization of powerful industry groups is particularly difficult in the case of complex systemic risk regulation, though the industry as a whole would have a strong incentive to address this kind of risk.

Different authors have therefore suggested that regulatory mechanisms should be devised to better align the participation of financial industry groups in the policymaking process with the promotion of stronger regulation. Strachan has proposed the establishment of a 'standing body of practitioners' reflecting the composition of the financial services industry as a whole and therefore less susceptible to the demands of particular interest groups.[87] Porter suggests that giving rewards to 'whistleblowers' who reveal regulatory violations could give rise to a set of

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[82] Schwarcz (forthcoming). Preventing Capture Through Consumer Empowerment Programs: Some Evidence from Insurance Regulation. In: *Preventing Regulatory Capture: Special Interest Influence, and How to Limit It*, by Carpenter and Moss (forthcoming). Cambridge, Cambridge University Press.

[83] Farnish (this volume). See also Ridley (this volume).

[84] Ridley (this volume).

[85] Porter (this volume). Walter (this volume). Helleiner and Porter (2010). 'Making Transnational Networks More Accountable.' *Economics, Management and Financial Markets*, 52.

[86] FSA (2009), *op. cit. in footnote* 17.

[87] Strachan (this volume).

firms with a strong interest in preventing regulatory forbearance and capture. Similarly, requiring banks to issue contingent capital – bonds that convert into equity in time of crisis – may strengthen the incentives for bondholders to promote strong prudential regulation.[88] Helleiner and Porter propose to maintain some separation between the ownership of clearinghouses and dealers, so that the former will retain 'an incentive to protest against regulatory initiatives that would create opportunities to undermine or bypass clearing arrangements'.[89] The internal attitude of financial firms towards the regulatory process may be altered through changes to liability rules. For instance, Baxter argues that extending the fiduciary duties of the board and of top executives to cover others as well as shareholders may also affect the incentives of the industry towards regulatory policies.[90]

In sum, the objective of promoting a greater plurality of voices and perspectives in the regulatory process can be achieved not only by opening up the rule-making process to stakeholders outside of the financial industry that are currently under-represented, but also by actively promoting a greater engagement of those actors within the financial industry with a material interest in preventing capture.

2.2 Reforming the Institutional Context

Measures seeking to mitigate capture by bringing in the regulatory process the input of a wider range of stakeholders are unlikely to be effective in cases when the same institutional context within which the stakeholder input is processed into regulatory policies is perceived as favouring certain interests over others. Similarly, these measures are unlikely to be able to address the problem of capture during the process of financial supervision, which is based on a continuous interaction between the supervisor and the firm that is supervised. A second approach to mitigate the risk of capture has therefore focused on addressing those institutional biases which create incentives for regulatory actors to favour financial industry groups under their supervision.

Granting regulatory agencies statutory independence and insulating the regulatory process from political horse-trading and the short-term pressures of politicians interested in appeasing politically influential special interests have frequently been presented as the primary institutional fix to protect the diffuse interest of the general public against the risk of capture.[91] Independence is a particularly valuable safeguard against capture in those areas that are more susceptible to economic and electoral considerations, such as prudential supervision and macroprudential regulation, where regulators are more likely to be subject to strong pressures not to lean against the wind during boom times. Regulatory independence remains an important safeguard to allow regulatory authorities to resist capture and to conduct themselves with a "through the cycle" mentality and resist the forces toward leniency during periods of economic booms.[92]

However, the statutory autonomy of regulatory agencies is not in itself a sufficient safeguard against the risk of capture, especially when some institutional features of the agencies may have the impact of biasing the conduct of regulators towards certain groups. As Barkow has argued, 'under modern conditions of political oversight, other design elements and mechanisms are often just as important to an agency's ability to achieve its long-term mission relatively free from capture'.[93] The institutional design elements discussed in this section regard 1) the mandate of regulatory agencies, 2) their internal decision making procedures, 3) the staffing and recruitment practices of regulatory agencies, and 4) the way regulatory agencies are funded.

[88] Porter, this volume.
[89] Helleiner and Porter (2010), op. cit. in footnote 85.
[90] Baxter (this volume).

[91] For a review of this literature, see Barkow (2010), *op. cit. in footnote* 77. The importance of statutory independence has been discussed in this volume by Mogg (this volume), Green (this volume), and Diplock (this volume).
[92] Valencia and Ueda (2012). Central Bank Independence and Macro-prudential Regulation. IMF Working Paper, WP/12/101.
[93] Barkow (2010), p.17, *op. cit. in footnote* 77.

2.2.1 Mandate

First, different authors have acknowledged how the mandate that regulators receive in the legislation by parliament may affect the possibility that the conduct of the same regulatory agency will be captured by special interests. Barkow argues that giving regulatory agencies a broad jurisdiction makes it more likely that these will be able to resist pressure from narrow groups. At the same time, if a regulatory agency is given 'conflicting responsibilities that require the agency to further the goals of industry at the same time that it is responsible for a general public-interest mission', it is likely that 'industry pressure and a focus on short-term economic concerns that are easily monitored will trump the long-term effects on the public that are harder to assess'.[94]

From this perspective, the approach common to many financial regulatory bodies of postulating a broad range of duties and placing upon the regulator the responsibility of balancing these duties is described by different authors as particularly problematic.[95] Ambiguities in the mandate of regulatory and supervisory agencies, or the presence of more distinct objectives, may lead regulatory agencies to unduly prefer one at the expense of the other and create opportunities for firms seeking to exploit those situations where supervisors can exercise discretion.[96] Clearly identifying a primary duty of the regulators could support them in asserting their independence of politicians and special interests.[97]

2.2.2 Internal Decision Making Procedures

Besides the formal mandate of regulatory agencies, other proposals have focused on those internal processes through which regulatory decisions are taken that may make regulators more likely to unduly favour narrow interests. For instance, different authors have discussed how rotating regulatory staff periodically, similar to the rotation policy that exists for auditing purposes, may play a role in preventing supervisors from developing excessive affinity with the market actors they regulate or an excessively narrow understanding of their responsibilities.[98] According to Strachan, the same objective could also be pursued by subjecting the approach of individual supervisors to the scrutiny of an internal peer review process, as well by ensuring that the most important decisions, such as those 'around capital, liquidity, the overall supervisory evaluation and enforcement action' are taken by a committee rather than by individual supervisors.[99]

Reforms in the internal decision making procedures may also be adopted in order to ensure that the development of regulatory policies takes into account a broader set of concerns and voices. For instance, different authors have suggested that all policy proposals should be subject to an impact assessment to identify the implications for the real economy,[100] or should be assessed against a consumer checklist.[101] Currie has also discussed the empowering of internal panels to perform an internal audit function, checking whether the 'regulatory decision making had placed the consumer and citizen interest at the heart of its processes from the outset'.[102]

Moreover, internal adjustments in the organizational elements and decision-making processes of regulatory agencies are also instrumental in order to address the issue of intellectual capture. For instance, exposing key decisions to a wider consideration of people with different backgrounds and mind sets may play an important role in mitigating the risk of intellectual capture which derives from the proximity that develops between firms and their supervisors.[103] The IMF Independent Evaluation Office (IEO) has recommended to 'actively seek alternative or dissenting views by involving eminent outside analysts on a regular basis in Board and/or

[94] ibid. p. 50.
[95] Walter (this volume); Currie (this volume).
[96] Walter (this volume); Strachan (this volume).
[97] Currie (this volume); Green (this volume).
[98] Strachan (this volume); Sheng (this volume); Baxter (this volume).
[99] Strachan (this volume).
[100] Raeburn (this volume).
[101] Farnish (this volume).
[102] Currie (this volume).
[103] Currie (this volume); Strachan (this volume).

Management discussions', and to better reflect areas of significant disagreement and minority views in internal documents. Another set of proposals from the IEO has focused on 'strengthen[ing] the incentives to "speak truth to power" ', such as encouraging staff to challenge the views of the management and of the country authorities supervised by the Fund, as well giving the staff 'the possibility of issuing reports without the need for Board endorsement'.[104] Along these lines, different authors have suggested that regulatory agencies should institutionalize within their structure a 'devil's advocate' figure to raise contrarian viewpoints,[105] or create internal advisory boards 'to challenge and think the unthinkable'.[106]

Finally, internal adjustments in the processes through which regulatory policies are designed and implemented could also be introduced to mitigate the cyclicality of regulatory capture. In particular, different authors have discussed how formal mechanisms could be introduced to review the legislation and regulatory approach periodically, 'irrespective of whether a crisis or scandal has taken place and irrespective of the general health of the economy', in order to mitigate the impact of the electoral and economic cycle over the content of regulation.[107]

2.2.3 Staffing and Recruitment

Another set of proposals has sought to mitigate the incentives for regulatory agencies to unduly favour the regulated industry which may emerge from their staffing and recruitment practices, and in particular from the "revolving doors" phenomenon.

Two competing approaches have emerged on this issue. Different commentators called for steps to constrain, as much as possible, the appointment in regulatory positions of people with industry backgrounds that may create frequent impartiality conflicts or to bar regulators from finding employment with industries that may have benefited from their work in the past.[108] The Governor of the Bank of England, Mervyn King, has argued that the best way to improve supervision and regulation should be to 'create people who believe that it is a public-service calling to work in the Bank of England and spend a good chunk, if not all, of their career as banking supervisors'.[109]

On the other hand, other authors have stressed the fact that the regulation and supervision of complex financial activities requires the kind of technical expertise and understanding of the economics and business models of the industry and that this is likely to be found uniquely among those people with a direct experience working in the financial services industry.[110] As a result, seeking to dissuade the exchange of people across regulatory agencies and the firms they regulate may be detrimental, insofar as this limits the capacity of regulatory agencies to recruit people with the relevant expertise. Contrary to what is argued by Mervyn King, different commentators have therefore argued that public policies should encourage, rather than restrict, the exchange of people between the industry and regulatory agencies – through secondments, structured training programmes for supervisory staff,[111] internships for their staff to financial institutions outside of the jurisdiction being supervised,[112] or

[104] IEO (2011). 'IMF Performance in the Run-Up to the Financial and Economic Crisis: IMF Surveillance in 2004–07', Independent Evaluation Office of the International Monetary Fund.

[105] Kwak (forthcoming), supra footnote 26. See also Carpenter, Moss, Wachtell Stinnett (this volume).

[106] Currie (this volume).

[107] Green (this volume); Ridley (this volume). The danger associated with this proposal is that the periodic review may occur during the wrong point in the cycle, creating new opportunities for certain actors to seek to water down the regime.

[108] See proposal by US Senator Ted Kaufman cited in Lin (2010). SEC's 'revolving door' under scrutiny. MarketWatch. 16 June 2010.

[109] Cited by Masters (2012).

[110] Che (1995). 'Revolving Doors and the Optimal Tolerance for Agency Collusion.' *RAND Journal of Economics*, 26(3): 378-97. GAO (2011b). Maskell (2010). 'Post-Employment, "Revolving Door", Laws for Federal Personnel', Congressional Research Service. See also Ridley, Strachan, and Walter (this volume).

[111] Strachan (this volume).

[112] IIF (2011). *Achieving Effective Supervision: An Industry Perspective*, Institute of International Finance.

by developing a multistage career pattern in both sectors.[113]

Different approaches have therefore been suggested to allow regulatory agencies to acquire the expertise needed from the market, while seeking to mitigate the conflict of interests that may arise.

One set of proposals has focused on injecting greater transparency on the movement of people between regulatory agencies and the financial industry, for instance requiring public disclosure in a registry of the history of those ex-regulators who represented clients before their former agency, or, more broadly, requiring regulatory agencies to disclose publicly the ties of individual regulators with the private sector.[114] Other proposals have focused on the establishment "cooling off periods", stipulating a minimum number of years required before regulators are able to seek employment with interests that may have significantly benefited from the policies they formulated, or prohibiting for new employees from the industry to be being involved in matters related to their former private-sector employer.[115]

Different approaches have focused instead on calibrating the scope of employment restrictions according to the level of seniority. Currie has suggested that tougher standards for pre- and post-employment restrictions should apply to senior executive teams and to the board of regulatory institutions, allowing in the latter case 'no conflicts and no immediate past involvement with any of the major players'.[116] This approach would rectify the anomalous presence of people with direct involvement in the banking industry that characterizes the most senior positions and the board of different financial regulatory bodies, while still allowing these institutions to recruit the required expertise in the market.

Another set of mitigating strategies relies on complementing the presence of regulatory staff with direct experience from the financial industry with a group of career supervisors who identify their long term future with its public service aims and objectives and who have a more questioning attitude towards the latest market trends and innovations.[117] In a similar vein, Green argues that while some of the skills required in order to provide effective supervision can be 'brought in from the market', the broader understanding of the wider market environment as a whole – a prerequisite for effective supervision – 'only comes with a certain minimum supervisory experience in terms of both length and breadth of service'.[118]

Finally, an alternative approach would be that of balancing the recruitment of regulators with current knowledge of the industry with people who possess a diversity of professional experiences and training.[119] For instance, Raeburn has argued that financial regulatory agencies need to recruit individuals whose backgrounds qualify them to recognize the impact of regulatory policies beyond the 'usual suspects' of the participants in financial markets.[120]This approach is particularly important to inject greater intellectual diversity into the activities of regulatory agencies and to reduce the risk of groupthink. As Chwieroth argues, recruitment procedures represent a 'pathway through which new beliefs can be transmitted' to the organization, and organizations that recruit uniquely among individuals with a particular type of training remain particularly vulnerable to developments within that sector or profession.[121] For instance, the IMF has in the past broadened its recruitment patterns in order to 'bring to the Fund a small number of career staff who might approach policy questions from a new and

[113] Ridley (this volume).
[114] POGO (2011), *op. cit. in footnote* 47.
[115] Helleiner and Porter (2010), *op. cit. in footnote* 85. and POGO (2011), *op. cit. in footnote* 47.
[116] Currie (this volume).

[117] Strachan (this volume)
[118] Green (this volume)
[119] Currie (this volume), Raeburn (this volume), and Farnish (this volume).
[120] Raeburn (this volume).
[121] Chwieroth (2009). *Capital Ideas: The IMF and the Rise of Financial Liberalization*. Princeton, NJ, Princeton University Press, pp. 249-50.

somewhat different perspective',[122] seeking in this way to counter the criticisms presented against the organization for displaying "less intellectual diversity than the Pentagon".[123]

2.2.4 Funding of Regulatory Agencies

A final set of institutional reforms has identified in the source and the level of funding of regulatory agency the key to mitigate the internal incentives that may make regulators prone to be captured. The difference in salary between the private and public sectors remains one of the primary determinants of the revolving doors phenomenon, as inadequate funding limits the capacity of regulatory agencies to retain experienced staff. Moreover, limited resources constrain the capacity of regulatory agencies to conduct research, generate knowledge, and to be a source of new ideas, thus increasing the risk that regulators will defer to the financial industry and rely excessively on its information.[124]

Unfortunately, the resources available to regulatory agencies have often failed to keep up with their expanding responsibilities. For instance, while from 1939–2009 the number of SEC employees has little more than doubled, the number of shares trading hands each day in the US has increased more than twenty times.[125] Also, the recent investigation in the UK into the failure of the Royal Bank of Scotland has raised concerns regarding the inadequacy to the funding of regulatory agencies, as the task of supervising a bank with a presence in over 50 countries and employing 226,400 people was fulfilled at the beginning of the crisis by a team comprising only four-and-a-half members.[126] This resources discrepancy has been aggravated by the response to the crisis, as the significant expansion in the remit and responsibilities of different regulatory agencies has in some cases been followed by denials of adequate funding to perform these additional tasks.[127] From this perspective, increasing the resources available to regulatory agencies may be regarded as a mechanism to mitigate the risk of capture by increasing their capacity to recruit and retain experienced staff and decreasing their reliance on the financial industry.

Different views remain however regarding what kind of funding model would achieve this goal while reducing the possibility of regulatory capture. The government represent the most natural source of additional funding but this may increase the risk of capture by giving political actors undue influence over the regulatory process, and in particular giving the government the power to "starve" the regulator of resources to constrain its operations.[128] Indeed, Walter has argued that systematic under-resourcing of regulatory agencies in the United States in the period before the crisis represented 'a common legislative tactic that contributed to the undermining of effective regulation'.[129]

However, also the alternative of funding the activities of regulators through a levy upon specific financial institutions, or more broadly on the financial system,[130] has the potential to worsen the problem of capture by increasing the sense of obligation of regulators towards the firms

[122] IMF Administration Department, cited by Momani (2005). 'Recruiting and Diversifying IMF Technocrats.' *Global Society*, 19(2): 167-87.
[123] Finnemore, in: IMF (2002). 'Governing the IMF.' Transcript of an Economic Forum, International Monetary Fund.
[124] Walter (this volume); Fullenkamp and Sharma (2012), *op. cit. in footnote* 59.
[125] Grocer (2010). Want to Fix SEC's Revolving Door? Give the Agency More Money. *Wall Street Journal*, 16 June 2010.
[126] FSA (2011). 'The failure of the Royal Bank of Scotland.' Financial Services Authority Board Report, London, Financial Services Authority, section 3.3. The investigation has concluded that 'the approach to resourcing the supervision of the largest banks was fundamentally flawed and, critically, the resources applied were far too low adequately to meet the challenges of supervising RBS', pp.279-80.
[127] Baxter (this volume); Ridley (this volume).
[128] Strachan (this volume); see also Diplock (this volume)
[129] Walter (this volume). The former chairman of the SEC Arthur Levitt argued that during his tenure Congress constantly threatened the SEC with budget cuts if it pursued more assertive regulatory efforts. See Barkow (2010), *op. cit. in footnote* 77.
Fullenkamp and Sharma (2012), *op. cit. in footnote* 59.
[130] E.g. see Hardy (2006); ibid. According to proposed legislation presented by the US Treasury in December 2011, the cost of the newly created Federal Stability Oversight Council will be raised by collecting semiannual fees from US bank and foreign banks, as well as nonbank institutions that fall under the supervision of the Federal Reserve.

that fund their activities.[131] An alternative to these two funding models proposed by Currie is that of a mixed model differentiating between the source of the funding and control over it, where funding comes mainly from the industry but the government oversees the level of funding.[132] However, given the difficulty for any of these funding mechanisms to raise enough resources for public sector salaries to be able to compete with those in the financial industry, Baxter has discussed the importance of developing non-monetary forms of compensation in the public sector and the importance of boosting the 'reputation and prestige' of regulatory agencies.[133]

Moreover attempts to mitigate the risk of capture by raising the resources of regulatory agencies may be reinforced by the introduction of measures to better align the compensation structure of regulators with the public interests. Different authors have called for regulating the compensation of regulators in a way similar to the measures to regulate bonuses now considered in the banking industry. Proposals along these lines include that of deferring the majority of regulators' pay so that a regulator would lose some of it in the case that shortcomings in his actions come to light, or requiring part of this deferred compensation to be invested into a fund that provides capital insurance to financial companies.[134]

In conclusion, a clear and unbiased mandate, adequate internal procedures which expose regulatory decisions to a variety of views, an adequate framework to manage conflicts of interest from the revolving door issue, and appropriate funding are important prerequisites for regulators to be able to carry out their duties without unduly favouring certain special interests.

[131] Strachan (this volume).
[132] Currie (this volume).
[133] Baxter (2011), *op. cit. in footnote* 14.
[134] Bebchuk and Spamann (2010). 'Regulating Bankers' Pay.' *Georgetown Law Journal*, 98(2): 247-87. Kane (2010). 'The Importance of Monitoring and Mitigating the Safety-Net Consequences of Regulation Induced Innovation.' *Review of Social Economy*, 58. Fullenkamp and Sharma (2012), *op. cit. in footnote* 59. For a discussion see Barth, Caprio and Levine (2012), p. 227, *op. cit. in footnote* 1.

2.3 External Checks and Balances

While the policy measures discussed in the previous sections have sought to mitigate the risks of capture from the inside, by correcting the access of stakeholders to the regulatory process and the institutional elements that may bias regulators towards the regulated financial industry, other policy approaches have focused on subjecting the regulatory process to a set of external checks and balances and ensuring that regulatory authorities are constantly supervised, held accountable, and challenged.

In theory, the conduct of regulatory agencies and the possibility that these will unduly favour special interests are already subject to multiple checks. A first set of checks is provided from their board and other internal review mechanisms. A second line of defence comes from the scrutiny of parliamentary committees or branches of government to which regulatory agencies are periodically required to respond and which ultimately remain the 'guardians of the balance of interests' in a democratic context.[135] Third, the media, as well as a plurality of NGOs, research institutes, consumer groups, and business groups both outside and within the financial sector all play a key role in making elected policymakers more attentive to the broader impact of regulatory policies on their constituency.[136]

However, in practice the effectiveness of these checks to ensure that no special interest has acquired a disproportionate influence is severely constrained. The oversight of parliaments may be affected by short-term electoral incentives. The composition of the boards of regulatory agencies may skew its action. The informational asymmetry and limited transparency which often characterize financial regulatory policymaking, as well as the limited resources of public interest groups may limit their capacity to scrutinize the operation of

[135] Strachan (this volume).
[136] For the role of the media in preventing capture, see Dyck, Moss and Zingales (2008). 'Media versus Special Interests.' NBER Working Paper Series No. 14360. For the role of NGOs and other groups see Scholte and Schnabel, eds. (2002). *Civil society and global finance*. London, Routledge, and Porter (2005). *Globalization and Finance*. Cambridge, MA, Polity.

regulatory institutions. As Baxter argues, 'these traditional checks seem inadequate to ensure a balance of interests because so many regulatory decisions, from emergency lending by the Fed to daily regulatory sanctions or approvals go unnoticed'.[137]

Different proposals to mitigate the risk that regulatory agencies will be captured by special interests have therefore focused on strengthening the external checks surrounding the regulatory system or on creating new ones. Four sets of proposals are discussed in this section: 1) measures to enhance the transparency of the policymaking process; 2) measures to strengthen the scrutiny by the judicial system; 3) the creation of independent expert bodies; and 4) checks from other regulators at the national and international level.

2.3.1 Transparency

One of the easiest ways to promote greater accountability and to favour the monitoring of instances of undue influence of special interests is that of increasing the transparency of the financial regulatory process. [138] For instance, different commentators have suggested that regulatory agencies should be required to publish on their websites details regarding their meetings with industry representatives, to make publicly available which groups comment on a regulatory proposal and whether they would be affected by the proposal together with the content of their response, as well as how the views of these groups have been taken into account in reaching the final conclusions.[139] Measures to enhance the transparency of the relationship between regulators and the regulated industry would be particularly valuable in the implementation phase of regulatory policy, where the confidentiality of supervisory relationships may make it more difficult to detect cases of capture.[140]

Some of these measures seeking to enhance the disclosure of information regarding the exchange between regulators and different firms have been criticized on the basis that they could force firms to disclose commercially sensitive information that may be used by their competitors. From this perspective, too much transparency would have the negative effect of deterring firms from sharing their information with regulators. Moreover, during the crisis the Federal Reserve have during the crisis resisted the demands to disclose information regarding its emerging lending activities. However, according to Baxter, existing restrictions on the disclosure of information with regard to the interaction between regulators and the regulated firms 'have ended up protecting the central bank and financial institutions from political and shareholder accountability more than preserving financial stability'.[141]

There are however objective limits to what greater transparency can achieve in detecting instances of capture. Unlike in the area of central banking, there are objective limits to the possibility of quantifying and communicating the extent to which the objectives of regulation are met. Moreover, even if all information were released to the public, this does not guarantee that there will be actors with the resources and incentives to process it and monitor regulators' actions.[142]

2.3.2 The Legal System

Another potential source of external checks against the risk of capture could come from the legal system. As the experience of other sectors reveals, granting the right for different stakeholders to appeal some regulatory decisions to the courts, either owing to process failures or to substance, may provide an external check over those situations where regulatory decisions are not based on solid evidence and where special interests play an excessive influence.[143] According

[137] Baxter (this volume).
[138] Currie (this volume); Baxter (this volume).
[139] See The Regulatory Information Reporting Act introduced by Senator Sheldon Whitehouse in July 2011; Strachan (this volume); Mogg (this volume).
[140] Walter (this volume)

[141] Baxter (this volume).
[142] Barth, Caprio and Levine (2012), p.12.
[143] Magill (forthcoming). 'Courts and Regulatory Capture.' In: *Preventing Regulatory Capture: Special Interest Influence, and How to Limit It*, by Carpenter and Moss (forthcoming).

to Magill, the greater independence of judges from the political system and their longer tenure may make them less prone to being captured than regulators.[144] Moreover, the presence of a legal review process may also have indirect benefits by favouring the accountability of regulators. As Currie argues, the presence of an external legal review may make the regulator 'much more mindful of the need to ensure that its decisions comply with its statutory duties and are well reasoned and grounded in fact'.[145]

However, similarly to the measures to increase the level of transparency discussed above, also the application of this approach in the financial regulatory sphere incurs into some severe limitations. The scope of financial regulatory decisions that can be subjected to judicial checks as a mechanism to detect instances of capture is limited by the nature of financial regulatory policies. In particular, the technical complexity of financial regulatory issues, the difficulty of clearly identifying instances when regulators have deviated from the public interest, and the fast pace of the issues regulators have to deal with on a daily basis frequently clash with the slow nature of judicial review. Moreover, while some authors present judicial review as a factor levelling the playing field and allowing also the weaker stakeholders to challenge episodes of capture by the strong, this solution may also have the opposite effect of empowering those parties with more resources since these are in a better position to take advantage of this mechanism.[146]

2.3.3 Expert Review Bodies

Given the limitations to the existing checks on the regulatory process, different authors have proposed the creation of external independent watchdogs with the responsibility to check the operations of regulatory authorities in order to detect deviation from the public interest.

Cambridge, Cambridge University Press; Mogg (this volume); Currie (this volume).

[144] Magill (forthcoming), *op. cit. in footnote* 143

[145] Currie (this volume).

[146] Barkow (2010), *op. cit. in footnote* 77.

For instance, Barth, Caprio, and Levine have called for the creation of an independent institution called the "Sentinel" whose unique power would be to acquire information required to assess financial regulation and to provide an expert and independent assessment of financial policies, thus allowing an informed debate.[147] Along the same lines, Omarova has advocated the creation of a "Public Interest Council" in charge of advising Congress and regulators with respect to issues of public concern.[148] Baxter has proposed a more limited solution in the form of a self-funding consulting organization that could be consulted on key financial regulatory issues, to be established on the model of the MITRE organization, a not-for-profit organization created in the US to conduct research on national defense issues.[149] Moreover, Howard Davies has discussed the possibility that a 'Sentinel-like body' could be set up by the financial industry itself.[150]

While these bodies would be staffed experts and focus uniquely on financial regulatory issues, other proposals have instead suggested that this public interest check over financial regulatory policies should be performed by a body whose remit goes beyond finance. Examples in this regard are the "Office of Regulatory Integrity", as proposed by US Senator Sheldon Whitehouse in the Regulatory Capture Prevention Act of 2011, or the Australia's Productivity Commission discussed by Walter.[151] As Walter argues, 'requiring all legislation/rule setting to pass through a general public interest review process would help because the controversial concept of the "public interest" should be defined transparently and in general terms rather than on a sectoral basis'.[152]

[147] Barth, Caprio, and Levin (2012), op. cit. in footnote 1; Levine (2010). 'The Governance of Financial Regulation: Reform Lessons from the Recent Crisis.' BIS Working Paper 329.

[148] Omarova (2012). 'Bankers, Bureaucrats, and Guardians: Toward Tripartism in Financial Services Regulation.' *Journal of Corporation Law*, 37(3).

[149] Baxter (this volume).

[150] Davies (2010). 'Comments on Ross Levine's paper "The governance of financial regulation: reform lessons from the recent crisis".' BIS Working Paper 329. See also Levine (2010), *op. cit.* in footnote 147.

[151] Walter (this volume).

[152] Walter (this volume).

Finally, the case for the establishment of Sentinel-like bodies has been presented not only at the national, but also at the international level. In particular, Diplock has proposed the creation of a public interest oversight body composed of international experts with no active regulatory roles, tasked to make recommendations to the members of the international regulatory community regarding to what extent international standards meet the test of public interest.[153]

However, important concerns regarding the effectiveness and viability of subjecting the work of regulatory agencies to the scrutiny of expert public interest bodies, in particular regarding how would be possible to finance these bodies without further depriving existing regulatory institutions of resources,[154] and to what extent the highly political task of defining what is the public interest on a given regulatory issue can be 'entrusted to a group of disinterested "wise men"'.[155]

2.3.4 Checks from Other National and International Regulators

Given the political difficulties in creating and funding new Sentinel-type of bodies, an alternative source of checks and balances against capture may be provided by other regulatory agencies. Not only does the division of regulatory responsibilities across different agencies make it more difficult for any single group to dominate the regulatory process, but also it creates the potential for each regulator to represent a source of reciprocal oversight against undue interference of special interests in the work of other bodies. This kind of reciprocal oversight is particularly likely when different agencies have competing mandates, as well as when they are subject to consultation requirements or shared oversight over certain markets.[156]

From this perspective, recent innovations introduced in different countries in response to the financial crisis have improved the conditions for this source of reciprocal checks and balances to emerge. For instance, the crisis has led in different countries to bodies with macroprudential mandates, which may provide a system-wide perspective and challenge the undue influence of special interest in specific sectors.[157] Newly created institutions such as the Consumer Financial Protection Bureau in the US or the Financial Conduct Authority in the UK have been given an explicit mandate to protect consumer interests in the regulation of financial products.[158] The crisis has also led to the creation of institutions such as the US Office of Financial Research, which according to Barth, Caprio, and Levine 'might in theory act like a Sentinel'.[159] The creation of bodies such as the US Financial Stability Oversight Council, which includes the major regulatory institutions, has opened up a new platform to foster communication between regulatory bodies.

A source of reciprocal oversight on the work of regulatory authorities may also come from the international level. Different mechanisms have been created over the years to subject national regulatory agencies to the scrutiny of international institutions. The East Asian financial crisis of 1997-8 has led the International Monetary Fund and World Bank to expand their remit to include periodically reviewing the financial system of their member countries through the Financial Sector Assessment Program (FSAP) and the Reports on the Observance of Standards and Codes (ROSC). The effectiveness of this review has, however, frequently been questioned, in particular given the capacity in the past of individual countries to block the publication of these reports, and the limited power of international institutions to challenge their most important countries.[160]

An alternative source of international checks could come from national regulatory authorities in foreign countries. The international competitive

[153] Diplock (this volume).
[154] Baxter (this volume).
[155] Davies (2010), *op. cit. in footnote* 155.
[156] Barkow (2010), *op. cit. in footnote* 77.
[157] Briault (this volume).
[158] Barkow (2010), op. cit. in footnote 77.
[159] Barth, Caprio and Levine (2012), p. 225, *op. cit. in footnote* 1.
[160] Walter (this volume).

dynamics that characterizes many financial markets mean that foreign regulatory authorities will have a strong incentive to denounce when their counterparts engage in regulatory forbearance and weak compliance in the implementation of internationally agreed standards that may give their domestic firms at a competitive advantage vis-à-vis their foreign competitors.[161]

Different innovations introduced since the crisis have created opportunities for national regulatory authorities to monitor the conduct of their counterparties and to identify national departures from international rules that lack reasonable public interest justifications.[162] G20 countries have agreed to be subject to periodic peer reviews conducted under the aegis of the Financial Stability Board (FSB), both on a thematic and on a country basis. The FSB has also been given the authority to propose exceptional measures for countries lagging behind in the implementation of internationally agreed standards, including blacklisting non-cooperative jurisdictions.[163] The FSB, in the conduct of its peer reviews, has established procedures to manage bilateral complaints regarding other countries' non-adherence to internationally agreed standards, potentially tilting the playing field in favour of their national firms.[164] Similar peer reviews will also be conducted at the European level by the newly established European supervisory authorities to monitor the implementation of the European single rulebook among different European countries. Moreover, the potential for host-country authorities to monitor instances of regulatory capture in the policies implemented by their foreign counterparties has been increased by the creation of "colleges of supervisors" to supervise internationally active firms, from banks to insurance firms. Pressures from foreign authorities through peer reviews and colleges of supervisors may play a valuable role in preventing the design and implementation of regulatory policies which may unduly favour home-country financial institutions at the expense of other jurisdictions.

In sum, it is important to acknowledge how some of the institutional innovation that have been set in motion during the response to the crisis have the potential to increase the level of external scrutiny against the risk of capture.

3. Conclusions and Summary of the Contributions to this Volume

This paper has sought to shed light on the challenges brought about through the continuous and intense interaction between financial regulators and market actors that characterize the regulatory policymaking process in finance, and the numerous mechanisms that may lead the content of regulatory policies to diverge from the public interest and unduly favour special interests. While the multifaceted nature of regulatory capture and complexity of financial markets make this risk an inevitable aspect of the regulatory process, this chapter has illustrated a variety of policy approaches through which such risk can be in part mitigated by enhancing the plurality of voices in the policymaking process, correcting those institutional elements which may bias regulators' actions in favour of special interests, and reinforcing external scrutiny over the regulatory process.

The breadth of the approaches reviewed above and the choice not focus on a single set of measures reflects the difference of opinions among the contributors to this volume and the literature regarding the appropriate approach, but also an acknowledgement that none of these remedies alone are likely to address the multifaceted nature of the problem of capture. Moreover, as the relationship between regulators and the regulated industry assumes different forms in different contexts and countries, so too does the policy approach need to adapt to these different environments.[165]

[161] Strachan (this volume).
[162] Walter (this volume).
[163] Helleiner (2010). 'What Role for the New Financial Stability Board? The Politics of International Standards After the Crisis.' *Global Policy*, October 2010.
[164] Strachan (this volume).
[165] Currie (this volume).

However, a central theme that emerges from the discussion of these different approaches is the acknowledgment that measures to ameliorate the integrity of the regulatory process are more accessible than it is often acknowledged. While some of the policy recommendations discussed in this paper require rather broad legislative reforms, important adjustments to mitigate the risk of capture can be found in more easily attainable changes in the governance of regulatory agencies, or inside the financial industry The regulatory agenda that has emerged since the aftermath of the crisis has neglected such "low hanging fruits", and largely focused on fixing gaps in the regulation of specific sectors or industries. The analysis developed in this volume highlights the fact that paying attention to the process through which financial regulations are designed and implemented is equally important in order to build a more resilient financial regulatory system.

The rest of this chapter briefly summarizes the content of the different contributions to this report.

The first section of the report invites contributions from the academic community. **Lawrence Baxter** (Chapter 2) discusses the 'elusive nature' of the concept of capture in financial regulation and identify different mechanisms to mitigate its extent. **Daniel Carpenter**, **David Moss** and **Melanie Wachtell Stinnett** (Chapter 3) discuss the lessons for financial regulatory policymaking from a recent collaborative project (*Preventing Regulatory Capture: Special Interest Influence, and How to Limit It*), arguing that capture is both less absolute and more preventable than is typically recognized. **Stefano Pagliari** and **Kevin Young** (Chapter 4) empirically analyse the different business groups and other stakeholders that characterize the rulemaking phase in financial regulation and examine potential mitigating strategies emerging from the unique ecology of interest groups that characterize financial regulatory policymaking. The analysis by **Andrew Walter** (Chapter 5) focuses instead on the implementation phase, highlighting how the more opaque, extended, and complex nature of this phase may offer new opportunities for industry to capture policy.

The second section offers the perspectives of the regulatory community by including the contributions of former senior regulators. **Clive Briault** (Chapter 6) discusses the UK experience since the late 1990s, arguing that the broader political, social, and cultural context within which regulators operated played a key role in informing the attitude of regulators towards the financial industry. **Jane Diplock** (Chapter 7) discusses the role of capture in the international sphere and proposes the creation of a public interest oversight body to strengthen the integrity and credibility of international standard-setting bodies. **David Green** (Chapter 8) looks at how financial regulation is characterized by a cycle of fluctuation between a period of regulation or supervisory behaviour that in retrospect appears to have been excessively slack, and regulation which appears to have been excessively demanding. **Andrew Sheng** (Chapter 9) examines different types of regulatory capture in financial regulation and what incentives drive its existence, discussing in his conclusion different ways to deal with this problem. **David Strachan** (Chapter 10) argues that it is inevitable that legitimate claims from different stakeholders may open the policymaking process to the risk or to the perception of capture, and discusses a series of safeguards which may be employed to bolster the integrity of, and confidence in, the rulemaking and supervisory process.

The third section of this report includes contributions from representatives of financial industry associations and other stakeholders such as consumer groups and non-financial end users. **Gerry Cross** (Chapter 11) looks at how the regulation of financial services is particularly prone to the risk of "cyclical capture" and discusses what measures the financial industry can take to avoid the situation where boom periods in the economy may erode the quality of supervision. Writing from her perspective as a consumer advocate, **Christine Farnish** (Chapter 12) discusses different measures to strengthen consumers' input in an environment in which financial services firms have a built-in advantage in terms of knowledge, data, and resources. **Richard Raeburn** (Chapter 13) examines the difficulties faced by corporate end users of financial services in dealing with the round of financial regulation since 2008, as well as the different measures to ensure that the financial regulatory process takes account of its impact on the real economy. **Adam Ridley** (Chapter 14) reflects upon his involvement in financial regulation in the investment banking community and other financial sectors, arguing that capture from the financial industry remains only one of the pathologies that affects the regulatory policymaking process.

The fourth and final section brings together the contributions of policymakers and academics that have reflected upon the experience of other sectors outside of finance. **David Currie** (Chapter 15) looks at his experience as a telecommunications regulator, discussing the lessons from this experience with regard to the importance of the marching orders that regulators receive from the legislatures, the selection processes for key regulatory positions, revolving doors, funding, and the need to build internal checks. **John Mogg** (Chapter 16) reflects upon his experience as chairman of the gas and electricity regulator in Great Britain. He suggests that the risks of capture come from a broader set of actors than is commonly acknowledged and emphasizes the importance of preserving the independence of regulatory authorities. Finally, **Tony Porter** (Chapter 17) offers an insight into the problem of capture in the financial regulatory arena from the experience of the regulation of the automobile industry, another highly globalized industry with a small number of powerful producers whose regulation has significant repercussions for society at large.