Financial Firms as Surrogate Regulators

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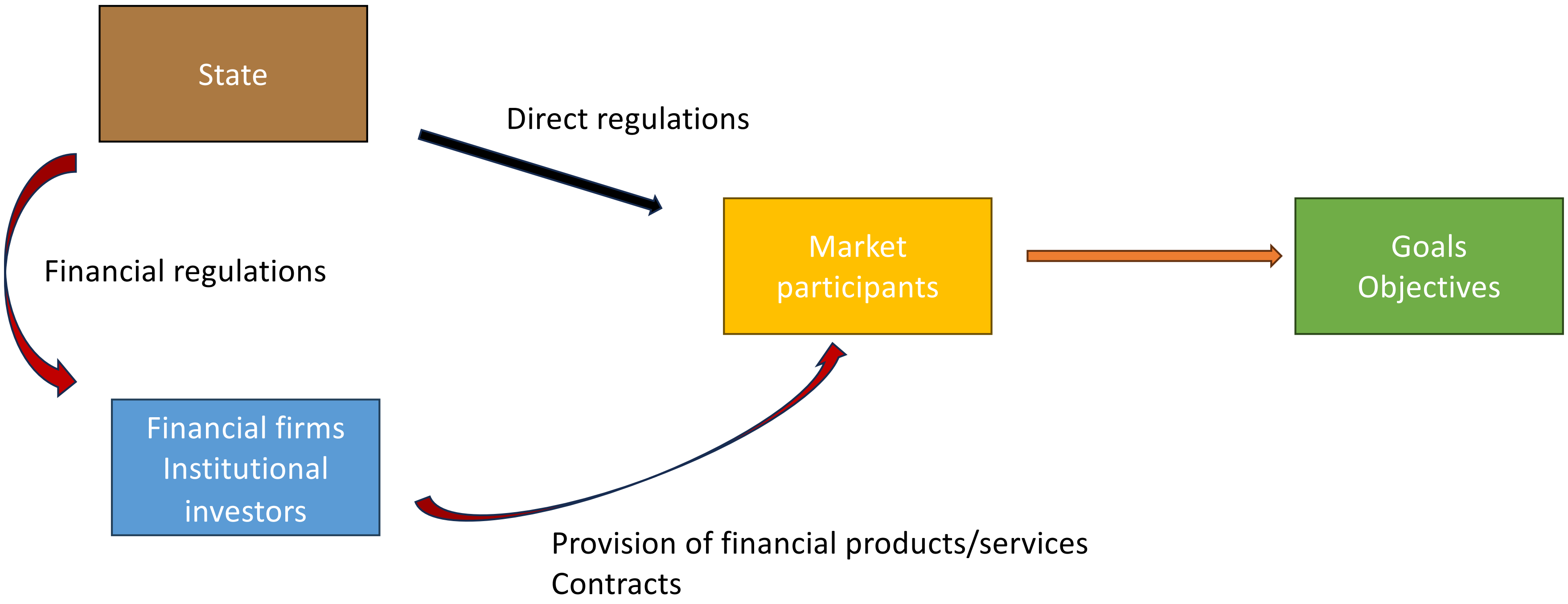
Outline

- Observation
- General theory: using financial firms as surrogate regulators
  - Pre-conditions
  - Models and examples
- Analysis and Reflection

Indirect regulations



Regulating through finance

- Internationally, e.g. Russian sanctions due to war against Ukraine
- Early discussion: more through private ordering
  - Role of D&O insurers for corporate governance
  - Liability insurers for environment or safety
- For public policy objectives: often more mandatory in nature
  - Anti-money launder and the countering of finance of terrorism (AML\CFT) for banks
  - Fraud prevention (e.g. in Taiwan)
- How about environment, social and governance (ESG) or other goals (such as DEI, sustainability)?
  - Largely through voluntary codes at the moment

Global initiatives in the 21st Century

- Banking
  - Equator Principles (2003)
  - Poseidon Principles (2019)
  - Principles for Responsible Banking (2019)
- Insurance
  - Principles for Sustainable Insurance (2012)
- Capital market
  - Principles for Responsible Investment (2006)
  - Stewardship Codes (from the UK and spread to some parts of the world)

EQUATOR PRINCIPLES

POSEIDON PRINCIPLES

UNEP FINANCE INITIATIVE PRINCIPLES FOR RESPONSIBLE BANKING

PSI Principles for Sustainable Insurance

PRI Principles for Responsible Investment

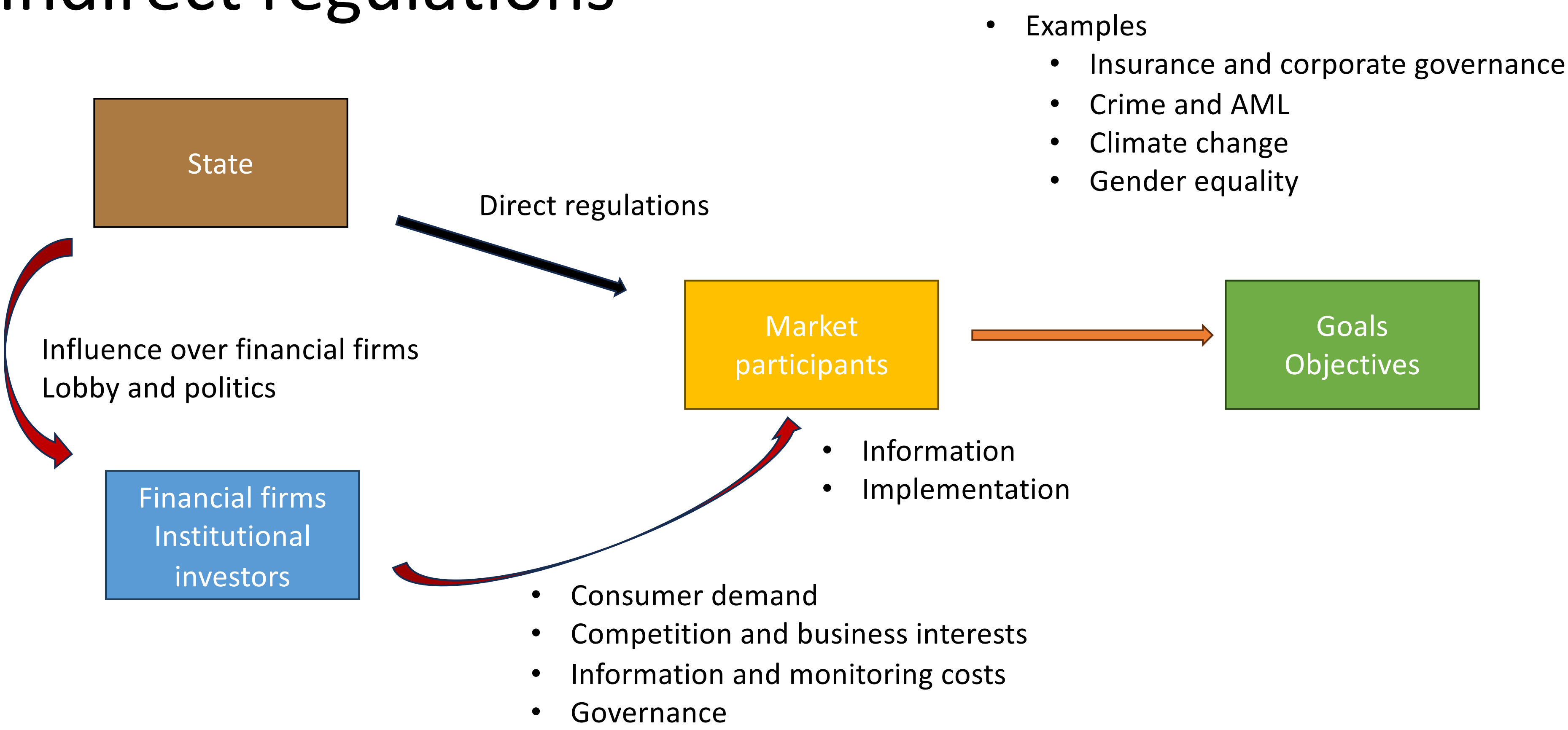
Questions

- Moral persuasion
  - Financial firms are the focal point of money.
  - With money, there comes responsibility.
- But
  - Is it really effective or efficient to regulate or achieve policy objectives through financial firms?
  - What are the conditions to make the approach work?
  - Any negative impact on market participants or stakeholders?

Rationale

- Premises of regulating through financial firms
  - Highly regulated nature of finance and financial services
    - Especially so for banks and life insurers
  - Demand for financial services
- Potential benefits
  - Saving direct regulatory and enforcement costs
  - Information costs: e.g. tracking criminal's cashflow
  - Some financial firms might naturally regulate conduct of customers due to their business interests (e.g. insurers setting standards).

Indirect regulations



Limitations

- The state's influence over financial firms differ by sector and by market.
  - Banks vs Insurers vs Capital Market Firms vs Unregulated Institutions
  - Political lobby: e.g. US banks' push against Basel Endgame
- Elasticity of demand for financial services
  - Responses from customers:
    - e.g. the impact of Equator Principles on projects that do not rely on bank finance?
  - Competition in the market
  - Firms' business interests

Limitations

- Transaction costs
  - Information
    - E.g. costs to investigate and verify carbon emission
  - Monitoring
    - Ability and costs to monitor a large number of customers on a continuous basis
    - Financial firms may be a more passive regulator rather than playing a more active role.
    - Free rider problems
  - Governance
    - How to ensure full compliance inside a financial firm?
- Otherwise
  - Window-dressing activities (e.g. greenwashing)
  - Externality and market efficiency
    - Costs transferred to customers
    - Potential financial inclusion issues in extreme cases

Conclusive remarks: A Cautious Note

- The state and international agencies should refrain from weaponizing finance and financial firms as a regulatory tool.
- It explains why currently UN initiatives mostly adopt a voluntary approach.
  - Sign-up rate is probably not as promising as the raw data sounds.
  - Probably not enough research to study the actual impact of those “Principles” or the Stewardship Code.
  - States should be cautious when implementing those voluntary codes into more mandatory rules.
- How to make financial firms to be an effective surrogate regulators?
  - Clear goals and targets
  - Reducing transaction costs
  - Let the market to decide
  - Other complimentary regulatory measures

Thanks for your time