OECD FORUM 2011 BACKGROUND NOTE

RESTORING TRUST IN THE SYSTEM

GENERAL INTRODUCTION FOR SESSION

When the financial system crashed, millions of people saw their savings disappear and their living standards fall. The crisis revealed serious gaps in the economy, and failures in governance and regulation, leading to a loss of public trust in the system as a whole. A massive joint effort by the world's governments averted a possible depression, but for a sustainable recovery to take hold they must now restore that trust in the role of government and the business sector.

Loss of faith in the banking system, for many the rock on which public and private finance were built, is a key element in the equation. Serious failures in corporate governance, risk management and supervision were of particular concern to the public and need to be seen to be remedied to move forward.

That means a system of financial regulation and education that restores basic public trust in the financial system. Many people who lost savings during the crisis felt let down because they did not understand the financial risk they were taking, or were misinformed about the level of risk involved. Governments are working to improve financial regulation and supervision, and to improve financial education for consumers, but do these efforts go far enough? How can people be sure that they will not suffer similar losses in the future?

Corporate governance failures also raised questions about business ethics and whether regulations needed overhaul. Concern was raised regarding implementation – in many cases, the right rules for business were in place, but the system for ensuring they were respected fell short.

Many of the right promises have been made, and changes are under way, but they will have to deliver results to restore people's trust and rebuild credibility. The need for such actions is clear. The cost of fighting one crisis has left governments hard pressed to manage their economies and ill-equipped to fight another crisis: financial regulation needs to work and people need to be able to trust their banking system.

For the sake of keeping the trust of voters, governments also need to be able to reassure citizens that their affairs are in safe hands. They know that trust and good governance are essential for the future.

PANEL 1: FINANCIAL REGULATION AND CONSUMER PROTECTION

Saving and investing, from pensions to home ownership, have become a more complex issue for people in recent years, as the burden of choice has shifted from government and employers to the individual. Many relished the freedom to make their own investment choices, but the crisis brought a stark reminder that in order to take control of your own financial destiny, you need to understand how money works, what exactly you are investing in and the level of risk you are running. Many people who lost money during the crisis did not understand that the promise of a high rate of return on their savings, for example, automatically carried with it a higher rate of risk. The result – a lifetime of saving wiped out overnight.

When they lost their money, many people felt they had been cheated and that banks and financial advisors were inherently untrustworthy. Those investing the money on behalf of their customers countered that they had provided all necessary information, and that it was up to people to take responsibility for their own choices. Customers complained that when information was provided, it was couched in such technical language that the layman could not possibly understand it or use it to make an informed choice.

This led to a number of conclusions. First, clearer rules were needed about the type of information financial institutions give their customers, and their responsibility for making it easy to understand. But at the same time, studies repeatedly showed that most people lack the basic level of financial literacy needed to make an informed choice even if given full and clear information. Worse, they do not realise how little they know. This can lead not just to poor investment choices, but to unsustainable debt levels that can plunge whole families into poverty. And this goes for well-educated people, not just the poorer sections of society.

Financial institutions have reacted by committing to easy to understand information targeted to individual needs of customers, while consumer organisations are keeping a close watch to see that they keep their commitments.

And work is being carried out to help consumers protect themselves. In the wake of the crisis, the OECD created the International Network on Financial Education (INFE), which numbers more than 150 institutions from 77 countries. The OECD is also helping governments ensure that the next generation is better prepared to manage its finances by testing 15-year-olds on their knowledge of personal finances and ability to apply it to their financial problems, a world first. The results will be available in the next Programme for International Student Assessment (PISA) study, to be released in 2013.

Financial education is good for individuals as it gives them the confidence to make financial decisions and helps improve their financial situation. It is also good for the financial industry, helping it to increase demand for appropriate financial products but also for transparency, competitiveness and efficiency. And money-savvy consumers can make it easier for regulators to do their jobs, as well as reducing the risk of thousands of people losing their pensions or homes in the future, and having to turn to government for help.

Questions for discussion

1. *How far can companies be made responsible for the financial education of their customers?*
2. *Is it realistic to expect everyone to be able to take charge of their own complex financial destiny?*
3. *Is financial literacy enough?*

PANEL 2: CORPORATE GOVERNANCE

The financial crisis revealed severe shortcomings in corporate governance and regulation, highlighting the need for solid business ethics, integrity and corporate social responsibility. Continued high pay and bonuses to top executives in failing companies raised questions about remuneration packages, and who was responsible for awarding them. How companies managed risk – or in some cases whether they even thought about managing risk before tumbling into financial meltdown – also became a topic of public debate. But the question quickly came down to whether the world needed new corporate governance rules, or rather a better system to make sure the existing ones were actually being respected.

The OECD took a close look in 2008 at the OECD Principles of Corporate Governance, the international benchmark in this area, to see what needed to be done. The conclusion was that the Principles provided a good basis to address the key concerns raised by the crisis, as long as they were actually being applied.

New recommendations called on boards to make sure that they set the strategic goals of the company, including risk management, and then determine a pay and bonus structure for executives linked to specific targets within that plan – so that success is rewarded, not failure. And the pay and bonus structure and policy should not be kept secret.

Board members need to be competent for the tasks expected of them – they should be able to have training, and undergo external evaluations. When selecting board members, the company should specify the skills and experience required by the board and identify appropriate individuals on that basis.

The financial crisis also raised questions about the role of institutional shareholders, many of whom are investing other people's money for long-term savings such as pensions. In the past, institutional investors were largely passive, but they have a responsibility as part owners of the companies they invest in. Good practice is for such investors to make better use of their rights as part owners, and to disclose their voting records.

Companies themselves recognised the need to restore the confidence of their customers and investors, and show that they are maintaining high ethical standards wherever they do business. This includes safeguarding consumer privacy, especially in businesses such as healthcare or finance where companies hold a great deal of intimate personal information about their customers.

Political affiliation, financial support and lobbying are one area where customers and shareholders look to companies to provide full and open information, as well as feedback and customer product ratings and, increasingly, social and environmental performance.

Questions for discussion

1. *Should corporate governance rules be strengthened, or should governments and companies focus more on ensuring that current rules are implemented?*
2. *How can companies maintain consumer and customer confidence? Who will safeguard the balance between openness and freedom of information on the one hand and protection of competitiveness and customer privacy on the other?*
3. *How to ensure transparency and accountability in pay and bonus packages to guarantee that payment is dependent on success and failure is not rewarded?*