Regulatory Capture of Financial Sector Supervisors through their Social Identification with the Financial Sector

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Based on joint work with Dennis Veltrop

Motivation (1)

- According to Stiglitz (2010, p. 12), “it was deficiencies in regulation and regulatory enforcement that failed to prevent the banks from imposing costs on the rest of society.”
- Barth, Caprio, and Levine (2012, p. 5) argue that “the Guardians of Finance adopted policies that induced financiers to take excessive risk … and the Guardians too often chose not to reform their destabilizing policies, even though they had the power and time to do so.”

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Motivation (2)

- One prominent reason why regulators and supervisors are argued to have failed is so-called regulatory capture.
- As Nobel laureate Stigler (1971) pointed out in a seminal article, regulatory and supervisory agencies tend to respond to the wishes of the best-organized interest groups, in particular the industry they regulate and supervise.
- Agencies identify industry interests (or even the interests of individual firms) with the public interest.

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Motivation (3)

- Kwak (2013) notes that capture is most pervasive when (1) there is a high degree of similarity between industry representatives and regulators and supervisors; (2) an industry has a notable social purpose with which regulators and supervisors can identify; (3) an industry has high social, cultural, or intellectual status; many social connections between industry and regulators and supervisors; and technically complex issues. These are all criteria that are applicable to the financial sector.

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Motivation (4)

- Barth et al. (2012: 38) point out 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.”
- Useful as the concept of cognitive capture may seem, there is a serious problem: it is hard to identify empirically. Drawing from social identity theory and by studying supervision at the individual level of analysis we seek to address this important gap.

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Social identity

- According to social identity theory, part of an individual's self-concept is derived from his or her membership of social groups, which results in salient social identities (Tajfel, 1982).

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Definition

"that part of an individual's self-concept which derives from a person's knowledge of his or her membership of a social group together with the value and emotional significance attached to that membership" (Tajfel, 1978)

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Identification with sector

- Social identification with the financial sector would lead financial supervisors to internalize group-defining (i.e. the financial sector) characteristics in their self-concept and strive for behaviors that are prototypical for the financial sector.
- The more supervisors socially identity with the financial sector, the more their behavior will be shaped by behaviors that are prototypical for the financial sector.

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Hypothesis (1)

- *H1: Social identification with the financial sector will be negatively associated with supervisor task performance.*

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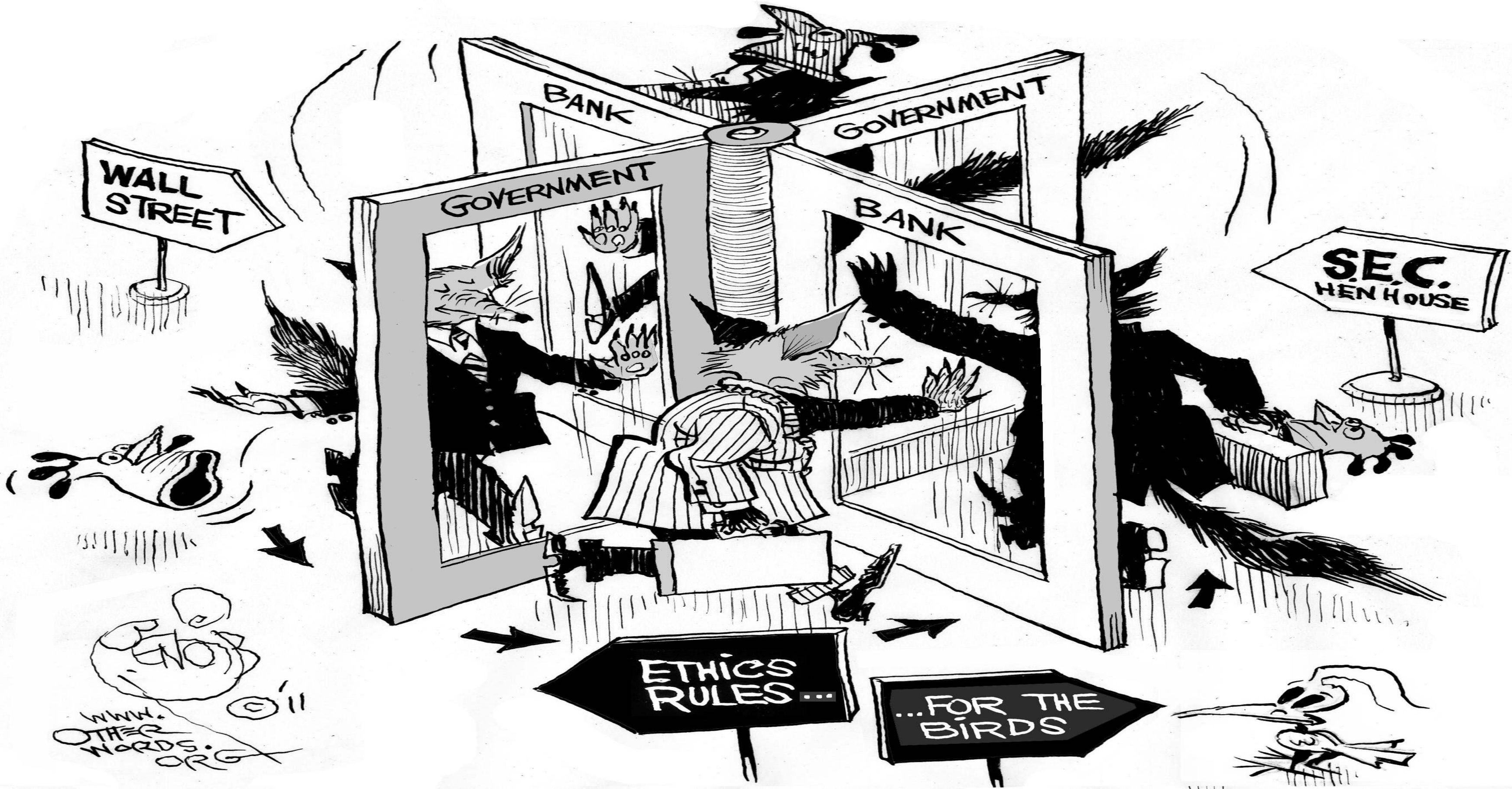
Revolving door



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Revolving door

- There are several well-known examples of supervisors coming from or going to the financial industry.
- Reason: supervisors need the expertise from the financial industry to effectively supervise the sector.
- However: risk that supervisors are overly sympathetic to the needs of their supervisees because they come from this sector themselves (McPhilemy, 2013).

Hypothesis 2

- *H2: Prior tenure in the financial sector will be positively associated with social identification with the financial sector.*

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Hypothesis 3

- *H3: Social identification with the financial sector will mediate the relationship between prior tenure in the financial sector tenure and supervisor task performance.*

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Professional identification

- Professionals tend to maintain multiple social identities, one of which is associated with their profession.
- Professional identification with being a supervisor refers to the extent to which supervisors experience a sense of oneness with the profession. In accordance with social identity theory, social identification with being a supervisor leads supervisors to include central and distinctive facets of being a supervisor into their self-concept.

Hypothesis 4

- While social identification with the financial sector makes supervisors predisposed to be more lenient towards the financial sector, professional identification with being a supervisor is expected to counter-moderate this effect.
- *H4: Professional identification with being a supervisor will moderate the relationship between social identification with the financial sector and supervisor task performance.*

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Hypothesis 5

- *H5: Professional identification with being a supervisor will moderate the indirect effect of financial sector tenure on supervisor task performance (through social identification with the financial sector). Specifically, social identification with the financial sector mediates the relationship between financial sector tenure and supervisor task performance when a supervisor's professional identity is low, but not when it is high.*

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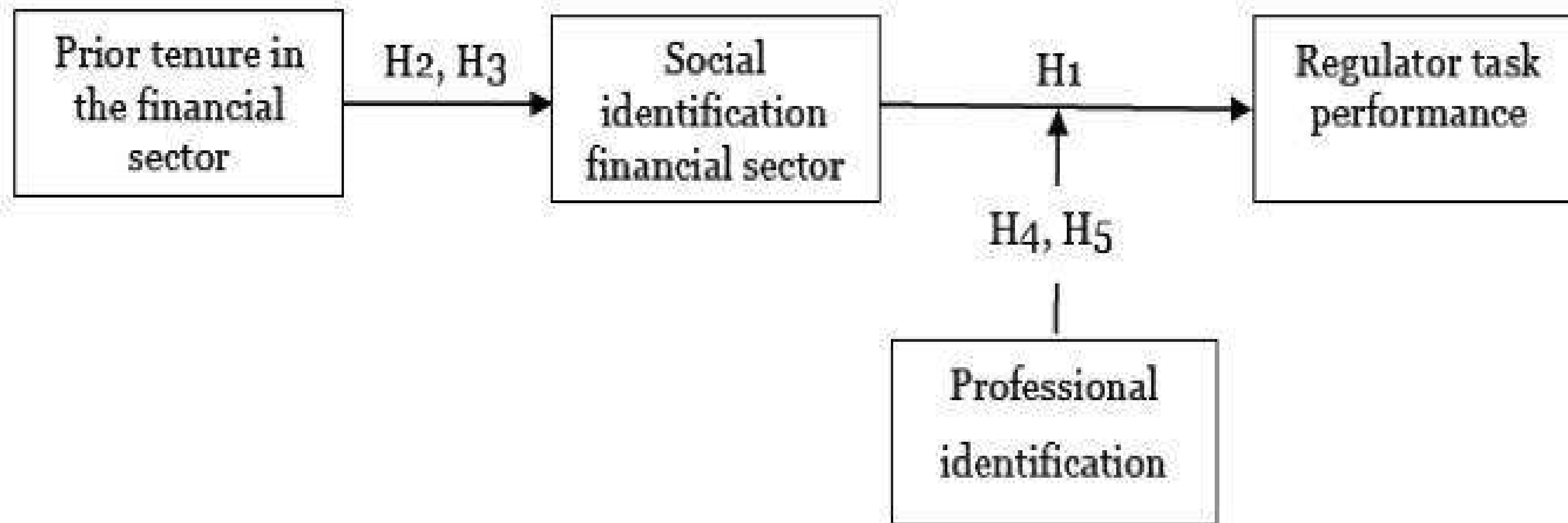
Theoretical model



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Method (1)

- Electronic surveys were distributed to all employees of DNB and AFM (Authority for the Financial Markets).
- **Task performance** was measured with Williams & Anderson’s (1991) measure of task performance. Items include ‘adequately completes assigned duties’, ‘performs tasks that are expected of him/her and ‘fails to perform essential duties (reverse scored)’.
- A referent-shift approach by asking respondents how their boss would rate their performance.

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Method (2)

- We measured the extent to which supervisors **socially identity with the financial sector** using Mael & Ashforth's (1992) six-item group identification scale. Example items are: "when someone criticizes the financial sector, it feels like a personal insult", "when I talk about the financial sector, I usually say 'we' rather than 'they'".

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Method (4)

- **Identification with being a supervisor** was measured with a four item scale adapted from Jetten et al. (2003) and Luhtanen & Crocker (1992) . The items were “I identify strongly with supervisors in general”, “Being a supervisor is an important part of who I am”, “I feel strong ties with other supervisors in general” and “I feel a strong sense of solidarity with other supervisors in general”.

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Method (5)

- Controls:
  - AFM vs DNB
  - Years working as supervisor
  - Identification with supervising institution

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Findings

- All hypotheses were strongly supported by our estimates. So:
  - prior tenure in the financial sector is positively related to social identification with the financial sector.
  - social identification with the financial sector is negatively related to supervisor task performance.
  - professional identification moderates the relationship between social identification with the financial sector and supervisor task performance.

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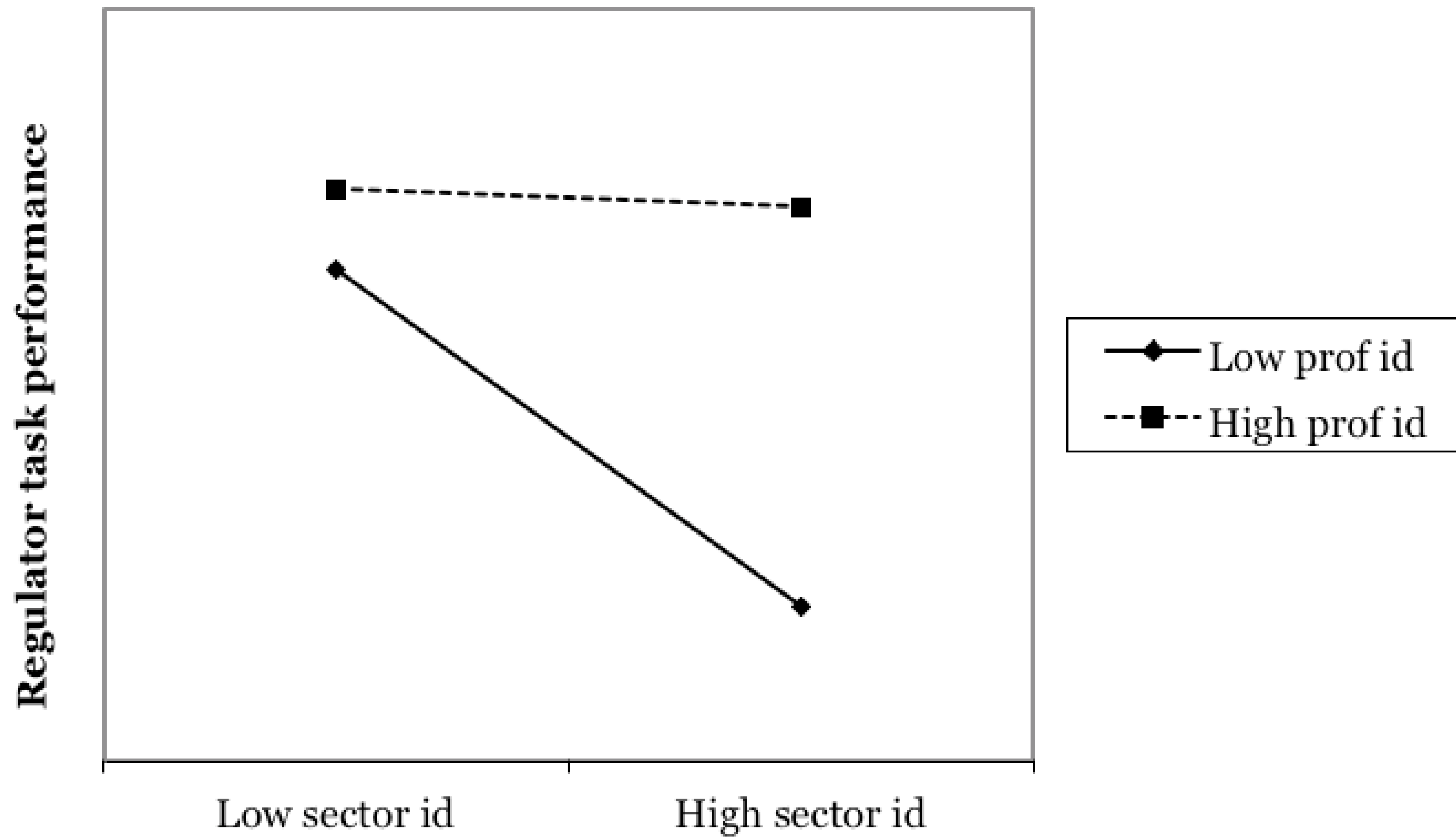
Role of professional identification



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Discussion (1)

- 'Cooling-off' periods may diminish the impact of the revolving phenomenon (Blanes, Draca, & Fons-Rosen, 2012). However, our results suggest that supervisors do not stop identifying with the financial sector once they leave the private sector.
- Periodically rotating supervisory staff: we do not find that supervisors' social identification with the financial industry is affected by the tenure of supervisors.

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Discussion (2)

- Rather than fully exfoliating regulators' and supervisors' interactions with the financial sector, our results point to a more feasible approach to limit capture, namely by fostering regulator professional identities to counteract the negative effects from socially identifying with the financial sector.

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Thank you for your attention

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