Designing Financial Supervision Institutions

Independence, Accountability and Governance

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Foreword

Donato Masciandaro and Marc Quintyn

This volume brings together contributions by a number of experts on a range of narrowly related topics – the structure, organization and governance of financial sector supervision – which are increasingly claiming the attention of policymakers, academia and practitioners around the world.

As Professor Charles Goodhart points out in the introduction to this volume, until two decades ago, structure, organization and governance of financial sector supervision was not a topic for an animated debate in any of the circles mentioned above. Financial systems in most countries were heavily regulated – the term repressed systems has often been used to characterize their status. By whom, and how they were supervised was not a topic that stirred great commotion.

In contrast with that era, the establishment of the Financial Supervisory Authority (FSA) in the United Kingdom in 1997, for instance, became front page news. More recently, discussions about supervisory actions in Hungary, Poland, Italy and Germany all became hot news items, indicating that financial sector supervision has clearly stepped out of the anonymity in which it resided in the first three post World War II decades.

The most important factor that has contributed to this major change in focus is undoubtedly financial liberalization which took hold in the seventies. First domestically, and subsequently internationally, liberalization triggered many changes that profoundly altered the face of the financial system and the nature of its operations. In response to these developments, the ways in which the sector was supervised also needed to change profoundly.

The major implication of financial liberalization has been an increase in competitive forces. This increase triggered at least three major changes in the working of the financial sector that required a drastic regulatory response. First, with increased competition came the pressure for financial institutions to take on more risks. Although risk–assessment technologies have advanced significantly, risk

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management requires high-quality governance of financial institutions to protect their creditors. This new approach had two major implications for supervision: first, stimulating good governance in financial institutions needed to be reflected in the supervisor's regulatory framework: supervision needs to be risk-based, forward-looking, and focused on the governance of the individual institutions. Thus, supervisory agencies needed to become 'governance regulators' And secondly, supervisory agencies, in order to stimulate good financial governance, need to set a credible example. Hence, (good) governance of the supervisory agency matters a great deal in this new context.

Secondly, increased competitive forces manifested themselves first within the banking systems, subsequently within other subsectors, and finally among all of them, leading to a blurring of boundaries among previously clearly delineated subsectors. These developments, in turn, prompted policymakers and supervisors to reflect the realities of the operation of the financial sector in their supervisory methods, hence the reorganization of supervisory structures as a new item on the policymakers' agenda.

Lastly, liberalization has also led to a 'privatization of risk' where savers are increasingly dependent on financial markets to determine their future financial security. This development also requires a reorientation of the supervisory tasks, as it forces supervisors to pay more attention to the risks that customers take upon themselves in the face of the opaqueness of the financial system.

The authors in this volume take a step back from the current rapid changes that financial supervision and regulation are undergoing. Although the world is faced with a variety of emerging trends in the supervisory response to the abovementioned developments – responses related to designing supervisory institutions as well as in their governance arrangements – the various chapters analyze recent developments, try to identify common trends, point out weaknesses in the debate, and bring unresolved issues to the surface. In this context, several chapters analyze the linkages between the respective required supervisory responses – the design aspect, the governance aspect and the regulatory framework. We believe that this blend of approaches coming from different angles of the economics and political economy profession makes this volume unique and worthwhile as a stocktaking exercise, and helps in shaping the research and policy agenda for the near – to medium term.

We would like to thank the authors for their valuable contributions to the debate on design and governance of supervisory agencies. We are especially grateful to Professor Goodhart who not only accepted to write the introduction, but made it a highly thought-provoking piece which will challenge and inspire policymakers and researchers. A word of thanks goes also to Rosaria Vega Pansini for her excellent editorial assistance.

Introduction

Charles Goodhart

This book is focused on the design and governance of financial supervisory authorities. This subject is important and policy-relevant, in part because the issues concerning the appropriate design and structure of financial supervisory authorities remain in a state of flux. As recently as some two decades ago, this latter was not the case. At that time there was a standardized structure for financial supervision. It was organized according to the line of business undertaken by each financial institution. Thus there were separate supervisors for banks, for securities houses, and for insurance companies. This was so both nationally, and internationally, with the Basel Committee on Banking Supervision (BCBS), the International Organization of Securities Commissions (IOSCO) for securities houses, and the International Association of Insurance Supervisors (IAIS) for insurance companies. There were a few countries with integrated supervision, combining supervision of two, or all of these, business lines under one roof, but such countries tended to be small, Nordic (or both). As a generality, the Central Bank also undertook the supervision of the commercial banks, and where this was not so, as for example in France and Germany, the Central Bank was often closely involved in the exercise, e.g. the Governor of the Central Bank also being the head, or on the Board, of the supervisory authority.

A number of factors led to a move away from this standard arrangement. First, and foremost, the structure of financial intermediation changed. The old dividing lines between separate business lines, often having been reinforced by legislature, such as the Glass-Steagall Act in the USA, increasingly broke down. Universal banks and financial conglomerates became, if not standard, a much larger part of the financial system. With the growth of such large and complex financial intermediaries, the maintenance of separate supervisory authorities became inefficient, leading to numerous overlaps, and in a few cases underlaps.

Two additional factors, leading in much the same direction, reinforced this switch. First, Central Banks were given much greater delegated responsibility for monetary policy, in the guise of the operational independence to set interest rates. This strengthened several of the arguments, e.g. reputation effects and conflicts of interest, for having supervision undertaken separately, outside the Central Bank, especially where there was a concurrent move to integrated supervision, when 'moral hazard' concerns about extending the safety net also took effect. All this is set out nicely by Freytag and Masciandaro in Chapter Six and by Di Giorgio and Di Noia in Chapter Nine.

A third factor, discussed by Westrup in Chapter Four, has been the growing importance of saving for pensions, and the increasing holdings of risky financial assets, both directly and indirectly, by a growing proportion of the population. Many such holders found it difficult to assess such risks. So consumer protection and conduct of business issues became more salient. Such concerns could arise in any (retail) part of the financial system; this represented an argument for having a unified regulator dealing with such issues throughout the financial system; whether such a regulator should just focus on conduct of business (leaving prudential supervision to a separate body – an approach commonly termed 'twin peaks'), or be a 'universal' supervisor is a subject to which we will revert. Either way, Central Banks have not traditionally sought to become involved in conduct of business matters, and, given the public concern about consumer protection, politicians were not likely to delegate such matters to a Central Bank.

All this means that there are now two key decisions to be taken by the political authorities on the structure of financial supervision. These are:

1. Should such supervision be integrated, or (continue to) be divided by main business line?

2. Should such supervision, whether integrated or not, be undertaken by the Central Bank?

This leads to the following four-way matrix.

CB		
Without CB		
	Specialized	Integrated

This four-way division is discussed in many of the chapters in the second part of the book, but especially in Chapter Six by Freytag and Masciandaro. They demonstrate that there has been a polarization of outcomes into the top left cell (whereby Central Banks remain involved in banking supervision but *not* involved with securities houses or insurance, when such supervision remains separated by business line), and into the bottom right-hand side cell. They argue that the main disadvantages of Central Bank involvement, which they term the moral hazard effect, the bureaucracy effect and the reputational endowment effect, all worsen whenever the scope of supervision widens and extends to the integrated model.

The book is primarily concerned with the structure and governance of domestic financial supervision, i.e. within a single country. But in so far as current trends lead both to universal banking and to a single integrated regulatory (financial) supervisory authority (RSA or FSA) at the domestic level, should not that be matched at the regional (European) or international level? At present the European (Lamfalussy) bodies, CEBS for banking, CESR for securities and CEIOPS for insurance, remain split along business lines, as do the international bodies, BCBS, IOSCO and IAIS.

There have been many calls for an integrated European FSA, though how that could work without any support from a Europe-wide fiscal authority remains unclear. Di Giorgio and Di Noia (Chapter Nine) do not go as far as to propose a single European FSA, which they regard as not yet practicable or feasible. Instead they revert to a 'twin-peak' proposal with,

> two new European Agencies, one responsible for the microeconomic stability ('European Prudential Supervision Authority') and one for transparency in the market, investor protection and disclosure

> requirements ('European Investor Protection for Market Transparency') of all financial intermediaries.

Besides Di Giorgio and Di Noia, the other author commenting on international, cross-border issues is Eisenbeis, in his Chapter 12 on 'Agency Problems and Banking Supervision'. Eisenbeis uses his American experience and view-point to comment on European practice in three main fields, deposit insurance, home/host potential conflicts in both deposit insurance and banking supervision, and finally the problems caused for crisis resolution by differing national bankruptcy laws. Eisenbeis argues that a European deposit insurance scheme should preferably be centralized, though in my view he exaggerates the effect of having slightly different national schemes on the locational decision of multinational banks. Again he wants the schemes to have a back-up guarantee from the public purse, whatever the source of the initial funding, since additional funding calls on remaining banks in the middle of a really serious crisis would be counterproductive. Fine, but then he also wants the deposit insurance institution to be accountable to the banks, not to the taxpayer via the legislature. But if the public purse is providing an open-ended guarantee, should not its representatives also have ultimate control? Finally, Eisenbeis notes the difficulties caused whenever a multinational failure straddles countries where some use a single entity model and others use a separate entity (national preference) model for bankruptcy resolution. But he refrains from mentioning that the USA, which maintains the separate entity model, is the worst culprit in this respect, whereas the EU has adopted the (preferable) single entity model.

The other chapter, Chapter 11, in this final Part III, is by Alesina and Tabellini on 'Bureaucrats or Politicians?' This provides a simple, formal model (without which no serious academic economist nowadays regards himself as properly attired), differentiating the objective and cost functions of politicians and bureaucrats. The main difference, they assert, is that bureaucrats are rewarded by (the appearance of) general efficiency, whereas politicians need to gain (maintain) the support of a majority of the population for (re)election. The main conclusion then is that the politician will want to keep control of any allocational, redistributive exercises, in order to

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maintain a winning coalition of voters, whereas policies without redistributive effects can more easily be delegated.

But what policies are without redistributive effect? For example, increases in interest rates damage borrowers (businesses, home buyers, and the government), but benefit lenders (the old). The fact that the old are more numerous does not prevent the more tightly organized groups of borrowers being able to lobby more effectively. And what, if anything, does their insight tell us about the governance and structure of financial regulation? Perhaps it reinforces Westrup's thesis that the widening scale of holdings of (risky) financial assets throughout the general public is likely to increase the involvement and oversight of government in financial regulation (or at least in *retail* financial matters), whatever the inherent benefits, according to Quintyn and Taylor, of keeping FSAs independent of the sticky embraces of such governments.

To revert to domestic, within country, supervision, what then are the effects and implications of choosing one, or other cell, of our earlier matrix – which could, of course, be further extended to include partial integration, and 'twin peaks'. This is the subject of most of Part II of the book, Chapters 6 – 10. In Chapter 10, Masciandaro, Nieto and Prast look at the effect of this choice on the method of financing the financial supervisor – providing its budget. Not surprisingly, the authors find that when the Central Bank is involved in banking supervision, the funds are more likely to come from seigniorage, that is, in effect, from the public purse. In contrast, where there is a more conglomerate market (as compared with bank) financial system, and an integrated structure of supervision, the funds are more likely to come in the form of fees paid by the supervised, private sector, institutions themselves.

This chapter was strictly positive in content, but I did detect a hint of some preference for the institutional finance alternative, perhaps to provide greater discipline and incentive for efficiency. I would have liked some further research on which approach provides more generous funding, e.g. taking some measure of the ratio of staff/funding of the financial supervisor (relative to the size of the relevant financial system) as the dependent variable, and seeing whether a dummy variable for mode of financing was significant. More ambitiously yet, one might even try to assess what extent of financing/staffing of financial supervision was optimal. That this is not beyond the realms of possibility is shown by the current, as yet unpublished, paper by H. Jackson and M. Roe, entitled 'Public Enforcement of Securities Laws: Preliminary Evidence', who seek to show that a robust and resilient financial system is positively correlated with a larger, better funded financial supervisor.

One problem with testing this latter hypothesis is that causation, no doubt, goes in both directions; there is simultaneity. Another, related problem is that it is extraordinarily 'difficult to find robust performance indicators for the performance of financial supervisors', (Masciandaro, Nieto and Prast). It is the original innovation of three chapters of this book, by Arnone, Darbar and Gambini, chapter Five, Arnone and Gambini, chapter Seven, and by Čihák and Podpiera, chapter Eight, to have found a proxy for such performance, in the form of the measured observance of each country to the Basel Core Principles (BCPs) (and in the case of insurance and securities houses to the relevant IAIS and IOSCO principles). Every time that the IMF/World Bank does a Financial Sector Assessment Program (FSAP) for an individual country, it does a Report on their Observation of Standards and Codes (ROSC), grading these in four ways, see Figure 5.2 of Arnone, Darbar and Gambini and Footnote 14 of Arnone and Gambini:

1. Fully Compliant

2. Largely compliant

3. Materially non-compliant

4. Non-compliant

It is obvious how an index can then be constructed, though quite how far such an index will really measure the performance of the financial supervisor may well remain a matter of some doubt. Certainly a qualitative index applied by an external professional assessor is much better than self-certification, but some further cross-checking could be a useful exercise. Anyhow, having got such an index, Čihák and Podpiera examine whether the overall index, and three of its subcomponents, are positively related to a dummy for (fully) integrated supervision, Tables 8.5 and 8.6. The idea is to test whether fully integrated supervision is better than specialized supervision. The answer is that it is, but apparently not significantly so, once GDP per capita is also included in the regression.

Similarly Arnone, Darbar and Gambini compare compliance with the BCP on the one hand, with compliance with another set of IMF codes, in this case on transparency practices in banking supervision, on the other hand, see for example their Figure 5.5. Not surprisingly they are positively correlated, especially in advanced countries.

Finally in this group of chapters, Arnone and Gambini study how dummies for the four cells in the previous matrix affect BCP compliance. Here they find that the dummy for specialization with no Central Bank involvement is worst, and integration within the Central Bank is best (the other two, i.e. specialization with Central Bank involvement, and integration without, being statistically identical (Table 7.4)). But the two options which appear to be statistically distinguishable are the unpopular ones with relatively small samples. I wondered whether the (small) sample of specialist supervision without CB involvement might include a number of (possibly corrupt) emerging economies, wherein the politicians liked to maintain control in this field; so an index of corruption might have been a useful extra variable. Similarly, I wondered whether the sample of integrated supervisory systems within the Central Bank might have included countries which were small (e.g. Iceland), and where the Central Bank had little, or no, monetary policy responsibility, as is now the case of the National Central Banks (NCBs) in the European System of Central Banks (ESCB), such as Eire.

As a generality, there is a need to distinguish, in such tests of the relationship between Central Banks and financial supervision, between those CBs with a close relationship and involvement with macro/monetary policy, and those without. If it is going to be the case that there will be a trend towards multi-country regions using a single currency (as in the euro-area or fully dollarized countries) – which I rather doubt – then there will be a growing number of NCBs with no, or very limited, monetary policy functions. What are they then going to do, except handle financial regulation and supervision? Di Giorgio and Di Noia touch on this question. An organisational and structural issue that cries out for more attention is whether there is, and what should be, a (the) role of NCBs within a currency area. Do we need the twelve US Federal Reserve Banks or the European NCBs, or are they just an expensive relic? If we need them, what should they do? One of the reasons why the Bundesbank put up such a fight to maintain a major role in the conduct, under BaFin, of financial supervision in Germany (despite having been in its earlier years a fervent proponent of the strict separation of monetary policy from financial supervision), was that it had already lost much of its monetary policy functions to the European Central Bank (ECB) (see on this Westrup, Chapter Four).

Let me revert to the problem of measuring the performance of a financial supervisor. As I have argued earlier (Goodhart, 2001), 'Regulating the Regulator – An Economist's Perspective on Accountability and Control', the objectives which the FSA in the UK has been set are in practice non-quantifiable. Moreover, as Arnone, Darbar and Gambini note, Regulatory and Supervisory Agencies (RSA) (in this Introduction I use the term FSA, but this is the same as RSA),

> (i) are likely to face several different objectives (not only the main goal of financial stability but also consumers' protection, conduct of business regulation), which are also not easy to measure, (ii) supervising the financial sector implies a certain degree of confidentiality about the results of investigations in order not to undermine public confidence in commercial institutions and, so preserve systemic stability, (iii) RSA are responsible not only to the institution from which they receive the mandate, but to a wider set of interests, including those of the supervised entities, peer jurisdictions and the public in general; and (iv) RSA are given broad regulatory and sanctioning powers which, as Lastra and Wood (1999) highlight, in some cases, like the one of revoking bank licences, provide them to some degree with 'the coercive power of the state against the private citizen'.

So, if it is almost impossible to measure supervisory performance and output (though more research could be done on this difficult topic), then how can one hold FSAs accountable? Why is this so important? It is because a major theme of this book, and the focus of Part I (especially of Chapter One by M. Quintyn and M. Taylor on 'Robust Regulators and their Political Masters', Chapter Two by L. Bini-Smaghi on 'Independence and Accountability in Supervision', and Chapter Three by Quintyn, Ramirez and Taylor on 'The Fear of Freedom), is for the need for supervisory authorities to have independence. But it is widely appreciated that the counterpart to greater independence must be greater accountability. As Bini-Smaghi notes,

> Independence and accountability are generally seen as being the counterpart of each other. In my view they are rather two faces of the same coin. If one of the two faces is falsified or damaged, the whole coin is worthless.

Brave words, but if it is, indeed, so difficult to measure and quantify performance and output, then is true accountability a chimera? Moreover, in so far as further research does, perhaps, indicate some quantifiable measures of performance, the attempt to turn them into targets for assessing achievement would be bound to fall foul of my own eponymous Law!

In practice, the inability to measure performance and value added means that 'accountability' is largely replaced by 'transparency'. If the financial supervisor cannot tell you that it has done good deeds, at least it can, subject to the needs for appropriate confidentiality, tell Parliament and public what it has done, and the arguments that led it to take such actions. One would have to be churlish to deny, in such circumstances, that transparency represents the greater part of accountability, but, even so, a financial supervisor cannot be accountable in the same way as a public company, whose success is measured by its profit record, or a monetary policy committee, whose success is measured by its achievement in hitting an inflation target. There is always a danger that supervisory success will be measured by outsiders by the absence of any financial failures, or of customer complaints; but in a dynamic, competitive context, the optimal number of failures (complaints) is not zero, but some unknown higher number. Or even worse that performance will be measured by process, e.g. number of prosecutions, number of visits, etc.

In addition to accountability via transparency, a financial supervisor undertakes quasi-legal functions in monitoring and implementing financial regulations, in whose formulation it will have also played a role, and in imposing sanctions on those who disregard such rules. In this respect a financial supervisor should, quite properly, be subject to judicial review. Given the importance of the legal aspects of financial supervision, it would have been good to complement eminent economist authors with some legal experts. There was barely any mention of judicial review in the chapters discussing independence and accountability, except for one (short) section in Quintyn and Taylor's Chapter One.

As already noted, a major theme of the book, and especially of Part I, is the need for financial supervisors to be independent (and accountable). This is, perhaps, particularly pronounced in the chapters emanating from the IMF, notably Chapters One and Three. In Chapter One, Marc Quintyn and Michael Taylor identify four dimensions of independence, being:

1. Institutional

2. Regulatory

3. Supervisory

4. Budgetary

Having been an early advocate of such independence (Goodhart, 1998), as the authors are kind enough to note, let me give rein to my contrarian tendencies by suggesting here some qualifications to the call for ever greater independence for financial supervisors.

Let me start with (4), 'Budgetary Independence', since the discussion of who pays for FSAs is separately raised by Masciandaro et al. in Chapter 10 and briefly discussed earlier here. The funding for an FSA will primarily come from outside bodies, either the regulated institutions, or from seigniorage, or perhaps directly from a Ministry. The danger of having an FSA primarily financed by fines on errant members is obvious. Since its value added is generally unobservable, payment by fee for services rendered is hardly viable. Imagine having the supervisor's officials poring over your books for weeks, and then receiving an invoice for that privilege. Nor is it clear that finance from private sector institutions, who will see this as an unwelcome tax, will be any less grudging and inadequate than finance from seignorage (I know of no empirical evidence on this). Either way those providing the funds will, quite reasonably, want some oversight and control over

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