Executive Summary

- The degree of political independence that financial supervisors should enjoy is a hotly debated topic.
- This is because financial supervisors are a "one of a kind" breed of regulatory agency. They supervise the sector that is at the heart of the allocation of capital in any society, and therefore attract much political interest, not only in normal times, but even more so in times of crisis.
- While a fair degree of independence is justified—institutionally, in their regulatory and supervisory work, and financially—independence alone will not establish the right incentive structure for supervisors.
- Agency independence is not a goal in itself. It is just one institutional arrangement that should assist in establishing a governance framework that provides the regulatory agency with the right incentives to discharge its delegated powers. The other three elements are accountability, transparency, and integrity.
- Accountability arrangements ensure that the agency maintains legitimacy towards its stakeholders. This legitimacy will support independence, as will accountability.
- Transparency and integrity arrangements play an important role in making independence and accountability effective.
- These four elements of regulatory governance keep each other in equilibrium, and together establish the right incentives for the agency to fulfill its mandate, and for its stakeholders to refrain from interfering.

Introduction

The concept of independence, and, in particular, political independence is loaded. In a principal–agent relationship, it is associated with (more) power for the agent and a loss of power or grip for the principal. While the notion of an independent central bank is now more or less generally accepted in democratic societies, the broader notion of independent regulatory agencies (IRAs)—agencies that regulate and monitor important parts of social and economic life on behalf of government—is slowly gaining acceptance.

Financial sector supervisors are a “one of a kind” regulatory agency among these IRAs, and the debate about their independence is fairly recent, i.e., since the late 1990s and the turn of the century. Financial supervisors possess some unique features among IRAs that complicate the discussion about their degree of political independence. They are close to the central banks in that they contribute to preserving a country’s financial stability by monitoring the health of individual institutions. Yet they differ from most other IRAs (central banks, competition regulators, and utilities regulators) in a number of crucial ways. Most importantly, they monitor a sector that fulfills a central role in the economy as allocator of capital, and as a source of governance for the corporate sector. For these very reasons, the sector has always generated much attention from the political class. This political interest, which is also eagerly exploited by the sector itself, opens the door to constant attempts at political interference and lobbying.

Add to this uniquely distinguishing feature (i.e., the nature of the sector they supervise) a number of other specific characteristics in the content of their supervision job, and it is clear why the independence of financial supervisors is such a much-debated issue. These other characteristics are:

- their mandate contains a great number of contingencies;
- given the sensitivities inherent in the workings of the financial system, transparency in their supervisory operations needs to be weighed against confidentiality more than in any of the other types of regulators;
- they wield wide-ranging judicial powers which include “the coercive power of the state against private citizens,” which is more far-reaching than for any other type of IRA.
These features lead to two conclusions regarding their independence. First, a fair degree of regulatory and supervisory independence is needed to insulate them from both political and industry interference and lobbying. Second, and equally important, given their job content, the granting of independence alone is most unlikely to provide the right incentive structure to financial supervisors. In order to fulfill their mandate properly, independence arrangements need to be designed in coordination with other features, which together establish a regulatory governance structure that provides the right incentives to the supervisors, as well as to the other stakeholders, in particular their political masters.

Such an incentive-compatible governance structure for financial supervisors should be built around elements of independence, accountability, transparency, and integrity. These four ingredients of a governance framework, if designed properly, tend to reinforce each other, as we shall demonstrate. In the next section, we substantiate the need for supervisory independence, and the subsequent section presents an incentive-compatible regulatory governance framework.

Essential Elements of Independence

The need for regulatory and supervisory independence in the financial sector stems broadly from the same sources as central bank independence, and finds its origin in the literature on time inconsistency in economic policy.¹ Time inconsistency occurs when the government’s optimal long-run policy differs from its optimal short-run policy, leading to situations where the government in the short run reneges on its long-term commitments. Thus, time inconsistency emphasizes the need for a credible and binding precommitment to a particular mandate that prevents violations ex post. In the case of monetary policy, Rogoff (1985) argued that one way to achieve policy credibility is to place it in the hands of a person or institution who weighs inflation deviations more heavily than in the social welfare function—the “conservative central banker” whose preferences will differ from those of the government. The need for agency independence follows from this: For the central banker to have a different reaction function, they need to be independent from government.

The analogy with supervisory independence is straightforward. Bank liquidations are typically politically unpopular, as they can result in genuine hardship for depositors and other creditors, many of who will also be voters. Vote-maximizing politicians with short time horizons may be concerned about the short-term costs of bank closures, whether fiscal, in terms of lost votes, or in terms of lost campaign contributions, and will be sensitive to the demands of these groups, particularly if these are politically well organized. Politicians may be tempted, as a result, to put pressure on supervisors to organize a bailout or exercise forbearance to avoid short-term costs. However, short-term forbearance may be the cause of higher longer-term resolution costs. Accordingly, politicians face the same incentives in relation to failing banks as they do in relation to the goal of price stability. Hence the need for independent regulators whose reaction function differs from that of their political masters.

Let us now define ways in which this independence could be made operational. For financial supervisors, there are actually four dimensions to it—institutional, regulatory, supervisory, and budgetary independence.

Institutional Independence

Institutional independence is achieved if the agency as an institution is separate from the executive and legislative branches of government. Institutional independence encompasses three critical elements:

• the terms of appointment and dismissal of its senior personnel should be clearly defined to avoid political interference, and thus ensure security of tenure;
• the agency’s governance structure should favor decision-making by a commission, as opposed to vesting all responsibilities in the chairperson, to reduce external influences;
• decision-making should be as open and transparent as possible, to minimize the risk of political interference.

Regulatory Independence

Regulatory independence refers to the ability of the agency to have an appropriate degree of autonomy in setting prudential rules and regulations for the sectors under its supervision. Autonomy in setting prudential
regulations will help in ensuring that the regulatory framework is stable and predictable, complies with international best practices, and is not contaminated with political considerations.

Supervisory Independence

Supervisory independence refers to the degree of independence with which the agency is able to exercise its judgment and powers in such matters as licensing, on-site inspections and off-site monitoring, sanctioning, and enforcement of sanctions (including revoking licenses), which are the supervisors’ main tools to ensure the stability of the system.

Supervisory independence is the most difficult of the four dimensions of independence to guarantee. To preserve its effectiveness, the supervisory function typically involves private ordering between the supervisor and the supervised institution. However, the privacy of the supervisory process makes it vulnerable to interference, from both politicians and supervised entities. Political interference (and interference from the industry itself) can take many forms, and can indeed be very subtle, making it difficult to shield the supervisors from all forms of interference.

As the supervisory process starts with the act of licensing a financial institution, supervisors should ideally have the final word on who can enter the system. A typical situation that may lead to problems is one where the government has the final say over the licensing of individual banks and may—either out of self-interest or lack of technical ability to assess business plans—license unviable projects. The same degree of autonomy should apply to exit procedures, based on the same argument that supervisors are in the best position to decide on the viability of individual institutions. Decisions to close or not close an institution that are taken on political, rather than technical, grounds may result in the prolongation of the life of insolvent or corrupt institutions, thus ultimately increasing resolution costs. Moreover, if the power of license revocation is not in the hands of the supervisor, the threat by the supervisor can be empty, and their other powers undermined.

To strengthen supervisory independence, it is recommended that (i) supervisors enjoy legal protection in the performance of their duties. The absence of proper legal protection in many instances has a paralyzing effect on supervision; (ii) supervisors enjoy appropriate salary levels to attract better qualified individuals who may be less prone to bribery; (iii) rules-based system of sanctions and interventions be applied (see Rules Versus Discretion Supervisory Intervention Finacial Institutions).

Budgetary Independence

Budgetary independence refers to the ability of the regulatory agency to determine the size of its own budget, and the specific allocations of resources and priorities that are set within the budget. Regulatory agencies that enjoy a high degree of budgetary independence are better equipped to withstand political interference (which might be exerted through budgetary pressures), to respond more quickly to newly emerging needs in the area of supervision, and to ensure that salaries are sufficiently attractive to hire competent staff.

From Regulatory Independence to Governance

“…governance is an effort to craft order, thereby to mitigate conflict and realize neutral gains. So conceived a governance structure obviously reshapes incentives.”

Independence for supervisors is a necessary but insufficient condition when establishing the proper incentive structure for meeting their mandate. When allowed to operate at arm’s length of the government, the challenge is to endow them with the right incentive-compatible governance attributes. Following Williamson’s definition of governance, the aim of the model of governance arrangements elaborated in this section is exactly to:

- craft order, internally in the agency, and between the agency and its stakeholders (for instance, by identifying mechanisms to avoid capture, see below);
- mitigate conflict between the agency and its stakeholders;
- assist in realizing gains for all stakeholders, i.e., to ensure that the delegation of power to the financial supervisor is a socially optimal solution.
Making Williamson's definition operational, Das and Quintyn (2002) identified four essential pillars of good regulatory governance: Independence, accountability, transparency, and integrity. If well designed, these four pillars can underpin most of the key elements of internal and external governance arrangements for regulatory agencies. They lay down principles for dealing with shareholders (the government) and stakeholders (regulated and supervised entities, customers of the regulated entities, and the public at large), and for setting up internal governance arrangements in support of the external ones. They underpin mechanisms for attaining the agency’s stated objectives and for monitoring its performance.

Although references to these four principles are rare in the corporate governance literature, some parallels can easily be made: The need for an arm's length relationship between managers and shareholders in the corporate sector finds its parallel in the need for independence for the regulator from the share- and stakeholders (government and regulated industry, respectively). Independent regulators have a fiduciary relationship with their stakeholders. To be effective, these fiduciary responsibilities need to be complemented with accountability arrangements towards the stakeholders. Furthermore, transparency mechanisms facilitate accountability, and integrity measures minimize conflicts of interest. As can already be observed from this overview, a major feature of this foursome is that they reinforce each other (Figure 1). Weakening one of them tends to undermine the effectiveness of the others, and, in the end, the quality of the agency’s governance.

![Figure 1. The four pillars of regulatory governance](image)

**Accountability**

Accountability is the indispensable, other side of independence. Yet it is a problematic one, because policy makers and agencies seem to have trouble getting a practical grasp of its workings. One of the problems is that many scholars still tend to refer to narrow concepts of accountability, more or less equivalent to reporting. Another problem is that the line between accountability and control remains very thin, leading to misunderstandings about the true meaning and content of accountability. The purpose of designing accountability arrangements is to put in place a combination of monitoring arrangements and instruments, so as to arrive at a situation where no one controls the agency directly, but the agency is nonetheless under control, i.e., it can be monitored—not just by the government, but by other stakeholders as well—to see if it fulfills its fiduciary obligations.

Modern interpretations of accountability as a mechanism of checks and balances stress that it fulfills at least four functions.

1. To provide public oversight. This is the classical role of accountability.
2. To maintain and enhance legitimacy of the agency. The actions of an agency with delegated power need to have legitimacy in the eyes of the other stakeholders, in order to enjoy the granted independence effectively. If the agency’s actions are perceived as lacking legitimacy, its independence will not be long lasting. Legitimacy can be generated through various accountability mechanisms and relations. Once it has been accepted that accountability generates legitimacy, and legitimacy supports independence, it becomes clear that the relationship between accountability and independence does not imply a trade-off, as is often stated, but is one of complementarities. In other words, properly designed independence and accountability arrangements lead to a virtuous interaction between both pillars of governance.

3. To enhance the integrity of regulatory governance. Besides political and industry capture, independent agencies face a third type of capture: Self-interest capture. There are situations in which the powers of the regulatory agency are captured by individual staff pursuing their own self-interest, which may not be consistent with social welfare. Regulatory self-interest can take a variety of forms including, in highly corrupt societies, the abuse of regulatory powers to extract rents. Less blatant, but potentially just as damaging, is the motivation of “not on my watch,” i.e., the desire of regulators to delay the emergence of problems until after they have left office. Agency accountability provides society with assurances that regulation is not being manipulated or subverted by private interests.

4. To improve agency performance. Accountability is not only about monitoring, blaming, and punishing. It is also about enhancing the agency’s performance. By giving account to the executive and legislative branches of government, the agency provides input to the government as to how to (re)shape its broader economic and financial policies, and receives feedback from the government. In this sense, accountability stimulates coordination with the government and enhances the agency’s legitimacy, without encroaching on its independence. Accountability also enhances agency performance by avoiding that the independent agency becomes uninformed and loses touch with the (political) reality of the nation. Accountability forces the agency into a dialogue with all stakeholders, with positive effects on its performance.

Transparency

Transparency refers to an environment in which the agency’s objectives, frameworks, decisions and their rationale, data and other information, as well as terms of accountability are provided to the stakeholders in a comprehensive, accessible, and timely manner.

Transparency has increasingly been recognized as a “good” in itself, but it also serves other purposes related to the other components of governance. As a good in itself, policy makers have been recognizing that it is a means of containing market uncertainty. In addition, transparency has become a powerful vehicle for countering poor operating practices and policies. It has become a main conduit of accountability to a large number of stakeholders.

Integrity

Integrity is often the forgotten pillar. Yet it is an essential one, as it provides several underpinnings for good internal governance in support of the external elements. Integrity refers to the set of mechanisms that ensure that agencies’ staff can pursue institutional goals without compromising them as a result of their own behavior or self-interest. Integrity affects staff of regulatory agencies at various levels. Procedures for appointing heads, their terms of office, and criteria for removal should be such that the integrity of the board-level appointees (policy-making body) is safeguarded. Second, the integrity of the agency’s day-to-day operations is ensured through internal audit arrangements, which ensure that the agency’s objectives are clearly set and observed, and accountability is maintained. Ensuring the quality of the agency’s operations will maintain the integrity of the institution and strengthen its credibility to the outside world. Third, integrity also implies that there are standards for the conduct by officials and staff of their personal affairs, to prevent conflicts of interest. Fourth, assuring integrity also implies that the staff of the regulatory agency enjoy legal protection while discharging their official duties.

Mutual Reinforcement

A key feature of these four pillars is that they hold each other in balance and reinforce each other as governance pillars. The previous paragraphs have already illustrated this, and a few more examples
will reinforce the point. Independence and accountability are two sides of the same coin. Independence cannot be effective without proper accountability. Without accountability, agencies (or their heads) can lose their independence easily in disputes with the government. Transparency is a key instrument to make accountability work. It is also a vehicle for safeguarding independence. By making actions and decisions transparent, chances for interference are reduced. Transparency also helps to establish and safeguard integrity, in the sense that published arrangements provide even better protection for agency staff (against themselves). Independence and integrity also reinforce each other. Legal protection of agency staff, as well as clear rules for the appointment and removal of agency heads, support both their independence and integrity. Finally, accountability and integrity also reinforce each other. Because of accountability requirements, there are additional reasons for heads and staff to keep their integrity. Together, they reduce the risk of self-interest capture.

Accountability is extremely important in the case of a financial supervisor. As stated before, this agency’s mandate is much less measurable (such as “to maintain a sound financial system” often in conjunction with other goals such as “consumer protection,” “prevention of money laundering,” etc.), and cannot be very specific because of all the contingencies involved in financial sector regulation and supervision. Some authors have argued that such a vague mandate precludes proper accountability, and, therefore, that these agencies should not be granted too much independence from government.

The argument developed here states that, on the contrary, these agencies should be able to operate at arm’s length from the government (and the industry) for the reasons discussed in the literature, but that accountability arrangements should be such that the agency remains “in check.” Given the wide range of contingencies in financial regulation and the large number of stakeholders in financial regulation and supervision, a “360 degree”-type of accountability is required, involving arrangements towards the three government branches, the supervised industry, the customers of financial services, and the public at large. In more general terms, the less specific and measurable the mandate, the more elaborate accountability arrangements should be.

Conclusion

In sum, these four underpinnings, taken together, create clarity in the relationship between the financial supervisors and the government (and other stakeholders). With sufficient checks and balances in place, the agency will have assurances that it can operate independently to pursue its mandate, and the government will have assurances that the agency remains “in check,” i.e., that its operations remain aligned with the government’s broad policy objectives. Referring to Williamson’s definition, all this is indeed about shaping and reshaping incentives on both sides.

More Info

Books:


Articles:


Notes

2 Williamson (2000).

See Also

Best Practice

• US Financial Regulation: A Hopeless Tangle, or Complexity for a Purpose?
• Why Organizations Need to be Regulated—Lessons from History

Viewpoints

• Viewpoint: Jay W. Lorsch
• Viewpoint: Viral Acharya and Julian Franks

Checklists

• Comparative and International Financial Regulation
• The EU Regulatory Regime

Industry Profile

• Banking and Financial Services

To see this article on-line, please visit http://www.qfinance.com/financial-regulation-best-practice/how-much-independence-for-supervisors-in-financial-market-regul?full