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Financial Supervision in the 21st Century

 Springer

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Foreword

What distinguishes this book is that it is not just about the last crisis and not very much about the law.

Most of the analyses that have appeared in the wake of the Global Financial Crisis (GFC) explore the nature of regulations which, if only they had been in place, might have averted the disaster or mitigated its effects. But that particular form of learning seems narrow and partial compared with what we need to minimize, i.e. the likelihood and severity of future crises. Spectacular failures in complex systems are nearly all novel. As with the forensic debriefing of commercial airplane crashes, we know how—by prescribing control enhancements based on retrospective investigations—to ensure that any particular accident that happened once can then never happen again.

As the GFC unfolded and was quickly dubbed a regulatory failure, critics questioned whether US regulators had learned anything at all from the Savings and Loans crisis of the 1980s. The answer was clearly yes; they had learned how to prevent another Savings and Loans crisis. But lessons drawn from the 1980s did not much help financial regulators anticipate or head off a sub-prime mortgage crisis, or understand the destabilizing implications of risk exposures based on Credit Default Swaps. Dissecting the last crisis is always necessary but never sufficient.

Nor is it sufficient to focus only on the content of the law, for two reasons. First, important risks often have nothing to do with noncompliance. Many serious road accidents and most plane crashes occur without anyone having violated a law. Causes can include mechanical failure, tiredness, carelessness, distractions, or unpredictable interactions among complex systems. Likewise, instability in financial markets may result from a range of causes—for example, unhealthy correlation in exposures or unforeseen interactions between computerized trading algorithms—which do not involve violations by anyone and which are unlikely to be controlled through any set of standard or static regulatory requirements enforced at the level of specific firms. But such risks to markets, investors, and financial systems nevertheless need to be spotted, studied, understood, and controlled, despite not being amenable to traditional forms of regulation.

Second, focusing solely on the state of the law overlooks the enormous difference that professional regulators (or “supervisors” as the Dutch call them) can make. These professionals stand between the law as written and societal protections as delivered. It matters how regulators organize themselves and what methods they use to prioritize attention and target resources. It matters what skills they develop. It matters what forms of discretion they recognize and exercise and how they explain and defend the choices they must inevitably make. It matters whether they understand the disparate motivations of the regulated community and whether they have mastered the full range of techniques for managing compliance and influencing behavior. It matters what forms of analysis they conduct and intelligence systems they use, as those choices will largely determine which risks they can see and which ones they may miss. It matters what forms of relationship they establish with the industry and whether purpose is sacrificed for comfort. And, perhaps most significantly, it matters a great deal whether they address themselves only to the narrow task of compliance-management or whether they assume the broader challenge of identifying and controlling risks.

By focusing on regulatory *practice* rather than regulatory law, the chapters in this book tackle important contemporary questions for professionals: What is “quality supervision”? What is the relationship between enforcing regulations and managing risks? On what basis might one determine whether to choose rule-based, principle-based, or self-regulatory structures? Can regulators address system-level risks? If so, what is the relationship between that task and the more familiar work of managing firm-specific behavior? How do we measure regulatory performance in the absence of any recent disaster? How should we evaluate it in the wake of a disaster? Do we only know how to describe regulatory failures, looking backward, or can we actually specify best practice, looking forward?

All these questions, of course, have relevance far beyond the field of financial regulation. Similar questions are being asked across the entire regulatory frontier by those concerned with controlling different risks, such as crime, pollution, occupational and transportation hazards, terrorism, corruption, and disease.

Most of the questions this book examines were being considered *anyway*, although at a more leisurely pace, even before the Global Financial Crisis (GFC) erupted. The reason we have this particular book at this particular time, written by a set of leading financial regulators from around the globe, is that the GFC shook financial regulation to its core, making change more urgent, exposing the inadequacy of traditional approaches, intensifying debate, and accelerating the processes of experimentation and innovation. More has happened lately, therefore, in this domain than in most other regulatory domains. Therein lies the value of this collection of chapters for a much broader regulatory audience: the chance to share the benefits of financial supervision’s recent ferment and accelerated learning.

The questions about regulatory practice that were being asked anyway, and which have been asked so much more intensively in the wake of the crisis, boil down to this: “What does it actually mean to be an effective risk-based regulator?” Many regulators adopt the rhetoric of a risk-based approach, but struggle to define the implications for operations.

We have learned from a spate of recent catastrophes (terrorist attacks, mining disasters, Hurricane Katrina, the Japanese earthquake and tsunami, as well as the financial crisis) what the public expects of their governments with respect to risk control. Citizens do not expect that governments will be able to avoid all disasters or contain all harms. But they do expect government agencies to provide the best protection possible, and at a reasonable price, by being:

- (a) *Vigilant*, so they can spot emerging threats early, pick up on precursors and warning signs, use their imaginations to work out what *could* happen, use their intelligence systems to discover what others are planning, and to do all this even before much harm is done
- (b) *Nimble*, flexible enough to organize themselves quickly and appropriately around each emerging risk rather than being locked into routines and processes constructed around the risks of a preceding decade, and being more problem-centric than program-centric
- (c) *Skillful*, masters of the entire intervention toolkit, experienced (as craftsmen) in picking the best tools for each task, and adept at inventing new approaches when existing methods turn out to be irrelevant or insufficient to suppress a risk¹

These notions are fundamental to effective risk control. The chapters in this book put flesh on these bones with a lot of practical experience and novel ideas. To give a few examples: In terms of *vigilance*, the contribution of Kellermann and Mosch describes the importance of thematic analysis and research as a supplement to more traditional forms of firm-specific monitoring, particularly given the significance of macro-prudential risks. As risks come in many different shapes and sizes, it helps to slice and dice the world from a variety of perspectives. Some risks result from specific forms of noncompliance by one firm. But others have to do with specific types of financial products, or investment instruments, or marketing methods, or categories of vulnerable investors, or market instabilities of one kind or another caused by regrettable correlations or collective behaviors. Using a broader range of analytic lenses and perspectives increases a supervisory agency's chances of spotting anomalies and understanding emerging threats early.

In terms of organizational *nimbleness*, the contribution of Houben explores the practical implications of the complex relationship between macro-prudential (i.e., system issues) and micro-prudential (i.e., firm-specific) considerations and describes the search for organizational designs that support effective collaboration between differently focused units. Addressing the merits of alternative regulatory *structures*, de Vries provides a thoughtful and practical discussion of the paradoxes of principle-based supervision, which leads to useful and nuanced guidance for supervisors as they contemplate whether and where to use rule-based, principle-based, or self-regulatory structures for different classes of risk. And as many European countries shift variously among *sectoral*, "twin peaks," and *single supervisor* oversight structures, the contribution of van Hengel, Hilbers, and Schoenmaker provides a

¹ This summary framework was originally presented in Sparrow (2012).

risk-focused analysis, specifying which classes or risks might be better managed under which structure and how best to handle the conflicts of interest that can arise between prudential and market-conduct supervision. Their chapter also addresses the design of multi-tiered regulatory structures, promoting a rational approach to determining which regulatory tasks ought properly to belong at the European level rather than national level and how best to structure the European controls.

In terms of *skillfulness*, the contribution of Richards explores the considerable range of tools available to regulators for influencing behavior and shows how to pick the right tools for the job by matching different methods to differing motivations and attitudes. Kellermann and Mosch emphasize the importance of skills-based education for supervisors, with a view to enhancing personal effectiveness, assertiveness, and confidence when dealing with powerful industry players. The contribution of Adams discusses the particular set of communication skills essential to risk-based regulation: how to shape public expectations, how to communicate risks in the absence of catastrophe, and how to procure a suitable and sustainable level of attention and appropriate tolerance for regulatory impositions.

The contribution of Nuijts and de Haan examines the prospects for “culture and conduct regulation,” recognizing that some risks stem from incentive schemes that induce unwise or illegal behaviors in order to meet short-term performance-based goals. These authors describe the Dutch Central Bank’s pioneering efforts to improve firms’ underlying decision-making frameworks, orienting them more closely to long-term stability. To do this, DNB has exploited the existing research literature on what characterizes “high-performance” organizations, and deployed organizational psychologists and change experts (alongside auditors, economists, and lawyers) to examine Board and executive-level decision-making processes. The attempt to diagnose “culture and conduct” in order to get at the roots of excessively risky behaviors is certainly ambitious. Many regulators might suspect this is not possible or question whether it pushes regulatory intrusiveness too far. But Nuijts and de Haan describe how DNB defends this approach and has actually implemented it using as diagnostic tools a combination of desk-research, interviews, organization-wide surveys, and observation of Board or executive-level meetings, and how DNB supervisors have been able to provide feedback and guidance to firms where defects in culture and weaknesses in decision-making became apparent.

In my view, the chapters collected in this book provide a rich set of landmarks in a terrain that a great many regulatory practitioners—financial and otherwise—are already exploring. This book helps clarify the aspirations of modern regulatory professionals as they confront increasingly complex and rapidly evolving risks. It highlights the strategic and organizational challenges a supervisory agency faces when it shifts its overarching framework from compliance-management to risk control. And it provides an illuminating collection of innovative ideas, many of which could readily and usefully be translated into other regulatory settings.

I heartily commend it to you.

Malcolm K. Sparrow

Reference

Sparrow MK (2012) The sabotage of harms: an emerging art form for public managers, ESADE Institute of Public Governance & Management, E-newsletter, March 2012 (published in English, Spanish & Catalan)