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Beyond Finance

Financial Supervision in the 21st Century

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Central bank and prudential supervisor of financial institutions

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2. Malcolm Sparrow: What does it mean to be a risk-based regulator?

Take a few steps back and look at where you are. Am I doing what's needed? Am I doing what I think a regulator ought to do? Malcolm Sparrow, Professor in the Practice of Public Management at Harvard, asks these questions (and many others) to regulators in the financial sector. He claims not to have a theory and he makes no recommendations; he 'simply sketches the landscapes of the dilemmas' with which regulators are faced. In this article, he does this in three sections. He successively puts the mission, daily practice and the responsibilities of regulators under the magnifying glass.

No regulator will argue with the fact that his job consists, at the very least, of combatting harmful and illegal practices. This is represented by the section in figure 1 in which the two circles overlap. The discussion about the extent of a regulator's mission becomes interesting outside that intersection: should regulators expected spend time on non-compliance issues that cause little or no harm? And should they tackle harms for which they have no rules and therefore may lack any formal authority?

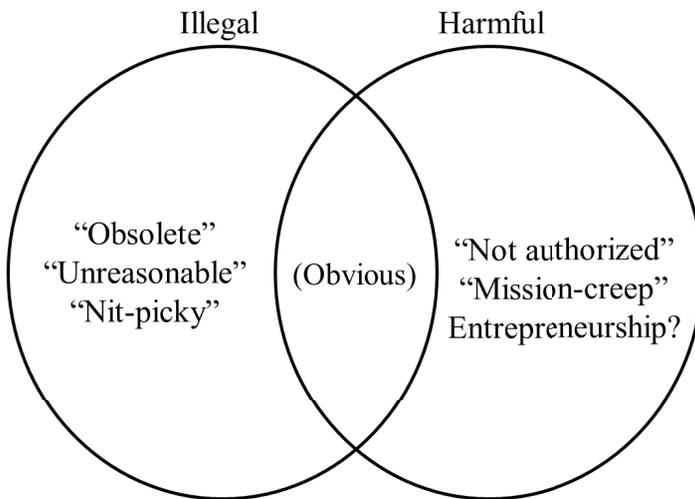
I regularly ask regulators which way would they lean if they had half a working day left over per week, after tackling all the issues that lie in the intersection. On what would they focus their regulatory work in these extra hours: more compliance work, or more harm-reduction? 95 per cent say that they would choose the circle on the right: harm reduction.

In my view, this is reflective of the times in which we live. What is the ordinary citizen concerned about? His attention is more focused on disasters, accidents, and other risk areas where citizens expect governments to provide some protection... These are events in which the first question to be asked is not whether rules have been infringed and, if so, which rules. The question is rather how the suffering caused by these events can be prevented, reduced, mitigated, or otherwise relieved. These are risk control issues first, and legal issues if and only if law turns out to be a useful tool in the business of controlling them.

Explicitly embracing the 'expert' model of regulation (i.e. choosing the frame provided by the right hand circle) means putting aside the notion that, for regulators,

Figure 1

Setting the Mission



Malcolm K. Sparrow

John F. Kennedy School of Government, Harvard University

‘the law is master’. Instead, the law becomes one tool amongst many, part of a larger toolkit incorporating a multiplicity of methods for influencing behaviors and reducing risks. Of course, adopting the expert frame brings with it the danger that regulators will be accused of acting outside their mandate of circumnavigating the democratic process. Quite commonly, regulators who have done excellent work in risk identification and control, when challenged, quickly resort back to the left hand circle – the legal model of regulation – to justify their actions and satisfy demands for accountability.

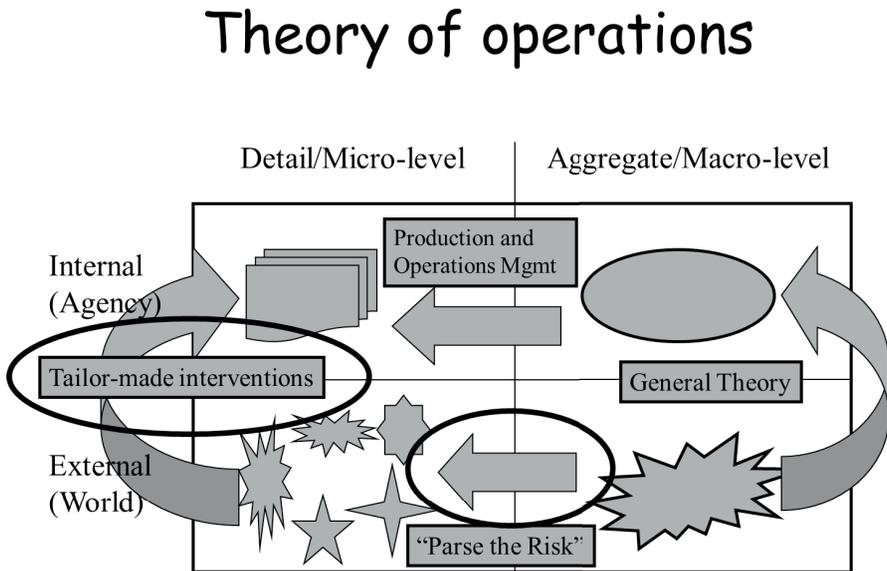
It would be good for regulators to be clear what position they occupy with respect to these two different frames; and to understand if they are moving in any particular direction, and why. One potential answer to the question ‘what does it mean to be a risk-based regulator’ might be ‘to explicitly embrace the expert model, and thus orient one’s efforts around the task of risk-control’. For a regulatory body traditionally focused on rules and compliance, that would constitute a profound change, with far-reaching implications.

The second dilemma that I want to discuss concerns the balance between program-centric work and problem-centric work. Figure 2 illustrates two rather different modes of organizational behavior. They both start in the bottom right hand quadrant, where some general class of harm – human trafficking, corruption, environmental pollution, financial instability, etc. – is deemed insufficiently controlled. It is a macro-level, general problem, and it exists in the outside world.

The program-centric route first establishes a general theory (‘what is our general approach?’), defining what government will do and it constructs major functional units (i.e. audit, investigations, education, etc.) and core processes. These core programs and processes belong in the top right quadrant. Then, the work had to be split up and handed out, which is generally done using classic matrix style functional and geographic organizational structures.

The alternate route to action passes instead through the bottom left hand quadrant, where specific risk concentrations are spotted, studied, carefully described and then tackled one by one. This ‘problem-centric’ approach often bypasses the core programs and standard approaches, and produces innovative and tailor-made responses to specific issues.

Figure 2



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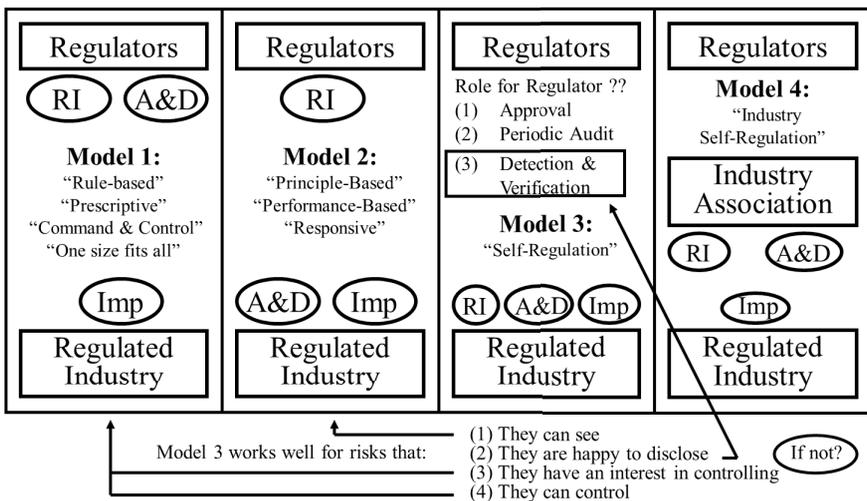
The state-of-the-art in terms of organizational theory for regulatory agencies involves figuring out the answers to three questions relating to these two quite different modes of conduct. First, how should problem-centric (or risk-based) be formally organized and supported? Second, how much of the work of the agency should flow through the two different modes? Thirdly, how do the two different types of work interact with each other, both inside the agency and in the experience of the regulated community?

Thirdly, I'd like to raise the question of where one chooses to place responsibility for various aspects of the risk-control task. Which parts of the job should the regulator take on, and which should be delegated to the industry? Splitting the risk-control task into three crude phases – risk identification, risk analysis and design (of interventions) and finally implementation – and placing these firmly in the hands of either government or of industry, provides us with a range of different permutations. These permutations relate rather closely with different regulatory structures.

Figure 3 shows four different regulatory structures, which differ primarily in the ways in which these parts of the risk-control task have been allocated.

Figure 3

Locating responsibility for: (1) Risk Identification (RI)
 (2) Analysis & Design (A&D)
 (3) Implementation (Imp)



If risk-identification (RI) and risk-analysis and design (A&D) are the responsibility of the regulator and the institutions are responsible only for the implementation (Imp) of the measures designed by the regulator, this is referred to as rule-based or prescriptive regulation. Pressure to move away from this first model result from diversity within the industry (i.e. the realization that one size really does not fit all), and the need to accommodate technical innovation more readily (i.e. the realization that rules evolve too slowly and therefore do not keep up). As a result of these pressures, we see various types of performance-based regulation, where the industry is trusted to conduct its own analysis of the risks the regulator is concerned about, and the regulator holds industry accountable for the results rather than for compliance with prescribed rules. This shift is also intended to give new emphasis to the spirit, rather than the letter, of the law.

High-tech industries push further, claiming they know their own risks better than government, and hence they should be trusted with the risk-identification piece as well. Under the third model, companies are expected to run their own risk-management systems, and regulators audit the risk-management program periodically to make sure it is operating effectively.

Finally, a fourth model emerges when companies band together, seeking economies of scale and negotiating power, and form association that conduct various aspects of the risk-control task on their behalf. Such associations tend not to use enforcement (they generally lack any enforcement powers) and rely on promulgating guidelines and standards instead. They can act as a buffer between industry and government, and they are more kindly disposed towards the industry, being a creation of it.

There are variants of these four basic models, of course. Some parts of the risk-control task can be contracted out to third parties, as happened in the case of credit rating agencies, for example. Also, any of these tasks can be shared, done in collaboration between industry and government, rather than being unambiguously placed either up or down. Sharing one or more of these tasks produces several varieties of what some call 'co-regulation'. Finally, the jurisdictional structure (shown in the chart as a single layer) is often in fact multi-layered, making the question of where to place which aspects of the risk-control task all the more important, as well as more complex. Regulators need to be masters of all these different structures, understanding their strengths and weaknesses, and better able to pick the right model for various classes of risk.

Concluding remarks

In these very brief comments I have chosen three out of the multiplicity of dilemmas with which regulators are confronted. Regard these as diagnostic devices. Clamp these frames down on your organization and see what they show you.

Is your agency oriented primarily around law enforcement or around the task of identifying and controlling risks? Is the tension between these ideas discussed, and adequately understood?

What is the balance between program-centric and problem-centric work in your organization? Does it need to change? Are there important risks – particularly novel, unfamiliar, invisible, or emerging risks – that are simply not controlled through your agency’s traditional programs and processes?

Which regulatory structures do you currently employ? Is the choice of regulatory structure well-tailored to specific risks and their properties, or is it based on ideological preferences or political pressures? The European ‘Better Regulation’ movement had appeared to espouse a preference for ‘light-touch, trusting, self-regulatory approaches’. It would be dangerous to assume that this approach, or any other one, could be ‘right’ for all risks. Getting the systems of control matched properly to different classes of risk, understanding the incentives and capabilities of the different parties, is a much more complex business.