The Governance of Financial Supervisors:

Improving Responsiveness to Market Developments

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Abstract

We offer a menu of mechanisms to improve the governance of 'normal times' financial supervisors (as opposed to resolution agencies and systemic risk boards). To enhance supervisory effectiveness, we propose to institutionalize strong CEOs, with boards or commissions being limited to basic policy decision-making and to monitoring. Moreover, lower level staff would get increased line responsibilities. Market responsiveness, for its part, would be improved by subjecting supervisors to reinforced disclosure requirements.

Keywords: Supervisory agency decision-making; financial supervision; supervisory responsiveness; transparency, flat hierarchies.

JEL Classification: D23; D73; G28; H83; K22; L22;

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I. INTRODUCTION

Tougher financial regulation and supervision generally follow financial crises, not least to appease public opinion. The credit crisis of 2007-09 is no exception, but its severity has created high expectations that policy-makers get it right this time. This has led to multiple reform proposals. In particular, it has been suggested to subject banks to more stringent capital and structural requirements and to set up new systemic risk and resolution agencies.

There are good reasons for targeting market participants as well as public sector institutions. Private sector actors failed to properly manage financial risks, while financial innovation and compensation practices compounded the problem by shifting those risks to parties unable to bear them. Financial regulators and supervisors, as well as monetary and fiscal authorities, proved incapable of addressing risk taking in a timely manner—or even contributed to private sector excesses by facilitating risk taking through low interest rates, misconceived regulation and laid-back supervision.[1]

While they extensively deal with corporate governance and supervisory architecture, post-crisis reforms pay scant attention to the governance of financial supervisors. In the literature, in turn, there is an ongoing debate on enhancing agency independence and accountability.[2] However, this leaves many supervisory governance issues unaddressed. Independence refers to the need for a sufficient distance between supervisors and politicians. Accountability centers on monitoring supervisors' compliance with their mandates and use of fiscal resources. In addition, the few studies which address agency governance in more detail focus on central banks and, more specifically, their monetary policy activities.[3]

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[1] For the multiple causes of the credit crisis, see recently Raghuram Rajan, FAULT LINES: HOW HIDDEN FRACTURES STILL THREATEN THE WORLD ECONOMY (Princeton University Press 2010).

[2] See, recently, Donato Masciandaro & Marc Quintyn (Eds.), DESIGNING FINANCIAL SUPERVISION INSTITUTIONS, INDEPENDENCE, ACCOUNTABILITY AND GOVERNANCE (Edward Elgar 2007) and the cited literature; Donato Masciandaro, Maria J. Nieto & Marc Quintyn, *Will They Sing the Same Tune? Measuring Convergence in the New European System of Financial Supervisors* (IMF Working Paper 2009/142, available at ssrn.com). See also Udaibir Das & Marc Quintyn, *Financial Crisis Prevention and Crisis Management, The Role of Regulatory Governance* (IMF Working Paper 2002/163, available at ssrn.com).

[3] See Bank of International Settlements (BIS), *Issues in the Governance of Central Banks* (May 2009); Lars Frisell, Kasper Roszbach & Giancarlo Spagnolo, *Governing the Governors: A Clinical Study of Central Banks* (Sveriges Riksbank Working Paper 2008/54, available at ssrn.com); Christopher Growe & Ellen E. Meade, *The Evolution of Central Bank Governance around the World*, 21 JOURNAL OF ECONOMIC PERSPECTIVES 69 (2007).

The purpose of this paper is to discuss more directly how 'normal times' financial supervision can be improved by means of internal and external governance proposals.

By normal times financial supervision we refer to the powers of a state agency[4] over a solvent bank or another financial intermediary considered in isolation. These powers should be distinguished from the powers a state agency may have to deal with the risks faced or propagated by financial intermediaries as a whole (systemic risk) or with the resolution of an insolvent financial intermediary. Systemic and resolution interventions are essentially salvage operations, given the very low probability of a financial crisis being prevented or a financial intermediary surviving resolution. By contrast, normal times interventions generally result in continued operations by the financial intermediary.

We single out internal and external governance devices that should improve financial supervisors' effectiveness as well as market responsiveness. The reforms we suggest are complementary to the work of resolution agencies and to current efforts to build systemic risk surveillance institutions: if normal times prudential supervisors are efficient and market responsive, bank insolvencies and systemic crises may become more manageable. However, we must stress that the core aim of our proposals is to improve day-to-day supervision, *not* to prevent or even merely detect financial crises early on.

The reforms we propose can be characterized as operational, discrete and resilient to regulatory capture. To begin with, each proposal is relatively easy to implement. In addition, we offer a menu of proposals from which policymakers can pick one, any or all of the single items with no material loss in complementarity advantages. Finally, our governance devices are tailored so as to limit the impact of rent seeking by minimizing the costs of deficient implementation due to interest group pressure.[5]

Improving effectiveness and market responsiveness while keeping rent-seeking under control requires the taking into account of supervisory agencies' behaviour. Therefore, we

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[4] We assume that financial supervision is conducted by an agency located outside the government, which is generally the case nowadays. See also *infra* note 11 and accompanying text.

[5] See e.g. Jean-Jacques Laffont & Jean Tirole, *The Politics of Government Decision-Making: A Theory of Regulatory Capture*, 106 QUARTERLY JOURNAL OF ECONOMICS 1089 (1991); Jean-Charles Rochet, WHY ARE THERE SO MANY BANKING CRISES? (2008); Donato Masciandaro & Marc Quintyn, *Politicians and Financial Supervision Unification Outside the Central Bank: Why Do They Do It?*, 5 JOURNAL OF FINANCIAL STABILITY 124 (2009).

begin our analysis by sketching the incentives of agency personnel and how they can be expected to shape collective decision-making. We point out that there is an inherent tension between bureaucrats' self regarding preferences (for example, career considerations) and their other regarding preferences (for example, ideological beliefs). The net impact of this bundle of incentives is hard to assess, not least because bureaucratic behavior, like all human behavior, is affected by cognitive distortions. However, we illustrate that bureaucratic decision-making in financial supervision agencies is not unlike corporate decision-making. This similarity makes it suitable to adopt an analytical approach to agency governance that is inspired, but not dominated, by the principal-agent approach adopted for business corporations.

We then proceed to discuss in detail how to improve internal governance, i.e. the way the supervisory agency is organized, directed, and controlled from within. We essentially argue that institutionalizing a strong CEO position would significantly improve agency management. The agency's board (or commission)[6] remains in charge of basic policy decision-making and monitoring. Operational decision-making, on the other hand, is the exclusive province of a CEO, whose grip on agency affairs would be strengthened by flattening the agency's hierarchy. The CEO is subject to appointment and removal by a majority of the board, partly because the board is best placed to observe CEO performance and partly to minimize the risk of external political interference.

By themselves, these internal governance reforms would not guarantee that agencies will avoid making mistakes. But they would improve agency effectiveness by giving the CEO default powers and allowing him or her to be in more immediate contact with front-line managers, thus reducing information distortion and managerial interference by mid-level career bureaucrats. These reforms will also enable the board to devote more time to monitoring the implementation of its policies while decreasing the risk of politically driven board intervention at the operational level.

Although we do not know of any paper developing similar proposals for financial supervisors, the proposals are not 'new'. Monetary authorities and a few financial supervisors

[6] The body at the top of an agency's hierarchy is generally called a board or a commission. We will generally refer to this body as the 'board'.

(especially when they are housed within central banks) have adopted some of the suggested internal governance arrangements. However, many supervisory agencies and, more importantly, critical supervisory reform proposals at the European or global levels do not provide for such arrangements. It is these situations that we target.

Finally, we address the issue of how to reform external governance, i.e. the constraints on supervisory behavior that derive from the voluntary or involuntary interaction with the outside world. Policymakers can shape this interaction directly, by requiring the agency to maintain a given relationship with an outside player (the Government, Parliament, other domestic or international supervisors, etc.) or by designing a supervisory framework that allows for some degree of outside "market" pressure on supervisory behaviour. In this paper, we propose to reinforce market responsiveness by enhancing supervisory agencies' disclosure.

We identify six key areas where supervisory agencies in many countries could become more transparent (and therefore more subject to market pressure) with no material harm to their effectiveness and independence: the appointment process, business planning, periodic reporting, interactions with lobbies, and, with due qualifications, decision-making and enforcement actions. In particular, we advocate public confirmation debates before the relevant political body for top appointees and public disclosure of agency business plans. We also propose that financial supervisors publicly disclose detailed financial statements and the type of governance information typically required from the entities they supervise. Finally, we suggest full disclosure of lobbying activities involving supervisory authorities, publication of the minutes of board meetings as well as comprehensive information about enforcement actions. These proposals are not entirely new. But to the extent they are not, the fact is that many supervisory agencies and, more importantly, critical supervisory reform proposals at the European or global levels do not provide for such arrangements.

The remaining of the paper is structured as follows. Section II sketches out decision-making within supervisory agencies. The next two sections, drawing from insights in the industrial organization and corporate governance literature, provide a menu of possible reforms. Section III proposes the adoption of leaner internal governance structures to improve supervisory agency effectiveness. We then explore the idea of enhancing supervisory responsiveness by way of public disclosure in Section IV. Section V briefly concludes.

II. SUPERVISORS' INCENTIVES AND PRINCIPAL-AGENT ISSUES

Financial supervisors exist because law enforcement by market participants and criminal prosecutors is universally deemed to be insufficient to ensure the orderly functioning of financial markets.[7]. The majority of financial sector supervisors operate as stand-alone public sector agencies, with the notable exception of banking supervisors being often part of the central bank.[8]

Usually, financial supervisors are not in a hierarchical relationship with the executive branch. The rationale for independence is that, supervision being a highly technical task, bureaucrats motivated by career concerns are more likely to respond adequately to market developments than politicians who typically only care about re-election.[9] But an alternative, more realistic explanation is that politicians delegate supervision because it is "[an] especially risky [area], i.e. where much can go wrong,"[10] in which case they can use unelected bureaucrats as scapegoats.[11] Consequently, the bureaucrats in charge of financial supervision are granted a fair amount of discretion. To the extent supervision is delegated for technical reasons, it is difficult to fine-tune the delegation of powers.[12] When the goal is to be able to

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[7] See e.g. David A. Moss, WHEN ALL ELSE FAILS (Harvard University Press 2002); Katharina Pistor & Chenggang Xu, *Incomplete Law,* 35 NEW YORK UNIVERSITY JOURNAL OF INTERNATIONAL LAW AND POLITICS 931 (2003).

[8] See Financial Stability Institute, Institutional Arrangements for Financial Sector Supervision, Results of the FSI 2006 Survey (Occasional Paper 2007/7 available at bis.org); Steveen Seelig & Alicia Novoa, *Governance Practices at Financial Regulatory and Supervisory Agencies* (IMF Working Paper 2009/135, available at ssrn.com).

[9] Alberto Alesina & Guido Tabellini, *Bureaucrats or Politicians? Part I: A Single Policy Task*, 97 AMERICAN ECONOMIC REVIEW 169 (2007); Steven P. Croley, REGULATION AND PUBLIC INTEREST, THE POSSIBILITY OF GOOD REGULATORY GOVERNMENT (Princeton University Press 2008).

[10] See generally Alberto Alesina & Guido Tabellini, *Why Do Politicians Delegate?* (NBER Working Paper 2005, available at ssrn.com).

[11] *Ibid*. See also Morris P. Fiorina, *Legislative Choice of Regulatory Forms: Legal Process or Administrative Process?* 39 PUBLIC CHOICE 33 (1982).

[12] See e.g. Murray J. Horn, THE POLITICAL ECONOMY OF PUBLIC ADMINISTRATION (Cambridge University Press 1995); David Epstein & Sharyn O'Halloran, DELEGATING POWERS (Cambridge University Press 1999).

blame bureaucrats if financial regulation proves costly or fails to prevent a crisis, it is best to give bureaucrats the possibility to choose among various options.[13]

Like in any private or public organization, discretion brings the risk that bureaucrats fail to discharge their duties in the best interest of their ultimate principals (consumers of financial services and taxpayers), or even their intermediate principals (politicians, financial intermediaries and other stakeholders).[14] In fact, the human beings in charge of financial supervision are not anthropologically different from other agents in the market. Whether at the top of such an organization (as chairperson, board members or commissioners) or at lower levels (as officers with managerial tasks, professionals, or rank and file employees), bureaucrats will tend to pursue their own personal goals, which may easily prompt them to take courses of action that are sub-optimal from the viewpoint of principals.[15]

It is well known that various forces drive bureaucrats' behaviour in general and supervisors' specifically.[16] Leaving aside purely monetary motivations, which in the worst-case scenario lead to acceptance of bribes, bureaucrats are generally held to be motivated by the desire to increase their personal power, their prestige, and their career chances, while at the same time minimizing the legal and reputational risk connected with the discharge of their duties. In the case of rank and file employees, the desire to conduct a quiet life plays an important role as well.

The desire for *personal power* easily prompts top bureaucrats to maximize their agency's budget with no due consideration of whether an additional dollar has any positive marginal utility, i.e. whether it increases the welfare of financial services consumers and

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[13] See James R. Barth, Gerard Caprio Jr. & Ross Levine, *Bank Regulation and Supervision: What Works Best?*, 13 JOURNAL OF FINANCIAL INTERMEDIATION 205 (2004); Stavros Gadinis & Howell Jackson, *Markets as Regulators: A Survey*, 80 SOUTHERN CALIFORNIA LAW REVIEW 1239 (2007).

[14] See Gordon Tullock, THE POLITICS OF BUREAUCRACY (Public Affairs Press 1965).

[15] See Timothy Besley, PRINCIPLED AGENTS? (Oxford University Press 2006). Supervisors' ability to discharge their duties is also affected by cognitive biases, which may exacerbate agency problems: see Stephen J. Choi & A.C. Pritchard, *Behavioral Economics and the SEC*, 56 STANFORD LAW REVIEW 1, especially at 21-36 (2003). The insights of behavioural economics should therefore reinforce the principal/agent approach taken here.

[16] See already George Stigler, G., 1971, *The Theory of Economic Regulation*, 2 BELL JOURNAL OF ECONOMICS 3 (1971). See more recently Canice Pendergast, *The Motivation and Bias of Bureaucrats*, 97 AMERICAN ECONOMIC REVIEW 180 (2007).

taxpayers.[17] It may also lead bureaucrats to enact systemic or investor protection rules that grant them interventionist powers even when other more effective and less intrusive legal arrangements would be available.

Conversely, a concern for their ideological legacy and for their reputation as people who do their job well can be a powerful incentive for bureaucrats to act in the interest of consumers of financial services or taxpayers. However, if the desire for *prestige* takes the form of maximizing the agents' presence in the media, incentives could become distorted and result in actions that are not in their principals' interest. Bureaucrats may focus their attention on media-sensitive issues that are less relevant for depositors or investors than other, less visible areas of action; alternatively, bureaucrats may put an excessive effort in promoting their agency's image, while not concentrating enough on substantive issues their principals care about.[18]

Career concerns are a comparable driver of bureaucratic behaviour.[19] They may result in civil servants interests being aligned with those of consumers of financial services or taxpayers, for example when they consider their job as a gateway to an elected office. But career concerns may also make bureaucrats sensitive to the interests of stakeholders more directly able to give them career opportunities, such as regulated entities, lobbyists, law firms and other providers of financial supervision-related services.[20]

Finally, all bureaucrats are averse to the risk of taking the blame or, more dramatically, being held *legally liable* for failure to act or for taking the wrong actions.[21] This explains the

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[17] See William A. Niskanen, BUREAUCRACY AND REPRESENTATIVE GOVERNMENT (Aldine-Atherton 1971).

[18] Cf. Luca Enriques, *Regulators' Response to the Current Crisis and the Upcoming Reregulation of Financial Markets: One Reluctant Regulator's View*, 30 UNIVERSITY OF PENNSYLVANIA JOURNAL OF INTERNATIONAL LAW 1147, 1150 (2009) ("good financial regulators are those who are able to put substance over form. But good financial regulators also tend to be smart enough to understand that they should put image over substance, if they want to thrive").

[19] See Mathias Deatripont, Ian Jewitt & Jean Tirole, *The Economics of Career Concerns, Part I, Comparing Information Structures*, 66 REVIEW OF ECONOMIC STUDIES 183 (1999); id., *Part II, Application to Missions and Accountability of Government Agencies*, 66 REVIEW OF ECONOMIC STUDIES 199 (1999).

[20] See also Donald C. Langevoort, *The SEC as a Lawmaker: Choices about Investor Protection in the Face of Uncertainty*, 84 WASHINGTON UNIVERSITY LAW REVIEW 1591 (2006).

[21] See Seelig & Novoa, *supra* note 7 at 14; Donald C. Langevoort, *The SEC and the Madoff Scandal: Three Narratives in Search of a Story*, 2009 MICHIGAN STATE LAW REVIEW 899.

tendency to always do something verifiable *ex post* when trouble can be spotted in advance and to stick to prior practices whenever something has to be done. That can lead to excessive action of an intrusive type on the one hand, and to excessive conservatism on the other.[22]

The net impact of this bundle of incentives is difficult to assess. Clearly, there is an inherent tension between bureaucrats' self-regarding preferences (for example career considerations) and their other regarding preferences (for example ideological beliefs).[23] The analysis is further complicated by bureaucratic behavior being affected by cognitive distortions ('bounded rationality'). For example, financial supervisors may pay excessive attention to isolated but salient events or prove overly cautious due to loss aversion.[24] But, for our purposes, there is no need to precisely assess incentive trade-offs and anomalies. To begin with, agencies adjust to complex situations through simplification. Bureaucratic decision-making is facilitated by using sense-making policies.[25] For example, one can expect financial supervisors' behavior to be dominated by two meta-incentives: not being perceived as an overly passive agent and keeping the regulatory burden within reasonable boundaries. Second, bureaucratic decision-making is often collective and, more importantly, benefits from organizational correctives. In other words, institutional design is likely to reduce the impact of cognitive distortions.[26]

From that perspective, bureaucratic decision-making in financial supervision agencies is not unlike corporate decision-making.[27] This is not a surprise. Like firms, agencies exist to

[22] See also Clare Leaver, *Bureaucratic Minimal Squawk Behavior: Theory and Evidence from Regulatory Agencies*, 99 AMERICAN ECONOMIC REVIEW 572 (2009) (bureaucrats try to please interest group so as to keep supervisory mistakes hidden); Giuseppe Dari-Mattiacci, Nuno Garoupa and Fernando Gomez-Pomar, *State Liability* (Working Paper 2010, available at ssrn.com).

[23] See Jean-Luc Migué & Gérard Bélanger, *Toward a General Theory of Managerial Discretion*, 17 PUBLIC CHOICE 27 (1974); Michael Levine & Jennifer Forrence, *Regulatory Capture, Public Interest and the Public Agenda: Toward a Synthesis*, 6 JOURNAL OF LAW, ECONOMICS AND ORGANIZATION 197 (1980); Gordon Tullock, A PARTIAL REHABILITATION OF THE PUBLIC INTEREST THEORY (Columbia University Press 1982).

[24] See e.g. Richard Rose, UNDERSTANDING BIG GOVERNMENT (Sage Publications 1984).

[25] See Karl E. Weick, SENSEMAKING IN ORGANIZATIONS (Sage Publications 1995).

[26] See Herbert A. Simon, ADMINISTRATIVE BEHAVIOR (4th ed., Free Press 1997). Note that we do not claim that behavioral factors do not influence corporate or bureaucratic decision-making. See also Christoph Engel, *The Behaviour of Corporate Actors, A Survey of the Empirical Literature* (Working Paper 2008, available at ssrn.com); Henry Birdseye Weil, *Why Markets Make Mistakes* (Working Paper 2009, available at ssrn.ocm).

[27] Compare Jennifer Arlen, Matthew Spitzer & Eric Talley, *Endowment Effects Within Corporate Agency Relationships*, 31 JOURNAL OF LEGAL STUDIES 1 (2002): Donald C. Langevoort, *Opening the Black-Box of*

coordinate and motivate individual activities. And like managers', bureaucrats' actions are constrained by outside forces, i.e. monitoring by principal(s) and (to some degree) competition by rivals. Because of these similarities, we deem it suitable to adopt an approach to principal-agent problems within supervisory authorities that is inspired by the approach adopted for business corporations.[28]

Agency problems within supervisory agencies are not only comparable to conflicts of interests within firms: they are also just as intense. First, the ultimate principals are widely dispersed individual consumers and non-financial firms. This generates significant collective action problems and allows agents to play with interest heterogeneity,[29] making it highly unlikely that agents' behaviour will be monitored in a responsive way.

Second, while the ultimate principals are far removed from supervisory agents, the reverse is true for the supervisors' immediate principals. While politicians or high-ranking government officials cannot ignore the interests of consumers of financial services if they want to be re-elected or promoted, they—like controlling shareholders—have incentives to act opportunistically. For example, getting re-elected or promoted is often conditional upon getting media attention. To achieve this result, politicians or high-ranking government officials can push for juicy supervisory activism (which maximizes press coverage) and at the same time make sure that targets are not politically influential market players (which minimizes political reactions).

Third, the supervisory authority must deal with a number of stakeholders with their own special interests—in particular regulated entities, industry associations, the specialized bar and other providers of regulation and supervision-related services. At least some of these stakeholders are sufficiently homogeneous and well-organized to affect supervisory decision-making (regulatory capture). Because their interests are at least partly distinct from those of

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"Corporate Culture" in Law and Economics, 6 JOURNAL OF INSTITUTIONAL AND THEORETICAL ECONOMICS 1 (2006).

[28] See also Carl Walsh, *Optimal Contracts for Central Bankers*, 85 AMERICAN ECONOMIC REVIEW 150 (1995).

[29] For example, the interests of public pension funds, private pension funds and corporate treasurers are diverse if not outright opposed.

the ultimate principals, these stakeholders will engage in rent-seeking and entice supervisory agents to deviate from the actions that would maximize the principals' welfare.

In addition, lack of rivalry often contributes to agency problems being more acute for supervisory authorities. Product market competition and other forms of market discipline generally reduce the scope for managerial opportunism in private corporations. By contrast, discreet supervisory tasks are often the monopoly of one supervisory agency in each jurisdiction. And even where there is no monopoly—e.g. when cross-border access has been facilitated by deregulation or when public prosecutors or private parties have effective enforcement powers—supervisory authorities can reduce competition by forming regulatory cartels.

The costs resulting from these intense agency problems ultimately fall upon consumers of financial services and taxpayers. Against this background, improving supervisory governance is not simply a 'nice to have', but a critical undertaking.

III. MORE EFFECTIVE INTERNAL GOVERNANCE

Internal governance refers to how supervisory agencies are organized, managed, and controlled from within. We propose to improve it by drawing on industrial organization research and treating financial supervisory agencies more like professional services firms and less like bureaucracies.

The claim here is not that financial supervision agencies could and should be run like for-profit firms. Some principal-agent issues are specific to bureaucratic organizations and across-the-board transplants of market-inspired mechanisms may easily fail – as evidenced by the relative decline of the New Public Management movement.[30] And even when firms and bureaucracies face similar challenges, the latter must not necessarily mimic the former. To the contrary, there are situations where it is firms that could learn from bureaucracies, especially when it comes to compensation and rules of succession.[31] Nevertheless, because decision-

[30] See e.g. Christopher Pollitt & Geert Bouckaert, PUBLIC MANAGEMENT REFORM: A COMPARATIVE ANALYSIS (Oxford University Press 2004). But see also Tom Christensen and Per Laegreid (eds.), ASHGATE COMPANION TO NEW PUBLIC MANAGEMENT (forthcoming).

[31] See e.g. Mathias Benz & Bruno Frey, *Corporate Governance: What Can we Learn from Public Governance*, 32 ACADEMY OF MANAGEMENT REVIEW 92 (2007).

making within financial supervision agencies has features in common with corporate decision-making, one can draw from insights into powers allocation and hierarchies within corporations to sketch out some organizational improvements for supervisors.[32]

Our first proposal is to allow for a strong CEO and limit the powers of boards to basic policy decision-making and CEO monitoring (Section 2.1). Our second proposal is to simplify the chain of command within the supervisory authority by reducing the distance between the CEO and day-to-day decision-makers (Section 2.2).

3.1 Strong CEOs

Financial supervision is increasingly conducted by agencies rather than by governments.[33] Like in the private sector, all but the main decisions have been delegated to agencies' boards. Because the basic features and the issues they face are comparable to those of their corporate brethrens,[34] experiences made in the corporate sector can provide useful insights on how to make agencies' boards more effective.

Nowadays, no one seriously doubts that corporate boards should focus on monitoring senior management as opposed to getting involved in day-to-day management. There is less clarity about the actual allocation of powers, which requires distinguishing between strategic decisions (which the board should make) and operational decisions (which senior management should make). We can observe that directors get less involved in the initiation or even execution of business decisions when the firm has a two-tier board, i.e. when the CEO is not a board member. Yet, there is no empirical evidence that two-tier board structures necessarily improve firm performance.[35] We can also observe that in firms with single tier boards, CEOs can be very powerful when they also chair the board. But yet again, there is no

[32] Compare Robert Gibbons, *Inside Organizations: Pricing, Politics and Path-Dependence*, 2 ANNUAL REVIEW OF ECONOMICS (2010) 337-365.

[33] See note 11 *supra*.

[34] Compare John Armour, Henry Hansmann & Reinier Kraakman, *What is a Corporation?*, in Kraakman et al., *supra* note 32, and BIS (2009), *supra* note 3, Chapter 4.

[35] See e.g. Caspar Rose, *The Composition of Semi-Two-Tier Corporate Boards and Firm Performance*, 13 CORPORATE GOVERNANCE: AN INTERNATIONAL REVIEW 691 (2005); Thomas Jeanjean & Hervé Stolowy, *Determinants of Board Members' Financial Expertise - Empirical Evidence from France*, 44 International Journal of Accounting 378 (2009).

empirical evidence that firms with separate chairperson and CEO perform better.[36] In view of the empirical evidence, the debates[37] about the effectiveness of two-tier board structures and the need to having different persons chairing the board and functioning as CEO thus seem to be of little meaning.

The implications in terms of supervisory agency governance are straightforward. The exact delineation of powers can (and should) vary given that, like in the private sector, one size cannot fit all. Broadly speaking, however, strategic planning and fundamental policy decisions should be made by a board.[38] Operational decisions should be the purview of a board-appointed CEO, who should be allocated powers enabling him or her to exercise leadership while remaining subject to board monitoring and removal. In reality, however, many financial supervisory agencies display decision-making features that greatly differentiate their governance from what we observe in the corporate world.

First, executive powers are often vested with the whole board, with little delegation to staff members, including the CEO. To take just two examples, at the French securities regulator (AMF) a board composed of sixteen members is in charge of most decisions, not just strategic ones, and may not delegate them to staff members.[39] Similarly, all of the Spanish securities regulator's (CNMV) powers lie with its board[40] and delegation of powers to an executive committee is restricted to administrative and preparatory functions.[41]

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[36] See e.g. James A. Brickley, Jeffrey L. Coles, & Gregg Jarrell, *Leadership Structure: Separating the CEO and Chairman of the Board*, 3 JOURNAL OF CORPORATE FINANCE 189 (1997); Jay Dahya & Nickolaos G. Travlos (2000), *Does the One Man Show Pay? Theory and Evidence on the Dual CEO Revisited*, 6 EUROPEAN FINANCIAL MANAGEMENT 85 (2000); Markus M. Schmid & Heinz Zimmermann, *Should Chairman and CEO Be Separated? Leadership Structure and Firm Performance in Switzerland* (Working Paper 2008, available at ssrn.com).

[37] See already *Report of the Committee on the Financial Aspects of Corporate Governance* (so-called Cadbury Report) 15.2.2 (London 1992); Michael C. Jensen, *Presidential Address: The Modern Industrial Revolution, Exit, and the Failure of Internal Control Systems*, 48 JOURNAL OF FINANCE 831 (1993).

[38] See also Alan S. Blinder & John Morgan, *Are Two Heads Better than One?: Monetary Policy by Committee*, 37 JOURNAL OF MONEY, CREDIT AND BANKING 798 (2005).

[39] Art. L. 621-2 Code Monétaire et Financier (Monetary and Financial Code).

[40] Art. 17 Ley del Mercado de Valores (Financial Market Law).

[41] Art. 18(5) Ley del Mercado de Valores and Art. 16(3) Reglamento de Régimen Interior.

Second, the chairman, may have some of the powers of a corporate CEO, but cannot be replaced by the board itself. To illustrate, again at the AMF, the Chairperson has statutory and board-delegated powers,[42] but the board can neither appoint nor replace him or her.[43]

These features, in turn, have negative governance implications. To begin with, the deep involvement in executive matters prevents the board from effectively performing its monitoring functions.[44] In addition, because board members and the chairman are political appointees in virtually all supervisory agencies, and therefore closer to politics than staff members, their involvement in day-to-day matters and individual cases increases the risk of politically motivated or politically influenced decisions. Correspondingly, politics trump expertise, when the latter is one of the core justifications for the very existence of regulators.[45] Further, granting executive powers to a chairman who is not selected by the board for that position and whom the board cannot replace raises an accountability issue. Because the chairman is often closer to politics than the other board members, this arrangement intensifies the risk of political capture.

It follows that internal governance at many financial supervisory authorities can be expected to gain in effectiveness and market responsiveness if they were to move to an organization model empowering a CEO appointed by the board to implement and enforce regulatory requirements, while limiting the board members' role to taking fundamental policy decisions and hiring, firing, and monitoring the CEO.

To be sure, empowering a CEO does not guarantee that financial supervisors will stop making mistakes. A good example is provided by the UK's Financial Services Authority (FSA). Its operational management is headed by a CEO who reports to a board, but it has been severely criticized for failing to foresee and properly manage the 2007-08 financial

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[42] Article R. 621-9 of the Code Monétaire et Financier. The provision is enacted by AMF Decision No. 249 of 15 December 2008, which delegates to the chairman decisions on issuers' disclosure duties, prospectus approval, collective investment schemes as well as access to clearing and settlement systems and central depositories.

[43] L. 621-5 Code Monétaire et Financier.

[44] On the tradeoff between proximity and objectivity (and therefore effective monitoring) in the context of corporate boards see Jonathan R. Macey, CORPORATE GOVERNANCE. PROMISES KEPT, PROMISES BROKEN 51-68 (Princeton University Press 2008).

[45] See e.g. Andrei Shleifer, *Efficient Regulation*, in Daniel Kessler (Ed), REGULATION VS. LITIGATION (forthcoming); Alesina & Tabellini, *supra* note 12 and accompanying text.

crisis.[46] However, the FSA experience is not proof that the board/CEO model can be summarily dismissed as unworkable. On the one hand, similar criticisms have been equally addressed to financial supervisors with different organization models. On the other hand, the board/CEO model seems to be working at financial supervisors in other jurisdictions as well as at a significant number of central banks.[47]

A related question arising from the choice of a board/CEO model is whether the roles of board chairman and CEO should be separated. One may argue that allowing the CEO to serve as chairman as well could affect the adequacy of the supervisory agency's responsiveness. As mentioned above, board members are generally political appointees and, thus, prone to regulatory capture. Consequently, one could claim that having the chairman serve as CEO would increase the influence of the interest groups best able to control his or her election and further bias supervisory interventions.

However, in our model, the board elects and removes the CEO, including when the CEO is also the chair. This forces the chairperson to be more responsive to the public interest in its CEO capacity. Indeed, the failure to do so creates a real risk of removal, the board being hopefully more politically diverse than its chairperson. On the other hand, our model does not modify the *status quo* in jurisdictions where the board already has the power to sanction opportunistic behavior by the chairperson. One could thus ask why not going one step further and either have different persons acting as chairperson and CEO or designate a third party for electing and removing the CEO. We do not make such proposals for efficiency and political economy reasons. As we have seen, there is no evidence that having separate chairpersons and CEOs increases agency effectiveness. There is also no reason to believe that a third party would prove less prone to regulatory or political capture than the board.

3.2 Flat hierarchies

[46] See The Run on the Rock Report, House of Common Treasury Committee, January 26, 2008 (available at www.parliament.the.stationery-office.uk); Vivek Ahuja & Matt Turner, *FSA, Myners, Walker under Attack*, WALL STREET JOURNAL (European ed.), May 15-17, 2009 at 21.

[47] Tonny Lybek & JoAnne Morris, *Central Bank Governance: A Survey of Boards and Management* (Working Paper 2004/226, available at imf.org).

Hierarchies generally emanate from the need to supervise workers and reflect limitations in the number of employees any given manager can supervise.[48] As a result, firms as well as government agencies often operate using multiple hierarchical levels.[49]

Organization scholars have pointed out that the multiplication of hierarchical layers can prove costly. Control by top management becomes more difficult and low level employees have diminished incentives to contribute, with negative effects on organizational effectiveness and responsiveness.[50] In addition, decision-making becomes less effective in novel situations. These issues can be dealt with by granting individual units some degree of autonomy, which fosters bottom-up assertion and self-management.[51] This improves performance by reducing the incentive to shirk and by enabling front line managers to use their private information to handle unforeseen situations.[52]

In recent years, many firms have become aware of control issues. From a practical perspective, the importance of keeping management layers to a minimum has led many hierarchies to become flatter, thereby giving increased responsibilities to junior professionals or, at least, bringing them closer to senior decision-makers. For example, a recent empirical study covering 300 U.S. firms shows an increase in the number of positions reporting directly to the CEO.[53] This evolution is not limited to knowledge-intensive intensive industries or the

[48] See G. Calvo and S. Wellisz, *Supervision, Loss of Control and the Optimal Size of the Firm*, 87 JOURNAL OF POLITICAL ECONOMY 943 (1978).

[49] See, generally, Jean Tirole, THE THEORY OF INDUSTRIAL ORGANIZATION (MIT 2000).

[50] See Oliver E. Williamson, *Hierarchical Control and Optimum Firm Size*, 75 JOURNAL OF POLITICAL ECONOMY 123 (1967); Jean Tirole, *Hierarchies and Bureaucracies: On the Role of Collusion in Organizations*, 2 JOURNAL OF LAW, ECONOMICS AND ORGANIZATION 181 (1986); Armin Falk and Michael Kosfeld, *The Hidden Costs of Control*, 96 AMERICAN ECONOMIC REVIEW 1611 (2006).

[51] See already Michael A. Campion, Gina J. Medsker & A. Catherine Higgs, *Relations Between Work Group Characteristics and Effectiveness: Implications for Designing Effective Work Groups*, 46 PERSONNEL PSYCHOLOGY 823 (1993); more recently Viral V. Acharya, Stewart Meyers & Raghuram Rajan, *The Internal Governance of Firms* (Working Paper 2009, available at nber.org).

[52] See Peter K. Mills, James L. Hall, Joel K. Leidecker and N. Margulies, *Flexiform: A Model for Professional Service Organizations*, 8 THE ACADEMY MANAGEMENT REVIEW 118 (1983); Edward E. Lawler, Susan Albers Mohrman, and Gerald E. Ledford, CREATING HIGH PERFORMANCE ORGANIZATIONS (Jossey-Bass 1995); J. Sundbo, *Management of Innovation in Services*, 17 THE SERVICE INDUSTRIES JOURNAL 432 (1997).

[53] Raghuram G. Rajan and Julie Wulf, *The Flattening Firm: Evidence from Panel Data on the Changing Nature of Corporate Hierarchies* 88 THE REVIEW OF ECONOMICS AND STATISTICS 759 (2006); see also Cari Tuna, *Big Firms Show the Door to Top Lieutenants*, WALL STREET JOURNAL (European ed.), September 21, 2009 at 34 (a survey of 672 large US companies shows that, between January 2008 and June 2009, 40 eliminated the COO or President position, while 20 added it).

U.S. For example, new airlines based in the Middle East are considered to have a competitive advantage due to their flatter hierarchies.[54] There is also empirical evidence that flatter hierarchies increase managerial effectiveness when both the CEOs' and lower level managers' efforts are important for the firm's output.[55] In such an environment, the CEO is not only needed to coordinate activities and manage 'optimal dissent' by front line managers.[56] She must also manage the promotion system so as to insure for the sustainability of a flatter hierarchy.[57]

By contrast, supervisory agency organization is often characterized by multiple management layers. Take, for instance, the Spanish securities commission, CNVM (*Comision Nacional de Valores Mobiliarios*). By statute, matters must be brought to the attention of the board following a proposal by the competent organizational unit, which is first revised by the head of the department comprising that unit, and then by the competent director general.[58] Similarly, the Swiss supervisory authority, FINMA (*Eidgenössische Finanzmarktaufsicht*) is divided into divisions, which in turn are segmented into sections or groups, with the division heads bringing matters to the attention of top executives.[59]

Such multi-layered organization leaves little discretion at the lower echelons. It results in a slower decision-making process, less motivated case-handlers, and a greater tendency to conservatism. To be sure, conservatism correspondingly implies greater predictability, which might be of value for market players, and especially newcomers. But in an environment like finance, where innovation is key, conservatism is intuitively detrimental to a supervisory agency's effectiveness and its all-important aptitude for adaptation to an ever and fast changing environment.

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[54] See *Rulers of the New Silk Road*, THE ECONOMIST, June 5, 2010 at 74, 75.

[55] Rajesh K. Aggarval, Huijing Fu & Yihui Pan, *An Empirical Investigation of Internal Governance* (Working Paper 2010, available at ssrn.com).

[56] Milton Harris & Artur Raviv, *Organization Design*, 48 MANAGEMENT SCIENCE 852 (2002); Thesmar, David, 2008, *Optimal Dissent in Organizations*, REVIEW OF ECONOMIC STUDIES (forthcoming).

[57] Raghuram G. Rajan & Luigi Zingales, *The Firm as a Dedicated Hierarchy: A Theory of the Origins and Growth of Firms* 116 QUARTERLY JOURNAL OF ECONOMICS 805 (2001).

[58] See Articles 27-31, Reglamento de Régimen Interior.

[59] Art. 14(2), 15(3) and 19 Organisationsreglement FINMA.

In view of private sector experiences, the implications in terms of supervisory agency governance are straightforward. Lower level staff should get increased powers and line responsibilities. The CEO should become more directly involved in front line activity monitoring. And staff members should be subject to a stricter career regime.

Here again, the adequacy of this model cannot be summarily dismissed as unworkable. In fact, it has already been experimented. The U.S. Securities and Exchange Commission (SEC) has recently increased the enforcement decision-making powers of lower level staff in order to address deficiencies in the effectiveness as well as market responsiveness of past enforcement actions.[60] More generally, central banks around the world have flattened their hierarchy in recent years. This is reported to have increased their effectiveness regardless of diversity in size, management practices and cultural traditions.[61]

Flattening the hierarchy is bound to cause transition problems, as it involves reorganizations that could face employees', and especially middle management's, opposition. However, if the transition is properly managed, a flatter organization will not necessarily be fiercely resisted, even in agencies with a tradition of lifetime employment. Middle management could be moved to advisory roles, which would help retaining 'institutional memory' and limit opposition, while in all cases the younger staff would gain in power and visibility and therefore strongly favor such a move.

One may argue that flattening the organizational chart would have the side effect of aggravating the problem supervisory agencies have with the retention of qualified staff.[62] Junior staff becomes more powerful, more visible, and therefore arguably more attractive for market players typically hiring from such agencies, like financial institutions and law firms. At a time when revolving doors have been singled out as one of the causes for agencies' failures,[63] flatter hierarchies could make it even more difficult for agencies to form

[60] See Kara Scannell, *SEC Empowers Staff Lawyers*, WALL STREET JOURNAL (European ed.), August 7-9, 2009 at 19.

[61] See BIS (2009), *supra* note 3, 164.

[62] See e.g. Stavros Gadinis, *The SEC and the Financial Industry: Evidence from Enforcement against Broker-Dealers 27* (Working Paper 2009, available at ssrn.com) (reporting that approximately 1/3 of SEC staff left the agency between 1998 and 2000).

[63] See recently Tom McGinty, *SEC's 'Revolving Door' Reviewed*, WALL STREET JOURNAL (European ed.), June 17, 2010 at 24.

professionals internally and to build the institutional culture that they need to perform their tasks responsively.[64]

However, it is doubtful whether the revolving doors phenomenon would materially intensify should agencies' organization become flatter. Junior staff members may get powerful earlier in their career and this non-monetary prospect should lower the incentive to leave for the private sector. To be sure, there is a stage at which power benefits are outweighed by compensation disadvantages.[65] However, the wedge between supervisory agencies' and private sector salaries increases with seniority,[66] making it comparatively less attractive for junior than for senior staff to leave for the private sector. Moreover, the problem might be addressed, if necessary, by designing appropriate retention bonuses for bureaucrats in key positions.

IV. MARKET DISCIPLINE DEVICES: ENHANCED DISCLOSURE

Generally speaking, market discipline is one of the most effective governance devices. Within firms, because competition in the product market drives down prices, there is simply less room for slack or misappropriation of assets to the detriment of shareholders. If equity markets, the market for managerial services and the market for corporate control are efficient, corporate managers will do their best to maximize the (long-term) value of the firm so as to retain their jobs and improve their career opportunities. Of course, market discipline does not always work as theory would predict: market frictions make this mechanism far from perfect. And coupled with state intervention, such as implicit or explicit guarantees for creditors in the banking sector, the effects of market pressure can even be detrimental. Nevertheless, it is fairly intuitive that complete isolation from market discipline is the best recipe for the systematic neglect of principals' interests by their agents.

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[64] See Yoshiharu Oritani, *Public Governance of Central Banks: An Approach from New Institutional Economics* (BIS Working Paper 2010/299) (arguing that employment security is a plus in central banks, as it facilitates the employment of staff with good institutional memory and long time horizons while reducing the risk of 'probity hazard').

[65] See Björn Bartling, Ernst Fehr and Klaus M. Schmidt, *Screening, Competition, and Job Design: Economic Origins of Good Jobs* (Working Paper 2009, available at ssrn.com).

[66] See e.g. Merton H. Miller, *Functional Regulation*, 2 PACIFIC-BASIN FINANCE JOURNAL 91, 103 (1994).

The same is true for financial supervisors. Competition among agencies leaves less room for slack or mismanagement of taxpayers' money. If regulatory markets, the market for bureaucratic services and the market for supervisory control are efficient, supervisors will do their best to maximize the (long-term) value of financial supervision so as to retain their jobs and improve their career opportunities. Of course, here too market discipline does not always work: the credit crisis has shown that 'light touch' supervision has more to do with a 'race to the bottom' than efficiency. But, again, even for financial supervisors complete isolation from market discipline is no recipe for success.

Admittedly, it may sound odd to call for market-inspired solutions to improve supervisory responsiveness in the aftermath of the most serious financial crisis in decades. However, a post-crisis prejudice against market-based devices would be misguided for at least two reasons. First of all, it would ignore the basic fact that the spectacular failures we observed in the financial sector are also the outcome of regulatory approaches that remained heavily interventionist despite some moves towards deregulation in selected areas. It is the perverse mixture of market mechanisms and state intervention (including supervisory and fiscal guarantees) rather than market mechanisms alone, that proved fatal.

Second, and more to the point, the underlying intuition of such a prejudice would likely be that market discipline devices necessarily involve regulatory arbitrage, whether within a single jurisdiction or cross-country. This implies a greater influence of regulated intermediaries over the financial supervisor and magnifies what is commonly thought to be the main cause of pre-crisis supervisory failures. We take no position here as to whether the dominant effect of regulatory arbitrage is indeed to weaken supervisory responsiveness due to race-to-the-bottom effects. This is ultimately an empirical question, the answer to which varies depending on the specific kind of financial supervision (e.g. prudential versus disclosure supervision) and the characteristics of individual countries' industries and institutions. What we have in mind are instead market discipline devices that do not imply an increase in regulatory arbitrage by supervised entities.

Under our approach, supervisory responsiveness is improved by enlisting market forces to directly align agents' and principals' interests. More specifically, we propose to improve supervisory disclosure.

It is nowadays generally accepted that financial supervisors must inform the public or, at least, involved parties about their activities.[67] Such disclosure generally contributes to the predictability and efficacy of supervisory interventions, but even more importantly, it makes external governance mechanisms more effective.[68] Following the lead of the U.S., many jurisdictions have significantly improved supervisory disclosure in recent years. For instance, it is now most common for supervisors to conduct public consultations before issuing regulations and to publish relatively elaborate annual reports.

To be sure, supervisory disclosure has to be wisely weighed, in terms of both quantity and timeliness.[69] Like in central banking, there is a point beyond which disclosure becomes counterproductive.[70] All the same, we have identified several key areas where many supervisory agencies could become more transparent (and therefore more subject to market pressure) with no material harm to their effectiveness: the appointment process, business planning, periodic reporting, interactions with lobbies, and, with due qualifications, decision-making. As shown by Table I, transparency could be improved in these areas even in jurisdictions with fairly developed financial markets.

Table 1: Existing disclosure by select supervisory agencies[1]

	Hearings for appointments	*Business plan*	*Annual report*	*Lobby contacts*	*Minutes of meetings*	*Name of investigated firms*
CBFA (Bel)	-	-	√	-	-	-
AMF (Fr)	-	√	√	-	-	-

[67] See IMF, Code of Good Practices on Transparency in Monetary and Financial Policies: Declaration of Principles (September 1999, available at imf.org).

[68] See e.g. V. Sundararajan, Udaibir S. Das & Plamen Yossifov, *Cross-Country and Cross-Sector Analysis of Transparency of Monetary and Financial Policies* (IMF Working Paper 2003/94).

[69] See Christopher Crowe & Ellen E. Meade, *The Evolution of Central Bank Governance Around the World*, 21 JOURNAL OF ECONOMIC PERSPECTIVE 69 (2007); Carin A.B. van der Cruijsen, Sylvester C.W. Eijffinger & Lex H. Hoogduin, *Optimal Central Bank Transparency*, JOURNAL OF INTERNATIONAL MONEY AND FINANCE (forthcoming).

[70] See Alan Blinder, *Talking about Monetary Policy: The Virtues (and Vices?) of Central Bank Communication* (BIS Working Paper 2009/274, available at bis.org).

BaFin (Ger)	-	-	√	-	-	-
AFM (Ned)	-	√	√	-	-	-
CNMV (Sp)	√[2]	√	√	-	-	√
FINMA (Swi)	-	-	√	-	-	-
FSA (UK)	-	√	√	-	√	√
Fed (US)	√	√	√	-	√[4]	-
SEC (US)	√	√	√	√	√	√
FSA (Jp)	-	√[3]	√	-	-	√

[1] Information drawn from agencies' websites (last visited on October 12, 2010).
[2] Public hearing in Parliament focusing on potential conflict of interests.
[4] Unless the meeting is 'closed'.

A. *Appointment process.* The appointment of board members and top officials is a key decision in the governance of financial supervisors. All or some of these decisions are in the hands of politicians, who may fail to select the best candidates in order to favour politically loyal individuals or even their cronies, thus potentially affecting a supervisory agency's effectiveness or responsiveness in a serious way.[71] Disclosure alone cannot prevent this from happening. However, public notice of the positions available, of the qualifications requested, and of how to present one's candidacy would broaden the pool of candidates and make it more likely that good ones will emerge. One could also think of requiring disclosure of the pool of candidates from which the decision-making body has picked the appointee. However, that would arguably discourage candidacies *ex ante*. But it would do little harm if disclosure were limited to the candidates having explicitly consented to it.

[71] See e.g. Joel Seligman, THE TRANSFORMATION OF WALL STREET, A HISTORY OF THE SECURITIES AND EXCHANGE COMMISSION AND MODERN CORPORATE FINANCE (3d ed., Aspen 2003).

Above all, however, it would be desirable for jurisdictions to impose a public confirmation debate before the relevant political body, like the hearings taking place before the U.S. Senate for appointees to executive and judiciary positions. Again, this is no guarantee of quality, competence, and professionalism of the top names in the agencies. But such a procedure is unlikely to be costly while offering significant protection against cronyism or blatantly inadequate appointees.

B. Business plan. Supervisory action is necessarily selective and imperfect. Financial supervisors cannot be expected to reduce the probability of financial intermediaries' taking excessive risk to zero, nor can they start enforcement actions every time they are alerted about a possible compliance issue.[72] Given their limited resources, financial supervisors must prioritize. For that to take place in an orderly and functional manner, they have to do it in advance according to a business plan or other similar document.

Here again, it would be desirable for all financial regulators to make such documents publicly available. While some may play this down as window-dressing, a business plan makes it easier for outsiders to judge whether the supervisory agency has a clear understanding of market developments and displays the organizational skills to plan its activities. Even more importantly, a business plan facilitates the *ex post* assessment of a supervisory agency's performance, once periodic reports show whether and how the goals set out in the business plan have been achieved.

C. Annual report (and periodic reporting). We mentioned that it is currently common for financial supervisors to publish relatively elaborate annual reports. However, annual and periodic reporting by financial supervisors is still a far cry from what is required from supervised banks or publicly traded companies. Clearly, some information has to remain confidential, but this also applies to the private sector. There is no reason why financial supervisors cannot publicly disclose detailed financial statements and the type of governance information typically required from the entities they supervise.

[72] See Alexander Dyck, Adair Morse, & Luigi Zingales, *Who Blows the Whistle on Corporate Fraud?* 65 THE JOURNAL OF FINANCE (2010) 2213.

In particular, there can be no justification for lack of transparency and data comparability when it comes to the number and type of ongoing and completed investigations or the follow-up by other public enforcers (prosecutors, other agencies or courts).

D. Contacts with lobbyists and industry representatives. Financial supervisors are bound to have contacts with supervised entities, industry associations, and other persons or organizations involved in lobbying activities. In the current environment of re-regulation across the world, with most of the nitty-gritty details of the new rules to be drafted by the supervisory agencies themselves, lobbying efforts can only intensify. Such contacts are not only inevitable, but also useful to the extent these stakeholders will provide the supervisors with information that, no matter how biased, can prove highly useful to devise adequate policies and interventions.[73] However, too close a relationship between supervisors and people engaged in lobbying activities can lead to capture.

Full disclosure about lobbying activities aimed at supervisory authorities' rulemaking, possibly including periodic disclosure by anyone engaged in lobbying activities,[74] would be useful to discourage excessive familiarity between supervisors and the industry they regulate and allow for public control over this delicate relationships. But even direct disclosure by the agency of its contacts with lobbyists would be useful. For instance, the SEC has recently announced that "[s]taff will ask those who request meetings [on regulatory matters] to provide, prior to the meeting, an agenda of intended topics for discussion. After the meeting, the agenda will become part of the public record."[75]

E. Decision-making publicity. Whenever decisions are made collectively within supervisory agencies, rules should be in place to provide for public meetings (which is nowadays inexpensive thanks to webcast technologies) or, as a second best, for publication of the minutes. In addition, comprehensive information should be made available about ongoing or, at least, completed investigations. Attention should, of course, be given to the protection of

[73] See e.g. Daniel C. Hardy, *Regulatory Capture in Banking* (IMF Working Paper 2006/34).

[74] See Lobbying Disclosure Act 1995, as modified by the Honest Leadership and Open Government Act 2007 (requiring *inter alia* a quarterly report on lobbying activities by anyone who has engaged in it).

[75] See Press Relaese, *SEC Chairman Schapiro Announces Open Process for Regulatory Reform Rulemaking*, 27 July 2010 (available at http://www.sec.gov/news/press/2010/2010-135.htm).

third party (i.e. non-supervised entities or persons) privacy rights by omitting or limiting the disclosure of sensitive personal data on them.

Exceptions should also be made for some enforcement decisions and emergency situations.[76] In particular, supervisory investigations should remain confidential if public disclosure is likely to hamper the gathering of evidence, prevent efficient settlements or unduly tarnish the reputation of involved financial intermediaries. Similarly, keeping quiet in emergency situations may prevent panics. But care must be taken to narrowly define exceptions given that early disclosure of supervisory action also has benefits. For example, revealing that an investigation has been launched can encourage witnesses to come forward, make it more difficult to organize data destruction, or prevent unfounded speculation about third party involvement. Similarly, swift information about the taking of emergency measures can calm down markets by revealing the scope of the problem as well as the nature and dimension of corrective actions. Moreover, even in instances where confidentiality is required, it is hard to justify on a permanent basis. Well before they become of mere historical interest, enforcement or emergency efforts should be disclosed to the public, if only to keep supervisory agencies accountable.

One may counter that, because influential stakeholders are more likely to make use of disclosed information about board meetings than the general public, disclosure increases the former's power vis-à-vis supervisory agents, by letting them identify (and punish) "unloyal" agents and reward "loyal" ones, possibly later in their career. The same argument, however, applies to all lawmaking bodies, but no one would seriously subscribe to the idea that Parliaments should legislate behind closed doors. Because of supervisors' career concerns, disclosure is even more important than for political bodies.

More generally, the above mentioned transparency measures are likely to improve supervisory responsiveness. They should reduce rather than increase regulatory capture as

[76] See Eva Hüpkes, Marc Quintyn, & Michael W. Taylor, *The Accountability of Financial Sector Supervisors – Principles and Practice*, 2005 EUROPEAN BUSINESS LAW REVIEW 1575, 1587. But compare John S. Jordan, Joe Peek & Eric S. Rosengren, *The Market Reaction to the Disclosure of Supervisory Actions: Implications for Bank Transparency*, 9 JOURNAL OF FINANCIAL INTERMEDIATION 298 (2000) (enhanced disclosure can improve the allocation of resources in the banking system).

they make it more difficult to make political loyalty-driven appointments, to camouflage the weakness or mid-stream adjustments of agency plans and to hide the influence of lobbies.

5. CONCLUSION

Contrasting with many recent studies, this paper focuses on 'normal times' and not on systemic supervision. This approach does not merely reflect that the two types of supervision are complementary. It also reflects the belief that day-to-day supervision is more likely to minimize the costs of future financial crisis as it is much easier to administer and implement than systemic supervision.

We propose a relatively rich menu of internal and external governance improvements for 'normal times' financial supervisors. They should have strong CEOs and flatter hierarchies. Appointment procedures, business plans, decision-making, and lobbying activities should be made more transparent.

There are three reasons for offering a menu of proposals. First, it reduces resistance to change. Second, it avoids 'one-size-fits-all' effects: jurisdictions can adopt those measures that are suitable in view of the development of their financial markets and their economic, social and cultural characteristics. Third, our proposals can be experimented individually without material loss in complementarity advantages.