STRENGTHENING GOVERNANCE ARRANGEMENTS FOR FINANCIAL SECTOR OVERSIGHT AGENCIES: EVIDENCE FROM THE FSAPS

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I. INTRODUCTION

Most countries have a number of public agencies that, together, are responsible for the governance of the financial sector and, as such, affect the interests of shareholders, customers, and the general public. The governance aspect of their operations is composed of three main components: first, the *relation between these institutions and the government* from whom they received their mandate; second, the *division of labor* among these institutions; and third, the internal *governance practices* in each of these agencies. These three aspects are narrowly intertwined.

Governance of all entities participating in the economic process is receiving a great deal of attention nowadays. Good governance is all the more important for entities in the financial sector, given the latter’s key role in the economy. Good internal governance arrangements in the individual oversight agencies start with a clear division of labor among the agencies, and solid coordination among them. Attention to each of these aspects is of a recent origin. Nearly twenty-five years ago, there was not much talk about these topics, neither in academic work, nor in policy discussions. Central banks in most countries were closer than at arm’s length from the government; bank supervision of largely repressed systems was mainly compliance-driven, and deposit insurers only existed in a few countries. Now, questions pertaining to the institutional organization and internal governance practices of those institutions have risen to the top of the agenda of every institution—national and international—involved in the design of the international financial architecture. This is not to say that the final word has been spoken about these topics. On the contrary, they are still in great flux and new challenges loom at the horizon all the time.

This paper aims at explaining where we stand with respect to the three issues. It will first lay out some principles which are emerging from the IMF's work with member countries, as well as with international standard-setting bodies. The views that the IMF is developing with regard to these topics originate from two sources.

First, the Fund's involvement in systemic crisis management shows that, in cooperation with the member countries, thought needs to be given to the post-crisis institutional framework for financial sector oversight. It is a well-known fact of life that it often takes a major crisis to bring about significant changes. Therefore, crisis environments force policymakers to rethink existing structures and institutions. One well-known example in this regard is the financial crisis that hit several east Asian countries in the 1990s. This crisis led to a drastic overhaul of the institutional framework in each of the affected countries.

A second angle from which the institutional and governance issues are analyzed, is the FSAP (Financial Sector Assessment Program, conducted jointly with the World Bank). A significant portion of the FSAP work consists of the assessment of compliance with international standards and codes promulgated by international standard-setting bodies. Directly or indirectly, these standards and codes allow us to discuss issues of institutional structure and internal governance. The focus in these assessments is mainly on the preventive strength of good institutional and governance structures: in other words, how can solid institutional and governance arrangements contribute to financial sector soundness?

Before discussing the three themes and their interconnectedness, we will briefly go into the reasons for the increasing attention in the governance structure for financial sector oversight.

II. Reasons for Increased Attention

Several reasons account for the growing interest in and importance of governance of financial sector oversight. They can be summarized in the following main topics:

- First and foremost, the *liberalization of financial markets.* Financial liberalization means, on the one hand, that the grip of the government over the financial sector, directly and indirectly, is loosened. On the other hand, liberalization leads to more risk-taking on the part of the financial institutions. Taken together, these developments have two major implications: first, that supervision of the risk-taking of financial institutions becomes more important and that safety nets need to be designed to protect the small, less-informed customers in case things go wrong nonetheless; and second, that these oversight functions should be implemented by agencies that stay at arm's length from the government;

- Another important development, related to the first one, but with relevance of its own, was the move toward *central bank independence*. In the 1980s, central bank independence set the new standards for the position of agencies vis-à-vis the government, and urged us to think about arrangements for independence, accountability, and governance of those agencies;

- Needless to say, attention to these issues surged during the 1990s after the *collapse of the command economies*. Rebuilding those states forced us to rethink institutional arrangements and pay closer attention to deficiencies in governance arrangements at all levels of the economy. Questions such as: "when is the right time to establish a deposit insurance?" or, "should the bank supervisors be inside or outside the central bank?" all needed to be revisited;

- The *deep systemic crises* of the 1990s, in particular those in East Asia, not only forced the international community to rethink the way financial institutions were supervised—great governance lacunae were identified as contributing factors in each of those crises. At the same time, attention had to be given to an appropriate crisis management institutional framework, and to the question as to how a normal time-framework could mitigate crises;

- These systemic crises have also raised *interest in financial stability as a policy objective in its own right*. Financial stability is increasingly seen as the twin concept of monetary stability. As a new trend, central banks claim an explicit role in preserving financial stability and, as a result thereof, are eager to play some part in financial sector or financial market oversight. The distinction between macroprudential and microprudential oversight again reopens some debate about institutional structures, or at a minimum, raises coordination issues among agencies;

- Finally, the more recent phenomenon of a *breakdown of barriers among institutions in the markets* (banks, nonbanks, insurers) and of cross-sector competition forces us to rethink some institutional structures. “Should supervisors be merged into one mega-supervisor?” “Should this agency be inside the central bank or outside?” These topics bring about their own governance questions in terms of cooperation among those agencies, avoidance of regulatory gaps, and conflicts of interest.

III. INSTITUTIONAL DIVISION OF LABOR

The first dimension in the governance of the financial system is the delineation of the responsibilities of the various agencies that together constitute the framework within which financial institutions operate. Agencies that typically play a role in ongoing financial sector oversight include the ministry of finance, the central bank, one or more supervisory authorities and, very often, a deposit insurance agency. Other agencies may be established in times of crisis, but today's focus is on the permanent ones.

The actual division of labor among these organizations differs from country to country according to local tradition and culture, the constitutional and legal framework, and the financial history. For instance, as I said before, financial crises have often led to a profound reshaping of the agencies and their responsibilities. The relationship among these agencies needs close attention because they are not all at the same hierarchical level. In fact, most agencies have delegated power from the ministry of finance (or the government). Therefore, complex lines of accountability and coordination need to be established and respected. We will start with this topic and subsequently move on to the division of responsibilities among those agencies which have received delegated powers from the government.

A. Relationship with the Ministry of Finance

Division of responsibilities

The first part in the division of responsibilities is the relation between the government, typically the ministry of finance, and the agencies. Some principles defining this relationship can be put forward:

- First, the government always bears the *ultimate responsibility* over the financial sector. The power given to the other oversight agencies is delegated power, implying that these other agencies are accountable to the government. This point will be picked up again, when we deal with independence in more detail;

- After having delegated powers, the government remains *responsible for dealing with the general framework*. This means that the government is responsible for the primary legislation and the broad policies, but that secondary legislation and dealing with individual institutions is left to the agencies;

- The government remains ultimately accountable to the legislative branch for its responsibilities and for those delegated to other agencies.

The delegation of responsibilities from the ministry of finance to agencies makes financial sector oversight more efficient and effective. In addition to this, if adopted consistently, it is also helpful in avoiding some sources of *conflicts of interest*:

- In some countries, the ministry of finance has the right to license institutions and withdraw licenses. This responsibility is better in the hands of the supervisory agency. Supervisors are in charge of supervising the individual entities under their jurisdiction and therefore are in a better position to decide on the entry side. Also, supervisors have more clout in imposing sanctions if the ultimate sanction, withdrawing a license, is under their power. The minister, who is responsible for the overall financial framework, should be protected from carrying the responsibility of authorizing, restricting, and closing *individual* institutions. Such decision should stay outside the political arena, where the minister is vulnerable to criticism, as suspicion could arise that licensing is influenced by political considerations;

- Similarly, the supervisors should be responsible for issuing prudential regulations within the prevailing legal framework. Such a division of labor, with the government and the legislature being responsible for the primary legislation, and the supervisory agency for the prudential rules, or secondary legislation, ensures that the regulations adequately reflect the needs for effective supervision, as opposed to other interests;

- Appeals procedures against decisions of central banks, supervisors, and deposit insurers should be handled by the courts, not by the minister of finance. If a minister becomes party to this process, suspicions of conflict of interest may arise.

Coordination with the Ministry of Finance

Receiving powers also involves sharing information. The minister, being ultimately responsible for the financial system and for formulating the broad policies, should receive all information needed to stay abreast of developments in the sector. Sharing information should take place without breaching confidentiality requirements. It is not unusual to hear stories that some agencies do not want to share information because they are “independent.” This is a grave misunderstanding about the concept of “independence.” Independence can never be absolute, because the agency’s power is “delegated” power. Therefore, adequate coordination with the principal and the government will actually support the independence of the agency because it provides legitimacy.

The rules of the game change *when public funds are involved.* In such cases, more coordination is normally necessary. Even though the minister may still leave the actual implementation (and day-to-day management) to the respective agencies, the minister has the final responsibility over the use of public funds and should therefore be involved in the decision-making process.

Taking it one step further, in a systemic crisis, a *temporary overhaul or redefinition of the respective mandates* might be warranted. Several countries have addressed this issue through memoranda of understanding which lay down coordination procedures for emergency cases. Such coordination machinery needs to be tested from time to time to ensure that it helps rather than hinders crisis management when it is needed. A typical case in point here is that in systemic crises, the limited deposit insurance loses its relevance and needs to be suspended temporarily.

B. Division of Responsibilities Among Agencies

Mandate and conflict of interest

Without going into the details of the respective functions—which are broadly known—this paper highlights some principles that should support good governance when establishing oversight agencies.

First, there is a need for a *clear mandate* for each of the institutions with delegated authority. A clear mandate helps to delineate the respective responsibilities, and facilitates accountability. It also facilitates coordination among institutions and reduces the occurrence of conflict-of-interest situations.

Indeed, the division of labor should be such that *conflicts of interest be avoided*. Actually, one of the reasons why most countries have *several* institutions with an oversight role is exactly to avoid potential sources for conflicts of interest and too great a concentration of power within one institution.

While the general mandate of an agency is often defined with clarity, there are some functions which may potentially give rise to conflicts of interest, if vested in one institution without necessary safeguards. Without being exhaustive, the following are some examples:

- In some countries, deposit insurance agencies are also involved in providing financial assistance to open banks, through liquidity support. To avoid conflicts of interest and misuse of funds, it is preferable that the functions of liquidity support and solvency assistance be separated. Central banks should not be involved in providing support to insolvent institutions, while other agencies should not be involved in liquidity support;

- Potential conflicts of interest may arise if a central bank also performs supervisory functions: faced with weakening banks, central banks could ease monetary policy so as to keep these banks out of further trouble. This is one of the arguments often put forward for not having banking supervision and monetary policy under one roof;

- Also, integrating supervision over all sectors under one roof *and* in the central bank may lead to the impression that the central bank, as lender of last resort, now also is responsible for providing such support to the nonbank sectors, which could lead to moral hazard. More generally, the more power is concentrated in one institution, the greater the chances are that conflicts of interest will arise, unless very strong firewalls and checks and balances are established within the institution.

What is clear from the examples is that, whichever the institutional division of labor is, many interests need to be balanced at all times in order to arrive at workable arrangements.

The need for coordination

The other side of the coin of the advantages of separating functions is the need for coordination and cooperation. Coordination and cooperation involve the exchange of information, as well as, ex post, communication of decisions such as the closure of a financial institution.

At the level of the agencies, it is necessary that information be exchanged about institutions in the markets. Such exchange of information can be mandated in the law governing those agencies or be specified in separate memoranda of understanding. The information flow should be such that the other institutions can fulfill their mandate without having to require the supervised entities to report the same data twice.

The exchange of information should, of course, respect confidentiality requirements. However, "independence" should not be used as an excuse for not sharing information, as sometimes happens. One channel which facilitates exchange of information, and at the same time improves governance arrangements, is the appointment of representatives of the agencies on each other's board.

The division or responsibilities among oversight agencies as such is not directly dealt with in the international standards and codes. However, these topics are discussed during FSAP missions. One important area which is part of the work on standard and codes is the interagency coordination. Each of the codes and sets of principles contains at least one question about interagency cooperation.

IV. Internal Governance Arrangements

The other dimension concerns governance arrangements of the individual institutions.

Financial systems are only as strong as the governing practices of *all stakeholders* (market participants, as well as their supervisors), the soundness of the institutions, and the efficiency of the market infrastructure—three important pillars. Promoting and practicing sound governance practices in the marketplace is a shared responsibility of market participants and regulatory agencies. This view is explicitly recognized in the work on the Basel II Accord.

The *transmission channel* through which sound regulatory governance supports financial stability is, in essence, through the credibility and legitimacy of the supervisors. Sound regulatory governance practices help reinforce the credibility and moral authority of the oversight agencies. Credible agencies, in turn, are in an excellent position to promote and enforce good governance practices in the supervised institutions. High quality governance in financial institutions, in turn, is a major building block of financial soundness and stability.

Ill-defined or dysfunctional governance arrangements, on the other hand, do not support the required credibility and will contribute to the spread of unsound practices in the institutions under regulatory oversight, potentially impairing the stability of the financial system as a whole.

Four institutional underpinnings

How can high quality governance in central banks, supervisory agencies, and deposit protection agencies be achieved? A prerequisite for good regulatory governance is a firm institutional basis. The four components which bring together the essential underpinnings of good regulatory governance, are: *independence, accountability, transparency, and integrity.*

An essential feature of these four institutional underpinnings is that they reinforce each other in supporting good governance practices. A few examples can illustrate this:

- Independence cannot survive without accountability. Adequate accountability arrangements—allowing the agency to explain what it does and why—will support its independence, because it provides legitimacy to the agency. An agency that goes against its mandate for an extended period of time will lose its independence. Accountability will avoid such a situation;

- Transparency is a vehicle for safeguarding independence and providing accountability. By making actions and decisions transparent, chances for interference are reduced. This is particularly important for supervision where outside interference is frequent. It is also a key instrument to make accountability work, in particular, toward the markets;

- Transparency also helps to establish and safeguard integrity in the sense that if arrangements to ensure integrity are published, they provide even better protection for agency staff;

- Independence and integrity also reinforce each other. Legal protection of agency staff, as well as clear rules for appointment and removal of agency heads, support both their independence and integrity. Independence helps integrity in the sense that, when agency staff feel they are independent, they will not easily yield to outside interference;

- Finally, the pair accountability-integrity is also mutually reinforcing. Because of accountability requirements, there are additional reasons for heads and staff to keep their integrity.

These four institutional underpinnings of good governance practices are equally important, irrespective of the agency under discussion: the central bank in its capacity as agent in charge of monetary policy, the supervisors of subsectors of the financial system, or the deposit protection agencies. Each of these institutions need a solid foundation upon which sound governance practices can be implemented.

Moreover, these four building blocks also help in supporting the two other dimensions discussed earlier. Independence and integrity measures are meant to block off interference in the pursuit of the mandate. Accountability and transparency ensure that vertical and horizontal coordination takes place in an organized manner so that each agency and the government can pursue their mandates. Thus, these four pillars for good governance ensure the respect of the agency for the other agencies' work and the broader mandate of the government.

The following paragraphs go in some more detail with respect to independence and integrity, and illustrate what is at stake with some examples from the FSAPs. These two are selected, not because they are more important, but because the notion of independence is often surrounded by misunderstandings, while integrity suffers from a lack of understanding. Both are obstacles to their application.

Independence

Independence is a very powerful word. This in itself is often a source of confusion and misunderstanding. When one talks about independence for oversight agencies (including the central bank), this refers to *operational independence*. Stanley Fischer, former Deputy Managing Director of the IMF, made the distinction between *goal independence* and *instrument*, or operational independence. For an oversight agency, goal independence is by definition excluded. The goals and the mandate of the agency are set in the law or the statutes that establish the agency, and are defined by those (the legislature typically) who delegate the power.

However, the agency should have independence in using the instruments and means assigned to it in order to fulfill its mandate. In other words, there should be no interference from the political side, or from the industry side, in the day-to-day work of the agency.

Work with the IMF membership reveals that these principles, together with the need for proper accountability, are not always well understood. Occasionally, cases emerge where governors were fired because their work did not please the political class, without having made professional mistakes, or cases where governors step down because they cannot operate in an environment with a high degree of interference in their work. On the other hand, and more subtle, are those cases where governors, or deputies of other agencies refuse to share information with the minister, or with other agencies under the cover of their independence. This is not the right approach. Statutory independence does not preclude cooperation. On the contrary, since all these agencies are *jointly responsible* for the governance of the financial system, cooperation is necessary.

Integrity

Integrity is the least understood of these four principles. This is perhaps so because integrity is all about internal procedures, whereas the other principles relate more to the agency's relations with the outside world, and therefore draw more attention.

Integrity refers to those mechanisms that ensure that staff of the agencies can pursue the agency's goals without compromising them due to their own behavior, or self-interest. Integrity affects the work of agency staff at various levels:

- First, *procedures for appointment* of heads, their terms of office, and criteria for removal should be such that the integrity of the board-level appointees (policymaking body) be safeguarded; in other words, that self-interest is excluded;

- Second, the integrity of the agency's day-to-day operations also needs to be ensured. Effective internal governance implies that *internal audit arrangements* and internal *governance rules* be in place to ensure that the agency's objectives are clearly set and observed, that decisions are made, and accountability is maintained;

- Third, integrity also implies that there are *standards for the conduct of personal affairs* of officials and staff to prevent exploitation of conflicts of interest;

- Fourth, assuring integrity also implies that the staff enjoy *legal protection while discharging their official duties*. Without such legal protection, objectivity of staff could be prone to contest—and staff to bribery or threat—and the overall effectiveness and credibility of the institution could suffer greatly.

Findings from the FSAPs reveal that, with respect to integrity arrangements, audit requirements are met by a majority of countries. Likewise, most deposit insurance agencies have some form of code of conduct for their staff, but these codes are not always made public. That compliance is relatively high, is probably related to the fact that many deposit insurance agencies are relatively young, or recently overhauled. The weak link, however (but deposit insurance agencies are not the only agencies), is the lack of legal protection of agency staff and executives. Given the powers vested in oversight agencies, and the responsibilities that come with them, staff in these agencies should be legally protected while executing their job. If supervisors or other agency staff can be sued personally for actions taken in good faith, their work becomes paralyzed as we have witnessed in several countries. In the end, such situations contribute to financial instability.

Issues in deposit insurance

The final paragraphs deal with the connection between governance issues and incentive structures in deposit insurance. There is a whole debate, mainly in the academic world, about the moral hazard attached to deposit insurance schemes.

In order to avoid that trap, it is necessary to have the right incentive structures in place. A few issues are highlighted here, which also are reflected in the work that the IADI is undertaking:

- Collecting premiums from the insured institutions *ex ante* is better than *ex post*. Ex ante, or funded, systems are often more rules-based, offer less discretion for the administrators and less uncertainty for the insured agencies;
- Limiting the coverage offered by the system is the most common way to contain moral hazard. The limit on deposit insurance should be set in relation to some yardstick, such as the country's GDP per capita;

- The main goal of deposit insurance agencies is the protection of small customers. It should be recognized that during a systemic banking crisis, the priorities often need to be changed and that, therefore, the role of a limited insurance becomes temporarily less important. This does not prevent the agency as such to assist in crisis management, in cooperation with other agencies;

- Finally, the use of risk-based premia is, in theory, useful but poses practical problems. First, a correct *forecast* of the risk that an institution poses for the fund is a very difficult task. Secondly, the calculation needs to be based on objective criteria that can be defended, if a bank were to challenge the risk assessment in court. Given these difficulties, a second-best solution of flat premia is the best that many countries, particularly the less sophisticated, can achieve.

V. Concluding Remarks

This paper provided some thoughts on the organization of financial sector oversight where deposit insurers play an increasingly important role: the internal governance practices which are a cornerstone for good oversight and for the soundness of the financial systems themselves. Thus far, FSAPs have proven to be an important instrument in identifying the issues, and work can now be undertaken to address the deficiencies, in cooperation with other international bodies, in order to strengthen the architecture of the financial systems worldwide.

It is important to recognize, as stated at the beginning, that many of these issues are in constant flux. A division of labor among agencies involved in governing the financial sector is not cast in stone once and for all. Two examples illustrate this:

- First, "financial stability" is now generally considered as a "public good." Having accepted this position, the authorities need to mandate institutions to pursue this goal of financial stability. Such mandate involves at least two interdependent fields: supervision of risks and threats that can cause instability, and taking actions to mitigate such threats. Clear responsibilities need to be assigned to fulfill these parts of the mandate;

- Second, turning to Europe, the euro-zone has unified monetary policy but designing the governance structure of financial regulation and supervision remains an unfinished agenda. Opposing views exist regarding the optimal structure. On the one hand, some think that a decentralized structure can do the job. On the other, some are of the view that greater centralization is needed to preserve financial stability. This debate will continue for some years, and adaptations to the existing institutional structures can be expected.

In order to tackle such issues, as well as the multiple requests for guidance from the IMF's membership, the Monetary and Financial

Systems Department has started to prepare governance guidelines for oversight agencies in the financial sector. Other standard-setting bodies will be consulted in this effort. Such guidelines will be based on several of the principles highlighted in this paper. It is hoped that, over time, such guidelines will prove useful in improving the governance of the financial sector.