International Seminar. Executive discretion and regulatory decision making – Issues and challenges in making regulation more effective.

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Introductory remarks

Regulatory discretion in the context of the financial crisis and its aftermath

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Ladies and gentlemen,

It is a pleasure to deliver some 'introductory remarks' on the 'discretion issue': the question of the appropriate amount of discretion that the executive branch should wield, more specifically the regulatory enforcement and inspection bodies *within* that branch of government.

The activities of these supervisory bodies are no longer a routine and almost obscure aspect of public administration. As a result of the shifting distribution and outsourcing of government tasks and responsibilities, *and* rising expectations regarding supervision in society, these bodies have become much more important and high-profile.

Therefore, it's a good thing that different national and international organisations like the World Bank, universities and the Netherlands' Academy for Legislation initiate together this dialogue on executive discretion and regulatory decision making among a wide variety of policy-makers and academics with an interest in the issue, as well as experienced experts working within supervisory bodies.

I like to tell you about an advisory report for the Dutch government that the Netherlands' Scientific Council for Government Policy has just issued. It deals with the governance of enforcement and inspection agencies at the national level, and let me state it right away: in our view a certain degree of regulatory discretion is indispensable, because of social complexity and dynamics. Rapid changes in technology and society, the existence of risks and uncertainties that cannot be fully

defined in laws and regulations, require supervisory bodies to go *beyond* the letter of the law. Allowing for some degree of discretion can increase the added value of government supervision for society. Is this a plea for some sort of 'rise of the unelected' (like Frank Vibert has addressed)? By no means! Let me try to explain, by outlining five core elements of our approach, and by indicating what they imply for financial supervisors – and their discretionary powers.

Core elements

What are the core characteristics of our approach? We distinguish five - interrelated - elements:

1. **Public interests first.** In our view**,** public interests should be the starting point for improving the activities of inspection agencies and market regulators. This position seems self-evident. However, quite often the degree of compliance with laws and regulations is the dominant starting point. Aiming to achieve the highest possible levels of compliance may stifle flexible responses to new circumstances and technologies. In devoting all their time and energy to enforcing rules, no matter how trivial, enforcement organisations may ignore or miss more significant problems. Moreover, as time passes and conditions change, we all know that precise rules often lose their efficacy. Following the rules may not always be sufficient or necessary to achieve the best possible outcomes. Ultimately, the drive to improve the effectiveness of enforcement structures should be aimed at attaining regulations' *intended* outcomes, rather than at regulatory compliance *as such*.

2. **Benefits-oriented.** In our view regulatory bodies should clarify the desired and obtained societal benefits of supervision, so that they can be properly considered in relation to costs and burdens. Positioning societal benefits more centrally in supervision policy and practice facilitates a more balanced assessment of these benefits with respect to costs and burdens. This also creates a realistic image of what may be expected of supervision. More than is the case at present, supervisors could provide more insight into their effectiveness and efficiency as part of their public accountability. Regulatory enforcement and inspections should - and can - be much more *evidence-*

based and *measurement-based*. In addition, supervisors should report publicly and regularly on the fulfilment of their objectives and the discharge of their functions.

3. **Governance-based.** Supervisors should thoroughly analyse and capitalise on the potential of market forces and civil society actors in order to achieve regulatory objectives (or public interests). Considerations relating to setting up and executing (or terminating!) government supervision must be based on a clear analysis of the existing 'governance structure' in a specific domain. This involves mapping out and tracking the entire arena, the existing checks and balances, incentives and disincentives, resilience potential, etc. This is the art of identifying the role that supervision can best play in that arena in order to bring about the desired effects and benefits. We refer to this as *governance-based* supervision.

4. **Reflective.** We strongly support the 'policy role' and responsibility of supervisory agencies to advise and contribute to policymaking (and policy evaluation) processes. The supervisor's activities should not be restricted to reducing risks posed by – actual or potential - violations of rules, but they should also include calling attention to problems, sharing expertise, and proactively providing feedback. Supervisory agencies not only serve as *effectors* - tools for making an impact on the world outside, but also as *detectors* - sources of up-to-date knowledge of the issues in their domain. Reflecting on that domain means signalling developments that may have an impact on public interests and the checks and balances in the relevant domain. Reflection also means analysing problem areas in laws and regulations that frustrate the supervisor's performance. In so far as it is risk-based, reflection is not restricted to reducing risks posed by infractions of the existing rules. A reflective supervisor also considers *systemic* risks and risks not covered - or not yet covered - by the law. Moreover, the reflective function is not restricted to analysing *risks or problems*, whether posed by infractions of rules or not. It also implies that the supervisory agency is alert to *best practices and new opportunities*. Reflective supervisors assist regulated companies and organisations in improving standards *beyond* minimal

compliance in order to enhance their performance accordingly. They do not hesitate to put issues on the public agenda, and make an active contribution to the debate about 'the state of the art' in their domain.

5. **Impartial, independent, accountable.** Finally, our broader perspective implies guaranteeing these three core values. Supervisors, whether situated within or outside a ministry, should be allowed sufficient independence and autonomy so as to safeguard impartial decision-making. Safeguarding the impartiality of supervisors is *essential* to acquiring and retaining public legitimacy and confidence. Supervisors should distance themselves from the executive government, the legislature and, of course, from those being supervised. Only then can they give authoritative feedback to the legislative and executive institutions responsible for structuring their domain. And only then can they escape from 'capture' by regulated entities. To foster an impartial attitude, formal *independence* is vital. This is not an aim in itself, but rather an underlying condition for the supervisor's impartial attitude. Does this amount to a transfer of public power from elected politicians to unelected officials? Is it a danger to democracy? No, a supervisory agency is obliged to operate within the power delegated by the legislature and has a special responsibility to publicly account for its decisions and actions. The agency operates in a web of accountability relationships that exist side by side. The executive branch, the judiciary and the legislature are the most important institutions that hold supervisors to account. This is not to say that there is – at least in The Netherlands – ample room to improve the accountability relationship with parliament.

Illustration: A broader perspective on financial supervision

Let me finish, by shortly illustrating these core elements of our approach by taking a closer look at the supervision of financial markets (my remarks are based on an excellent study on this subject, commissioned by us and published on our website).

Financial markets are complex and dynamic. National markets have become more and more interconnected as firms expanded their business globally. We have seen a

wave of financial innovations and the emergence of new financial actors. Moreover, as firms have continuously adapted their business models to new circumstances, such as the changing macroeconomic environment, innovations in ICT or changing regulations, financial markets have become highly dynamic. What does this imply for financial supervisors - and their amount of discretion?

The financial crisis laid bare some serious shortcomings in the existing regulatory and supervisory frameworks. The crisis taught financial supervision – and government supervision more generally - some important lessons.

First of all, given the characteristics of financial markets – and policy domains more generally - we should have realistic expectations of what supervision can achieve. In our view, financial supervision contributes to the **public interest** of financial system stability and integrity, but it cannot provide 100% guarantees. Second, ensuring compliance with existing financial market rules is key*, but not sufficient* to contribute to financial market stability. Supervisors now know that they will have to act *beyond* ensuring compliance and will have to enjoy a sufficient degree of **independence** in order to fulfill this task. Supervisors will need to be adaptive themselves, able to respond quickly to newly emerging threats to the stability and integrity of the financial system. They need to be **reflective** and play an active 'policy role', contributing to the regulatory process - and related public debates - by calling attention to emerging problems.

Financial supervisors will have to broaden their scope and engage actively with the interplay of forces in their domain (this is what we mean by **governance-based**). They should be focused on the stability of the *total system* rather than solely on the stability of *individual* firms. They will have to become more forward-looking, identifying whether firms' business models, corporate governance structures, and conduct and culture could harm the financial system's stability and integrity. A key challenge here is that supervisors currently have only limited experiences with these new 'soft' behavioral indicators. They may be weak, but are often key indicators for future problems. In The Netherlands the Authority for Financial Markets and the Dutch central bank are – fortunately - increasingly aware of this.

Of course, financial supervisors will have to match their degree of independence with adequate **accountability** mechanisms, communicating with different audiences about the possibilities, effects and limits of supervision, in so far as this is not counterproductive to the supervisor's mandate. Gaining and maintaining political and public support for the supervisory agencies' work is key, and supervisors will sometimes have to venture into new territory, exploring the boundaries of increased transparency. No doubt, the balance between transparency and secrecy is delicate. As financial markets are reflexive – i.e. market participants' perspectives are real in their consequences for the functioning of the financial system – the information that supervisors disclose may potentially have disruptive effects.

Demonstrating the precise **societal effects** of financial supervision is surely not an easy task, since financial stability is influenced by many actors and factors. However, a pertinent future task for - not only - the financial supervisors lies precisely in finding ways to effectively communicate with different audiences (parliament, public, financial interests) about their conduct and the results achieved.

Conclusion: no discretion without accountability

Government supervisory bodies – in all shapes and sizes – play a vital role in achieving policy and regulatory objectives and in guaranteeing public interests. In my view they are a basic institution of crucial importance. Their discretionary powers are no danger to democracy, as long as they are held accountable in three classic senses of the term (Vibert 2007: 169-174):

1) Are they accountable in the sense that they must give public reasons for the ways in which they exercise their powers?

2) Are they accountable in the sense that they must act within proper and defined limits and must respect the core functions of other institutions?

3) Are they accountable in the sense that they are capable of being sanctioned by other institutions, for instance the judiciary (through judicial review) and the legislature (through redefining their statutory basis)?

If these checks and balances function properly the benefits of independent and impartial supervisors can prevail.