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ARTICLE

# Strengthening the governance of national financial supervision in the EU: existing weaknesses and a proposal for reform

**Dr. Christopher P. Buttigieg**

EUROPÄISCHE RECHTSAKADEMIE
ACADEMY OF EUROPEAN LAW
ACADEMIE DE DROIT EUROPEEN
ACCADEMIA DI DIRITTO EUROPEO
TRIER · TREVES · TREVIRI

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**Abstract** The paper is a contribution to the debate on the governance of financial supervision in Europe. It analyses the: [i] rationale for delegation of regulatory and supervisory powers to an independent supervisor; [ii] governance arrangements for independence and accountability of supervision; and [iii] institutional models for supervision at national level. The paper also examines the extent of the independence and supervisory capacity of national supervisors in Europe by reference to the financial sector assessment programme reports published by the International Monetary Fund and identifies the main weaknesses in the governance of financial supervisors, which also have a negative impact on supervision on a European scale. The paper makes recommendations for a mechanism to address these weaknesses.

**Keywords** Financial services · Governance · Regulation · Supervision

## 1 Introduction

The paper seeks to contribute to the debate on the governance of financial supervision in Europe. It analyses the: [i] rationale for delegation of regulatory and supervisory powers to an independent supervisor; [ii] governance arrangements for independence and accountability of supervision; and [iii] institutional models for supervision at

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C.P. Buttigieg (✉)
Banking and Finance Department, Faculty of Economics, Management and Accountancy,
University of Malta, Msida, Malta
e-mail: christopher.p.buttigieg@um.edu.mt

national level. The paper also examines the extent of the independence of national financial supervisors in Europe and their supervisory capacity by reference to the financial sector assessment programme ('FSAP') reports published by the International Monetary Fund ('IMF'). The paper identifies the main weaknesses in the governance structures concerning supervision at national level which also have a negative impact on supervision on a European scale, and makes recommendations for a mechanism to address these weaknesses.

In a dynamic financial environment dominated by financial institutions of a significant size that are motivated primarily by a desire to make profits and which have the means to lobby and influence policy-making, financial supervision may become an exceptionally demanding and challenging task. In this regard, the architecture of the institutional framework for supervision and internal governance arrangements for this purpose, particularly the robustness of the independence, autonomy, accountability, transparency and integrity structures of a financial supervisor have a bearing on the effectiveness of supervision.[1]

With the exception of banks in the Eurozone, credit rating agencies and trade repositories, the supervision of which is carried out centrally by European authorities, the supervision of financial services in the EU remains the ultimate responsibility of supervisors established at Member State level. However, within the context of the internal market, the consequence of inadequate supervision in a Member State can have a negative impact in other states. Therefore, supervision should be characterised by cooperation and coordination between financial supervisors.

The regulatory framework that established the European Supervisory Authorities set-up by the EU post the 2007–2009 financial crisis provides a number of mechanisms for enhanced supervisory cooperation, such as the possibility of delegating supervision and the establishment of colleges of supervisors. The degree to which such mechanisms may be applied successfully in practice depends on the extent of the mutual trust between financial supervisors. The required degree of trust is built on confidence in each other's governance arrangements for financial supervision. In particular, that supervision focuses on attaining the objectives of safeguarding systemic stability and protecting investors ('the high-level objectives of regulation') and is not redirected at achieving other priorities determined by national or industry agenda, which may conflict with the primary objectives.

The financial crisis and the subsequent euro banking crisis called into question the capacity and the performance of financial supervisors including the extent of their independence from their political masters and the industry. The crisis raised significant concerns about the extent and adequacy of cooperation between financial supervisors and demonstrated that the manner in which supervisors organise themselves, the methods they use to prioritise attention and target resources, the expertise and skill they have and manage to develop, and the forms of relationship they establish with the politicians and the industry, may all have an impact on the outcome of supervision.[2]

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[1] *Das/Quintyn/Chenard* [15]; *Arnone/Gambini* [4]; *Dickson* [16]; Basel Committee of Banking Supervision, 'Core Principles for Effective Banking Supervision–Principle 1', September 2012 and International Organisation of Securities Commissions, 'Objectives and Principles of Securities Regulation-Principle 2', July 2010.

[2] *Sparrow* [54], vi.

In the aftermath of the crisis, every effort was made to strengthen the supervisory framework by granting financial supervisors better and stronger supervisory powers and resources. In spite of this, as demonstrated by the International Monetary Fund (IMF) financial sector assessment programme reports published between 2010 and 2012, in a number of Member States certain weaknesses in internal governance arrangements for supervision still remain. At national level these weakness may result in ineffective financial supervision. At European level, these weaknesses are likely to have a negative impact on mutual trust between financial supervisors and on the extent of cooperation and coordination between these authorities.

The paper supports the point that the weakness in the governance mechanisms for supervision, particularly the independence, autonomy and accountability structures of a financial supervisor, have an impact on the robustness of the supervisory processes at national level and on a European scale. The paper argues that the level of independence of a supervisor in practice depends on the extent to which the executives who are responsible for leading the authority act professionally and objectively and do not have special allegiances to the political class or to the industry. The argument is made that financial supervision within the EU could be strengthened if the independence of supervisors from political and industry influence and the autonomy and structures of accountability to democratically elected institutions and peers are guaranteed through a regulatory framework established for this purpose at EU level.

The examination in the paper focuses on the governance of supervision at national level and does not extend to the European authorities established by EU policymakers in the aftermath of the crisis or the European Central Bank's ('ECB') role as a supervisor for banks in the Eurozone. Nonetheless, reference to the framework for the independence and accountability of the ECB in the context of the Single Supervisory Mechanism ('SSM') will be made to draw some lessons and conclusions which are relevant for the purpose of the paper. In a number of instances the paper also refers to the position in the United States where a significant segment of the financial industry has been supervised by independent agencies for over a century. Some additional lessons may be drawn from the governance arrangements for financial supervision which operate across the Atlantic.

For narrative ease the paper is divided into six sections. Section 1 reviews the nature of financial supervision. Section 2 examines the rationale for the delegation of supervision to an independent and autonomous agency. Section 3 assesses the mechanisms that may be applied to guarantee the independence, autonomy and accountability of supervisors. Section 4 provides an update on the institutional models for national supervision within Europe, examines each of these models and reviews the weakness in the governance framework of a number of these supervisors. Section 5 puts forward a proposal to strengthen the governance structure of European supervision at national level. Some concluding remarks are made at the end of the paper.

This is the second of a series of papers by the author on the topic of financial supervision, the first of which was published in the professional journal *The Accountant* in April 2013. The article, entitled *"The Institutional Models for Financial Supervision: An Analysis"*, examined the different institutional models for supervision. Regrettably, an inaccuracy in the institutional models in Bulgaria, Greece and Luxembourg was identified post-publication. This paper also has the purpose of correcting this inaccuracy and of updating the analysis with the changes in the institutional models for supervision which occurred during 2013, particularly, the changes implemented in Hungary, Romania and the United Kingdom. The paper also makes reference to the position in Croatia which joined the EU on 1 July, 2013.

## 2 The nature of financial supervision

This section reviews the nature of financial supervision. In the context of the paper this is important in order to understand the rationale for the delegation of supervision by politicians to an independent agency. The analysis in this section suggests that in order to achieve financial supervision which is effective and responsive to the needs of our time, a supervisor should *inter alia* have the following fundamental characteristics:

[a] suitable technical expertise and resources;
[b] constant commitment to achieving the objectives of regulation;
[c] time-consistent strategy which includes focus on financial innovation;
[d] a clear, predictable and coordinated approach to supervision; and
[e] cooperation and coordination with other supervisors.

Before delving into the nature of financial supervision, it is crucial at this early stage to comment on the distinction between regulation and supervision—terms that are, in certain instances, used interchangeably in literature but which are different and involve very specific functions. It is also important to understand the difference between micro and macro supervision which are two different but equally important categories of supervision.

Regulation may be defined as the act of making laws and rules including soft law, while supervision refers to the action of monitoring the implementation and application of the rules in specific cases and includes the authorisation, supervision *stricto senso*, crisis management and the taking of enforcement action where specific breaches have been committed.[3] In the context of financial services both regulation and supervision should seek to achieve the high-level objectives of regulation. These two functions are, however, distinct in nature and require specific technical skills if they are to be implemented correctly.

The carrying out of supervision may be further categorised into micro- and macro-prudential supervision. Micro-prudential supervision is concerned about the stability of individual financial institutions and is largely carried out through the over-sight of the governance, compliance, capital structures and risk management of specific institutions. Macro-prudential supervision is interested in the safety and stability of the financial system as a whole and seeks to identify threats to systemic stability by analysing the trends and imbalances in the financial system.[4]

Financial supervision in general entails the ongoing monitoring and identification of potential risks to the financial system and to the customers of financial institutions.

[3] See amongst others: *Lastra* [39]; *Wymeersch* [63]; *Lastra* [35].

[4] *Persaud* [49].

It necessitates the taking of concrete action to mitigate such risks and to address identified compliance issues. The nature of supervision is explained as follows:

Supervision is about oversight of financial institutions' implementation of these rules. It is about putting up yellow flags to slow things down and trying to ensure that banking is carried out safely without putting depositors and taxpayers at risk. It is about determining whether there could be a breakdown in risk management controls at an institution, and whether the culture of the institution and its appetite risk will create dangers that could lead to the bank running off the road (i.e., becoming insolvent).

... supervisory oversight is about the kind of attention financial institutions receive from supervisors on a regular basis. It is about the questions we ask, what we say to institutions, how we say it, the type of information we request, the people we ask to meet, how we deal with push back, what we do when we go on-site or otherwise deal with an institution, and the extent to which we tick the boxes or think about the core risks and how they are being managed.

... supervisors are the people on the front lines who seek to identify weak risk management systems at individual institutions and decide what to do about them.[5]

The size and complexity of a financial system have a bearing on the mechanisms used for supervision. The more complex the financial system, the more detailed and rigorous the mechanism for supervision that must be applied in order to ensure the safety and soundness of financial services. The crisis bears witness to the complexities that exist in the financial system and the difficulties in supervision that may emerge where business risks, such as credit, market, liquidity risk and large exposures of individual financial institutions together with financial innovation and interconnectedness in the system are not properly and fully understood and monitored.

Furthermore, the detailed and sometimes compounded regulatory framework devised by policy-makers as a response to the crisis has turned the monitoring of compliance by financial institutions into a more difficult and demanding undertaking. A range of new tasks have been imposed on financial supervisors, such as the assessment of business models, financial product analysis, the preparation of recovery plans, the requirement to focus on resolution and the carrying out of stress tests, all of which require specialised knowledge and experience in specific fields of finance.[6]

Therefore, proper financial supervision requires suitable technical expertise and resources that are committed to the attainment of the high-level objectives of regulation. Where technical expertise is weak and resources are insufficient or where, as a consequence of political or industry capture, the supervisor's attention is diverted towards achieving aims other than the mentioned objectives, mistakes in supervision which have significant consequences for the financial system or the individual investors can easily occur. In such an unsound environment, the supervisor risks becoming a sitting duck waiting to be shot by its political masters at the first sign of yet another financial debacle caused by insufficient or inappropriate supervision.

The importance of suitable technical expertise and resources for financial supervision is abundantly supported by the evidence that emerged from the crisis, particularly

[5] *Dickson* [16], 221.

[6] *Athanassiou* [5].

in view of the supervisory failures to assess the vulnerabilities of financial institutions and the threats to the stability of the financial system and to investors.[7] These failures raised concerns about the effectiveness of the approach and mechanisms for supervision, as supervisors were not adequately equipped, focused, prepared and capable to discharge their responsibilities.[8] To address these failures, it has been argued that supervision needs to be intrusive, adaptive, sceptical, proactive, comprehensive, and conclusive.[9]

Given the failures of supervision before the crisis, at international level the Financial Stability Board ('FSB') adopted a set of standards for more intensive and effective supervision.[10] The FSB promotes the view that supervision should be proactive and that supervisors should have the will, technical expertise and resources to identify risks to the financial system and act early where these are identified. The FSB standards stipulate the conditions and tools for the improvement of the internal governance of a supervisor and the application of more intrusive supervisory techniques and further substantiate the view that today supervision is an intricate task which requires specific specialisation.

Experience suggests that it takes broad knowledge of the financial system, extensive years of involvement in financial supervision, personal commitment and dedication to build the technical expertise and adequate supervisory approach which would allow the proper fulfilment of the role of a financial supervisor.[11] This is relevant at every stage of the supervisory process. In the field of authorisation of applicants for a licence, the assessment made should allow the identification of possible rotten apples, thereby acting as a concrete filter which ensures that only persons who are fit and proper access the financial system. With regard to ongoing monitoring this should be guided by a risk-based approach which is directed by financial intelligence, thereby focusing supervision on the financial institutions and products that form a major threat to the financial system. Finally, enforcement should be applied in a way which ensures that this acts as a proper deterrent to perpetrators of financial market malpractice.

Moreover, in view of the dynamic, global and interconnected nature of the financial sector and its tendency towards constant financial innovation, one may argue that effective supervision requires a long-term and stable (i.e., time-consistent) strategy and approach. Again, it is important to mention that for such a time-consistent strategy and approach to be effective, it should be focused on achieving the high-level objectives of regulation and should not be diverted in attaining other political or industry aims. The strategy should *inter alia* embrace a commitment to monitor developments in financial markets, in particular new financial components that surface from financial innovation, and to the setting of standards to mitigate the possible emerging risks.

[7] Company Lawyer, 'FSA reveals details of its "unacceptable" supervision of Northern Rock' Company Lawyer (2008); *Palmer/Cerruti* [48]; *Claessens/Dell'Ariccia/Igan/Laeven* [12]; *Caprio/D'Apice/Ferri/Puopolo* [10].

[8] *Vinãls et al. Hsu* [61].

[9] *Vinãls et al. Hsu* [61], p. 5.

[10] FSB, 'Intensity and Effectiveness of SIFI Supervision: Recommendations for Enhanced Supervision', 02.11.10.

[11] The author has fourteen years of experience as a financial supervisor in Malta.

The crisis demonstrated that innovation occurred so rapidly that supervisors were not in a position to catch up. For example, before the crisis none of the financial supervisors in Europe had identified the risks which had been building up within the real estate market in the United States, and that the related ratings of credit default swaps were therefore based on quicksand. At the time, no pre-emptive action was taken to safeguard the financial system. Today, the strategy and approach to supervision must comprise a commitment to dedicate resources to the monitoring of financial products, processes and techniques that could be harmful to the financial system and/or investors, particularly through the deconstruction of innovation into their individual components which should be analysed and understood in depth.

Furthermore, effective supervision is based on fair and transparent processes. Such processes may be implemented through rules of procedure that are made public and which offer clarity and predictability on the manner in which supervision is carried out, and the mechanisms that are applied for making contact with the industry. An arbitrary and opaque approach to supervision would present the financial industry with the risk that business practices considered suitable to the supervisor today may become unacceptable in the short term without proper notice.

Randomness in the approach to supervision increases operational and administrative risk for the industry, making it more difficult and expensive to operate in the financial system. It is therefore important that the approach to supervision be clear and predictable. However, experience suggests that a certain degree of flexibility in method is also essential if a financial supervisor is to be in a position to deal with the different circumstances that may arise in supervision, such as the specific and sometimes difficult conditions which may be encountered when investigating breaches of regulatory requirements or dealing with the failure of a financial institution.[12]

In addition, the global nature of financial markets calls for a commitment to cooperate and coordinate supervision with peers. This is particularly relevant within the context of the European internal market, which promotes freedom to provide services and the cross-border distribution of products, thereby creating a competitive environment among a wider range of financial institutions as well as interconnections between multiple financial markets. In such an environment, the consequence of insufficient or weak supervision in a Member State can have a negative impact far beyond the borders of that particular state. Therefore, to ensure that there are no gaps in the monitoring of the financial system, the supervision of pan-European financial services necessitates active cooperation and coordination between the supervisors of the different states.

## 3 Rationale for delegation to an independent supervisor

This section examines the rational for delegation of regulatory and supervisory powers to an independent supervisor. Before examining this subject it is important to

[12]The author was responsible for carrying out a number of investigations of market malpractice, some of which involved insider dealing or financial product mis-selling.

understand the meaning of independence and autonomy within the context of financial supervision. Being 'independent' means that the financial supervisor is capable of exercising discretion by making regulatory and supervisory decisions without being required to follow political or industry directions. Therefore, a supervisor should be subject only to non-binding consultations with government and industry.[13] On the other hand, being 'autonomous' means that the agency is operationally independent and has the resources, including financial resources, to be in a position to operate and function without requiring government support or approval.

Academics have attempted to explain the rationale for the delegation by politicians to independent agencies of critical functions and decision-making powers. Some have argued that delegation by politicians to financial supervisors is necessary in view of the technical nature of the work involved and is the solution for time-inconsistency, apparent inefficiency, lack of credibility and uncertainty that generally characterises decision-making by politicians. Others have expressed the cynical view that politicians delegate supervision to shift the responsibility for the severe financial, economic and social consequences of financial failures when these arise. In practice there are other reasons for the establishment of independent agencies, including the fulfilment of international expectations and obligations.

In circumstances where there may be clear political benefits in the short-term, political calculation may result in a preference for inferior outcomes in financial supervision. In consequence, where politicians make a policy commitment for the long-term, this may not be credible as such decisions may easily be reversed or amended if this happens to be in the interest of the powers that be.[14] Moreover, in a democracy, the changing of the guard in government from one political party to another, may lead to changes in policy direction. This could, in turn, generate uncertainty for financial supervision if this is left in the hands of politicians.[15]

It has been argued that politicians should delegate supervision to an independent agency so as to increase the credibility of their policy commitments and to bind future policy-makers who might have a preference for different outcomes.[16] Credibility and certainty are necessary and valuable assets in economic and regulatory policy, in the absence of which it would be difficult for a jurisdiction to attract private investment.[17] Therefore, it has been argued that where politicians delegate powers in a particular policy area to an independent agency, then changes in the powers that be should not inevitably translate into policy changes in that particular area.[18] In this sense, delegation to an independent and autonomous agency is used as a tool to induce future policy-makers to act in accordance with the current policy direction.

Given that effective supervision depends on technical expertise; commitment to achieving the objectives of financial regulation; time-consistency; and a clear, predictable and coordinated approach to supervision, unelected, technical and career

[13] *Lastra* [40].

[14] *Gilardi* [26].

[15] *Gilardi* [26].

[16] *Trillas* [60].

[17] *Haksoon* [30].

[18] *Swank/Dur* [56]. Also see *Frisell/Roszbach/Spagnolo* [23] and *Evans/Levine/Rickman* [19].

oriented bureaucrats would appear to be better placed than elected politicians to carry out this function. Politicians generally lack specialisation and for the most part focus on the issues that could have an impact on their re-election in the short-term.[19] An autonomous agency having a long-term contract to achieve specific objectives and the required powers to carry out the assigned tasks, can strategise independently and set the regulatory and supervisory agenda for the long-term, without any serious concern about possible change in political direction.

However, depending on the approach and personal objectives of the executives that are responsible for leading the agency, an independent supervisor endowed with significant powers could develop into an over-mighty bully. One of the most striking examples of abuse of power by a leading national supervisor in the EU, relates to the 2005 odyssey of Banca Antonveneta that had become the target of a public offer by a Dutch Bank, ABN Amro.[20] This takeover was improperly disrupted by the Bank of Italy which favoured a local bidder, Banca Poplare Italiana, in order to prevent an Italian bank falling under foreign control. This scandal led to calls by the Italian Government for the resignation of the Governor of the Bank of Italy, Mr Antonio Fazio, who was accused of abuse of power, but who could not be removed by the government in view of the rules governing the appointment and removal of the senior executives of the Bank.

As the 2005 Fazio scandal demonstrates, situations may arise where the cost of independence could exceed its benefits, as abuse of supervisory powers may result in misdirected, non-transparent and non-impartial supervision. Therefore, accountability mechanisms become a crucial tool to ensure that the executives responsible for leading the agency do not become excessively powerful. Consequently, the design of the conditions that guarantee the independence, autonomy and accountability of the financial supervisor, including the mechanisms for decision-making, the conditions for the appointment of the executives responsible for leading the agency, their term of office and the criteria for removal, deserve special attention.

Independence is also considered important in order to prevent certain political traits, such as personal favoritism and patronage, from featuring in supervisory matters, and in administrative decisions about personnel, procurement, and service delivery.[21] Again, one may reasonably contend that unless the supervisor is managed by individuals who have a proper sense of integrity and professionalism, the above-mentioned negative traits may also feature in the operation of an independent agency.

Politicians could face lack of credibility as their policy preferences may vary by time depending on the context within which they are operating.[22] In certain instances the best policy in a particular field may be forgone or replaced in view of political circumstances and to achieve short-term political goals.[23] For example, it is possible

[19] *Alesina/Tabellini* [1]; *Lastra* [37].

[20] BBC, 'Italy bank boss 'facing inquiry' BBC (30.09.05) http://news.bbc.co.uk/2/hi/business/4296726.stm; J Cronin, 'Antonio Fazio: Italy's embattled banker' BBC (11.11.05) http://news.bbc.co.uk/2/hi/business/4319090.stm; The Economist, 'Year-End Accounts. Antonio Fazio, governor of the Bank of Italy, resigns. About time,' Economist, (19.12.05) available www.economist.com accessed 04.01.14.

[21] *Behn* [6].

[22] *Gilardi* [27], 72–75.

[23] *Cukierman* [13].

that during an election campaign a politician may be disposed to ease the conditions for the authorisation of financial institutions or the safety features relating to the granting of mortgages (such as the taking of collateral) in order to fulfil the demands of his/her constituents. Therefore, the outcome of such a political decision would be that of foregoing the long-term objective of safeguarding the integrity of the financial system for the attainment of the support that would guarantee re-election in the future.

Establishing an independent financial supervisor does not necessary result in the best policy, regulatory and supervisory choices being made. Once more, achieving the right outcomes is not only a function of the institutional architecture or the legislative framework for governance but depends to a large extent on the characteristics and personal objectives of the individuals who manage the institution and whether they exercise the powers granted by statute for the right reasons. Unless the supervisor is managed by persons who are and act independently from government and industry, political and industry capture may still act as a distortion to the making of suitable decisions.

The independence of the supervisor from government is also essential for dealing with situations where the government is a shareholder in one or more financial institutions. In these circumstances, unless there is clear supervisory independence, political calculations could easily result in interference in supervisory matters with the purpose of achieving favourable outcomes for entities in which government has a shareholding over other competing private operators. Then again, the level of impartiality of a supervisor in practice depends on the extent to which the executives who are responsible for leading the supervisor act independently and do not have special allegiances to the political class which result in choices that favour government entities and political choices.

On the one hand, political calculations will lead politicians to attempt to influence indirectly the decisions of a supervisor where this results in clear advantages. On the other politicians will not hesitate to blame quickly the supervisor where regulatory and supervisory decisions have negative consequences.[24]

A cynical view of the rationale for the delegation by politicians to independent and autonomous agencies is that the delegation process is merely a ceremony intended to provide authenticity for certain policy decisions.[25] Moreover, such a cynical view might also lead to the conclusion that due to the severe financial, economic and social effects of a possible financial failure of major proportions, it is appropriate for politicians to delegate tasks, such as supervision, and be able to hold the supervisor responsible in case of disaster.[26]

[24] See reporting on LIBOR scandal: M Scott, 'British Law Makers take aim at regulators' New York Times (New York 16.07.12) http://dealbook.nytimes.com/2012/07/16/british-lawmakers-take-aim-at-regulators/; D Rushe, 'Treasury secretary appears before House committee and blames British regulators for failing to stop rate manipulation' The Guardian (London 25.07.12) http://www.guardian.co.uk/business/2012/jul/25/tim-geithner-libor-euro-testimony Schumpeter, 'The WatchDog that didn't bark' The Economist (London 17.07.12) http://www.economist.com/blogs/schumpeter/2012/07/libor-and-regulation accessed 05.08.12.

[25] *Meyer/Rowan* [43].

[26] *Alesina/Tabellini* [2].

This risk-shielding is only possible if the supervisor is granted the power to act independently from government. The reaction of politicians to the crisis sustains the argument that politicians push the blame on supervisors for policy failure. However, in practice there is no tangible proof that the original intention of policy-makers was that of having a scapegoat in case of need. In reality delegation of powers to an independent supervisor is not merely an exercise of abdication of powers, but aims at ensuring a certain degree of commitment and time consistency in policy choice.

Experience supports the view that technical knowledge, commitment, credibility and time-consistency in policy choice and supervisory decision-making, calls for a supervisor which has an arms length relationship with politicians and the industry and which is in a position to exercise real discretion in decision-making.[27] It may be argued that discretion in decision-making largely depends on the extent to which the financial supervisor is organised in a way, which guarantees its independence and autonomy, that is, the extent to which the supervisor's organisation is based on sound internal governance arrangements for financial supervision.

Sound internal governance arrangements for supervision include the adoption of legal safeguards and organisational procedures which guarantee the autonomy of the supervisor such as securing an adequate independent source of funding for the financial supervisor, and exempting it from restrictive civil service conditions for staff recruitment and remuneration.[28] With regard to the latter, the point has been made that monetary incentives are indeed crucial for a supervisor to be in a position to attract and retain talented candidates, to reward high performance and foster dedication, all of which are important to strengthen the effectiveness of supervision.[29] Indeed, the quality and robustness of supervision may be at risk where the supervisor's functional independence is constrained. This is particularly relevant where the funding method for the supervisor does not provide sufficient financial resources to allow the agency to meet its regulatory and operational needs on a long-term basis. This is the position in the United States as reported by the IMF in their 2010 financial sector assessment programme report. [30]

The IMF expressed the concern that the method of funding of the federal securities regulators, the Securities and Exchange Commission ('SEC') and the Commodities Future Trading Commission, whereby their budget is determined by government, was inadequate to meet the needs for funding necessary for implementing long term investment in supervisory tools and recommended that consideration should be given to moving to direct self-funding, by having the ability to capture fee income for own funding rather than remitting it to general government revenue and relying on a government budget.[31] Ultimately, a funding model based on industry fees as against one derived from government budgets is preferable as it secures a more permanent source of revenues for the supervisor, thereby allowing the cost of supervisory activity to

[27] (*n*12).

[28] *Smith* [53].

[29] *Lastra* [40], p. 486.

[30] IMF, 'United States: FSAP-Detailed Assessment of Implementation of the IOSCO Objectives and Principles', May 2010 https://www.imf.org/external/pubs/ft/scr/2010/cr10125.pdf accessed 03.01.13.

[31] International Monetary Fund (*n*30).

be better estimated and also modified depending on market developments. Moreover, it also safeguards the agency from being subject to fiscal uncertainties or political conditioning.

In the final analysis, it is reasonable to suggest that sound internal governance arrangements, allowing the supervisor to have an independent source of funding, underpin the arm's length relationship, as they seek to ensure that the supervisor is less at the mercy of the government for raising proper resources for the recruitment of technical staff and for the conduct of its supervisory activity and create the conditions that should mitigate the temptation and opportunity to fall for regulatory capture.

## 4 Governance arrangements for independence, autonomy and accountability

This section reviews the literature on governance arrangements for independence, autonomy and accountability of supervision and makes some suggestions on sound mechanisms that may be applied in this regard.

The degree of independence and autonomy of a financial supervisor from government and the industry depends on the extent to which its internal regulatory, supervisory and administrative processes are insulated from influences that distort its activity from achieving the objectives of financial regulation. Influences that distort the activity of financial supervisors may come in the form of pressures to serve political objectives ('political capture') or the financial interests of the industry ('industry capture'). Such influences may also come in the form of personal career objectives ('self-interest capture').

To mitigate the influences that may arise from regulatory capture, a policy decision to establish an independent supervisor inevitably requires the consequential decision to implement a set of governance shields, more specifically: **[i]** the values that are to govern the supervisor's overall activity; **[ii]** the constitutional arrangements for its establishment; and **[iii]** its internal organisational arrangements. A proper combination of these elements would generally have a bearing on the extent to which the supervisor would be in a position to shield itself from the influences that could distort the focus of its supervisory activity.

The overarching values that govern the activity of a supervisor have an impact on the degree to which it will be in a position to realise the objectives of financial regulation. A supervisor whose primary aim is that of accomplishing the common good is generally guided by the normative values of fairness, equity, integrity and responsibility. On the other hand, where the executives who steer the activity of a supervisor are guided principally by self-interest and career concerns, the supervisory environment could end up being characterised by different forms of regulatory capture and conflicts of interests that generate suspect regulatory choices.[32]

Independence may be distorted by regulatory capture where a supervisor feels vulnerable to existing political powers or those of the future. Vulnerability that results in industry capture exists where those responsible for supervision become too familiar

[32] *Enriques/Hertig* [18], p. 363; *Dijkstra* [17]; and *Stigler* [55].

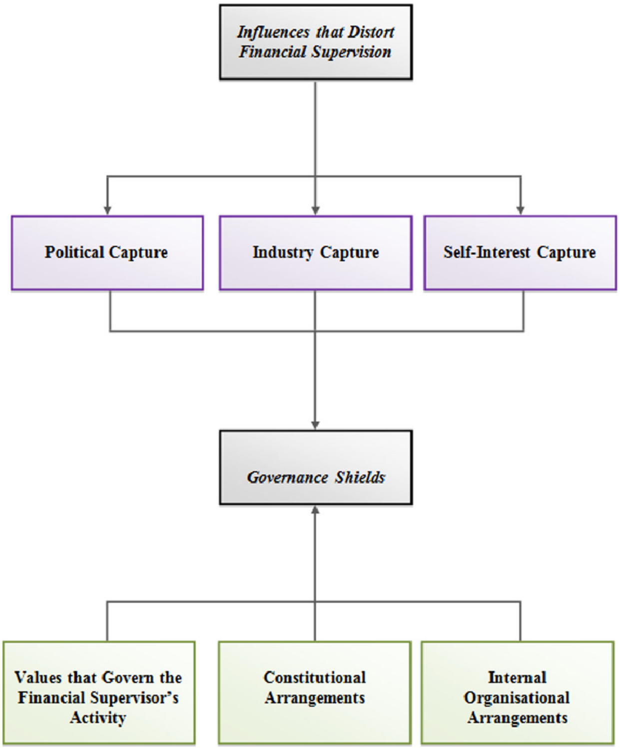


**Diagram 1** Influence that distort supervision and the governance shields

with the industry or have career plans which go beyond working with the supervisor. These concerns are still very relevant today.

Both political and industry-related vulnerabilities make the officials responsible for steering the supervisor susceptible to external influence in decision-making and undermine the *de facto* independence of the institution. Independence should not be interpreted narrowly. Indeed, the point has been made that the principle:

… that a regulator be "operationally independent from political interference" is not to be interpreted … as applying only to a minister seeking to interfere in an insider-dealing case. When a government can demand that a regulator takes on additional work as specified by the Government such that resources have to be diverted from day to day supervision and even from enforcement the operational independence of the regulator is called into question.[33]

A financial supervisor should therefore have the governance arrangements in place to resist accepting the undertaking of tasks that are unrelated to its core activity. Supervisors should not be distracted by auxiliary work, where it can find itself subjected to influence or criticism by third parties.

[33] IMF, 'Sweden: FSAP Update-Detailed Assessment of Observance on IOSCO Principles and Objectives' September 2011 www.imf.org accessed 03.01.13.

It follows that unless there is: [i] a clear direction regarding the values that should be at the heart of the supervisors' work; [ii] procedural guarantees in terms of both the manner and the eagerness of decision-making; and [iii] proper accountability structures in place (including the possibility of judicial review as a safeguard for objectivity), the independence and discretion granted to supervisors could be easily abused.

Therefore, the independence, objectives and overarching values set for a supervisor, its decision-making procedures and the accountability mechanisms, should be clearly stipulated in the constitutional document that establishes the agency, and should be the blueprint for its over-all governance. Moreover, the internal governance arrangements and the procedures employed for steering the supervisor should guarantee its *de facto* independence. Autonomous institutions without clear objectives and functions, sound organisational structure and governance are fragile and condemned to malfunction, as they will not be in a position to achieve the objectives they have been created to attain.[34]

Hence, if the financial supervisor is to serve as a source of commitment in decision-making for the attainment of the objectives of financial regulation, the constitutional document should clearly provide for clear objectives, role, competence, duties and discretionary powers and define its various organs together with their respective roles and responsibilities.

The constitutional document should also empower the supervisor to raise its own income, set its own salary packages and enter into contracts without requiring government approval. As already determined in the previous section of this paper, budgetary freedom is a fundamental component of a supervisor's autonomy both *vis*-à-*vis* government and with respect to the industry.

To strengthen further the *de facto* independence of financial supervision, the overarching values of the supervisor should constitute a measure for determining some of the necessary characteristics and professionalism which are required of the members who will compose the supervisor's governing body, the executives engaged to lead its supervisory and administrative organs and the officials who will be involved in supervision. Professional judgement, expert knowledge, impartiality and intellectual honesty are all essential criteria to achieve professional independence, competence and credibility. The view has been expressed that:

professional independence—which contributes to the reputation and prestige of the institution—is also safeguarded by the establishment of a list of incompatible or disqualifying activities so as to prevent conflicts of interest. For instance, while in office [financial supervisors] should be precluded from simultaneously holding private-sector jobs.[35]

Therefore, in seeking to ensure that only the right people are engaged for the purpose of steering the supervisor, it is fair to suggest that the constitutional document should perhaps define the criteria which determine the fundamental qualities of such persons. As a minimum, they should be characterised by integrity, competence and solvency. By reference to the Regulation on the Single Supervisory Mechanism (SSM) and specifically the provisions on the appointment of the ECB's supervisory

[34] *Farazmand* [21].

[35] *Lastra* [37], p. 56.

board, it is reasonable to suggest that, in order strengthen their independence, the executives of a supervisor should be individuals of recognised standing and experience in financial services.[36]

On an ongoing basis, overarching supervisor values would also serve as some of the standards which may be used for assessing the correctness in the supervisor's performance. It could be reviewed whether the overarching values are reflected in the decision made by the supervisor's executives or whether their choices have been inspired by less honourable objectives.

Devising the governance structure of a supervisor requires the introduction of structural guarantees and institutional arrangements that seek to ensure that the supervisor pursues the objectives of financial regulation. These arrangements should be designed to minimise the possibility of slippage in the direction of regulatory capture.

There are different types of procedural controls that may be applied in order to contain slippage and opportunistic behavior which may occur as a consequence of the powers and discretion granted to the supervisor. Of particular significance is the procedure for the selection of the officials who will steer the supervisor, whereby the persons to be selected should be required to demonstrate that they have the personality, experience, technical ability and leadership skills which are required to allow them to set the agenda, gain the respect of stakeholders and avoid being controlled by third parties whether political or the industry. In the end, a procedure which objectively and effectively tests the candidates' experience, knowledge and ability to achieve the objectives of regulation, strengthens even further the professional independence of the supervisor.[37]

It has been suggested that rules of conduct which bind a supervisor to a specific course of action in making supervisory decisions may be applied as a control mechanism in order to guarantee independence in the decision-making process.[38] However, such rules would significantly limit the supervisor's discretion, which is essential for the proper conduct of its functions. A more workable proposal, which is applied in practice, is that of requiring supervisory decisions to be made collegially by an independent college of executives experienced in supervision, having the role of reviewing proposed supervisory decisions and requesting justifying reasons for a proposed course of action, before the final supervisory decision is made and issued.

Moreover, the risk of politically-driven interventions in the day-to-day operations of the supervisor may be reduced if the institutional design of the supervisor provides for a separation of powers between those powers relating to policy, to be exercised by the main board of the organisation appointed by government, and the powers necessary for the conduct of day-to-day supervision, which may be allocated to a chief regulator appointed by the board and who is therefore completely independent from government.[39] The rationale for such separation of powers is that board members are generally political appointees who might not have regulatory experience—in certain instances, former politicians, including cabinet members—and as a consequence

[36] Regulation 1024/2013, Article 26.

[37] *Lastra* [40], p. 482.

[38] *Goodhart* [28], p. 157.

[39] *Enriques et al*. [18], p. 365.

closer to politicians than staff members, and therefore their participation in day-to-day supervision increases the risk of political capture.

On the other hand, a chief regulator and the other members of staff are appointed by the board and should in theory be less prone to this type of capture. While this is a valid proposal, experience with the operation of this type of governance mechanism suggests that senior officials within a financial supervisor could however also be subject to political capture, especially in circumstances where the particular official harbours higher career ambitions within the agency or in other government institutions. Therefore, this tool on its own is not enough to guarantee the independence of a chief supervisor. It follows that to avoid such a form of capture, a chief regulator should ideally be of an age that excludes this form of career aspirations. Moreover, these mechanisms should be supported by other governance arrangements such as by making appointments for a tenure that is longer than that held by legislators [40] or by imposing term limits.

Term limits are another governance tool, which are considered effective in order to avoid undue dependence and to guarantee a certain degree of *de facto* independence of the appointee responsible for steering the supervisor. Without term limits, a chief financial supervisor in office may become too influential and authoritative in relation to outsiders, so that competition for the office of a chief financial supervisor could become distorted with tenure. Moreover, in the absence of term limits, the value of remaining in office may become excessively significant, which in turn could trigger a chief financial supervisor to focus his/her energy on ensuring reappointment and consequently divert time from supervisory work. Therefore, it has become best practice to adopt the approach of granting appointments only for a fixed non-renewable term, but nonetheless one which is sufficient to safeguard independence while gathering enough expertise in the job to deliver long term objectives. This is the approach taken with regards to the position of the Chairman of the ECB's supervisory board, who is appointed for a non-renewable period of five years.[41]

Procedural guarantees may not be effective unless the executive of a financial supervisor which has the power to make regulatory and supervisory decisions, is made accountable for any ramifications of its actions. Accountability is an obligation owed by one person (the accountable) to another (the accountee), whereby the accountable must explain and justify his/her actions or decisions against specified criteria and take responsibility for failure, possibly entailing where relevant, the possible dismissal of the accountable.[42] There are different forms of accountability that may be applied. In the case of a supervisor, accountability is generally owed to the judiciary, whereby the courts are granted the power to review administrative actions or decisions by the supervisor, and to parliament, which allows monitoring of independent agencies by a democratically elected institution.[43]

Hence, accountability arrangements serve as a monitoring mechanism—one which seeks to ensure that the financial supervisor acts diligently and fairly, does

[40] *Lastra* [40].

[41] Regulation 1024/2013, Article 26.

[42] *Lastra/Shams* [38].

[43] *Lastra* [40]; and *Lastra/Shams* [38].

not abuse its powers and is not controlled by third parties, such as the industry it supervises. Accountability also becomes a solution to the legitimacy concerns that surface from the possibility that a supervisor having broad responsibilities and enforcement powers could become a law unto itself. Accountability arrangements thus serve as a support for the supervisor's independence.

Financial regulation and supervisory decision-making is likely to involve politically sensitive trade-offs, such as those between economic efficiency and social well-being or concerning investor protection and competition. Such decisions may be regarded as being shifted from democratically elected institutions to non-democratically elected bureaucratic agencies.[44] In a democratic system, a social order is legitimate where the policy-makers are accountable to their citizens who are given the opportunity to partake in rule-making through representation and can express their disagreement with the policy-makers by voting them out of office. This infers a certain degree of equivalence between the policy-makers and the citizens through mechanisms of representation. Supervisory independence makes the democratic mechanism that allows constituents to make a binding decision on the performance of the ruling parties an unworkable mechanism for the operation of a supervisor. Moreover, while the political establishment can transfer binding powers to a supervisor, politicians cannot transfer their legitimacy. It follows that in the eyes of the general public, the supervisor might face legitimacy drawbacks.

In order to achieve social legitimacy and market credibility, the discretionary independence of a supervisor needs to be supported by positive performance in the fulfilment of its duties and by mechanisms for accountability,[45] whereby the greater the discretion granted to the supervisor, the greater the need for adequate accountability.[46] Ultimately, accountable independence [47] provides society with a certain degree of assurance that supervision is being carried out for the right reasons and is not being influenced, undermined or abused by private interests or, equally detrimentally, by incompetent and weak persons.

The concept of accountability entails that the actors being held accountable have obligations to act in ways that are consistent with accepted standards of behaviour and that they will be sanctioned for failures to do so.[48] Judicial review of the supervisor's decisions is crucial to control the unreasonable exercise of discretionary powers.[49] On the other hand, with regard to accountability to government, in order not to jeopardise the independence of the supervisor, accountability should be established through a combination of control instruments in such a way that no one really controls the supervisor, yet the agency is nonetheless under control.[50] In this

[44] *Bini Smaghi* [7].

[45] *Majone* [41], p. 93. Also see *Lastra* [40]; *Page* [47].

[46] *Lastra and Shams* [38].

[47] This usage is borrowed from *Lastra* [40], p. 481.

[48] *Grant/Keohane* [29], p. 29.

[49] *Lastra/Shams* [38].

[50] *Moe* [44].

regard, transparency, which is an essential feature of good governance, becomes a complement to accountability.[51] It has been argued that:

the provision of information in the context of accountability, whether in an *ex ante* investigation or an *ex post* requirement of disclosure, facilitates transparency. On the other hand, a transparent economic and political environment enhances the effectiveness of accountability.[52]

Nonetheless, the publication of information on supervision has to be selective as the actual benefit of full transparency on supervisory matters is not entirely clear.[53] This is particularly true given the potential uncertainty and instability that could be generated by transparency of information on serious supervisory concerns such as the potential failure of a financial institution.[54] Moreover, confidentiality constraints exist with regard to supervisory matters. Indeed, it has been argued that there is a tension between the duty to be accountable by disclosing information and the duty to retain supervisory information confidential.[55] It is reasonable to suggest that this tension may be loosened through possible agreements between the accountable and the accountee concerning restricted access to information and confidentiality by the accountee, such as that reached between the European Parliament and the ECB within the context of the SSM.[56]

In terms of accountability to government, on the one hand the executives of a supervisor must be independent of political influence, while on the other hand they also need to be held accountable for their activities. Parliamentary accountability, involving a democratically elected institution, would appear to be the best choice for this purpose as clearly ministerial intervention should be avoided, as this could easily result in interference by the executive and political capture. Nonetheless, coordination with the executive is important to ensure consistent overall policy making.[57] Moreover, while parliament should be in position to review, assess and comment on the activity of a supervisor it should not be granted powers to exercise immediate authority on the supervisor by interfering directly in its supervisory activity.[58] Therefore, a delicate balance must be struck in the construction of this accountability mechanism. One may argue that the optimal solution would be to assign a parliamentary committee for this purpose which is provided with the required information to facilitate opinion-formation on the performance of the supervisor and which takes a results oriented approach in assessing its functioning.[59]

Such parliamentary committee would be responsible for assessing the performance of the activity of the supervisor and make a judgement call on whether it

[51] *Lastra* [36].

[52] *Lastra and Shams* [38].

[53] *Amtenbrink/Lastra* [3].

[54] *Lastra* [36], p. 9.

[55] *Lastra* [36], p. 9.

[56] Inter-Institutional Agreement between European Parliament and ECB on the SSM 2013 http://www.ecb.europa.eu/ssm/pdf/130912_IIA_final_draft.pdf accessed 04.01.14.

[57] *Amtenbrink/Lastra* [3].

[58] *Hupkes/Quintyn/Taylor*[32].

[59] *Amtenbrink/Lastra* [3].

has achieved the objectives for which it was established, and more particularly the extent to which it has contributed towards attaining the objectives of financial regulation. The composition of such parliamentary committee should include representatives from all the spheres of the political divide, who should preferably have some form of understanding about the nature of supervision. This would guarantee that no special allegiance to one particular party is formed and that no bias is allowed with regard to the assessment of the performance of the supervisor.

Assessing the performance of the activity of the supervisor may be a complex task, as thus far no real objective criteria, either quantitative or qualitative, have been established on what is appropriate in terms of *ex-post* assessment of supervision. Therefore, input or process monitoring is considered to be the optimal solution to assess a supervisor's performance.[60] It might be suggested that instability within the financial system and investor losses (amongst other criteria) may be applied as possible measures of a supervisor's success. Albeit, accountability cannot simply rely on whether or not crises are taking place.[61] On the other hand, the identification, prevention and risk management of future potential financial debacles may be applied as a standard for the assessment of the performance of supervision, which may be achieved through an examination of the processes applied by a supervisor in determining where to focus its supervisory activity and the manner in which this contributes to a stable financial system. The manner in which such processes operate and the extent to which this contributes to the effectiveness of supervision may however also depend on the institutional models applied for supervision.

## 5 Institutional models for supervision and existing weaknesses

This section examines the institutional models for national supervision in Europe and identifies the weaknesses in the governance arrangements of a number of these supervisors. The analysis in this section serves as a basis for a proposed framework for the strengthening of the governance of national supervisors across the EU, which is crucial if national and European supervision is to be strengthened. The proposal for the strengthening of supervision is made in Sect. 6 of this paper.

As noted in Sect. 1 of the paper, supervision may be divided into two elements of activity, macro- and micro-prudential supervision. Macro-prudential supervision is generally undertaken by central banks, which seek to ensure financial stability and focus on the interconnectedness in the financial system.[62] Micro-prudential supervision is carried out by supervisors which follow different institutional models, and focuses on the stability of individual financial institutions. From a European perspective, existing institutional models for micro-prudential supervision may be categorised under one of three headings, the two or three pillar sectoral model (banking,

[60] *Garciano/Lastra* [24].

[61] *Garciano/Lastra* [24].

[62] *Taylor* [57].

**Table 1** Models for supervision 31 December 2013

| EU state | Model | Two pillar-sectoral model | Three pillar-sectoral model | Twin peaks | Single financial supervisor |
|---|---|---|---|---|---|
| Austria | | | | | ✓ |
| Belgium | | | | ✓ | |
| Bulgaria | | ✓ | | | |
| Cyprus | | | ✓ | | |
| Croatia | | ✓ | | | |
| Czech Republic | | | | | ✓ |
| Denmark | | | | | ✓ |
| Estonia | | | | | ✓ |
| Finland | | | | | ✓ |
| France | | | | ✓[64] | |
| Germany | | | | | ✓[65] |
| Greece | | ✓ | | | |
| Hungary | | | | | ✓ |
| Ireland | | | | | ✓ |
| Italy | | | ✓ | | |
| Latvia | | | | | ✓ |
| Lithuania | | | | | ✓ |
| Luxembourg | | ✓ | | | |
| Malta | | | | | ✓ |
| Netherlands | | | | ✓ | |
| Poland | | | | | ✓ |
| Portugal | | | ✓ | | |
| Romania | | ✓ | | | |
| Slovakia | | | | | ✓ |
| Slovenia | | | ✓ | | |
| Spain | | | ✓ | | |
| Sweden | | | | | ✓ |
| United Kingdom | | | | ✓ | |

| EEA state | Model | Two pillar-sectoral model | Three pillar model | Twin peaks | Single financial supervisor |
|---|---|---|---|---|---|
| Iceland | | | | | ✓ |
| Liechtenstein | | | | | ✓ |
| Norway | | | | | ✓ |

securities and insurance), the functional approach model ('twin peaks'), and the single financial supervisor model.[63] Table 1 analyses the institutional models adopted by the EU Member States and EEA states. This is followed by an analysis of the models.

[63] *Wymeersch* [62], pp. 250–251.

The sectoral institutional model is built upon the premise that the main line of business of the financial institution should determine the supervisor responsible for its supervision.[66] Before the process of deregulation of financial services, which took place during the last quarter of the twentieth century, financial institutions were largely prohibited from undertaking more than one line of activity. It was therefore appropriate for supervision to be structured and operated along identical segregated lines, that is, each area of financial services having its own supervisor with each having its own policies and practices. As a consequence of deregulation and the movement towards liberalisation of the financial sector, the situation was reversed and financial institutions were allowed to provide different types of services. As a consequence, whereas it was once possible to have a clear-cut distinction between banks, securities business, and insurance companies, or between a deposit-based product and a securities or an insurance product, financial innovation and the formation of conglomerates has meant that market fragmentation has lessened.

Financial supervision should *inter alia* be based on the type of entities that are being supervised.[67] Therefore, a model based on distinctions between banking, securities, and insurance may not be an effective mechanism to supervise a financial system in which these distinctions are increasingly irrelevant.[68] The evident difficulty being that the position of the financial conglomerate may become concealed, in particular with respect to operational and solvency risks, since no sector specific supervisor would be unambiguously responsible for the supervision of the conglomerate as a whole. In certain instances, an attempt to achieve consolidated supervision was made through the appointment of a lead supervisor, selected from amongst the sector specific supervisors. The lead supervisor would be assigned the responsibility for consolidated supervision and the coordination of supervision with the other sector specific supervisors. However, poor communication and difficulties with cooperation may result in turf wars between supervisors and ineffective consolidated supervision.

The difficulties that emerge from consolidated supervision have led to the application of two alternative institutional models for micro-prudential supervision, these being the twin peaks model and the single financial supervisor model.

The twin peaks model organises supervision along the lines of the objectives of regulation. This model consolidates the sector specific supervisors into two functional supervisors, which are vested with clear objectives for which they may be held accountable: a prudential supervisor, which is made responsible for monitoring the financial soundness of the individual institutions, and a conduct of business supervisor,

[64] The twin peaks model in France is only relevant to the oversight of securities markets. The Autorite de Controle Prudentiel ('ACP') is responsible for the prudential supervision of investment services providers and market infrastructure providers. The Autoirite des Marches Financiers ('AMF') is responsible for market and conduct of business supervision of all market participants and the prudential supervision of portfolio managers and funds. The ACP is also responsible for the supervision of banks and insurance companies. See IMF, 'France: FSAP' December 2012 www.imf.org accessed 31.10.13.

[65] With regards to the supervision of banks the Bundesanstalt Fur Finanzdienstleistungsaufsicht ('BAFIN') is assisted by the Deutsche Bundesbank.

[66] *Wymeersch* [62], p. 251.

[67] *Briault* [9].

[68] *Taylor* [59].

responsible for monitoring compliance with investor protection regulation.[69] A case for a twin peaks model for micro-prudential supervision is made on the basis that this should do away with duplication and overlap and would produce supervisors that have a specific and unambiguous remit.[70] It also institutes a system for supervision, which should address existing conflicts between the objectives of regulation. Indeed, experience in supervision suggests that the objective of prudential supervision may conflict with the investor protection objective.[71] Moreover, supervision that seeks to achieve these distinct objectives requires a particular mindset, specialised technical skills, and specific supervisory tools. It is therefore efficient to concentrate in one institution the expertise in each field.

A framework for supervision based on the twin peaks model may in theory be a suitable alternative to achieve consolidated supervision. However, in practice, the division between prudential and conduct of business supervision is not as straightforward as the model might imply. Countries applying this model have encountered a number of practical difficulties. As in the case of the sectoral model, the application of the twin peaks model in practice is also characterised by communication difficulties and overlapping supervision. It is argued that these difficulties could have a serious impact on the co-ordination of supervision of financial institutions that fall within the competence of both supervisors and could lead to the duplication of work and inconsistencies in decision-making.[72] Furthermore, given their different and sometimes conflicting supervisory practices, especially in the field of enforcement, tensions between the two supervisors generally occur.[73] In certain instances, these difficulties may be surmounted through the application of a single supervisor institutional model for supervision.

At the end of the last century, many jurisdictions reviewed their institutional model for supervision. A number of these selected the single financial supervisor approach.[74] As indicated in Table 1, as at December 2013 fourteen EU states and all the EEA states had a single financial supervisor. This is 45% of the entire EU supervisory network. A single financial supervisor is responsible for monitoring compliance with both prudential and conduct of business regulation of the entire industry. Therefore, this may be a suitable option for doing away with turf wars that distort the effectiveness of supervision. However, a single financial supervisor has both advantages and disadvantages.

A single financial supervisor benefits from economies of scale and scope and lessens compliance-related costs for the industry, given that regulated entities are subject to one authorisation procedure, one rule book and one disciplinary process. It also makes possible the bringing together and the development of scarce regulatory expertise and is associated with increased supervisory consistency and quality

[69] *Taylor* [58].

[70] *Taylor* [58].

[71] ($n$12).

[72] *Knott* [33].

[73] *Kremers/Schoenmaker* [34].

[74] *Fabri* [20].

of supervision.[75] Moreover, empirical research on the models for supervision in the context of the political environment of different jurisdictions, suggests that the choice of a single financial supervisor is generally associated with a political environment characterised by lower levels of corruption, better institutional governance, and more efficient judicial systems.[76] This notwithstanding, certain drawbacks of the model have been identified.

In the absence of a proper accountability mechanism, a single financial supervisor is likely to become an over-powerful bully and a bureaucratic monster, which is disconnected from the industry.[77] Furthermore, the lack of regulatory competition could curb improvement in supervisory systems, procedures and methods. However, it is conceded that in a global financial market, competition could possibly come from other jurisdictions.

It has been argued that careful consideration and design is needed to ensure the effective functioning of an integrated supervisor, as the plurality of tasks allocated to the institution, may give rise to multi-tasking related challenges, such as the inherent conflicts between the different objectives of regulation.[78] On this count it is reasonable to suggest that the sectoral model and the twin peaks model may achieve more focus on critical issues and be able to mobilise more resources effectively than a single financial supervisor that may be distracted by urgent issues in other sectors under its brief.

### 5.1 Which institutional model for effective financial supervision?

The financial crisis has challenged each of the three models for supervision. It demonstrated that irrespective of the selected option, supervisory failures may still occur and that these create a pretext or a suitable occasion for reform.[79] Taking as an example the single financial supervisor model, Belgium and the United Kingdom are jurisdictions where following the financial crisis this specific model was criticised as having been an ineffective mechanism and has now been replaced with a twin peaks model.

On the other hand, in the Netherlands, where the twin peaks model has been in place since 2002, some high profile failures during the financial crisis seriously tested the robustness of the model. However, this did not result in policy change. Moreover, the twin peaks model is also the model of preference for countries where reform is being considered, such as Spain[80] and Italy[81], and which currently have a three pillar sectoral model. The trend post the financial crisis suggests an emerging preference for the twin peaks model. Nonetheless, from a theoretical standpoint there are no categorically strong arguments in favour of any one of the models, there are only

[75] *Cihak/Podpiera* [11].

[76] *Dalla Pellegrina/Masciandro* [14].

[77] *Briault* [9].

[78] *Holopainen* [31].

[79] *Maschiandaro/Quin* [42].

[80] Financial Stability Board, 'Report on the Peer Review of Spain' (Basel, January 2011) 7 www.fsb.org accessed 10.09.12.

[81] G30, 'The Structure of Financial Supervision' (Washington, 2008) 14.

pros and cons to the different models, the importance of which largely depends on the conditions of the financial system in the particular jurisdiction. In practice each model suffers from its own particular strengths and weaknesses.

Therefore, while the selected institutional model may have an effect on the quality of supervision, in itself it does not and cannot guarantee it. Indeed, unless a supervisor operates within a framework built on high-level standards of internal governance, such as independent decision-making, scepticism, accountability, integrity and fairness of judgement, transparency and adequacy of powers and resources, it is doubtful whether effective supervision may be achieved. In practice, while there has been an upward trend in the implementation of sound internal governance arrangements for supervision across jurisdictions, the process has not been uniform and in certain cases reversals have been noted.[82]

Several reasons explain the apparent unsystematic application of high-level standards for sound internal governance of supervision. With regard to independence, it has been noted that policy-makers are still rather reluctant to grant full independence to supervisors as *inter alia* politicians still want a certain degree of control over those activities that can generate political benefits such as the licensing and de-licensing of financial institutions.[83]

Empirical research has shown that in certain instances the move toward a higher degree of independence has been held back by *inter alia* the introduction or, in certain cases, the continuation by some governments of control arrangements, such as appointing a minister as head of the board, or putting a clause in the law allowing the minister to intervene in the supervisor's operation, where necessary.[84] These types of arrangements are often justified as accountability mechanisms. However, one may argue that their ultimate objective is that of controlling the supervisor rather than sustaining its independence. Empirical evidence on this point may be derived from the IMF financial sector assessment programme reports, which point out that in certain instances supervisors were constrained from action or followed the government agenda of the day, and therefore did not intervene to enquire about questionable financial practices that supported short-term national financial prosperity.[85]

A case in point is Spain. An IMF assessment of Spain's compliance with international standards and codes on banking and securities regulation brought to light the significant powers exercised by the Ministry of Economy over the regulatory and supervisory process.[86] The Ministry has a representative on the board of the Bank of Spain and the Spanish *Comision Nacional Del Mercado De Valores* ('CNMV') with voting powers. The review determined that the power to issue financial services licences in Spain rests with the Ministry and not with the Bank of Spain and the Spanish CNMV. These two supervisors do not have the power to revoke authorisations or

[82] *Quintyn/Ramirez/Taylor* [50].

[83] *Quintyn/Ramirez/Taylor* [50].

[84] *Quintyn/Ramirez/Taylor* [50].

[85] FSB (*n*80) 4.

[86] IMF, 'Spain: Basel Principles for Effective Supervision and IOSCO Objectives and Principles– Detailed Assessment-June 2012 Reports No. 12/142/12/143 www.imf.org accessed 16.05.13.

impose sanctions for serious breaches of the regulatory framework. These functions are given to the Ministry.

Another interesting example is the IMF's assessment of the Luxembourg *Commission de Surveillance du Secteur Financier* ('CSSF'). The IMF concluded that the legal framework which establishes the Luxembourg regulator does not sufficiently guarantee the full operational independence of the CSSF: the CSSF is placed under the direct authority of the Minister; its missions include the "orderly expansion" of Luxembourg's financial center; its general policy and budget are decided by a board whose members are all appointed by the government upon proposals from supervised entities and the Minister; its executives are appointed by the government and can be dismissed in cases of disagreement about policy or execution of the CSSF's remit; and its statute confines the executives' role to elaborating measures and taking decisions required to accomplish the CSSF's missions.[87]

Yet another example is France, with regards to which the IMF noted that a representative of the *Ministère de l'Economie et des Finances* is present at the meetings of the boards of the French *Autorité des Marchés Financiers* ('AMF') and *Autorité de Contrôle Prudentiel* ('ACP') as well as at the meetings of their enforcement committees. The International Monetary Fund commented that this arrangement gives rise to concerns regarding the independence of supervisors in France, particularly given the power of the Ministerial representative to ask for a second set of deliberations on the supervisory matters being discussed by the board. Moreover, the IMF also noted that the board of the French supervisors is also composed of a number of industry representatives, which on the other hand raises concerns regarding independence from commercial interests.[88]

Concerns about interference in supervision by politicians are not only pertinent to Europe. In the United States, an agency enjoying independence from politicians is understood as being independent of control from a single political party, but not necessarily independent from partisan politics.[89] This is different from the view of independence taken in Europe where agency independence would generally also refer to a certain degree of independence from the legislative and the executive authorities of government.[90] In this connection a concern has been expressed regarding the high degree of politicisation of agencies such as the Securities and Exchange Commission ('SEC').[91] In terms of its governing law, the SEC is headed by a bipartisan five-member Commission, comprised of the chairman and four commissioners, who are appointed by the President and confirmed by the Senate for staggered five-year terms.[92] By law, no more than three of the commissioners may belong to the same

[87] IMF, 'Luxembourg: Financial System Stability Assessment', June 2011 www.imf.org accessed 16.05.13.

[88] IMF, 'France: Financial System Stability Assessment', December 2012 www.imf.org accessed 16.05.13.

[89] *Shapiro* [52].

[90] *Geradin* [25], p. 38.

[91] F. Norris, 'Independent Agencies, Sometimes in Name Only, New York Times (New York, 08.08.13) http://www.nytimes.com/2013/08/09/business/independent-agencies-sometimes-in-name-only.html?_r=0 accessed 22.02.14.

[92] IMF(*n*30).

political party. In this manner, independence is said to be achieved as the agency is not subject to the complete control of one political party.[93] Nonetheless, it has been observed that the appointed commissioners carry out their duties by applying a partisan approach, as the members generally embrace completely the philosophy of their political masters.[94] This has resulted in a concern that the operation of the SEC does not stand outside political domain and is being influenced by partisan politics.[95] Ultimately, appointments that are made purely on the basis of political patronage undermine the purpose of independence.

The involvement of political and industry bodies in supervisory matters creates an environment which is conducive to regulatory capture, with the clear risk that the supervisor may be unable to respond adequately to supervisory concerns should there be conflicting interests between the financial supervisor and its political master or an industry representative. This could undermine the supervisor's independence. Similar IMF assessments of other EU Member States carried out during the years 2010 to 2012 raised analogous concerns regarding the independence of supervision and/or the adequacy of resources for supervision in nine out of twelve states.[96]

Moreover, the point has been made that a supervisory arrangement may suffer an accountability deficit, since the possibilities of control by democratically elected institutions may be limited.[97] A democratically elected institution which operates in a complex and large public sector environment, may be acting as principal for a large number of agents. This widens the accountability deficit, as the attention of each of these agents may unsurprisingly be selective, as the time and attention at the disposal of the democratically elected institution would clearly be limited.[98]

The cynical view has also been expressed that an accountability deficit in supervision occurs because only some aspects of a supervisor's activity may have a bearing on a politicians' re-election chances in the short term. These include the extent to which new licenses have been issued that generate growth in a given economy and the degree to which financial services contribute to the general well-being of constituents. The political class will tend to focus their monitoring only on these aspects and will ignore the remaining activity of the supervisor, unless this becomes of political concern, such as where supervisory debacles occur.[99]

Furthermore, the technical competence required in the field of supervision which the political class may lack, also contributes to the deepening of the accountability deficit as it is doubtful whether the politicians would be in a position to assess properly the activity and performance of a supervisor.

[93] *Bosworth-Davies* [8].

[94] Norris (*n*91).

[95] Norris (*n*91).

[96] Concerns were raised by the IMF regarding the position in Romania, Sweden, Luxembourg, Czech Republic, France, Poland; Slovenia and Spain http://www.imf.org/external/NP/fsap/fsap.aspx accessed 16.05.13.

[97] *Flinder* [22]; and *Mulgan* [46].

[98] *Schillemans* [51], p. 397.

[99] *Moe* [45], p. 767.

In an environment where there is active cross-border business and where cooperation and coordination between supervisors which is based on mutual trust is crucial for effective supervision, a haphazard framework which regulates the governance of supervision at national level complemented by the traditional vertical forms of accountability are not enough to guarantee the legitimacy of a supervisor with its peers in other Member States. It is submitted that in the context of the internal market, unless robust standards for internal governance of supervision and horizontal accountability mechanisms are applied, supervisors may have mutual concerns about the standards and competence of their peers in other Member States.

## 6 Strengthening the governance of supervision: a proposal

The seminal DeLarosiere Report on supervision in the EU emphasised the importance of independence of supervision from possible political and industry influences, at both EU and national level. It emphasised that:

this means that supervisors should have clear mandates and tasks as well as sufficient resources and powers. In order to strengthen legitimacy and as a counterpart for independence, proper accountability to the political authorities at the EU and national levels should be ensured. In short, supervisory work must be independent from the political authorities, but fully accountable to them.[100]

Notwithstanding the calls by policy-makers for mechanisms which guarantee the independence, autonomy and the accountability of supervisors, presently the harmonisation of the governance arrangements for supervision is limited to the powers to supervise, investigate, sanction and exchange information. Therefore, it would be optimal if a European framework to regulate the standards of independence and accountability would be established together with standardised measures of the effectiveness of a supervisor and established mechanisms for horizontal accountability. European regulation of governance of supervision would be an important tool to strengthen the robustness of European supervision.

The legal basis for an EU legislative measure which regulates the governance of a supervisor and which sets standards for measuring supervisory effectiveness may be based on Articles 114 or 115 of the TFEU, which regulate the adoption of EU laws that have the purpose of establishing and ensuring the functioning of the internal market. Such measures would have the objective of achieving a certain degree of uniformity in the governance of national supervisors, strengthening the quality of national supervision and, by so doing, reinforcing the effectiveness of supervision at national level within the EU.

Such a legislative measure would have to respect the principles of subsidiarity and proportionality. The regulatory framework would not go beyond stipulating the high-level objectives, values, constitutional arrangements and internal organisational arrangements that ought to be respected by Member States with regard to the setting up and ongoing functioning of financial supervisors. It would not interfere with

[100] J. DeLarosiere, 'The High-Level Group on Financial Supervision in the EU—Report' (Brussels, 25.02.2009) 47.

the choice of institutional model for financial supervision or the detailed governance arrangements relating to the operation of the financial supervisor.

Moreover, the proposed framework would leave day-to-day supervision to be dealt with at national level, while creating high-level standards regulating the governance of supervision which may be complemented by joint European Securities Markets Authority ('ESMA'), European Banking Authority ('EBA') and European Insurance and Occupational Pensions Authority ('EIOPA') Level 3 Guidance for regulatory convergence. The latter could be an area where a process of reflexive governance of financial supervision could be appropriate and where discussion, mutual learning and the codification of best practices may be applied to establish a number of possible options which could then be applied at national level for the implementation of the high-level standards on independence and accountability of supervision.

The process could also be fruitful in establishing guidance on the measures that may be applied in assessing the performance of a financial supervisor in the context of different types of financial systems. These would form the basis for horizontal accountability by way of peer reviews of national supervisors coordinated by ESMA, EBA and EIOPA which again would form an opportunity for discussion and mutual learning on the best ways of addressing the high-principles for sound governance of supervision. The inherent outcome of this would be the reinforcement of mutual ties and respect between national supervisors, something which is critical for strengthening of the overall effectiveness of supervision in Europe.

## 7 Conclusion

The analysis in the paper is a contribution to the debate on the governance of supervision in Europe. It suggests that in order to achieve supervision that is effective and responsive to the needs of our time, a supervisor should *inter alia* have suitable technical expertise and resources. Moreover, effective supervision requires a constant commitment to achieving the objectives of regulation and a clear, predictable and time-consistent approach to supervision. It also requires coordination and cooperation with peers in other Member States. It is therefore important that the carrying out of supervision is delegated to an independent agency with sound internal governance arrangements including legal safeguards and organisational procedures which guarantee its independence, autonomy and accountability.

The degree of independence of a supervisor from government and the industry depends on the extent to which its internal regulatory, supervisory and administrative processes are insulated from influences that distort its activity from achieving the objectives of financial regulation. Influences that distort the activity of supervisors may come in the form of political capture or industry capture or self-interest capture. To mitigate the influences that may arise from these different forms of capture, a policy decision to establish an autonomous supervisor inevitably requires as a consequence the decision to implement a set of governance shields, more specifically: the values that are to govern the supervisor's overall activity; the constitutional arrangements for its establishment; and its internal organisational arrangements.

The effectiveness of supervision may however also depend on the institutional models applied for this purpose. Institutional models for supervision vary across EU

Member States. Three main models are generally applied, the sectoral model, the twin peaks model and the single financial services supervisor model. In certain instances, the institutional model for supervision has gradually evolved in reaction to changes in the dynamics of financial services and the integration of financial institutions. Changes to the architecture were also effected as a consequence of the occurrence of debacles, such as the global crisis. In this regard, while the selected institutional model may have an effect on the quality of supervision, in itself it does not and cannot guarantee it.

Unless a supervisor operates within a framework built on high-level standards of sound internal governance, such as independent decision-making, accountability, integrity and fairness of judgement, transparency and adequacy of powers and resources, it is doubtful whether effective supervision may be achieved. The good governance of a supervisor also depends on the extent to which the executives who are responsible for leading the supervisor act independently and do not have special allegiances to the political class or to the industry.

As determined in the IMF financial sector assessment programme reports of a number of Member States, the internal governance of supervision remains vulnerable to political or industry capture. These issues of governance have an impact on the robustness of national supervision in Europe and may be addressed through a regulatory framework which guarantees the autonomy of national supervisors from political and industry influence as well as accountability structures to democratically elected institutions and peers at EU level. This is also important if mutual ties and respect between national supervisors are to be reinforced, which is in turn critical for strengthening of the overall effectiveness of supervision in Europe.

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