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Point of view

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# Governance challenges for Independent Regulators

In October 2016, I was invited by the OECD to participate on behalf of Nestor Advisors at its Asian Round Table in Seoul. The subject we were discussing was the governance of regulators; an issue that the OECD is rightly championing, as it does not always get the attention it merits.

One of the prompts for this discussion was a new OECD publication specifically addressing the governance of independent regulators[1]. In many countries these bodies play a major role in regulating capital markets, economic sectors, companies and their advisers, and their decisions can have a significant impact on those they regulate – for good or ill. It is therefore essential to ensure they are well governed.

Who are these so-called "independent regulators" meant to be independent from?

All of them are expected to be independent of those they regulate, and in some cases they have been specifically established to replace self-regulation where this is no longer felt to be appropriate. This is the reason for the introduction of independent audit regulators, for example; these bodies now operate in over 50 jurisdictions, all of them having been set up within the last fifteen years.

Most independent regulators are also designed to be independent of their national governments and parliaments, in order to reduce the risk of political interference in economic decision-making. One of the principles of the International Organisation of Securities Commissions (IOSCO) is that securities regulators should be "operationally independent and accountable"[2].

The hope is, that by operating at one remove from the various vested interests with which they must contend, they will be better able to "balance competing wants and needs… through the application of good governance… [and] act objectively, impartially and consistently, without conflict of interest, bias or undue influence" (to quote the OECD report).

That, at least, is the principle. In practice, it is no easy task. Regulators are subject to direct and indirect pressure from many quarters, some legitimate, some not; they are operating in an economic and political environment over which they often have little real control; and the consequences of their actions can be very hard for them to predict with any degree of certainty. Their reputation, and licence to operate, is only as secure as their last decision.

[1] 'Being an Independent Regulator'; OECD; 2016

[2] 'Objectives and Principles of Securities Regulation'; IOSCO; 2010

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These difficulties are also faced by the organisations that they regulate, and like those companies, regulators are not immune to system failures and human foibles. Which is why it is essential that independent regulators pay as much attention to their own governance as they do to promoting good governance in those they regulate. The tenets of good governance found in the OECD Principles and national corporate governance codes – an effective board with transparent procedures, a clear division of responsibilities, strong risk management and so on – are just as applicable to regulators.

For independent regulators, the way in which they are set up is critical to the way their ability to operate both independently and effectively. Some of these factors, such as the precise nature of the government, parliament and regulator's respective statutory responsibilities, and the extent to which government can intervene in the regulator's activities, are fairly self-evident (although just because the issues are easy to identify does not make them easy to deal with).

Others may be less so. One such factor is the funding model. If the regulator does not have a secure and sufficient funding stream but relies on, for example, discretionary funding from government or fees or voluntary levy payments from those they regulate, then the providers of the funding have much greater leverage over the extent and nature of the regulator's activities.

Even when there is a clear remit, secure funding and a statutory limitation on the ability of government and parliament to intervene in its operations, regulators face many governance challenges. The most significant concern is how they deal with their key stakeholders – the regulated and the government. For while regulators must be independent of both, they cannot be effective without understanding and engaging closely with them.

Regulators need to have a good understanding of the activity they are attempting to regulate. Without it, they will find it difficult to anticipate the likely impact of the actions they might take, increasing the risk of often costly unintended consequences, or to determine what regulatory approach is most likely to lead to a positive reaction. For that reason, regulators can benefit from having at least some people at board, management and operational levels who have experience of working in or with the organisations they are regulating.

This can be particularly useful when regulating specific sectors or professions. The pool of people who have the necessary expertise is smaller, and the judgements the regulators are being asked to make require an understanding of how the sector or profession works in practice, not just on paper. That is why, for example, when I worked at the UK's Financial Reporting Council, the team responsible for assessing the quality of audit work carried out by the profession largely comprised people who were themselves former auditors.

Recruiting and retaining individuals with the necessary experience can be difficult. Most regulators are public sector bodies and cannot compete with the commercial world in terms of pay and reward. And individuals who might be interested in working in a regulator for a limited period as part of their career development may be deterred from doing so if they believe that doing so without adversely affect their future employment prospects.

For example, a board member of one securities regulator recently told me that, since the government had introduced a rule banning their staff and directors from being employed by any listed company for two years after they left the regulator, it had become impossible to recruit anyone with any experience or ambition, and had in addition left current staff feeling disaffected and demotivated.

If a regulator is successful in recruiting people with the expertise and experience that it requires, then this creates another challenge.  There will be a perception – and, indeed, a real risk – that they might be unwilling to take tough actions where necessary because of their past and possible future career.

There are ways of managing this risk. Most regulators will have procedures in place to ensure that members of staff do not supervise organisations for which they have previously worked, and to reduce the danger of them "going easy" on the companies they do supervise (such as regular rotation of responsibilities or cooling-off periods on departure).  Internal monitoring by management should ensure that any examples of obvious bias are identified and addressed.

More difficult to identify is unconscious bias, particularly where it exists at an organisational level. Good governance can help to guard against this. While regulators need to have a critical mass of internal expertise in order to operate effectively, this needs to be offset by a diversity of experience and perspectives at board and senior management levels – group think is as much as a risk for regulators as for other organisations.

Adhering to the principles of good regulation – acting in a way that is evidence-based, proportionate, transparent and accountable – can also reduce conscious and unconscious bias.

One example of where an unconscious bias might creep in is when the regulator consults on proposed new policies or rules.  The detailed design of the consultation process and the extent to which all those that will be affected by the decision, not just those being regulated, have an opportunity to provide input which can make a big difference.

It can happen that regulators will give more weight to the views of the regulated entities simply because they comprehend them better – they understand where they are coming from in a way that they may not with other stakeholders.

To guard against this, I have heard it suggested that, when considering possible new rules, regulators should first seek the views of the intended beneficiaries before then preparing draft rules to discuss with those to whom they will apply.

The person advocating this approach felt that this would help to counter an inherent but unspoken assumption that "cost" – which was incurred by those being regulated - mattered more than "benefit", which usually accrued to someone else, such as their customers.

While that sort of implicit bias may well be a factor in individual regulatory decisions, if you study broad trends in regulation you notice that the emphasis shifts between cost and benefit.  Looking at the financial services sector over a long period of time, for example, you see a pattern of deregulation and re-regulation that is also found in many other areas of regulation.

The main reason for this is changes in political philosophy and priorities.  A view will be taken at a political level that certain objectives are not being achieved or that certain constituencies are not being well served by the current system.  This might lead to changes in legislation that redefine the role of the regulator; or it might lead to – often well-intended – pressure on the regulator to change its own thinking to bring it in line with that of the politicians.

The first of these scenarios is the most straightforward – the job of the independent regulator is to implement the law, and if the law changes the regulator must change too; whether it agrees with those changes is irrelevant.  The second scenario is a much harder challenge for independent regulators to deal with appropriately, as lines inevitably become blurred.

On the one hand, independent regulators cannot ignore political developments. They are an integral part of the environment in which regulators operate, and they can only be effective if they are attuned to that environment. They cannot be completely indifferent to political and public opinion.

At the same time, to some extent they need to be - and need to be seen to be - above the fray: to "act objectively, impartially and consistently, without conflict of interest, bias or undue influence".

The formal relationship between the government and the regulator is crucial to the latter's ability to operate effectively. In its report on 'The Governance of Regulators', the OECD sets out a number of clear principles to be followed. These include:

- Where legislation allows government ministers to direct independent regulators, the limits of the power should be clear and any directions made should be published (ideally, for economic regulators, Ministers should not have such a power);
- Any communication between ministers or government departments and the regulator should follow a procedure that does not call its independence into question;
- The criteria for appointing members of the regulator's governing body, and grounds for terminating their appointment, should be stated in legislation; and
- If there are ministerial representatives on the governing body, they should only participate in meetings in a non-voting capacity.

However, even when these principles have been followed, independent regulators are not immune from unseen influence. This is because regulators receive their authority from governments or parliaments, who can take it away again by changing legislation. Knowing that the government has the ability to improve or remove your legal powers or your resources - or even you personally – is bound to affect how you think about things.

Political influence therefore exists irrespective of the formal arrangements. It can infect the regulator's thinking even when politicians are not actively trying to exert it. Regulators can be tempted to tailor their approach to match what they think will find favour, in order to continue to enjoy political support. Perceived political pressure can sometimes be self-imposed.

For independent regulators being responsive to political developments is usually a strength; but being too responsive can be a weakness.

This is a difficult enough balance to strike when there is political and economic stability. When there have been shocks to the system of the sort we have seen in many countries in the last twelve months, there is a greater temptation for politicians, the media or the public to argue that "something must be done". When that mind-set takes hold – even when it is justifiable - the risk of unnecessary, ineffective and potentially damaging regulation increases.

Which is why, in turbulent political times, it becomes all the more important for independent regulators to remember the reason they were created in the first place, and only take actions that are consistent, proportionate and evidence-based.