European Journal of Political Economy 24 (2008) 833–848

Contents lists available at ScienceDirect

European Journal of Political Economy

journal homepage: www.elsevier.com/locate/ejpe

Inside and outside the central bank: Independence and accountability in financial supervision
Trends and determinants

Donato Masciandaro [a,*], Marc Quintyn [b], Michael W. Taylor [c]

[a] Paolo Baffi Centre, Bocconi University, via Sarfatti 25, 20136 Milan, Italy
[b] IMF Institute, International Monetary Fund, Washington, United States
[c] Hong Kong Monetary Authority, Hong Kong

ARTICLE INFO

Article history:
Received 1 November 2007
Received in revised form 15 June 2008
Accepted 8 July 2008
Available online 18 July 2008

JEL classification:
G18
G28
E 58

Keywords:
Financial supervision
Central banking
Independence
Accountability
Political economy

ABSTRACT

This paper analyzes recent trends in, and determinants of, financial supervisory governance inside and outside central banks. We first review the case for supervisory independence and accountability in order to frame the econometric work on their determinants. We then calculate the levels of supervisory independence and accountability in 55 countries, disentangling similarities and differences among central banks and pure financial supervisors. The empirical analysis of the determinants indicates that the quality of public sector governance plays a decisive role in establishing accountability arrangements, more than independence arrangements. It also shows that decisions regarding levels of independence and accountability are not well-connected. The results also show that the likelihood for establishing governance arrangements suitable for supervision is higher when the supervisor is located outside the central bank.

1. Introduction

The world of financial sector supervision has been under reconstruction for over a decade. Attention for the institutional architecture of supervision (inside central bank, outside central bank, sector-specific agencies or integrated agencies) is increasingly being accompanied by interest in the governance of these agencies, with a special focus on their independence and accountability.

The attention to governance is a new phenomenon. While an entirely new strand of literature emerged in the 1980s and 1990s on central bank independence (CBI), or to be more precise, on the independence of the central bank's monetary policy function, no such attention went to the supervisory function. Somehow, it was assumed in the literature that, for those central banks that also performed supervisory functions, the independence in monetary policy spilled over into the supervisory functions. It is no exaggeration to state that almost no attention went to the governance of those supervisory agencies that were not attached to the central bank — as was the case in a great number of European countries.

The discussions that surrounded the establishment of the Financial Services Authority (FSA) in the United Kingdom and the Australian Prudential Regulations Authority (APRA) in Australia in the second half of the 1990s were the first ones that explicitly mentioned independence and accountability issues. Around the same time, some academics — Lastra (1996) and Goodhart (1998) —

* Corresponding author. Tel.: +39 2 58365310; fax: +39 2 58365343.
E-mail address: donato.masciandaro@uniboccon.it (D. Masciandaro).

0176-2680/$ – see front matter
doi:10.1016/j.ejpoleco.2008.07.005

raised the issue of financial supervisory independence as a principle. Likewise, some practitioners claimed that the lack of supervisory independence was one of the contributing factors of the crises that had occurred (De Krivoy, 2000 on the Venezuelan crisis, for instance). The Basel Core Principle for Effective Bank Supervision — Basel Committee on Banking Supervision (1997) and then Basel Committee on Banking Supervision (2006) — gave the principle of supervisory independence official backing.

As argued in Das and Quintyn (2002) and Quintyn (2007), attention for governance arrangements for supervisors is urgently needed because the job content of supervisors has been changing dramatically in response to the worldwide liberalization of financial sectors. Supervisors used to be compliance officers, checking if banks complied with various economic rules and regulations. Nowadays, supervisors are "governance supervisors" who have to monitor on behalf of the debt holders of the financial institutions the quality of the institutions' governance arrangements. Quintyn (2007) shows that good regulatory governance (governance of financial supervisors) is a precondition to implement this task successfully.

In recent years, a number of papers — Quintyn and Taylor (2003) and (2007), Hüpkes et al. (2005) — have built the case for independence and accountability for supervisory agencies and spelled out the operational implications. However, given that the governance arrangements adopted in reformed or newly established agencies are inevitably the result of a political decision-making process, this paper takes a political economy view with respect to the emerging trends in supervisory independence and accountability. Recognizing that the political decision-making processes with respect to the institutional structure of supervision and their governance structure are not independent from one another, this paper builds upon two approaches recently developed in the literature. One is the analysis in trends of supervisory governance based on the construction of indices for independence and accountability — mimicking the successful line of research with regard to central bank independence — as pioneered in Quintyn et al. (2007). The other one is the analysis of the determinants of the newly emerging supervisory structures, developed by Masciandaro (2006), (2007) and (in press).

The paper is structured as follows. Section 2 links the discussion about independence and accountability of financial supervisors with the CBI literature. Section 3 discusses current trends in independence and accountability of supervisors based on the indices computed in this paper. Section 4 presents the econometric analysis of the determinants and Section 5 brings together the conclusions, as well as suggestions for further research.

2. Background

Research on the theoretical underpinnings and empirical findings of financial supervisory governance is still in its early stages — unlike CBI. This section briefly provides, by way of background, an overview of the main arguments for financial supervisory independence as a crucial ingredient of financial supervisory governance. From the onset, it is worth reminding — as has been argued in Das and Quintyn (2002) and Quintyn (2007) — that the debate should be cast in terms of financial supervisory governance, comprising independence, accountability, transparency and integrity, as opposed to independence alone.

This paper focuses nonetheless on independence and accountability because the degrees of independence and accountability of any given supervisory agency are the outcome of a political decision-making process, while the two other elements (transparency and integrity) are to be mainly established by the agency itself. As a result, their quality and effectiveness depends in the first place on the quality of independence and accountability arrangements.

In contrast with the CBI debate — slowly broadening now to a debate on central bank governance — the terrain with respect to financial regulation and supervision has remained relatively uncharted.[1] In recent years several papers have argued that the responsibility for financial supervision should be delegated to a specialized independent agency, i.e. an authority with clear objectives and political independence, having adequate supervisory instruments at its disposal to achieve these objectives, and held accountable in the exercise of its responsibilities to ensure adequate checks and balances.[2]

These papers have argued that the case for supervisory agency independence is analogous to that for CBI, in the sense that in general both are responses to a time-inconsistency problem. However, accountability arrangements for independent financial regulatory agencies must necessarily be more complex than for independent central banks owing to their multiple, and harder to measure, objectives and the existence of a multiple principals environment. It has been further argued that from the social welfare standpoint independence and accountability should not be regarded as mutually exclusive but are complimentary to the extent that well-designed accountability arrangements can help to buttress agency independence.[3]

A formal framework for examining the case for regulatory agency independence is provided by the work of Alesina and Tabellini (2004) on the division of tasks between politicians and bureaucrats. Their model, for which a specific application has been developed in Masciandaro (in press), is structured around the differing preferences of politicians, who are held directly accountable at elections for how they have pleased the voters, and bureaucrats who are not directly answerable to voters. They argue that, from a social point of view, it is optimal to let bureaucrats rather than politicians carry out tasks that have the following characteristics: (i) the tasks require a high degree of specific technical ability relative to effort; (ii) the ex post preferences of the public are clear and no large degree of flexibility is needed; (iii) time inconsistency is an issue; and (iv) powerful vested interests have large stakes in the policy outcome.

[1] For a complete survey of CBI, see Berger et al. (2001) and Cukierman (2008 — this issue). See also contributions in this volume.

[2] Quintyn and Taylor (2003) and (2007) and Hüpkes et al. (2005).

[3] For similar argument with respect to CBI and central bank accountability, see Eijiffinger et al. (2000) who pointed out the complementarities between independence and accountability. Hughes and Libich (2006) analyse a monetary policy game considering three institutional features: independence, accountability and transparency, highlighting synergies and trade-offs.