Why Financial Regulation Fails

It had been a challenging day at the central bank. The newly-established “Planning and Budget Committee” was ploughing through detailed budget submissions for the coming year. Business budgeting in this way was an entirely new process for everyone concerned, and plagued by problems. But this central bank was determined to reform internally, and apply the business management systems that the central banking world had long ignored. External people were recruited to support corporate management, for the first time ever. It was a new world!

Naturally, most submissions focused on justifying coveted items like new staff resources or overseas travel. Inevitably, many were being disallowed or cut back. But the three committee members – the long-serving (internal) Deputy Governor, the change-agent (external) "Special Adviser" and the newly engaged (also external) "Performance Auditor” – had made a commitment to set a positive tone whenever that was possible. And an opportunity to do just that arose.

The Special Adviser noticed that the Financial Regulation Department was seeking virtually no budget for "local travel". Here was a chance to allocate <u>more</u> than was asked for, and set that positive tone. After all, the central bank was located in the capital, while the banks it regulated all had their headquarters in another city an hour’s flight away. It must be necessary and important to regularly visit those banks. He suggested adding funds to the budget submission for that purpose.

The Deputy Governor was puzzled. "Why would they need to travel anywhere? The banks fill in returns and send them to us. We analyse those returns here. If we have any queries, we sort them out by telephone. Travelling would be a waste of money!"

The Special Adviser and the Performance Auditor looked at one another in surprise. The Performance Auditor spoke up. "All right, I accept that the work of compiling and analysing financial information can be done from here. But surely it’s important for supervisors to visit the banks, talk with people, and personally see the activity that lies behind the paperwork. They can get a feel for the operating culture too."

It had already been a long day. The Deputy Governor grew impatient! "No, travel isn't necessary. They can learn everything they need to know from here. I don't want the supervisors wasting their time flying up there and wandering around.”

The Adviser and the Auditor exchanged glances again, this time in dismay. The Adviser tried once more. "But Deputy Governor, I know from my consulting projects that to properly study any business it's essential to get on site, watch the processes at work, and meet the people. It’s intangible and intuitive information, not an analysis – a chance to "sniff the air" and smell what's going on. Especially what isn’t being reported or shouldn't be going on! Surely that's important to a regulator?”

The Deputy Governor finally understood. "Oh, I see what you mean. Yes, that would be very helpful.” He thought hard for a moment. "But they still shouldn't get any travel budget. All the people we have in supervision have only worked here. They don’t have that kind of skill and wouldn’t be able to smell anything. Sending our supervisors to visit the banks would just waste time and money!"

It was time to go home. Everyone had learned. The Deputy Governor had learned something about business. And the others had learned why financial regulation fails!