The Limitations of Supervision:
On compliance incentives and information

Prof Sandeep Kapur
Birkbeck, University of London

Introduction

Regulation aims to alter the discretionary choices of private entities in order to
minimise the damage they inflict on others and on themselves. The enforcement of
regulation requires creation of incentives for compliance, but limitations of regulatory
resources and practical or legal limits on available penalties imply that enforcement is
often less than comprehensive. In this note I describe how the design of regulatory
mandates affects compliance incentives, and also how non-conventional channels of
information can improve supervision.

Compliance incentives

In many settings, the regulator's ability to monitor activities and to enforce changes is
subject to resource constraints. While we have moved beyond a world in which
financial supervision regimes were celebrated for their low expenditures, it would be
naive to believe that there will be unlimited regulatory resources in the future: even
generous regulatory budgets can be stretched by the fact that supervisors must
compete for talent with those that they seek to supervise. The perception that
regulatory resources are limited can dilute compliance incentives. The question is:
how should the limited regulatory resources be prioritised across regulated entities to
maximise overall levels of compliance?

A natural approach would be to calibrate regulatory attention across entities in
accordance with the risk they pose. The risk posed by any entity depends on various
factors. To some extent it depends on the inherent nature of the entity, that is, who
they are. A badly-driven bus is poses greater danger to pedestrians and its many

1 Note prepared for a meeting organised by The Financial Services Authority for 'Academic input for
better regulation', January 2012.
2 email: s.kapur@bbk.ac.uk
occupants than a badly-driven car. A large financial institution that is strongly interconnected with others poses greater threat to systemic stability than a small one. It is hard to deny that we should pay more regulatory attention to large entities than to small ones.

But the risk characteristics of entities also depend on what they choose to do, for instance on the extent to which they choose to depart from prudential norms. The danger posed by a bus depends not only on its size but also on the speed at which it is driven. The risk posed by a financial institution may depend on how aggressive it is, say, in letting its leverage ratios depart from prudential norms. Should we not allocate regulatory attention across entities based on their (imperfectly-observed) departures from sensible norms, paying greater attention to those who speed relative to others? The answer to this question turns out to be subtle.

Conventional theoretical analyses of regulation focus on the bilateral interaction between a supervisor (e.g., the FSA or PRA) and a supervisee (a financial institution). In practice, regulators supervise multiple supervisees simultaneously. This multiplicity matters because it can introduce strategic interaction among the multiple supervisees. For instance, with limited resources for supervision, activities that draw regulatory attention towards one supervisee can distract attention from others. A police officer who is pre-occupied with enforcement activity against one speeding vehicle cannot monitor others’ speeding with the same degree of attention. This regulatory dilution may well weaken compliance incentives for others.

To put it differently, regulatory regimes that allocate regulatory attention according to the likely degree of non-compliance assume the form of a contest. With limited regulatory resources, each non-compliant supervisee hopes that regulatory attention will be soaked up by others who in even greater non-compliance. You feel confident driving above the speed limit, vaguely reassured by the belief that police attention must focus on drivers who are going even faster: ‘why will they pick on me driving at 80 mph when others are going at 85 mph? The more others speed, the more you can afford to speed yourself. And, of course, your speeding in turn dilutes the regulatory pressure on others. There is collective ‘safety in numbers’.
The aggregate consequences of such regulatory dilution can be stark as the induced departures from prudential norms tend to be mutually self-enforcing. At the height of the recent financial mania, financial institutions evaluated their risk positions not by reference the soundness of their own financial ratios, but by reference to rivals with even more compromised ratios. This was a race to the bottom, and the significant departures from prudent norms made a more or less inevitable.\(^3\)

What are the implications for regulatory design? It is non-controversial that regulatory attention must be calibrated to the exogenous (i.e., given) risk attributes of various entities with, say, large interconnected banks receiving more scrutiny than others. However, the calibration of regulatory attention to the endogenously chosen risk positions of institutions is potentially complicated. It is tempting from a regulatory perspective to scrutinize large departures from regulatory norms more severely than small departures, but we must then allow the possibility that such targeting could itself induce wider departures on average.

In other words, it may sometimes be sensible to target seemingly minor misdemeanours as vigorously as major ones. If this sounds like a policy of ‘zero tolerance’, then so be it. Further, when it comes to setting regulatory budgets, it helps to create a perception ‘whatever it takes’. We may worry about the adequacy of resources for such a policy, but note that greater compliance ex ante could by itself conserve some resources by reducing the need for enforcement action. More generally, when designing a regulatory mandate with multiple regulatees, we have to be mindful of the fact that strategic interaction among regulatees can alter compliance incentives.

**Information**

The quality of supervision is also limited by the availability of information. In a simple world, the regulator might ask a financial institution to divulge all the information that is relevant to an assessment of its risky activities and the institution would report these accurately. And, in a stable industry, the regulator would know what questions

---

\(^3\) The notion that one entity’s non-compliance can encourage non-compliance by others can be is a form of ‘strategic complementarity’ in their choices. For a formal analysis of this interaction and its aggregate consequences, see Heyes and Kapur, ‘Enforcement Missions: Targets vs Budgets’, *Journal of Environmental Economics & Management*, 2009, 58(2), 129-140.
to ask. The informational challenge is greater in industries characterized by innovations, or even pseudo-innovations. The explosive growth in securitization, the introduction of complex derivatives, or the increased reliance on short-term capital markets altered the questions that financial regulators should have asked, but the fog of financial alchemy and intrinsic political and institutional constraints meant that they did not always know what questions to ask or how to interpret the answers they received.

There was little incentive for institutions to volunteer information even when (as we learn from later publication of internal communications) they knew that their activities were riskier than they claimed them to be. Indeed some financial innovation was intended precisely to circumvent regulatory attention from risky activities: consider the growth of off-balance sheet accounting, or hedge funds’ insistence of commercial secrecy of their positions. Here conventional statutory disclosure requirements are not very effective.

If we believe that individuals within regulated firms are more aware of risks posed by their institutions, we could seek ways to elicit this information. Equally, market rivals and external experts might prove useful channels of information: consider, for instance, attempts by Harry Markopolos to uncover the fraudulent activities of Bernie Madoff (and SEC reactions to his submissions). The recently-enacted whistleblower program introduced as part of the Dodd-Frank Act offers a valuable experiment of the role that high-powered financial incentives might play to amplify these channels. The practical design of these policies must discriminate between bounty hunters, the complaints of disgruntled employees and those motivated by higher concerns. In general, a more informal approach to information gathering and even recognising the role of ‘stray market rumours’ might enable regulators to react pre-emptively.

---

4 The Securities Whistleblower Incentives and Protections section, enacted in August 2011, offers monetary awards to individuals who voluntarily provide original information that leads to successful SEC enforcement actions that leads to monetary sanctions over $1 million: Awards can be 10 to 30% of the monetary sanctions collected.