CHAPTER 11

"To Protect or Not to Protect, That Is the Question": Statutory Protections for Financial Supervisors—How to Promote Financial Stability by Enacting the Right Laws

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This chapter considers the possible legal protections that should be extended to financial supervisors.[1] It begins with a discussion of why such protections are necessary, then describes how the Basel Core Principles and the IMF Transparency Code address the issue. It then examines two approaches that have been enacted into law, in New Zealand and Spain, respectively. Aspects of the role played by human rights legislation are also be examined, and suggested statutory objectives for use internationally are provided.

Introduction

It is now generally accepted as a best practice that statutory protections are necessary to ensure that financial supervisors are able to undertake their jobs effectively and properly. Why are such protections necessary?

When financial institutions, particularly banks and other depository institutions, get into trouble on their way to outright failure, supervisors typically are engaged in a number of ways, including the application of a range of sanctions such as the appointment of a conservator, the imposition of fines and other penalties, and, ultimately, revocation of license. During the period prior to the institution's failure, supervisors must act quickly and effectively to prevent, remediate, or mitigate the problems of the institution. When their actions are examined after the event, supervisors will often be criticized for actions taken and also may be criticized for failure to take particular courses of action. Because of the nature of their powers and responsibilities, which are discussed further below, such criticism will inevitably lead to legal challenges to the actions taken by financial supervisors.

Financial supervisors are most at risk of legal challenge when they attempt to enforce laws, impose sanctions or other penalties, or to take control of a troubled institution. Supervisors will often have no option but to take such action to protect the depositors of the institution, other creditors, and the overall health of the financial system. In situations where depositors lose some or all of their savings or other creditors lose their claim in the assets of an ongoing institution, it is quite possible that financial supervisors will be subject to civil or, in some countries, criminal action.

The threat of litigation will inevitably have an effect on how financial supervisors perform. The threat is likely to be greater when there is a systemic banking crisis with a large number of insolvent banks. In such a situation the supervisor will undoubtedly have to revoke a number of banking licenses and liquidate banks. But even in the case of the failure of a single bank, the threat still exists.

This has led financial supervisors in a number of countries to consider steps to protect financial supervisors in their work.

Supervisory Powers and the Basel Core Principles

In 1997 the Basel Committee on Banking Supervision (the Committee)[2] promulgated the Basel Core Principles for Effective Banking Supervision (the Basel Core Principles, or BCP) which were revised in October 2006. "The Core Principles are a framework of minimum standards for sound supervisory practices and are considered universally applicable."[3]

In theory, international standards such as the BCP (and other standards such as the 40+9 Recommendations of the Financial Action Task Force on Money Laundering) constitute "soft law." However, in practice—through the Financial Sector Assessment Program (FSAP)[4] of the IMF and World Bank and the offshore financial center (OFC) assessment program of the IMF, and through technical assistance provided by the IMF and World Bank among others—the BCP have moved closer to the realm of "hard law," with the kind of force more typically found in international conventions. Indeed, in many countries the standards have been implemented into the domestic legal framework, thereby becoming hard rather than soft law for the particular jurisdiction.

The need for supervisors to have strong powers to operate effectively is recognized by Core Principle 23—Corrective and remedial powers of supervisors:

> Supervisors must have at their disposal an adequate range of supervisory tools to bring about timely corrective actions. This includes the ability, where appropriate, to revoke the banking licence or to recommend its revocation.

In addition to the Core Principles, the Basel Committee has produced criteria for use in the assessment of a country's compliance with the Core Principles. These assessment criteria are set forth in some detail in the Basel Core Principles Methodology (BCP Methodology).

The range of sanctions referred to in the BCP Methodology that should be available to banking supervisors and, by extension, to other financial supervisors, are found in Essential Criterion 4 of BCP 23:

- Restricting the current activities of the bank
- Withholding approval of new activities or acquisitions
- Restricting or suspending payments to shareholders or share repurchases
- Restricting asset transfers
- Barring individuals from banking
- Replacing or restricting the powers of managers, Board directors or controlling owners
- Facilitating a takeover by or merger with a healthier institution
- Providing for the interim management of the bank
- Revoking or recommending the revocation of the banking licence.

These sanctions are in addition to Essential Criterion 3 of BCP 23, which provides that the supervisor should have

> an appropriate range of supervisory tools for use when, in the supervisor's judgment, a bank is not complying with laws, regulations or supervisory decisions, or is engaged in unsafe or unsound practices, or when the interests of depositors are otherwise threatened. These tools include the ability to require a bank to take prompt remedial action and to impose penalties.

Further, according to Essential Criterion 6 of BCP 23 a supervisor is to be empowered to apply penalties and sanctions "not only to the bank but, when and if necessary, also to management and/or the Board, or individuals therein."

The list of sanctions above demonstrates the strength of the powers provided and the effects, financial and otherwise, that their use may have on a wide number of individuals, including bank managers, shareholders, depositors, employees of the failed banks, and others. It is therefore possible, indeed it is likely, that there will be a large number of aggrieved parties when any such supervisory action is taken. The range of individuals who claim to have been adversely affected will depend on the exact circumstances of each case, but it is inevitable when a bank fails that some will lose out. Aggrieved parties will often look for someone to blame for their losses and sometimes for a defendant with sufficient assets to sue. Financial supervisors will often be the target.

Statutory Protection

To be effective, the exact scope of the protection being provided must be clearly set out in statutory form, with no scope for ambiguity.

Why must such protection be statutory? Because the rights of aggrieved parties (parties who consider themselves to have been harmed by governmental action) are being limited by any such protections, both the aggrieved parties and the supervisors need to be aware of their exact legal positions and to ascertain whether the supervisor has, in fact, acted within the scope of the legal protection as enacted in the law. Only a statutory provision will be capable of achieving this clarity. In some cases, this type of protection may even be embodied in a constitutional provision as, for example, in the Basic Law of Germany.

The issue of legal protection for the financial supervisor was considered to be sufficiently significant that it is referred to in Core Principle 1, which provides:

> A suitable legal framework for banking supervision is also necessary, including provisions relating to authorisation of banking establishments and their ongoing supervision; powers to address compliance with laws as well as safety and soundness concerns; and *legal protection for supervisors*. (emphasis added)

According to the BCP Methodology, the following essential criteria are necessary to ensure that both the supervisory authority and its staff are adequately protected: First, the law must provide protection to the supervisory authority and its staff against lawsuits brought against them for any actions taken and/or omissions made in the discharge of their duties. This is subject to a "good faith" requirement (this aspect is discussed further below). Second, it is also necessary to ensure that the supervisory authority and its staff receive adequate protection against the costs involved in defending any claims brought against them. The protection will apply when they are "discharging their duties" and will therefore presumably not apply where a supervisor is either acting *ultra vires,* i.e., falling outside the scope of their authority.

The reference in BCP 1 to "legal protection for supervisors," raises three questions. First, is it a good idea to protect both the authority and its staff, or is it sufficient to protect the staff alone? Second, is it necessary or desirable to protect the sovereign, the state, or the government as a whole? Third, why is an indemnity necessary or desirable; is it because the costs alone, even if the result is a procedural or substantive victory, can have a chilling effect on the conduct of financial supervisors?

Transparency Code

Before answering these questions, reference should be made to a second international standard, dealing with transparency, that refers to statutory protections. The connection between transparency and statutory protections for financial supervisors may not be immediately obvious. In recent years, however, a growing acceptance of the benefits of transparency has been emerging globally, and the availability of information that can be understood by members of the public can assist in creating an environment in which there is less suspicion of administrative action and where information supplied to the public will be more likely to be believed. It is good practice to ensure that all aspects of the activities of regulatory agencies are covered by the transparency requirement.

The IMF, in cooperation with the Bank for International Settlements,[5] developed the Code of Good Practices on Transparency in Monetary and Financial Policies (the Transparency Code).[6] The Transparency Code was adopted by the IMF in September 1999 and is one of the standards that may be included when undertaking an FSAP.

The design of the Transparency Code rests on two principles. The first of these is that it is possible for monetary and financial policies to have a greater efficacy where the public knows what the instruments and goals of the policies are. This is coupled with a demonstration by the authorities of a credible commitment to achieving these goals. The second relates to good governance and provides that central banks and other financial agencies should be accountable for their actions. This is especially true where they are granted a considerable amount of autonomy.

The Transparency Code provides that information about legal protections for officials and staff of the central bank in the conduct of their official duties be publicly disclosed,[7] and this requirement is extended to officials and staff of financial agencies as well.[8] In other words, it should be clear in advance to all affected parties what the legal position is in relation to both who is protected, to what extent they are protected, and what any limits on the protection may be. Of course, any such information must be set out in clear and accessible language so that members of the public can easily understand it, and this is something that is also provided for in the Transparency Code.

It is also good practice to ensure that the transparency extends to setting out the reasons why the protections are being provided.

According to the supporting document to the Transparency Code,[9] the rationale for public disclosure of information about the legal protections being provided to the officials and/or staff of financial agencies rests upon the need of "to ensure that such officials and staff can perform the official duties without fear of being personally subjected to legal action."[10] The Supporting Document to the Transparency Code goes further than simply concentrating on the need for public disclosure and contains a survey of the statutory protection accorded to officials and staff of financial agencies in a number of jurisdictions.[11] What this reveals is that there are significant differences in approach to the degree of protection provided, but unfortunately it does not provide information on the actual degree of transparency in each of these jurisdictions.

Human Rights Issues

As seen above, the Basel Core Principles include "legal protection for supervisors," and the Methodology makes it clear that this protection extends both to the supervisory authority and to its staff. Essential Criterion 1 to Principle 1(5) states: "The law provides protection to the supervisory authority and its staff against lawsuits for actions taken and/or omissions made while discharging its duties in good faith" while Essential Criteria 2 to Principle 1(5) provides: "the supervisory authority and its staff are adequately protected against the costs of defending their actions and/or omissions made discharging their duties in good faith."

This requires, therefore, that the supervisory agency itself be protected from civil suit. Some countries, such as India, have extended the supervisory protection even further so that no suits are permitted—not just against the agency and the supervisors in their individual capacities, but also against the state. Is this in accord with the rule of law and established principles of human rights? An answer may be found in one such international standard, the Convention for the Protection of Human Rights and Fundamental Freedoms as amended by Protocol No. 11 (Rome, 4.XI.1950), popularly known as the European Convention on Human Rights (ECHR).[12]

The ECHR established the European Court of Human Rights (the Court) and contains a series of obligations and prohibitions to protect human rights and promote fundamental freedoms. The ECHR has become the best-known attempt to promote human rights; many legal jurisdictions, not just in Europe, have used it has the basis for their national human rights legislation.

Article 6.1 of the ECHR states: "In the determination of his civil rights and obligations … everyone is entitled to a fair and public hearing within a reasonable period of time by an independent and impartial tribunal established by law." The ECHR has interpreted this to mean that individuals have a right of access to a court of law to redress grievances.

For example, in *Bellet v. France*, the Court stated: [13]

> The fact of having access to domestic remedies, only to be told that one's actions are barred by operation of law does not always satisfy the requirements of Article 6 para. 1 (art. 6-1). The degree of access afforded by the national legislation must also be sufficient to secure the individuals' "right to a court," having regard to the principle of the rule of law in a democratic society. For the right of access to be effective, an individual must have a clear, practical opportunity to challenge an act that is an interference with his rights (see the de Geouffre de la Pradelle judgment previously cited, p. 43, para. 34).[14]

The next question to be asked is whether providing statutory protection for supervisors is consistent with upholding the human rights of those who are likely to be affected by the supervisors' decisions. Is it legal under the ECHR to provide such statutory protection?

As seen above, the ECHR provides an entitlement to everyone to have a fair and public hearing by an independent and impartial tribunal established by law. Is this right absolute or is it permissible under the ECHR to have exceptions or limitations? The jurisprudence of the Court has held that the right to have access to a court of law is not an absolute right and, of particular importance for the purpose of this chapter, that the interests of the state can, in appropriate circumstances, be taken into consideration.

Where the Court is considering whether the right of access of a claimant can be restricted, there are three tests that the court takes into account. The first is to determine whether the claim actually relates to a human rights issue. Political rights, for example, are not within the scope of Article 6.1, but claims for a breach of statutory duty are. Second, it is important to realize that Article 6.1 does not address substantive law issues which may prevent a litigant from having access to an appropriate court. However, the Court has indicated that it would not be consistent with the rule of law to simply "remove from the jurisdiction of the courts a whole range of civil claims or confer immunities from civil liability on large groups or categories of persons."[15] Third, it is possible for a state to limit the right of access to a court by the use of appropriate statutory provisions provided the need to have a balance between the protection of the rights of an individual and the interests of the community as a whole is taken into account. In one case,[16] the Court determined that a statutory immunity granted to the United Kingdom Department of Health and Social Security (as it was known at that time) was not an impairment of the right of access to an independent and impartial tribunal.

The state therefore, under the ECHR, is not prevented from providing statutory immunity for supervisors. It can do this without violating the human rights of an individual provided that certain conditions are met.

However, providing that the statutory protections are built into the legal provisions, there is an argument that the rights of individuals to bring actions should not be restricted. Because claimants would have to prove that the defendant has acted either in bad faith or not in the ordinary course of their duties to have a successful claim, they should surely have the right to a tribunal to air their case. The costs involved in bringing such a case and the relatively low chance of success would deter frivolous claims.

Therefore, in providing for such protections, states must ensure that in protecting supervisors in their individual capacity, and in some cases the supervisory agency in its institutional capacity, that they do not block all means for individuals to seek redress for damages.

Statutory Protection in Two Jurisdictions

The following section is an examination of two jurisdictions—New Zealand and Spain—that have provided statutory protections for financial sector supervisors. New Zealand is a common law jurisdiction; Spain is civil law.

These two jurisdictions provide a clear illustration of different approaches. In particular, they demonstrate that there is not, as yet, an internationally agreed approach to this issue and that there appears to be a fundamental issue that needs to be addressed—that is, whether the supervisory authority as a body should, or should not, have the same degree of statutory protections as are provided to the members of the authority's staff. In New Zealand the supervisory authority and its staff are protected, which is in keeping with the Basel Core Principles. In Spain the law provides a right of action against a supervisory authority to those who suffered alleged damage.

A Common Law Approach: New Zealand

New Zealand provides an example of a common law jurisdiction that provides extensive statutory protection. Under the Reserve Bank of New Zealand Act 1989, protection is provided to the Reserve Bank and its officers, employees, and agents. Section 179 (2) provides that "no person to whom this section applies is personally liable for an act done or omitted to be done in the exercise or performance in good faith of that person's functions, duties, or powers under this Act."

The protection therefore is not absolute but subject to a number of conditions. First, it includes the concept of acting within the scope of authority. Second, it contains a good faith requirement for the protections to apply. Third, it explicitly states that the employee shall not be personally liable for damages. Additionally, in section 179A, it indemnifies officers, employees, and agents of the Reserve Bank.

The indemnity for the Reserve Bank and its officers and employees provides in section 179 A (1) as follows:

> (1) The Crown indemnifies the persons listed in subsection (2) for any liability that arises from the exercise or purported exercise of, or omission to exercise, any power conferred by this Act unless it is shown that the exercise or purported exercise of, or omission to exercise, the power was in bad faith.

The indemnity therefore covers all persons who may be working for, or on behalf of, the Reserve Bank, including agents and members of advisory committees. It will also extend to any exercise or purported exercise or omission to exercise *any* power under the Act. It is important to note, however, that it excludes any exercise of a power that is carried out in bad faith.

The indemnity is given by the Crown, i.e., the sovereign, not the Reserve Bank, and therefore presumably would provide greater certainty to those covered by the indemnity.

A Civil Law Approach: Spain

Under Spanish law, government agencies can be liable for damages caused by their employees in certain situations. These are set out in statutory form in the Legal Procedure of Public Administrations and the Administrative Common Procedure Act of 26th November 1992.

Section 139, entitled Principles of Responsibility provides:

> 1. Citizens will be entitled to receive an indemnification from the relevant Public Administrations [government agencies] in connection with any damage that they may suffer in any of their assets and rights, except in cases of force majeure, provided that damage arises as a result of the normal or abnormal operation of public services.

> 2. In any event, any alleged damage shall have to be actual, financially assessable and individualized as to a person or group of persons.

The emphasis under the Spanish legislation is on the rights of citizens to seek redress from the government (public administration). An interesting feature is that it provides broad coverage to citizens against both normal and abnormal actions of government officials. Arguably, this acts as an incentive for citizens to proceed against the government rather than individual civil servants.

Comparing the Two Approaches

The New Zealand approach emphasizes the protection of both the agency itself and the individuals who will undertake the particular actions. The degree of protection provided is therefore very high. Under the Spanish approach, the law seeks to provide members of the public with a specific right against a public body. Under the Spanish system an aggrieved citizen who can prove actual financial damage is able to make a claim against the relevant government agency.

The New Zealand approach clearly provides a high level of protection and is in accordance with precise language of BCP 1 and the BCP Methodology. But does it go too far in the opposite direction, potentially breaching international standards on access to courts, as discussed above in connection with the ECHR?

Good Faith and Bad Faith

The concept of "good faith" has already been mentioned several times in this chapter. But what exactly does it mean? According to the *Oxford Dictionary of Law*, 5th edition, it is: "Honesty. An act carried out in good faith is one carried out honestly. Good faith is implied by law into certain contracts, such as those relating to commercial agency." Under English law a good example is provided by section 90 of the Bills of Exchange Act 1882, which provides that "[a] thing is deemed to be done in good faith, within the meaning of this Act, where it is in fact done honestly, whether it is done negligently or not." This principle is based on even earlier case law such as *Crook v. Jadis* (1834) 5 B. & Ad. 910.

It is therefore clear, at least from English case law, that negligence by itself does not amount to bad faith. What is required is to establish some degree of dishonesty. Under English law—and this is generally the case in common law jurisdictions,—there is another facet to bad faith, which is termed misfeasance.[17] This concerns the situation where a public official uses his or her power for an ulterior or improper purpose that is considered to be contrary to the overall public good. Such behavior falls within the concept of bad faith. Arguably, it is necessary to extend the concept of bad faith to include abuses of power by public officials.

Of course, those who wish to bring a claim based on bad faith will be required to prove it. It will not be for the person who has undertaken the act to prove that he or she did in fact act without bad faith.

The issue of good faith therefore centers on the concept of honesty and the need for the public official to have acted with a proper purpose. It would seem, under the English common law at least, that provided a person has acted honestly and with proper purpose he or she should be protected by the statutory protections provided.

What Should the Law Contain?

Having looked at the Basel Core Principles, the legal issues involved in protecting financial supervisors, and two approaches to legislation, an appropriate law should contain provisions:

- Limiting protection to actions taken by supervisors within the scope of their authority.
- Limiting protections to actions taken in good faith, or, alternatively, excluding actions taken in bad faith.
- Extending coverage to all individuals, including members of the board of directors, officers, and employees, as well as agents, consultants, and contractors such as public accounting firms. The reason for such wide coverage is that anyone left out will potentially become an even greater target.

- In addition to providing protections for the individuals listed above, possibly also protecting the financial supervisory agency or central bank, but it should not be a blanket grant of immunity that would cover not only those two categories but also the actions of the state itself so as to block the access of an aggrieved party to a court of law.
- Providing an indemnity by the central bank, the state or sovereign, or other relevant authority or agency that covers all of the costs of defending any suits that may be brought against an authority or any of the other parties listed in the third bullet above.

Conclusions

Although more countries have enacted statutory protections and indemnities for financial supervisors in recent years, many, particularly those with civil law regimes, do not currently have such protections, and this is something that needs to be addressed. In so doing, countries should consider the application of such protections to financial sector supervisors, as well, rather than limiting protections to banking supervisors. It is becoming increasingly common for jurisdictions to consider the use of a single unified regulator with responsibility for the entire financial sector. Adequate legal protections are necessary to enable such a unified financial supervisor to function effectively, as recognized by the Basel Committee with respect to banking supervisors.

Because financial sector supervisors often must act with considerable speed, especially during a systemic crisis when many banks may be insolvent or nearly insolvent, decisions that were necessarily taken quickly may not always stand up to scrutiny when viewed after the crisis has abated. Accordingly, there may be many aggrieved parties who would wish to take legal action after the full extent of the government's actions can be assessed. Provided the supervisor has acted in good faith, within the scope of authority, and with access to courts to redress the claims of aggrieved parties, the protections should apply.

Legislators may balk at singling out central bankers or financial supervisors for such protections. What about other civil servants, such as police and other law enforcement officials, and tax collectors? There may be valid reasons for extending protection to these groups too, but it is beyond the scope of this chapter to consider this issue.

Would enacting such protections act as a curb on corruption or would corrupt officials be insulated as a result of such protections? This is an ongoing problem to which there is no easy answer. It is hoped that the provision of such protections would have the effect of curbing corruption. But the problem of corruption is not one that should act as a brake on the introduction of appropriate statutory protections for financial supervisors.

Notes

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[1] For the purposes of this chapter, the term *financial supervisor* includes all of the directors, officers, employees, and agents of the financial supervisory agency and anyone else acting on its behalf.

[2] The Committee is based at the Bank for International Settlements. For more information, see www.bis.org.

[3] BCP, p. 2, para. 5.

[4] *See* www.imf.org/external/np/fsap/fsap.asp.

[5] A representative group of central banks, financial agencies, other relevant international and regional organizations, and selected academic experts were also involved in the consultations.

[6] *See* www.imf.org/external/np/mae/mft/code/index.htm#IV.

[7] Section 4.4.1.

[8] Section 8.4.1.

[9] *See* www.imf.org/external/np/mae/mft/sup/index.htm.

[10] Section 8.4.1.

[11] Section 8.4.1. Box 3-3.

[12] *See* http://conventions.coe.int/Treaty/en/Treaties/Html/005.htm.

[13] *Bellet v. France*, judgment of 20 November 1995, para. 36, 21/1995/527/613.

[14] *de Geouffre de la Pradelle v. France*, judgment of 16 December 1992 (Series A no. 253-B).

[15] *Fayed v. United Kingdom,* 15 EHRR CD 32 para 65.

[16] *Ashingdane v. United Kingdom*, May 28 1985, 7 EHRR 528, para. 59.

[17] Under English law the tort of misfeasance can be traced back to at least 1364.