CHAPTER THREE - PRUDENTIAL SUPERVISION OVERLAPS AND OPTIONS

3.1 INTRODUCTION

Convergence among financial institutions has resulted in a number of regulatory overlaps. Prudential supervision is still conducted by States (in respect of building societies, credit unions and friendly societies), while the Commonwealth supervises banking (apart from State banking), insurance (apart from State insurance), superannuation, and collective investments.

Within the ISC, the three prudential supervisory divisions (life insurance, general insurance and superannuation) have had to develop a joint approach to the supervision of financial conglomerates. For example, approximately two-thirds of life insurance groups have at least one approved trustee (of public offer superannuation funds) within their structure, and a number of general insurance companies have affiliates involved in life insurance and superannuation. To complement solo supervision, coordination processes are being developed within the ISC by which an assessment of a whole organisation can be made.

Developments in the finance sector have also resulted in separate prudential regimes applying to retail savings products with similar functional characteristics. For example, banks and life offices have different capital requirements, even though deposits are regarded by some as akin to short-term, capital guaranteed life policies. Capital and custodian requirements for life insurance, superannuation, and collective investments also vary depending on the type of product, the institution offering it, and the applicable supervisory regime (see Appendix B for details).

This chapter discusses the implications of these overlaps in terms of the prudential risks posed by conglomerates, the role of the Council of Financial Supervisors in addressing those risks, overseas regulatory experience and some options for strengthening the regulatory framework for the supervision of financial conglomerates in Australia.

3.2 CURRENT OVERLAPS

Blurring/convergence

Blurring or convergence has largely been driven by the forces of price competition and cost control, as financial institutions have sought to expand and diversify their business operations and take advantage of a common brandname/logo and existing back office and distribution infrastructure to cross-sell financial products (ie. selling more products to an existing customer base at a small marginal cost). To the extent that products are manufactured in a different way (rather than just distributed in a different way), taxation arbitrage may be involved.

A key issue is the degree to which blurring is occurring at the level of the individual entity (ie. a financial institution selling diverse products off a single balance sheet), or at the group level as a result of financial conglomeration (ie. a financial group competing outside traditional markets through the use of subsidiaries). To the extent that blurring is a group level phenomenon, a stronger case can be made for preserving the existing framework of solo supervision for the separate subsidiaries of the group, with some new overlay to facilitate supervision of the group as a whole. On the other hand, a high incidence of blurring at the level of individual entities (balance sheet convergence) suggests that consideration should be given to a more substantial rearrangement of the regulatory system to facilitate more functional supervision and standardisation of solo requirements. This issue is considered further in Section 3.3.

ISC life insurance and superannuation overlap

The overlap of life insurance and superannuation is readily apparent. The majority of business written by life offices is now superannuation. At 31 March 1996, 74 percent of life office assets were in superannuation business. Approximately two thirds of the 52 life companies now have at least one approved trustee (of a public offer superannuation fund) within their group structure. All life insurers are subject to supervision by the life insurance division of the ISC, while approved trustees are subject to supervision by the superannuation division of the ISC.

In order to improve the effectiveness and efficiency of its prudential supervision, the regulatory divisions of the ISC have developed a coordinated approach to the supervision of public offer superannuation and life insurance through the internal use of the lead regulator approach (ie. the ISC division which oversees the predominant business of a conglomerate establishes, maintains and regularly provides to the other division an appraisal of the organisation as a whole).

ASC unit trusts/collective investments and ISC public offer superannuation

Another regulatory boundary that cuts across functionally similar financial products concerns ASC and ISC supervision of collective investment schemes (excluding the ‘exotics’) and retail superannuation entities respectively.

Fund managers can commercially operate superannuation and non-superannuation unit trusts through the same group operation (there may be some separation driven by differing compliance requirements). The key functional difference between these products, in many instances, is simply the preservation status and concessional taxation treatment afforded to superannuation. Nevertheless, there are significant differences in the regulatory regime for unit trusts - administered by the ASC - and retail superannuation funds - administered by the ISC. In other words, the regulatory arrangements drive a wedge into a commercially common industry.

At present, non-superannuation unit trusts are required to have a two party structure - an independent trustee that has custody of the scheme assets and monitors the fund manager’s compliance with the scheme’s governing rules, and the scheme manager, who generally takes responsibility for promoting the scheme and investing the assets. Each of the two parties is subject to specific duties and obligations under the *Corporations Law*. The Government is presently reviewing the regulatory regime for collective investments and may, or may not, eventually move towards a 'single responsible entity' and the mandatory use of custodians, as foreshadowed in the *Collective Investments Bill*, introduced into Parliament in 1995, but now lapsed.

Public offer superannuation funds are supervised by the ISC under the SIS regime. Key requirements include a single responsible entity (an ISC-approved trustee), compliance with retirement income standards, and extensive disclosure requirements for potential investors. A more detailed comparison of the different regulatory requirements of SIS and the Collective Investments Bill is set out in Appendix B.

The prudential supervision of public offer superannuation funds is more extensive and rigorous than that presently applying to unit trusts. Consequently, it tends to provide a safer haven for retail savings (irrespective of the investor bearing market risk in both cases). The ISC is aware of different market views on the question of harmonising prudential requirements (as distinct from sales conduct requirements) for non-superannuation unit trusts and ISC regulated retail superannuation funds. In the final analysis, the prior question is whether the community prefers to have standard unit trusts prudentially supervised on the one hand, or to maintain the risk spectrum on the other. The former option would see the managed funds industry subject to the same degree of prudential supervision, irrespective of superannuation status.

RBA, AFIC/State and ASC supervision of banks and NBFIs

There is also an overlap in the prudential supervision of deposit-taking institutions, and financial intermediaries more generally. The RBA is the prudential supervisor of banks, based on the Commonwealth's Constitutional power over banking (except State banking). Other intermediaries - namely credit unions, building societies, merchant banks and finance companies - are supervised by AFIC, which in turn reports to a State Ministerial Council, or (in certain respects) by the ASC.

For most consumers, building societies and credit unions have an appearance similar to banks, and conduct their activities in a manner consistent with banks. The division of responsibilities for deposit-taking institutions arguably causes some inefficiencies, in that it distributes the decision making among different organisations that are responsible to different levels of government. There may be considerable merit in removing this separate supervision of deposit taking institutions by negotiating with the State governments with a view to AFIC institutions becoming prudentially supervised by the RBA.

There is also blurring of the line of demarcation between banking and other (non AFIC) financial intermediaries. For example, merchant banks are similar in many respects to banks, but are <u>not</u> authorised under the *Banking Act 1959*, and therefore not supervised by the RBA. They have exemptions from RBA supervision on the grounds that, while they carry on 'banking business', they do not carry on the 'general business of banking'. As this distinction increasingly loses whatever meaning it may have had in the past, it needs to be asked whether these intermediaries should be supervised by the RBA according to the same prudential framework as applies to authorised banks.

3.3 CONVERGENCE - FINANCIAL GROUPS VERSUS FINANCIAL ENTITIES

It is the ISC's view that the extent of blurring or convergence at the individual entity level has been overstated. One example of entity level or balance sheet convergence taking place in Australian financial markets is life offices offering short-term savings products which may be regarded as term deposit look-alikes (if capital guaranteed) or unit trust look-alikes (if market linked). Note that variable rate home loans written directly by statutory funds (rather than a subsidiary) are relatively rare. Overall, the significance of intra-entity blurring at this stage is probably relatively minor. So far, the level of 'on balance sheet' intrusion by one type of financial institution into the traditional area of another's is very small in relation to their aggregate business (balance sheets have not converged), and there remain fundamental differences in the inherent nature of banking, insurance and funds management business, including the competencies and the risks involved.

While some may argue that a large proportion of life company business - in the order of 38 per cent - is now non-traditional (ie. not risk or long-term capital guaranteed) business, particularly market linked single premium products, the ISC would argue that quite apart from regulatory treatment, there are substantial differences which make these products relatively poor substitutes for unit trust products, say. These include institutional risk, product complexity, particularly in relation to fee and benefit structure, differences in modes of distribution, and in particular **differences in taxation treatment** (among other things, tax on life insurance products is paid by the life company whereas tax on unit trust products is paid by the beneficiary). In addition, there are significant differences in the respective cultures, histories, and business core competencies of the product providers concerned.

A question which has been raised in some quarters is whether the solvency/capital adequacy standards for life offices under the new Life Act will be higher than those applying to banks. This is a 'level playing field' argument which the ISC views with considerable scepticism, for the following reasons:

- making such a comparison is like comparing apples with oranges - the balance sheets of banks and life offices are quite different and, therefore, so are the institutional risks they create;

- to the extent product blurring (or balance sheet overlap) does exist, it is much more likely to reflect tax arbitrage or cost differentials, than regulatory arbitrage;

- in any event, the significance of regulatory arbitrage is over-stated. Financial conglomerates cannot simply move product manufacturing around parts of the group like pawns on a chess board - the customer has some say in the matter; and

- a more important consideration than equalising capital standards (if that were possible in practice), is maintaining international consistency. At present at least, the prudential standards for banks and insurers internationally are quite different.

On the other hand, there has been a considerable degree of convergence at the group level. For example, banking groups have become increasingly involved in insurance and funds management (mainly through subsidiaries) under the same regulatory regimes as stand-alone insurance companies and fund managers. To take the Colonial Group as an example, it is the group collectively which is engaged in bancassurance and cross-selling, not its members Colonial Mutual Life or State Bank individually.

Similarly, Mr Aad Jacob, Chairman of the European bancassurance major, the ING Group, was reported in *The Australian* of 5 June 1996 as telling an international conference in Sydney the previous day that banking and insurance would always remain separate activities, whatever the institutional structures that controlled them. Mr Jacob was also reported as saying that European groups that had not understood this difference had struggled in their attempts to forge new financial structures.

In Australia (unlike North America and Japan) there have been no statutory restrictions on suitably structured financial groups undertaking banking, insurance, and funds management. In fact, the Australian financial system is dominated by conglomerates, although, until recently, these groups have generally not had banking and insurance arms of similar size. The emergence of conglomerates has been a market matter, not a regulatory issue. However, it is true that financial conglomerates do pose some challenges for financial supervisors, which are receiving attention.

A key supervisory issue which arises in respect of financial conglomerates is whether there are risks arising from the financial group as a whole which are not adequately addressed by any of the individual 'institutional' regulators supervising the group's component parts on a specialised solo basis. It has been argued that some of these risks and problems are as follows[1]:

(a) they might be more difficult to manage than institutions with a more specialised focus;

(b) they might be less transparent than simpler institutions, because of complex structures or intra-group exposures;

(c) problems in one part of a group might be communicated directly or indirectly to otherwise healthy parts - including psychological or moral contagion risk or 'guilt by association';

[1] Council of Financial Supervisors, *Annual Report 1995*, p. 26.

(d) problems of transparency and contagion might be a particular worry if significant parts of a group are not overseen by any prudential supervisor or regulator; and

(e) the priorities of supervisors with responsibilities for different parts of the group might not coincide.

These potential problems are compounded when international conglomerates move into new countries, as well as new products. A major issue arising from these concerns is whether ‘firewalls’ within the group can effectively quarantine a troubled entity from the fortunes of its healthy affiliates (experience suggests they cannot).

Most financial conglomerates in Australia are headed by either a substantial financial institution which is supervised, or by a non-financial entity which is not supervised. For groups containing a bank, the bank generally acts as holding company for the other entities in the group. This reflects longstanding banking policy requiring a wide spread in the ownership of banks.

A key exception to this rule is Colonial Mutual Life’s (CML) ownership of the State Bank of New South Wales. In obtaining approval to acquire the State Bank, the Colonial Group committed itself to demutualising the life company by no later than 31 December 1998 in order to establish a diversified shareholding base consistent with the intent of the *Banks (Shareholdings) Act 1972*. The supervisors with responsibilities for entities in the new Colonial Group (the RBA and ISC) favour early demutualisation because this will give easier access to capital and thus enhance depositor and policyholder protection.

A holding company structure - where a non-operating financial holding company has separate subsidiaries for its banking, insurance and investment activities - is favoured by some market players. It is also a widely used structure internationally. Supporters for a holding company structure cite a number of reasons relating to prudential management and fair valuation of the company, including: greater transparency of structure; fairer valuations by the market; management autonomy for member entities; and clear recognition of separate capitalisation.

Irrespective of the structure of the financial conglomerate - whether the holding company is a bank or non-bank - the issue arises as to the most appropriate means of regulating those risks and, in particular, **whether structures should be put in place to monitor the financial health and standing of the financial group as a whole**. Needless to say, there exists a spectrum of regulatory possibilities for group supervision. These range from the existing mechanism for achieving greater cooperation and coordination among the four main financial supervisors in Australia (ie. the Council of Financial Supervisors) to a new mega-supervisor.

3.4 COUNCIL OF FINANCIAL SUPERVISORS

Background

The CFS was established in 1992, following a recommendation by the 1991 Parliamentary Inquiry into Banking and Deregulation (the Martin Committee). The CFS is an informal rather than a statutory body, and consequently its establishment has not changed the individual statutory responsibilities or powers of its members - the RBA, ISC, ASC, and AFIC - which continue to have specialised roles as solo supervisors.

The basis for the Martin Committee's recommendation regarding the CFS was stated to be the continuing trend within the financial system for the creation of financial conglomerates and the consequent need for closer coordination among the various supervisory authorities. In making its recommendation, it noted that informal bilateral contacts between supervisors had been developing in Australia in response to system developments, but referred to the more formal coordination arrangements established in some overseas countries.

The Martin Committee saw merit in achieving greater coordination of supervision by means of the CFS designating one supervisor as the 'convenor' with overall responsibility for each financial conglomerate, while suggesting that supervision of the individual arms of the conglomerate remain with the individual supervisors (the solo plus model). In the event, the CFS did not initially adopt this model, preferring less formal cooperative mechanisms, but has recently been moving progressively in the direction of more formalised coordination in an evolutionary manner.

The Martin Committee also examined the option of a mega-supervisor for the financial system but said that it was 'not convinced the establishment of one mega-supervisor is necessary at this time to ensure adequate protection of the savings of the public'[2]. However, it indicated there may be a need to re-examine this matter at a later date, especially if the trend towards the formation of conglomerates by merger or alliance continues, and if a mega-supervisor were found to be desirable the CFS could form the basis for it.

CFS scorecard

Positives

The CFS has proven to be a useful forum for discussion of various supervisory issues of common interest, most notable among which, apart from financial conglomerate supervision, has been the regulation of derivatives. It has also been involved in monitoring and discussing developments in financial system supervision overseas, including through close involvement with the main international bodies.

[2] The Report of the House of Representatives Standing Committee on Finance and Public Administration, *A Pocket Full of Change*, AGPS, Canberra, 1991, p. 237.

In relation to financial conglomerates, the CFS proved to be a useful mechanism for coordinating supervision when, in 1994, a new configuration in the market emerged with the CML purchase of the State Bank of NSW. This was the first occurrence in Australia of a bancassurance group where the life office was parent and the banking and life insurance arms were broadly similar in size. The two solo supervisors - the RBA and ISC - agreed as part of a CFS process that this new configuration warranted some additional safeguards, and these have since been put in place, including an RBA/ISC MOU setting out the respective responsibilities and cooperative procedures to apply to bancassurance groups with this type of configuration.

The members of the CFS have been involved in a number of other joint projects. These have included developing legislative proposals for freer and faster information exchange; secondments and staff interchanges which facilitate cross-fertilisation of ideas and approaches, particularly in respect of supervisory techniques (however, these are quite difficult to arrange in practice); processes to harmonise regulatory gaps and overlaps between the ASC and ISC in respect of financial advice; and the evolution of an agreed model for the supervision of financial conglomerates headed by a holding company. These coordinated initiatives have enabled member organisations to improve consistency between their regimes, and to exchange information and ideas which can eventually translate into higher standards of supervisory performance at an individual organisational level.

The CFS has also given rise to the need for staff in the RBA, ISC, ASC and AFIC to liaise informally on a day to day basis. For example, ISC staff have routinely exchanged internal working papers with contacts in CFS member agencies (eg. in relation to derivatives regulation, solvency and capital adequacy standards and disclosure issues) for consideration and comment. The insights provided by officers from the other agencies have considerably enhanced the quality of the end product in many instances.

The effectiveness of coordination and cooperation between regulators (both domestically and internationally), including in relation to crisis management, depends heavily on the degree of mutual trust and confidence which has developed. This is because regulators have a primary responsibility to fulfil their statutory obligations within their home jurisdiction. Statutory coordination within one country, or even one agency, can assist, but ultimately a high degree of mutual trust and confidence is required, and this is certainly true for coordination across national borders. With this in mind, one of the positives of the CFS to date has been the personal rapport which has developed between agency heads and their senior executives.

Negatives

The ISC considers the CFS has worked well, and that the negative points raised in some quarters relate more to the perception and appearance, than to the substance, of the CFS's track record. First, the CFS has an admittedly low visibility and profile in the marketplace. Most market participants recognise the individual members of the CFS, but few know of the CFS as an organisation, or of its functions and activities.

The CFS has no statutory backing, which arguably reduces its credibility in the market, and diminishes its authority to force a faster pace of regulatory harmonisation, and a greater degree of negotiation and compromise in the formulation of consensus positions for domestic financial policy and international input.

The positive achievements of the CFS are undoubtedly due in significant part to the personalities of the individuals who have comprised its membership since inception, and what appears to be their similar philosophical approaches to supervision, at least at a basic level. The high degree of cooperation among CFS members could be significantly reduced, however, if one or more of these personalities changed and were replaced by more interventionist/independent regulators with a fundamentally different approach to supervision (however, this could also be a problem under a more formal arrangement).

Similar basic philosophies and extensive cooperation at the CFS level have also not prevented differences in the methodology of supervision among the various authorities, both generally and at the work-place level. It is such differences which, notwithstanding the CFS's existence, appear to have placed some constraints on the degree and speed of harmonisation that has been achieved in the consumer protection area. While there is scope for this to be resolved by more determined cooperation under the auspices of the CFS, an alternative solution might be found in a more fundamental change to the regulatory structure.

The division of responsibilities among Governments and Ministers can also act as an impediment to coordination and harmonisation in supervision. One of the complications in the previous arrangements - including the role and responsibilities of the CFS - was having ministerial responsibility for financial supervision split between the Commonwealth Treasury (RBA and ISC), the Attorney-General's Department (ASC), and State Governments (AFIC). Part of this problem now has been solved with the ASC coming into Treasury portfolio.

There is presently no formal contact between the CFS and financial industry participants whereby harmonisation issues can be addressed from both a public and private sector perspective. It is possible that regular direct contacts of such kind, also involving other regulators whose activities impact on the financial system, could improve understanding among the various parties.

CFS future

In summary, the CFS has made a valuable contribution to improved regulatory coordination, including information exchange, harmonisation, and conglomerate supervision. At the same time, there are some aspects of its operation, encompassing its informality and low profile, which warrant examination to see if improvements can be effected. Such an examination would be consistent with the recognition by its members that the form and role of the CFS should evolve as the shape of the financial system changes and new problems emerge or existing problems are accentuated.

Consideration should be given to upgrading the status of the CFS by giving it statutory backing, including a formal mandate and a mechanism for industry input. Such a move would raise the profile of the CFS in the financial market by formalising supervisory coordination, and by making more transparent the existing cooperative arrangements. Upgrading CFS powers and responsibilities would enhance conglomerate supervision, by encouraging supervisors to address more intensively the issues raised by supervision at a group level. Upgraded powers and responsibilities would also enhance information exchange between CFS members, allow for a more coordinated approach when providing policy advice to the Treasurer, extend liaison with industry, enable coordinated and effective representation at international forums, and facilitate harmonisation among member legislative regimes.

3.5 INTERNATIONAL EXPERIENCE AND DEVELOPMENTS

The manner in which industrialised countries have had to adjust their prudential regulation to deal with market developments such as globalisation and blurring has varied, depending on a number of factors including the existing domestic regulatory and taxation arrangements. The experience of other countries can contribute to the Australian debate on the most appropriate regulatory arrangement: however, there is no obvious, ideal model in evidence, and it is clear that any structure will have imperfections and ambiguities to some degree. A summary of the arrangements in a number of countries is given at Attachment C.

The UK ‘twin peaks’ proposal

The ‘twin peaks’ (or actually triple peaks) model proposed by Taylor for the UK - ie, a single prudential supervisor and a single business conduct regulator - cannot be usefully applied in a practical way to Australian circumstances for the following three reasons, in particular.

First, the model asserts that prudential supervision is not required for the investment (ie. managed funds) industry because investors readily accept the market risk, and the possible failure of the scheme manager is not a source of systemic risk. This model, even if suitable for the UK, is not applicable to Australian superannuation (at least). Given the case for the superannuation part of the managed funds sector to be closely supervised in the interests of prudent management of fund assets, which regulator or ‘peak’ would have coverage - the systemic regulator because prudential security is involved, or the conduct regulator because institutional solvency is not? Also, the model says very little about the institutional supervision of insurance, which in our view is necessary for prudential reasons, but which is inherently dissimilar to banking supervision.

Second, it is simplistic and naive to assert that capital requirements are not relevant to investor protection in the managed funds industry. While investors may bear market risk, there is a strong case for protecting them from reckless, incompetent and dishonest scheme management. In the absence of compensation arrangements (along the lines of deposit insurance), operators of managed funds schemes need to demonstrate they have the capacity and commitment to keep the business running smoothly during its expansion phase and to cope with administrative stresses, compliance requirements, liquidity pressures and so on. Certainly, this has been ISC experience in its supervision of retail superannuation. And, where investor compensation arrangements are in place, there is a strong case for prudential supervision to counter moral hazard.

Third, while academic theorising has its place, ‘twin peaks’ and other highly abstracted and simplified models are of limited use in practical policy development, which has to accommodate a range of real world constraints, including complexity and untidiness of the commercial arrangements in the marketplace. For example, the Taylor model assumes a costless transition from the existing UK arrangements to his brave new world blueprint, whereas in practice, the adjustment involved could be traumatic and costly, and the ultimate outcome might be contrived and inflexible.

The South African model

The South African model (see Attachment C) could be applied to Australia by merging the ASC with the ISC, and by upgrading the status, role and responsibilities of the CFS. That is, the RBA would be analogous to the South African Reserve Bank (SARB), and a merged ASC/ISC to the Financial Services Board (FSB). While this may have superficial appeal - in terms of a reduction in the number of regulators - a combined ASC/ISC would present some serious practical problems.

At first glance, there could be synergies in a combined ASC/ISC in the following areas:

- regulation of financial advice and complaints handling;
- regulation of product disclosure;
- surveillance and investigation techniques for retail superannuation funds and standard unit trusts;
- scope for rationalisation and cost savings in (policy, legal, corporate) support services and public relations and education;
- regulation of electronic commerce;
- international representational activities; and
- assessing regulatory implications of new sophisticated financial products (eg. derivatives, endowment warrants etc).

However, there would also be considerable drawbacks from a combined ASC/ISC. First, there would be considerable difficulty in reconciling the different approaches to enforcement of the two organisations. The ASC enforcement approach is prosecution based, whereas the ISC approach is based on preservation of policyholder or superannuation member entitlements and civil remedies. More generally, the ISC’s expertise in prudential supervision could be lost, and its cultural preference for moral suasion would clash with the ASC’s black letter law approach.

Second, there are tendencies for larger organisations to be more bureaucratic and cumbersome. The ASC is presently almost three times the size of the ISC and a merger would create a more unwieldy organisation. The new agency would be highly multi-functional, and would lack a clear and common sense of purpose.

Third, a combined ASC/ISC would create an anomaly whereby some of the merged organisation's legislation would be subject to Commonwealth control (ie. insurance and superannuation legislation), whereas other legislation (Corporations Law) is subject to coordinated Commonwealth/State control.

Fourth, some market areas - eg. risk insurance - could find themselves ignored or downgraded as pressures for a uniform regulatory approach (attuned to market integrity) developed. Institutional memory would be lost.

Fifth, there would be difficulty in merging the management approaches of the supervisory areas of the two organisations, and in particular, there would be considerable difficulty in merging the ISC's centralised Canberra based chain of command with the ASC's more decentralised structure, which includes highly autonomous regional offices. The adjustment costs of relocating staff and merging administrative systems would be immense.

The New Zealand model - no prudential supervision of insurance

It is sometimes suggested that Australia could adopt the New Zealand model of insurance supervision, which is fairly minimal (see Attachment C). Arguments in favour of such limited supervision are along the lines of reduced compliance costs for companies, and the 'buyer beware' proposition that consumers are in the best position to evaluate the financial soundness of insurers via market information, such as ratings.

Problems with adopting the New Zealand model in Australia

First, the Australian insurance market is considerably (about 12 times) larger than that of New Zealand. In terms of premium income, for the year ending 30 June 1995, authorised Australian general insurers wrote approximately $US 10.2 billion of business or almost seven times more than New Zealand's $US 1.48 billion. In the year to March 1995, registered Australian life insurers wrote approximately $US 14.3 billion of business or around thirteen times more than New Zealand's $US 1.08 billion. Any move to cease prudential supervision of Australia's much larger portion of the world insurance market may introduce an element of uncertainty in international perceptions about the stability of the Australian market.

Second, the much larger Australian market displays considerable structural differences to that of New Zealand. The Australian insurance market is served by 212 companies. Of these, 160 are general insurers, of which the 58 percent which are foreign owned receive 50 per cent of industry premiums and control 48 per cent of industry assets. Of the 52 life insurers, the 48 per cent which are foreign owned receive 29 per cent of premiums and control 24 per cent of industry assets. In other words, foreign ownership accounts for about half of the Australian general insurance market, and less that 30 per cent of the Australian life insurance market. Foreign ownership in New Zealand is considerably higher.

The Australian insurance market, unlike New Zealand, is notable for the presence and market leadership of Australian owned companies. The market leader among general insurers is a local company (NRMA Insurance with 16 per cent of the market), and 4 of the top ten companies comprising a total of 39 per cent of the market are Australian owned. Similarly, the market leader in life insurance is an Australian-owned company (AMP with 28 per cent of the market) and 6 of the top 10 life insurers comprising 54 per cent of the market are Australian owned.

By comparison, the New Zealand market is heavily dominated by foreign entities. Of the 107 insurers operating in the New Zealand market, 89 per cent are owned by foreign insurance companies that are prudentially supervised in their home countries. Adopting the New Zealand model of supervision would have the politically damaging effect of reducing the level of policy holder protection in Australia, by not supervising the large section of the insurance market held by Australian companies.

In other words, the New Zealand Government can effectively have a system of minimal prudential supervision for insurers only because of the dominance of the New Zealand insurance market by foreign companies. Minimal prudential supervision only is required, since the solvency of the New Zealand subsidiary is effectively guaranteed by the solvency and strength of the foreign parent, which in turn is supervised under the prudential regime of the home country. This has been acknowledged by one of the authors of the Government-commissioned report which eventually led to the *Insurance Companies (Ratings and Inspections) Act 1994* as follows:

> The report and recommendations were strongly influenced by the fact that the overwhelming majority of the New Zealand fire and general insurance market comprises subsidiaries or branches of overseas firms. This characteristic is also true of the banking market in New Zealand. The solvency of an insurer operating in New Zealand is much more influenced by the extent to which its parent company is willing to back its branch or subsidiary in New Zealand, and the quality and extent of its reinsurance arrangements than by the quantity of capital which it holds in New Zealand.[3]

Third, it is also questionable whether it is appropriate for Australia to revert to a form of prudential supervision that has previously been tried, and been proven a failure (see Chapter Two).

[3] I. McLean, ‘The Viability of Industry-Government Partnership in Risk Insurance’, in Britton, N.R., McDonald, J., and Oliver, J., (eds), *Insurance Liability and Loss Mitigation: Partners in Risk Resolution*, Griffith University, Queensland, 1995, p. 100.

Fourth, The New Zealand approach is predicated on customers ‘voting with their feet’ (ie. changing insurers) when rating agencies downgrade an insurer. This assumption is naive:

- Many life insurance policyholders - in endowment, ‘whole-of-life’, regular premium, and restricted superannuation - are effectively ‘locked into’ a contractual relationship for a long period, in some cases up to retirement age. Such policyholders may not be able to ‘vote with their feet’ if they are no longer insurable, or even if they can do so it will be at considerable cost.

- It is unlikely that policyholders generally would monitor ratings regularly - even where policies are renewed annually (eg. term life, general insurance). Because of inertia and search costs, many people tend to renew automatically without considering a company’s rating.

- In general insurance, premium rates and underwriting profits are subject to cyclical swings whereby premium rates are periodically depressed by the intense competition, forcing companies to make underwriting losses to maintain market share. Later, the whole market raises premiums in tandem to restore profitability. Rating of general insurance companies would also go through a similar cycle. We believe consumers would be confused by the volatility in company ratings.

- Solvency measures and accounting standards are not yet sufficiently developed and standardised to achieve the degree of transparency required, eg. accounting standards for derivatives trading are still under development and intermittent ratings do not show derivative exposures created overnight.[4]

- We understand that ratings agencies are not themselves comfortable being cast in a role of *de facto* supervisors, as they see their core business more narrowly. Given the enhanced role that ratings agencies would have under a fully deregulated insurance supervisory system, the question inevitably arises as to who regulates the ratings agencies.

- For troubled insurers, the existing procedures (intervention, orderly mergers or run-offs of existing claims - all to protect the interests of the policyholders) would not be available. In addition, once an insurer’s financial difficulty was publicised by a ratings agency, public reaction could well ensure that the company definitely failed. This would be particularly unfortunate if the rating was erroneous.

[4] The significance of this point has also been emphasised by McLean in commenting on the New Zealand experience. ‘Accounting for insurance is much more difficult than accounting for most other businesses, since liabilities of insurers in most lines of insurance are hard to measure. Measurement of liabilities involves the use of probabilities, which accountants have much difficulty in coming to terms with. ... Insurance regulators typically overcome these problems by obtaining material directly from insurers and making their own assessment of it. Insurance company accounts are usually made available for public inspection, but this is of little use to the average consumer.’ (Ibid., at p. 98).

- There would generally be lower market and consumer confidence in the soundness of the industry. This would reduce sales, leaving some households unprotected, reduce Australia's international stature as a financial centre, and lead to a rise in the cost of reinsurance.

Fifth, Australian insurers seeking to expand and diversify overseas may not be able to enter jurisdictions which require a certain type and level of home country supervision. New Zealand is the only OECD member country to adopt minimal supervision of the insurance industry. Adopting the New Zealand model would place Australia out of line with supervisory regimes in other OECD member countries.

Sixth, the insurance sector is too important to be subjected to an economic experiment, particularly when the New Zealand experiment with a disclosure based approach does not yet have a clear outcome. As Michael Taylor writes in relation to banking:

> In addition, there are serious obstacles to both the form and nature of enhanced public disclosures. The use of derivative instruments has added to the complexity and opacity of the risk profiles of financial firms in ways which conventional accounting techniques are not able to capture. Until the accounting profession is able to deliver a set of agreed, internationally applied valuation rules for the new financial instruments there will inevitable be a limit on the extent to which public disclosure can adequately reflect the extent of an institution's trading risks. Reliance on voluntary disclosures has so far produced only mixed results, especially since many firms regard information which would be of value to third parties as commercially sensitive - revealing to competitors the firm's appetite for risk or position-taking strategies.[5]

[5] 'Banking Supervision at a Crossroads', in *The Financial Regulator*, Vol 1, No 1, June 1996, p. 16.

Similarly Charles Goodhart writes:

> The Barings case is widely held to show the need for intensified supervision. On the contrary it may demonstrate that the complexity of the business and the difficulty of the exercise is such that supervisors should withdraw from the exposed position where they are expected successfully to second-guess and oversee the failings of inefficient and crooked management on the basis of strictly limited bits of private information. Has New Zealand shown the way forward?... Unfortunately the New Zealand experiment can never be conclusive, if only because all, but one, of the main banks are under consolidated supervision in other countries eg. Australia. Moreover, there have been some recent suggestions that thinking there is changing back towards the orthodoxy.[6]

Other international developments - G7 Finance Ministers' Communiques, Tripartite Group and Joint Forum

G7 Finance Ministers' Communiques

At the G7 Summit at Halifax in 1995, Ministers identified issues of critical concern for supervisors and market participants in the financial services sector. Member countries noted that globalisation of capital markets, integration of financial services and the exponential rate of technological and financial innovation, including the increased use of derivative products, require significant enhancement of risk management procedures, and expose financial institutions to potentially greater risks. To this end, member countries asked the Basle Committee and IOSCO to intensify international cooperative efforts in the supervision of financial institutions and markets to safeguard the financial system and to prevent the erosion of prudential standards. With the emergence of the IAIS as a third international body, it is intended that future reporting to the G7 Ministers be on a fully tripartite basis under the Joint Forum banner. The concern of the G7 Ministers about international financial stability was stated again at the Lyon Summit in June 1996.

Tripartite Group

An informal group of banking, securities and insurance supervisors, known as the Tripartite Group, had already started (in 1993) to address the issues raised later by the G7. In July 1995 a report entitled *The Supervision of Financial Conglomerates* was prepared by this inter-disciplinary group chaired by Mr Tom de Swaan, of the Dutch Central Bank. In this report, the Tripartite Group identified the kinds of problems financial conglomerates pose for supervisors, and proposed ways in which these might be overcome.

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6 Charles A.E. Goodhart, *Some Regulatory Concerns*, LSE Financial Markets Group, ESRC Research Centre, Special Paper No. 79, December 1995, p. 26.

Joint Forum

The Tripartite report has been the basis for further collaborative efforts, and in particular was the catalyst for the Basle Committee, IOSCO, and the IAIS subsequently establishing a formal Joint Forum - comprising nine securities, nine insurance and nine banking regulators - (also chaired by Mr Tom de Swaan) to develop multi-disciplinary principles for the supervision of financial conglomerates. This group, which includes Australian representation, is drawing up best practice principles for the supervision of international financial conglomerates in areas such as: information exchange; selection and role of lead supervisor; 'fit and proper' tests; appropriate group structures; group capital adequacy; intra-group exposures and group large exposures; and coordination of crisis management. The principles would not be binding but - like the Basle capital adequacy regime for banks - could be expected to spread as a result of peer and market pressure.

The Australian representatives present a joint Council of Financial Supervisors position to the proceedings, having regard to the desirability of consistency between CFS and Joint Forum principles for conglomerate supervision.

3.6 OPTION 1 - LEAD SUPERVISOR MODEL

In 1993, the CFS indicated that, on balance, the introduction of a formal solo plus approach to prudential supervision **at that time** was neither necessary nor desirable, and decided instead to adopt less formal guidelines for supervision of domestic financial conglomerates.

Since then, concern has grown that the solo system on its own is not enough and an extra group level perspective is desirable, while recognising that ultimately international coordination depends on mutual trust, and that within a national system, the extra layer of group supervision would not give the lead regulators powers which cut across the solo ones.

Since the CFS adopted its position in 1993, supervision of financial conglomerates has been increasingly discussed in an international framework. International consistency in financial supervision is particularly useful for countries which have liberalised their financial systems, and has at least three significant advantages:

- first, it simplifies the supervision of international institutions by harmonising home country supervision of the parent company with host country supervision of the foreign subsidiaries - this also makes it easier for local institutions to expand abroad;

- second, it makes the burden of compliance by the supervised institution easier and cheaper by providing certainty and consistency to the regulatory rules; and

- third, it reduces the scope for regulatory arbitrage.

Relevance to Australia of the solo plus approach for the supervision of conglomerates

The CFS has looked at options for better coordinating domestic prudential supervision in a manner which *inter alia* is consistent with the Joint Forum's recommendations for improving the supervision of international conglomerates. In particular, the CFS has examined the possibility of an additional layer of supervision at the group or holding company level to supplement the traditional solo supervision of separate entities. This solo plus model, if implemented, would involve the appointment of a CFS member agency (normally the RBA or ISC) to act as 'convenor' for a financial holding company group. The role of 'convenor' is in addition to the existing responsibilities of individual supervisors for supervised entities. In broad terms, a 'convenor' would have responsibility for:

- overseeing and regulating the conglomerate's holding company;
- disseminating information collected from the holding company to other supervisors; and
- coordinating the supervisory response to any problems involving (or potentially involving) more than one entity in the conglomerate.

A 'convenor' could be appointed in respect of specific conglomerates, and might have, for example, broad powers over the conglomerate's holding company in areas such as:

- the board structure of the holding company;
- limitations on activities - to address concerns about the nature and/or extent of activities undertaken by the holding company through unsupervised entities in the group, and to ensure that the holding company is essentially non-operating;
- access to information - to provide an understanding of the management structure and lines of responsibility of the group, and permit an assessment of the risks being undertaken by the group, and the ability to disseminate the information to other supervisors;
- directions regarding compliance of supervised entities with prudential requirements - to ensure the holding company takes necessary action to ensure compliance of supervised entities with prudential requirements;
- application of sanctions for non-compliance - including provision to require the divestment of subsidiaries.

Selecting a CFS member agency to act as 'convenor' for a financial holding company group would, in practice, usually be an obvious choice. The CFS view is that, for bancassurance groups, the RBA would be the 'convenor' where the bank is the dominant business within the group, and where the banking and insurance arms are broadly equivalent in size. In instances where a life office is the dominant business within a group and the bank is only small, the ISC would be the ‘convenor’.

It is proposed that the solo plus model, if implemented, could also be used for financial services conglomerates that do not have holding company structures.

Arguments in support of the solo plus model

First and most important, specialised solo supervision would be explicitly retained as the cornerstone/centrepiece of prudential supervision, given the differing commercial practices and balance sheet risks of banking, insurance and funds management, which are distinguished by their history, culture, and commercial expertise (core competencies) irrespective of tax and regulatory treatment.

Second, the solo plus approach balances the need for a holistic view of supervision - including a coherent view of the overall health of each conglomerate and the coordination of any remedial action that may be required - with the need for regulators to have specialised expertise and techniques, including a close understanding and knowledge of their particular industries.

Third, it is an approach that is consistent with international regulatory trends. Such consistency is highly desirable in an increasingly global economy where financial conglomerates operate across national boundaries. For example, entry into overseas markets may depend on Australia’s home country supervision of the parent being in line with international standards. The fact that Australian banks are required to meet the Basle capital adequacy standard makes it easier for them to operate in other countries.

Fourth, the solo plus approach makes efficient use of the existing resources of the prudential supervisors. By enhancing the cooperation of existing prudential supervisors, maximum use is made of the specialised skills and knowledge obtained in the course of the supervisors’ core activities. Also, there is minimal disruption to the core activities conducted by prudential supervisors. The proposal does not involve large legislative changes, nor does it involve potentially significant administrative changes to existing prudential supervisors. It would be a natural, evolutionary step for the Council of Financial Supervisors.

Arguments against the solo plus supervisor model

First, the solo plus approach preserves the status quo, where a conglomerate continues to be supervised by a number of organisations. It also arguably addresses only the symptoms of the problem (the need for information exchange and coordinated intervention) and ignores the causes (institutional fragmentation).

Second, there is the possibility that the solo plus approach may result in other supervisors relying unduly on the oversight and judgement of the ‘convenor’.

Third, there is a risk that a under the solo plus approach, the ‘convenor’ would come to be seen as taking the same responsibility for the prudent conduct of a financial group as a whole, including its unsupervised parts, as it did for the particular part for which it had a solo statutory responsibility. This perception could cause lead to false market perceptions about the role and function of the solo plus approach.

What a streamlined solo plus model might look like

Based on the premise that there is a natural and fundamental two-way split between financial intermediaries and insurers/fund managers, it is roughly logical that the solo plus model of prudential supervision could have the following three key elements:

- the RBA would be kept intact, because of the synergies between central banking and bank supervision, and because of its overall responsibility for systemic stability. If the States agreed, the RBA would also supervise the non-bank financial intermediaries (possibly less intensively), given the efficiencies to be gained from removing the Commonwealth/State overlap in the regulation of operationally similar institutions;

- the ISC would prudentially supervise insurance and managed funds including superannuation (and standard trusts if a wider risk spectrum is foregone) to account for life office superannuation, to minimise inconsistency in the regulation of market linked savings products, and to preserve its specialised expertise in insurance supervision;

- the RBA and ISC would concentrate on the core functions of prudential supervision under an upgraded CFS (and have no consumer protection role). In regard to bancassurance groups, the RBA would be lead supervisor except where the life office is dominant in a group and the bank is small (in which case the ISC would be lead supervisor), and group supervisory arrangements would continue to evolve in line with international developments.

While this solo plus model is not conceptually perfect, it could be made to work well in practice. The choice of regulatory structure ultimately boils down to a question of practicalities, and weighing up the advantages and disadvantages of the options. It should also be kept in mind that the ultimate objective is not to achieve a particular configuration in the regulatory framework *per se*, but rather to ensure that coordination, information exchange and harmonisation are effective, in the interests of stability, efficiency and investor protection.

Under a streamlined solo plus model, there may be scope for enforcement of retirement income standards[7] to be undertaken by an agency other than the ISC (eg. Treasury or the ATO). Conceptually, the enforcement of retirement income standards could be

[7] Superannuation funds that elect to become regulated superannuation funds must, in order to be taxed at a concessional rate, conform to the retirement income standards. These include, *inter alia*, rules relating to preservation, contributions, minimum benefits, and that the purpose of the fund is to provide retirement income for fund members.

transferred to another agency (it was previously conducted by the ATO). The practical issue, however, is where the efficiencies and synergies are the greatest. As the ISC has in place an audit programme for superannuation funds and receives annual returns from superannuation funds, it is likely that the efficiencies and synergies are greatest when the enforcement of retirement income standards is undertaken in conjunction with these prudential supervision activities.

Under a streamlined solo plus model, it can be argued that the issue of group level supervision is less imperative, because statutory firewalls can be used to quarantine troubled entities, and so avoid damaging other entities within a financial group. However, recent experience (eg. BCCI and Barings) has shown that no legal or functional safeguards can effectively insulate the individual entities in a financial conglomerate at times of crisis.

Any regulatory model will have consequences for the staffing of supervisory agencies. A practical issue facing all supervisors is the recruitment of highly skilled staff, particularly for on-site inspection work. In practice, to recruit highly skilled staff would require supervisors to offer salaries at rates above existing levels in the APS. The location of staff, presently in different cities, is also an issue. Under the solo plus approach, there may be a case for moving Canberra based staff to Sydney to enable greater market contact and regulatory cooperation, and for making the ISC a statutory authority outside the *Public Service Act 1922* and its employment terms and conditions.

3.7 OPTION 2 - MEGA-SUPERVISOR MODEL

One of the reform options that has been canvassed for the arrangement of prudential supervision is the merging of the existing supervisors into a single mega-supervisor.

The implementation of a mega-supervisor could be by way of a merger between the RBA, ISC and AFIC (including the State authorities), and the transfer of certain functions from the ASC. Such a merger would place prudential supervision of banks, NBFIs, life offices, general insurers, superannuation funds and (possibly) unit trusts under the one roof. The mega-supervisor would also have responsibility for central banking, including monetary policy (it would be inefficient to split bank supervision and monetary policy).

The approach is conditional on obtaining the agreement of State governments to cede control over building societies and credit unions to the Commonwealth.

Such a mega-supervisor would have responsibility for all prudential supervision in the financial system, for the purpose of systemic stability and to remedy market flaws more generally.

Arguments supporting a mega-supervisor model

First, the mega-supervisor approach to prudential supervision could assist in avoiding competitive inequalities and minimising gaps, overlaps, and inconsistencies in supervisory arrangements. This is on the assumption that institutional supervisors operating under one roof would liaise and coordinate their activities more closely than at present or, to put it more bluntly, that the Board and CEO could force a faster rate and more radical degree of harmonisation as a result of their mandate and authority.

Second, the mega-supervisor approach might better achieve a 'holistic' approach to supervision by, for example, placing all prudential functions involving the supervision of a financial conglomerate under one roof, thereby enabling supervisors to obtain a clear picture of the health or otherwise of the conglomerate at the group level.

Third, the mega-supervisor approach might be more cost-efficient. For example, savings might be achieved by sharing support services in both specialist and corporate services areas (eg. legal, actuarial, economic, library, computer systems, premises etc). In other words, there could be potential economies of scale and scope in a combined operation. From the industry's perspective, a financial conglomerate would only have to deal with and report to one agency.

Fourth, the mega-supervisor approach would lead to greater public transparency in supervisory arrangements - because the supervisor would be a single organisation with a high profile - and increase the credibility of the supervisory process. Certainly, the low profile and visibility of the CFS have been criticised.

Fifth, a mega-supervisor could provide greater career opportunities for supervisory personnel. A large well-managed organisation dedicated to prudential supervision could develop a strong professional ethos which could serve to attract and retain high calibre staff. Moreover, if the organisation was outside the framework of the *Public Service Act 1922* (as is the case with the RBA), then higher salaries could be offered, thereby helping to recruit expertise from the private sector. Alternatively, to the extent that the total pool of supervisory expertise is in short supply, better use might be made of it.

Arguments against a mega-supervisor

First, a mega-supervisor approach which retained specialist skills for separate industries would have limited scope for economies of scale with supervision, in practice, effectively being carried out in discrete units, each with a high degree of autonomy. This would internalise coordination and harmonisation tensions, but not automatically eliminate them. If this were to be the case, there would be little point in merging the existing distinct and separate prudential supervisors. A practical point in this regard is that the coordination and harmonisation process should be easier now that all the Commonwealth supervisors are in the Treasury portfolio.

Second, the mega-supervisor would have to deal with a clash of quite distinct cultures, skill sets, and supervisory practices. There would be some likelihood that resolving this internal conflict could result in a compromise approach inconsistent with the basic principles of specialised supervision. Effectively managing the mega-supervisor, developing a single corporate culture and contending with inevitable rivalries between the discrete supervisory groups, would present a monumental leadership challenge for the new CEO.

Third, the mega-supervisor approach to prudential supervision could lead to a moral hazard problem in the form of a perception by the community that the risk spectrum among financial institutions and markets has completely disappeared or become very blurred. In particular, the distinction between capital guaranteed deposits and market linked insurance and superannuation could be lost, putting immense pressure on the Government to capital guarantee the latter.

Fourth, the mega-supervisor approach could result in the formation of a large bureaucratic, cumbersome and unwieldy organisation with an undue degree of power and insufficient accountability. In the USA, Dr Greenspan has been quoted as saying that the potential for regulatory competition arbitrage can have the salutary effect of keeping regulators on their toes and subjecting them to some market discipline.

Fifth, the mega-supervisor would come under - or could itself generate - pressure to standardise the basic supervisory tools and techniques (eg. solvency measures, statutory returns, on-site visits) irrespective of unique industry characteristics which make a uniform approach overly blunt and rigid and on which there is no agreement. A secondary consequence of this would be to relegate the smaller industries to ‘poor cousin’ status and to risk losing the institutional memory of their old regulators.

Sixth, there is no strong international consensus in support of a mega-supervisor model and where such arrangements do exist, coordination issues still tend to arise between the various supervisory divisions. For example, the experience in South Africa, Canada, Sweden, Norway and Denmark to our knowledge does not provide any clear evidence that mega-supervision yields significant benefits.

Seventh, in terms of the empirical experience, it has been pointed out that the cases of instability which have troubled the Australian financial system have not arisen from a lack of coordination among supervisors of a financial conglomerate, but rather from poor management decisions by financial entities.

Eighth, and last but not least, the transition costs of reorganising supervisory functions should not be underestimated. For example, the formation of a mega-supervisor would require major changes to legislation and administration. Given the considerable time taken for the passage of legislation, there may be serious delays and uncertainty in the implementation process. Formation of a mega-supervisor would also involve considerable costs in the re-location of existing staff presently located in different cities (however, it is conceded that the location of agencies is an issue in any event - eg. there may be a case for moving Canberra based staff to Sydney).

3.8 CONCLUSIONS

1. Blurring/convergence

The extent of product blurring or balance sheet convergence within entities is for practical policy-making purposes not of major significance. While some life office short-term savings products have some functional similarity with term deposits (if capital guaranteed) and unit trusts (if market linked), there remain substantive differences in terms of tax, cost and distribution which make them imperfect substitutes in the eyes of the consumer. The majority of blurring/convergence is essentially at the financial conglomerate/group level. This occurrence, although recent, has not been limited in Australia by regulation, as has been the case in North America and Japan.

The emergence of conglomerates has been a market matter, not a regulatory issue. However, it is true that financial conglomerates do pose some additional challenges for financial supervisors. These challenges - which go matters such as of group capital adequacy, appropriate group structures, and coordination of crisis management - create a need for an additional layer of supervision at the group level to supplement the traditional solo supervision at the entity level. This approach can be called the solo plus model of prudential supervision. The ISC would favour the continuing evolution of the current ‘solo plus’ approach, with an upgraded CFS performing a coordinating role.

2. ISC life insurance and superannuation

The large amount of life office superannuation (over 74 per cent of the assets of life offices are superannuation, and around 38 per cent of superannuation is held in statutory funds) has resulted in the life insurance and public offer superannuation areas of the ISC coordinating their supervision under an internal lead regulator approach (ie. the ISC division which oversees the predominant business of a conglomerate establishes, maintains and regularly provides to the other division an appraisal of the overall organisation). Any splitting in supervision of insurance from superannuation would therefore be inefficient, since it would create a new inter-agency overlap.

3. ASC unit trusts/collective investments and ISC public offer superannuation

The SIS regime and the ASC regime have adopted somewhat different approaches to the prudential supervision of what are essentially functionally similar savings products (ie. managed funds). The Collective Investment Report, if adopted, would narrow but not eliminate these differences.

The ISC is ambivalent as to whether standard unit trusts should be supervised along with retail superannuation, or kept separate. The prior question is whether the community and Government prefer to have standard unit trusts prudentially supervised to enhance their security, on the grounds that they are seen as a relatively safe haven for small savings. If so, the ISC would see them as coming under the same prudential (but not retirement income) regime as retail superannuation. If not, the ISC would see them as remaining under ASC compliance (but not prudential) supervision, in the interests of maintaining a wider risk spectrum.

4. RBA , AFIC and State and ASC supervision of banks and NBFIs

The current separate supervision of financial intermediaries by the Commonwealth (RBA and ASC) and States (AFIC) is confusing and inefficient. While there is a natural distinction between financial intermediaries and insurers/fund managers, there are few balance sheet peculiarities that could clearly separate banks from NBFIs.

Building societies are, in a sense, apprentice banks and many building societies have acknowledged this in the last decade by obtaining banking licenses. Merchant banks are similar to authorised banks except for a bias in favour of investment (v. commercial) banking. Credit unions and finance companies borrow and lend. In the absence of any rationale for the separate supervision of deposit-taking institutions, the Commonwealth should negotiate with the States with a view to AFIC institutions being prudentially supervised by the RBA.

5. International experience

The experience of other countries in financial supervision demonstrates that while there is uniform agreement that conglomerates pose particular problems for prudential supervisors, there are different domestic approaches to address these concerns. There is no ideal model which springs to attention.

Where mega-regulators operate, they have been formed by merging industry specific regulators and putting them under one roof where, by and large, they continue their pre-merger functions and operations as separate divisions. In the United Kingdom, where the solo plus model is in place, debate continues over the possibility of further reform and the introduction of a mega-regulator. Countries that don't have a mega-regulator tend to have close cooperation between prudential supervisors.

To date, only one country (New Zealand) has experimented with a 'hands off', highly market based approach to prudential supervision of insurance, and this case is atypical due to foreign ownership of the bulk of the financial system. All other major industrialised countries continue to acknowledge the balance sheet diversity and the historical, cultural, and commercial distinctions between banking, insurance and collective investments by supervising the institutions that operate in these industries on a specialised solo basis.

In a recent paper, Professor David Llewellyn argued that, in many ways institutional structure is the comparatively easy part of the regulatory process[8]. It is not difficult to devise a whole range of viable institutional structures and, to some, this may have the attraction of appearing actively reformist, even if the real benefits lack substance.

[8] D. T. Llewellyn, *The Rationale and Institutional Structure of Financial Regulation*, Commissioned Report for the Insurance and Superannuation Commission, August 1996.

However, institutional structure is of second order importance. *Institutional structure does not in itself guarantee what really matters: the effectiveness of regulation in achieving its objectives in an efficient and cost-effective manner.* Without a firm analytical foundation based on the real objectives of regulatory reform (eg. enhanced coordination, information exchange and harmonisation) any new institutional structure is likely to be *ad hoc* and arbitrary and may compromise the attainment of the objectives sought by regulation. In summary, Llewellyn emphasises these major qualifications regarding institutional structure:

- Models of institutional structure are, in practice, of second order importance compared with more fundamental issues such as the objectives of regulation (eg. systemic stability, prudential security, consumer protection) and the general approaches of regulatory agencies.

- Concentrating on questions of institutional structure has the danger of assuming that changes to institutions automatically solve problems. There is doubt about this and a danger of mistaking form for substance. There is a danger that concentrating on institutional structure diverts attention from the issues that really matter.[9]

Institutional structure has implications for the costs of regulation, raises questions about the accountability of regulators, and has an impact on the effectiveness of regulation because of the culture that develops within particular institutions and the approaches they adopt[10]. There is also the question of the role played by practitioners in the regulatory process. This is important in technical aspects of regulation, but also in inculcating a sense of ownership by the regulated industry of the objectives and process of regulation. It is likely that regulation will be, not only more cost effective, but also more acceptable to regulated firms if practitioners are seen to have a significant input into regulatory arrangements. The skill lies in incorporating a decisive role for the practitioner while at the same time guarding against the potential danger of special pleading and 'regulatory capture'.

[9] *Ibid*., pp. 50-1.
[10] *Ibid*., p. 50.