INTERNATIONAL EXPERIENCE AND DEVELOPMENTS

The United Kingdom's experience

The system of prudential supervision and financial services regulation in the United Kingdom - covering banking, building societies, securities, investment management and insurance - has evolved over time with a series of policy responses to specific events. As a consequence, the present regulatory system is premised on a compartmentalisation of function and of risk, with the result that a range of regulatory bodies are able to stake a claim to an interest in systemically important firms. The UK financial system has four main supervisory bodies:

- the Bank of England, which supervises banks and conducts central banking, including monetary policy;

- the Securities and Investment Board which - through a number of self-regulatory bodies - regulates securities and investments. These bodies include the Securities and Futures Authority (covering the London Stock Exchange and the UK Futures & Options Exchange), the Investment Management Regulatory Organisation (the prudential supervisor of unit trusts), and the Personal Investment Authority (the consumer protection agency responsible for consumer aspects of life insurance, unit trusts, tied agents and independent financial advisers).

- the Department of Trade and Industry, which prudentially supervises insurance companies; and

- the Building Societies Commission, which supervises building societies. There is a separate regulator for friendly societies and credit unions.

At present, the United Kingdom has adopted the solo-plus concept of prudential supervision in response to the growth of financial conglomerates. Under this arrangement, one of the primary supervisors is designated as a 'convenor' for each financial conglomerate and has overall responsibility, but supervision of the conglomerate's individual parts remains with the solo supervisors. There are no formal criteria for selecting the 'convenor', but in practice agreement has been reached without difficulty; normally the 'convenor' is the regulator of the most important entity within the group, which may or may not be the holding company at the head of the group (the Bank of England is 'convenor' when a bank is part of a conglomerate). The existence of a 'convenor' does not affect the legal responsibilities of the individual supervisory authorities responsible for the different parts of the group.

There have been calls within the United Kingdom to replace the solo-plus approach to supervision with a 'twin peaks' regulatory structure. Proponents of this approach argue that the finance industry's regulatory system should be redesigned around the twin peaks of systemic protection (by institutional supervision) and consumer protection (by conduct regulation)[1]. The first peak, a Financial Stability Commission would ensure that there are adequate prudential measures to uphold the soundness of the system, the capital adequacy of banks, and the control of risk. The second peak, a Consumer Protection Commission, would enforce the conduct of business regulation to ensure that consumers receive fair and honest service. (A third peak, a Market Surveillance Agency, has also been proposed. Such an agency would be charged with oversight of all London's financial markets, particularly from the point of view of detecting and prosecuting various forms of market abuse. This latter body would be a UK equivalent of the US Securities and Exchange Commission and the ASC.)

The twin aims of financial supervision would be pursued by two separate regulatory bodies, both of which would be answerable to the Treasury. The proposed structure, it is claimed, would eliminate regulatory gaps and overlaps; would create regulatory bodies with clear and precise goals; would establish mechanisms for resolving conflicts between the various objectives of financial services regulation; and would encourage a regulatory process which is open, transparent, and publicly accountable.

The South African model

Two authorities are responsible for prudential supervision in South Africa, namely the South African Reserve Bank (SARB), which supervises banks, and the Financial Services Board (FSB), which regulates all other financial institutions, services and markets.

The SARB and FSB, in turn are advised by the Policy Board for Financial Services and Regulation (Policy Board). The Policy Board was established to serve as a mechanism for coordinating regulatory policy in respect of the entire financial sector, and reports to the South African Minister for Finance.

The Policy Board comprises representatives from both the regulatory authorities and the regulated financial institutions and markets. To promote practitioner-based regulation, the majority of members are from the private sector.

Origin and Responsibilities of the Policy Board

The SARB and the FSB administer separate statutes developed independently, in different time periods, which were intended to serve specific regulatory requirements of different financial sub-sectors. This resulted in South Africa's financial regulation lacking total consistency in respect of philosophy, objectives, principles, standards, and practical impact. In addition, these laws did not allow for competitive neutrality between different classes of financial institutions and functions.

These factors, combined with the emergence of conglomerates and the need for greater regulatory cooperation, led to calls for a 'holistic' approach to financial supervision, first by the Jacobs Committee in 1992, which proposed that a 'Financial Regulation Policy Board' be established to coordinate the SARB and FSB, and later by the

[1] Taylor, M (1995), *Twin Peaks: A Regulatory Structure for the New Century*, CFSI, Number 20, December 1995.

Melamet Committee in 1993, which recommended the establishment of a single regulatory authority, via the merger of the SARB and the FSB. In the event, the recommendation of the Jacobs Committee prevailed, and the Policy Board was established and started functioning on 1 July 1993 and, with effect from 15 November 1993, was transformed into a statutory body.

The Policy Board has no executive powers. It has responsibility for formulating and coordinating policy relating to the further development of the financial services sector, as well as financial regulation. The Policy Board acts as an adviser to the Minister for Finance on developments in the financial services sector, changes in the regulatory structure, amendments to existing legislation, the introduction of new legislation, and improvements in financial supervision.

Responsibility for administering legislation rests with the SARB and the FSB.

The Canadian model

Financial sector prudential supervision in Canada is conducted by the Office of the Superintendent of Financial Institutions (OSFI). This mega-supervisor was formed in 1987 by the merger of the former regulators of banks and insurance companies, and reports directly to the Minister of Finance. However, securities and insurance related consumer protection are regulated separately by way of Provincial supervision.

OSFI was created in the late 1980's out of a perception that the regulatory system needed to be rebuilt following some bank failures. Its creation also reflected a more general view that financial developments were moving ahead of existing regulatory arrangements.

OSFI has responsibility for the administration of financial institution laws, the execution of supervisory actions and the assessment of the solvency of supervised institutions. It supervises banks, non-bank financial institutions, credit unions, investment companies, pension funds, trusts, and insurance companies. OSFI also has close contact with the Canadian Deposit Insurance Corporation, which acts as a deposit insurer, and the Bank of Canada, which is the central bank and lender of last resort. Each agency has interdependent, but not overlapping roles. A committee comprising these agency heads and the Deputy Minister of Finance helps to facilitate information exchange and consultation on supervisory matters that have implications for solvency, last-resort lending and the risk of deposit insurance payout.

Securities companies/markets and credit unions are supervised by federal and provincial authorities. Insurance companies and trust and loan companies can be authorised at both the federal and provincial level; where this happens, responsibilities are shared between OSFI and the provincial authorities.

While OSFI has generally been regarded as a success, there have been some problems in bringing together the different streams of supervision together under a single body. 'Cultures' differed between bank and insurance supervisors, just as they did between financial institutions themselves. This made the task of supervision more complex.

Operationally, supervision within OSFI is split into divisions responsible for deposit taking institutions, insurance companies, and pension funds.

Under current legislation, financial institutions must establish subsidiaries if they propose to engage in activities such as insurance, securities dealing, and specialised finance (eg. merchant banking). The requirement reflects the government's policy of maintaining a separation between the core activities of different types of financial institutions as well as risk containment.

The Swedish model

The supervision of financial entities in Sweden is undertaken by one institution, the Swedish Financial Supervisory Authority, which was formed on 1 July 1991 by a merger of the Bank Inspectorate and the Insurance Inspectorate. The Swedish Financial Supervisory Authority is responsible to the Government which is, in turn, accountable to the Parliament. Non-supervisory functions related to the banking industry are carried out by a separate institution, the Riksbank, which is directly responsible to the Parliament.

As in Canada, the Swedish Financial Supervisory Authority was created out of a perception that the regulatory system needed to be rebuilt following some bank failures. Its creation also reflected a more general view that financial developments were moving ahead of existing regulatory arrangements.

The role of the Swedish Financial Supervisory Authority is to supervise the activities of financial markets. More than 2 500 institutions are subject to the supervision of the Authority within three areas: the insurance market, the credit market, and the securities market.

The Authority's organisational structure reflects its recognition of three distinct types of business. Its three supervisory departments (insurance market department, credit market department, and securities market department) supervise the entities operating in those market segments. This approach enables the Authority, 'under one roof', to supervise all finance market entities operating across the risk spectrum from the more secure banking end to the less secure funds management end. The various departments supervise the entities that offer a particular product in that segment of the market. The focus of supervision has, however, shifted from being institution-oriented to being function-oriented. Supervision is conducted by inspection teams, consisting of individuals that specialise in the types of risks that arise in the activities conducted by each type of institution. Inspection team members have to be able to discuss risk evaluation issues and how risk control systems should be constructed with specialists at the companies concerned. This division of responsibility among team members enables the Swedish Financial Supervisory Authority to assess the adequacy of an institution's risk control system.[2]

In the insurance market, the Swedish Financial Supervisory Authority supervises domestic and foreign life insurers and non-life insurers, friendly societies, and insurance

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[2] The Swedish Financial Supervisory Authority, *Annual Report 1994/95*, p. 7.

brokers (individuals and companies). In the credit market, the Authority supervises banks, branches of foreign banks, savings banks, authorised credit market companies, credit companies, and finance companies. In the securities market, the authority supervises exchanges, domestic and foreign securities companies, domestic and foreign fund managers, and mutual funds. It is possible, therefore, for a conglomerate that has an insurance company, bank, and mutual fund to be separately supervised by the three departments of the Authority. Although the Authority was formed by the merger of other institutions, it has retained 'under one roof' the distinction between insurance, the credit market, and the securities market that previously existed 'under three roofs'. In effect, this has not eliminated the prudential boundaries, but has internalised them. The ISC is not aware from its Swedish contacts of any evidence indicating significant synergies or efficiency gains created by the formation of a mega-supervisor.

The Swedish Financial Supervisory Authority also contains a Consumer Rights Unit that handles consumer rights issues in the securities, insurance and credit markets.

The activities of the Swedish Financial Supervisory Authority are financed out of budget appropriations, and costs are recovered through levies charged on institutions which are subject to its supervision.

The Danish model

The Danish Supervisory Authority of Financial Affairs was formed on 1 January 1988 with the merger of the Government Bank Inspectorate (the supervisor of commercial and savings banks) and the Insurance Supervisory Authority. The Authority, which supervises over 700 financial entities, is responsible to the Danish Government and the Minister of Business and Industry.

The Danish government saw two main advantages in forming a mega-regulator. First, the erosion of sectoral barriers in the financial sector meant that merging supervisors would create an administrative unit across the financial system, reflecting the activities of financial conglomerates. Second, from an organisational point of view, the Danish government saw merit in gathering resources and expertise in one agency, eg. for use in international negotiations, such as the European Union.

In recognition of the differences between banking, insurance and securities, the Authority participates in the drawing up of different sets of rules for the various parts of the financial sector. The Authority administers twenty-five Acts in its supervision of the principal areas of the financial sector.

The Danish system is an example of a mega-supervisor which uses a variety of tools and techniques. Specialist offices within the Financial Supervisory Authority use specialised supervision to account for the different types of balance sheets and risk (ie. different offices supervise the different entities that take deposits, and sell risk insurance). The sixteen offices within the mega-supervisor include a Banks and Savings Bank Office, an Insurance and Investment Funds Office, an Office of Credit Risks, an Office of Market Risks, an Office for Financial Conglomerates, and a Mortgage Credit Office.

The Authority monitors compliance with solvency requirements, develops and adjusts supervisory methods, represents Denmark internationally, and handles negotiations in the European Union and other international forums. It is not part of the Danish central bank, however, there is close collaboration with the central bank in certain matters, eg. in connection with bank crises.

Supervision costs are financed by entities in the financial system. As is the case with the ISC in Australia, the Supervisory Authority's budget is included in the national budget. The Authority's budget is then reimbursed via annual payments from supervised entities. Supervised entities are said to take a positive view of supervision, since national supervision demonstrates to the business sector in Denmark and abroad that the company meets the national requirements for solvency and financial soundness.

The New Zealand model - no prudential supervision of insurance

Industry overview

New Zealand insurance is a small part of the world insurance market, yet is served by a large number of companies that are predominantly foreign owned.

In terms of premium income in 1992, the total New Zealand insurance market amounted to $US 2 565 million, and was ranked 30th in the world, or 0.17 percent of the world market.

In 1991, the New Zealand insurance market was served by 107 companies. Of these 96 (or 89 per cent) are foreign companies, and 11 (or 10 per cent) are local companies. The insurance industry in New Zealand has developed essentially on the basis of branches of primarily British operations, later supplemented by branches of Australian operations.

A full range of insurance products are available, and distribution (as in Australia) is via agents, brokers and some direct selling.

Regulatory environment

The insurance industry is regulated by the New Zealand Department of Justice under the following legislation:

- the *Insurance Companies Deposits Act 1953;* and
- the *Life Insurance Act 1908*.

The notable feature of the New Zealand system is the absence of day to day control by a regulator, such as an Insurance Commissioner. Insurers are required under the legislation only to lodge annual financial returns.

It should be noted that there are no requirements for:

- a minimum paid up capital; and
- approval of reinsurance arrangements.

For foreign companies seeking to conduct business in New Zealand, authorisation requirements are minimal. They involve:

- obtaining approval from the Overseas Investment Commission; and
- lodging appropriate deposits under the *Insurance Companies Deposits Act 1953*.

The *Insurance Companies Deposits Act 1953* requires companies to lodge audited annual accounts with the Department of Justice in the form set out in the Act. The *Life Insurance Act 1908* requires life insurance companies to file various statements and accounts with the Department of Justice. Life insurance companies must also file a quarterly return with the Reserve Bank declaring their holding in Government and local body securities.

All companies in existence prior to 1 July 1994 including any branches of overseas companies are subject to companies legislation. Under these Acts, companies are required to file various returns with the Registrar of Companies. The only significant requirement in relation to foreign companies is the requirement for an annual audit of New Zealand branches. Branches of overseas companies are required to file parent company financial statements with the branch annual financial statements.

With the exception of the self imposed solvency tests administered by the Insurance Council of New Zealand, the solvency of insurers in New Zealand is principally regulated by the requirement to place deposits with the public trustee, which may vary depending on the type or class of business underwritten. A new requirement to disclose insurance company credit ratings has been introduced in the *Insurance Companies (Ratings and Inspections) Act 1994*. However, insurers are not required to meet a minimum rating (and if they were, we have been informally advised that the ratings agencies would find it commercially difficult to downgrade an insurer below the minimum).

Economic features of the New Zealand model

New Zealand's approach to prudential supervision is highly market oriented. First, there are no barriers to entry, since insurance companies operating in New Zealand do not have to meet any capital requirements.

Second, there are low compliance costs. Apart from lodging a deposit with the Government, insurers have no on-going statutory solvency requirements. Under the self-imposed industry-based solvency test, companies do not have to undertake the level of solvency reporting that usually accompanies statutory solvency requirements.

Third, the New Zealand approach to supervision introduces a degree of competitive neutrality into the finance system by making statutory requirements for insurers comparable to other players in the financial sector.

These factors combine to make the New Zealand market renowned for low barriers to entry, administrative simplicity and transparency which, in turn, are said to improve the competitive focus of New Zealand insurers.