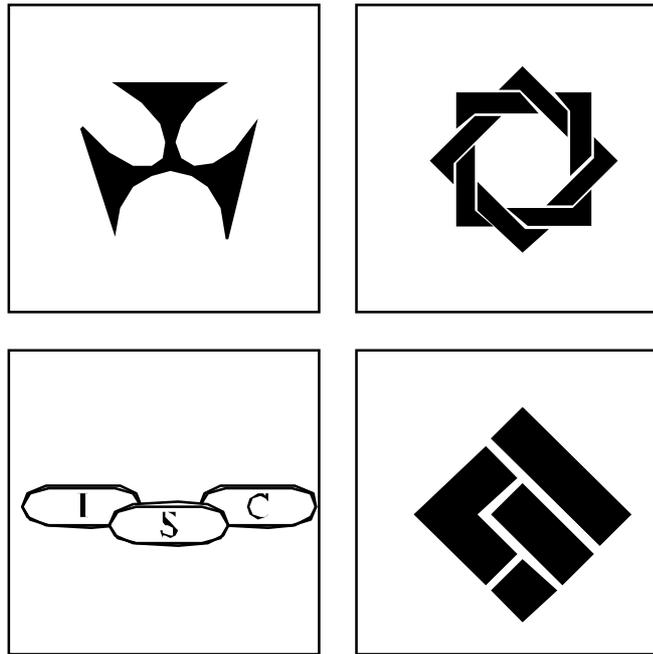


Council of Financial Supervisors



Submission to the Financial System Inquiry

September 1996

Executive Summary

The Council of Financial Supervisors was established in 1992 to improve co-ordination and communication among the main regulators of the financial system. Council members - the RBA, ISC, ASC and AFIC - believe it has made a very effective start in this. This Submission outlines the Council's work over the past four years and its current work program.

While the Council has been a relatively low-profile body - attributable in part to the absence of major financial problems in recent years - it has undertaken a good deal of preparatory work and contingency planning. In the future, an important role is seen for the Council in two main areas:

- co-ordinating prudential supervision of financial conglomerates; and
- harmonising, where appropriate, regulatory requirements in different parts of the financial system.

In terms of its co-ordination role, the Council can be seen as a *de facto* mega-regulator. It represents a flexible, low-cost approach to regulatory co-ordination without the risks of a single agency - in particular, it avoids conveying any impression that the same degree of official protection applies to all financial institutions.

There could be some merit in formalising the Council's co-ordinating role in legislation - as long as this did not restrict its present flexibility or its capacity to adapt as the financial system evolves - and in establishing regular consultations with relevant industry bodies and other agencies which have interests in the financial system.

This Submission comprises three parts. The first provides background on the Council, noting its aims and detailing its administrative arrangements. The second part identifies the main issues being addressed by the Council. Part three comments on the case for ongoing co-ordination based on current Council arrangements and raises some matters for consideration by the Inquiry.

I - Origins and Aims of the Council

This section provides background on the establishment of the Council and its aims, together with details of Council membership and administrative arrangements.

Background

The Council is a non-statutory body which was established in 1992 following a recommendation by the 1991 Parliamentary Inquiry into Banking and Deregulation (the 'Martin Committee'):

"14.43 The Committee recommends that:

38. a Council of Financial Supervisors be established to facilitate closer co-ordination between the supervisors of the Australian financial system. The Council should include the Reserve Bank, AFIC [Australian Financial Institutions Commission] the ISC [Insurance and Superannuation Commission] and the ASC [Australian Securities Commission] and be chaired by the Supervisor of Banks."¹

The Committee argued that, with banks and other intermediaries' increasing involvement in funds management, a clear case existed for closer liaison among these agencies. Closer bilateral ties between different agencies were emerging already in deference to the trend towards financial conglomeration and a perceived need for greater consistency of regulation. The move to establish multilateral links through a Council-style arrangement was facilitated by the establishment of the ASC in 1991, and the AFIC regime in 1992. The Council therefore represented a logical and timely development in the evolution of the regulatory framework in Australia.

¹ "A Pocket Full of Change - Banking and Deregulation", AGPS, November 1991 (p.234). (The reference to a 'Supervisor of Banks' follows an earlier recommendation by the Committee for the creation of a second Deputy Governor of the Reserve Bank, bearing that title, to have the specific responsibility for prudential supervision of banks.)

The first meeting of the Council was held on 27 November 1992. Following its second meeting in April 1993, the Treasurer, who has Ministerial responsibility for the Council, issued a press release which included the following:

"The main objectives of the Council are to:

- promote regular, high level liaison among the various regulatory agencies in the financial sector;
- identify important issues and trends in the financial system as a whole; and
- enhance the overall quality of supervision, particularly through helping to avoid unnecessary overlaps, inconsistencies and gaps in regulation of the financial system.

The Council is not a supervisor in its own right, and its creation does not alter the existing statutory responsibilities of its various members. The Council is to meet at least each six months and will report to me and other relevant Ministers, as appropriate, on matters of substance arising from its deliberations. The Council will also publish an annual report commenting on issues and trends in prudential supervision matters in the financial system."

A key focus of Council attention has been on the implications for member agencies' individual responsibilities of the operations of financial conglomerates, which dominate Australia's financial system. This has highlighted the importance of information-sharing among agencies, as reflected in the refined set of objectives listed in the Council's first annual report, published in December 1993:

"The Council seeks to enhance the quality of financial supervision and regulation in Australia. Its main objectives are to:

- facilitate exchanges of information bearing on the efficiency and well-being of the financial system, including the promotion of regular liaison among financial supervisors;

- assist each supervisory agency to be aware of, and to understand, developments in other parts of the financial system;
- identify issues and trends important to the financial system as a whole; and
- avoid unintended gaps, duplication and inconsistencies in regulation."²

Through its annual reports the Council has stressed the following aspects of its approach:

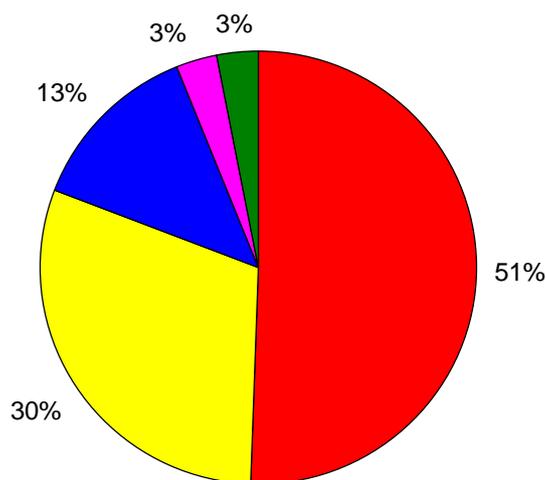
- it encourages the harmonisation of regulatory requirements where the interests of agencies overlap, but does not seek to promote identical standards for all financial institutions or products, recognising that the protection afforded different depositors and investors will vary depending on a number of factors, including the risk characteristics of the products in question, the institutions and investors involved, and the statutory responsibilities and community expectations of supervisors; and
- its creation has augmented, rather than replaced, other channels of communication between the agencies.

² Council of Financial Supervisors' Annual Report 1993 (p.5).

Council member responsibilities

The particular responsibilities of member agencies are outlined in their individual submissions to the Inquiry and will not be repeated here. As the following diagram shows, Council members currently have supervisory/regulatory authority over institutions managing about 97 per cent of financial system assets.

SUPERVISION/REGULATION OF FINANCIAL SYSTEM
Per cent of total assets/funds under management



March 1996

<u>SUPERVISOR OR REGULATOR</u>	<u>FINANCIAL INSTITUTION</u>	<u>FINANCIAL SERVICES & MARKETS</u>
 RESERVE BANK OF AUSTRALIA	<ul style="list-style-type: none"> banks (consolidated) 	<ul style="list-style-type: none"> foreign exchange dealers
 INSURANCE AND SUPERANNUATION COMMISSION	<ul style="list-style-type: none"> life offices general insurers superannuation (pension funds) 	<ul style="list-style-type: none"> insurance agents and brokers
 AUSTRALIAN SECURITIES COMMISSION	<ul style="list-style-type: none"> unit trusts merchant banks finance companies pastoral finance companies 	<ul style="list-style-type: none"> fund raising by corporations and trusts stock, futures and options exchanges exempt stock and futures markets (bonds, over the counter derivatives) securities dealers and advisers futures brokers and advisers auditors and liquidators accounting standards
 AUSTRALIAN FINANCIAL INSTITUTIONS COMMISSION	<ul style="list-style-type: none"> building societies credit unions special service providers 	
 State authorities (not members of Council)	<ul style="list-style-type: none"> friendly societies trustee companies (common funds) co-operative housing societies State government-owned insurance offices 	<ul style="list-style-type: none"> consumer credit

Administrative arrangements

The Council of Financial Supervisors does not have its own staff; support, including a Council Secretary, is provided by officers of the Reserve Bank. The Council has met on fifteen occasions since its first meeting in November 1992. Travel and incidental costs are borne by the members.

The Council has issued three annual reports. Although there is no statutory requirement for the Council to table its reports in Federal Parliament, the Treasurer has agreed to do so on each occasion. Production and printing costs of the Council's annual reports (3,500 copies in 1995) are met by the Reserve Bank; distribution costs are shared by the members. Apart from copies provided for Parliament (and the press gallery), the bulk of copies goes to Council members, for forwarding to their constituents and/or counterparts overseas, industry and professional bodies, and universities and schools.

Precise estimates of the Council's overall costs (including those relating to members' time preparing for and attending meetings) are not available, but these would not be large.

The membership of the Council comprises the Governor (Council Chairman) and Deputy Governor of the Reserve Bank; the Executive Director of the AFIC; the Commissioner of the ISC; and the Chairman of the ASC.

As noted earlier, the Federal Treasurer has Ministerial responsibility for the Council.

II - Council Activities

This section mentions briefly the main issues addressed by the Council to date; more detailed discussion can be found in the Council's annual reports.

Financial conglomerates³

These groups have come to dominate financial systems in most developed countries. In Australia, they account for around 80 per cent or more of total system assets, with the largest 25 conglomerates accounting for more than 70 per cent.

For supervisors of financial institutions, financial conglomerates raise a number of concerns, including the risk of contagion (or 'guilt by association'), questions of transparency, associations with unsupervised entities in the group, conflicts of supervisors' interests, and managerial complexities for the groups concerned. Such concerns point to the need for agreement on some commonsense principles for supervising financial conglomerates, and highlight the critical importance of effective co-operation among the supervisors and regulators involved with different parts of a group's operations. To this end the Council has been addressing the following issues:

- The Council has agreed several guidelines for co-operation among agencies involved in the supervision of entities in financial conglomerates:
 - the various agencies will, through the Council, or bilaterally as appropriate, liaise with each other on prudential supervision issues and potentially significant developments affecting financial institutions which are members of a financial conglomerate.
 - the supervisory agencies will share information with each other, as necessary and practicable, on entities in a financial conglomerate for which they have responsibility.
 - the agencies will pursue changes to legislation to remove impediments to such information sharing.

³ In this Submission, the term 'financial conglomerate' refers to a group of companies under common ownership which undertakes financial activities across more than one financial sector (such as banking, insurance, securities).

- the agencies will, in particular, liaise with each other when a problem affecting any entity in a financial conglomerate is judged to have the potential to impact on other members of the group; the supervisor of the parent (or largest) entity will normally act as co-ordinator in this process.

- Consistent with these guidelines, Council members are pursuing legislative changes to facilitate information sharing among themselves, and, where appropriate, with non-Council members such as overseas supervisory agencies. Drafting of amendments to banking and insurance legislation is under way. Interim working arrangements have been agreed pending the enactment of the amended legislation.

- With growing market interest in conglomerate structures involving a (non-operating) holding company, the Council has reviewed the issues raised by such holding companies. Longstanding policy had not permitted such arrangements where a bank was involved. In March 1996, Council members endorsed an approach agreed between the Bank and the ISC on a regulatory framework for holding companies which would allow them to own supervised financial institutions subject to certain controls being exercised⁴.

Under the proposed arrangements, one Council member agency would be appointed 'convenor' for each conglomerate with a non-operating holding company structure. The convenor would have responsibility for:

- overseeing and regulating the holding company (but not the licensed operating entities in the group, which would continue to be supervised as they are at present);
- disseminating information collected from the holding company to other relevant supervisors; and
- co-ordinating the responses by relevant supervisors to any problems involving (or potentially involving) more than one entity in the conglomerate.

⁴ The Council's 1995 Annual Report (Chapter 4) provides some background. The controls, in brief, would cover restrictions on ownership; access to its management and to relevant information about the group; its obligations to ensure that supervised subsidiaries meet prudential requirements; and limitations on the holding company's own activities.

The appointment of convenors would be a matter for the Treasurer, acting on the joint recommendation from the relevant supervisors. In the unlikely event that supervisors did not agree, the Treasurer would determine the agency to serve as convenor; in addition, the Treasurer would resolve any disputes regarding proposed remedial actions, and give approval to the application of any sanctions.

This approach has been directed initially at bank/insurance conglomerates, but is intended ultimately to apply to any financial conglomerate where supervised entities are owned by a holding company. In April 1996, the Council sought the Treasurer's support for the preparation of new legislation to regulate holding companies, but this work has been suspended, pending the Inquiry's deliberations.

- The supervision of financial conglomerates is attracting a lot of attention internationally, and the Council is keeping abreast of this work. In July 1995, the report of an informal Tripartite Group of banking, securities and insurance regulators on the supervision of financial conglomerates was released under the auspices of the Basle Committee on Banking Supervision, the International Organisation of Securities Commissions and the International Association of Insurance Supervisors. The Group's recommendations emphasise the need for close co-operation among supervisors, including the exchange of information about entities within financial conglomerates. The recommendations in the report have no formal status at this stage, but the successor to the Tripartite Group - the Joint Forum on Financial Conglomerates - is developing a set of principles and practices upon which the supervision of financial conglomerates could be based internationally. The ASC and the ISC are represented at the Joint Forum, and have consulted closely on its agenda with the Reserve Bank; in effect, the Council is playing a part in shaping developments in this area.
- The Council's consideration of holding company structures and the broader work of the Tripartite Group have focussed attention on the need for supervisors to complement their supervision of individual entities with an assessment of the 'financial health' of a financial conglomerate as a whole, an integral part of which is an assessment of the capital adequacy of financial conglomerates. This issue is on the Council's current agenda, particularly in relation to conglomerates which combine banking and insurance.

The report of the Tripartite Group advocated the appointment for each conglomerate of a 'lead regulator' or 'convenor' - generally the supervisor of the dominant operating entity - to gather, and disseminate, information on the group (particularly regarding the risks assumed), and to co-ordinate any supervisory action. The moves by the Council to facilitate information-sharing, and to develop procedures for the effective oversight of financial conglomerates (including any holding companies), are consistent with the thrust of the work of the Tripartite Group.

Regulatory gaps/overlaps

Among the issues of interest to the Council, the matter of regulatory overlap and inconsistency has attracted most criticism from market participants. (They are generally less inclined to draw attention to gaps - unless, of course, these have the effect of bestowing some advantage on a competitor.) For its part, the Council recognises the need to look for structural improvements and to accommodate market developments (where these are not unfair or uncompetitive). In particular, it is identifying proposals to remedy unintended gaps, overlaps or inconsistencies in the regimes regulating sales and investment advice practices for functionally similar retail savings products. This work is being conducted mainly by the ASC and the ISC, in close consultation with interested parties in the industry.

Three areas have been identified as warranting early attention:

- product disclosure - where the Council is aware of the need to pursue competitive neutrality between its members' regimes, and to minimise incentives for regulatory arbitrage. The Council will continue to identify areas where uniformity, or at least greater harmonisation, of product disclosure rules in banking, insurance and superannuation, and securities is both desirable from a competition point of view and practical from a regulatory perspective;
- financial adviser regulation - this area has arguably attracted the most industry (and media) debate. Council is supportive of the recent efforts of the ASC (which, through the Corporations Law, covers securities advisers) and the ISC (which covers insurance agents and brokers) in 'fast tracking' greater consistency between their respective regimes for regulating retail financial advice. This pursuit of harmonised arrangements could lead a single regulatory regime for financial advisers; and

- complaints handling - the proliferation of complaints handling schemes in the financial sector has the potential to create confusion and produce uneven outcomes. The Council has endorsed the ISC's efforts to bring together the administrators of the various schemes with a view to establishing some common standards, increasing co-ordination and identifying any gaps in the schemes' collective coverage of the financial sector. It has also endorsed the ASC's efforts to encourage the schemes to establish a 'hotline' which, among other things, can be used for receiving and referring complaints to the appropriate scheme.

Derivatives

Properly handled, derivatives enable risks to be unbundled and better managed. In the absence of sound risk management systems, however, they can lead to problems for investors and regulators alike. Regulators have identified a number of concerns with derivatives - related mainly to the potential for increased systemic risk, a lack of transparency and legal uncertainties - and have moved to enhance their regulatory and supervisory regimes, pursue greater transparency in the market, and promote improvements in individual firm's risk management practices.

In Australia, these broad issues are being considered by different regulators, and by the industry, with the Council providing a forum to help avoid inconsistencies and overlaps in the regulation of derivatives. Council members also have formed a joint working party to review the problems of 'undisclosed counterparties' to transactions in derivatives markets, and how these might be addressed.

Contingency plans/emergency arrangements

The Council's initiatives on information-sharing, and its proposals for the supervision of financial conglomerates, are helping to lay the groundwork for an effective, co-ordinated regulatory response to any financial sector problems which cut across agency responsibilities.

The Council provides a forum for resolution of any conflicts of regulators' interests. In the event that the Council were unable to resolve any issues, these would need to be determined at Ministerial level. The fact that the Reserve Bank, ISC and ASC all fall within the Treasurer's portfolio could be expected to facilitate this process. To this time no such problems have arisen; indeed,

the Council has played an important part in building goodwill and understanding among its members.

International developments

Given the emergence of global financial markets, domestic regulatory agendas have to keep in step with international developments, or otherwise risk disadvantaging domestic financial institutions in the eyes of other institutions and ratings agencies.

Council members are therefore active in monitoring, and in some cases helping to shape, these developments. This activity occurs through their involvement with main international bodies such as the Basle Committee on Banking Supervision, the International Organisation of Securities Commissions, and the International Association of Insurance Supervisors. The Council is an important forum for discussing and furthering all manner of activities, including information-sharing; supervision of financial conglomerates; capital adequacy treatment of market risk, netting arrangements; the regulation of derivatives; and accounting standards.

III - A Future Role for the Council

This section reviews the Council's role and suggests some ways in which that role could be developed.

It is clear that regulatory arrangements covering different sectors of the financial system need to be co-ordinated effectively. This objective has been pursued in different ways in different countries. Special factors are tending to meld the frameworks of some countries (eg in the European Union), and international bodies are increasingly laying down a framework of principles and guidelines in key areas: nonetheless, regulatory arrangements in most countries continue to reflect their individual cultural and economic histories.

In Australia, the Martin Committee considered and rejected the option of establishing a single supervisory agency. It did, however, see merit in achieving closer co-ordination among supervisors through the introduction of a system of lead regulation. The Committee suggested that the Council designate one of its members as 'lead regulator' for each financial conglomerate. The Commonwealth Government responded to this suggestion by requesting that it be a matter for further discussion among Council members.

In its 1993 Annual Report, the Council expressed some misgivings about lead regulation, related in large part to concerns about 'moral hazard':

"...the [lead regulator] concept presents some important drawbacks, including the possibility of other supervisors relying unduly on the oversight and judgment of the lead regulator. More important is the risk that the lead regulator will come to be seen as taking the same responsibility for the prudent conduct of a financial group, as a whole, as it does for the particular part for which it has a statutory responsibility. Investors' decisions based on possibly erroneous notions concerning the substance of investor protection arrangements could weaken the role of market discipline in constraining the overall 'riskiness' of financial institutions. If problems occur, it could add to pressures on government, at taxpayers' expense, to 'make good' any

losses that might arise, including in unsupervised parts of a conglomerate."⁵

The typical composition/structure of conglomerates in Australia was another factor. Council noted at the time that almost all large conglomerates in Australia were headed by supervised institutions. In most cases, where a supervised entity headed a conglomerate it was by far the largest member of the group; with a few exceptions, non-financial corporations had only modest linkages to financial conglomerates, and the significance of unsupervised financial intermediaries (eg finance companies, money market corporations) in conglomerates was declining. These observations remain relevant today.

The Council's early guidelines did, however, introduce the notion of a 'co-ordinator' to take on a role akin to that of a lead regulator, in the event of a potential problem which might affect a conglomerate. As noted earlier in relation to holding companies, the Council has proposed that a member agency be appointed 'convenor' for each financial conglomerate with a holding company. This approach is broadly consistent with the recommendations of the international Tripartite Group; the preference for 'convenor' over 'lead regulator' reflects a view that the latter term gives an impression of overriding regulatory responsibility, which is not a feature of the proposed arrangements.

A small number of countries tackle the co-ordination problem by combining specialist agencies in a single regulator. Norway, Sweden and Singapore, for example, have a single regulatory agency covering banking, insurance, securities and funds management institutions/activities. Simply internalising co-ordination problems, however, does not solve them; in these countries, the single regulator is typically compartmentalised into different units (banking, insurance, etc), so that information flows and broader issues of co-ordination have still to be addressed. The Council's 1993 Annual Report noted:

"In some countries financial supervisors have been amalgamated into a single 'mega-supervisor' with a view to avoiding, or at least internalising, legal and practical issues that may otherwise impede co-ordination among supervisory agencies. In practice, however, the merging of financial supervisors has not necessarily led to a commensurate harmonisation of relevant regulations and, in most cases, the various divisions responsible for overseeing different parts

⁵ Council of Financial Supervisors' Annual Report 1993 (p.36).

of the financial system appear to have continued to operate independently of one another..."⁶

The issue of mega-regulation will no doubt be pursued elsewhere. In the Council's view, the case has not yet been made that one large agency will handle co-ordination issues better than two or three smaller agencies working co-operatively through a body such as the Council.

Two other models of co-ordination mechanisms are provided by the UK and South Africa. In brief:

- The UK adopts a 'collegiate' approach to supervising financial conglomerates. A non-statutory system of lead regulation was introduced in the late 1980s; the arrangements are overseen by the Treasury and cover the main supervisory bodies. For each conglomerate, a lead regulator is nominated to promote exchanges of information bearing on the overall financial soundness of the group, and to co-ordinate remedial action, although each supervisor retains statutory responsibility for the institutions it authorises. The Bank of England is usually the lead regulator for conglomerates containing a bank. As part of the arrangements, a 'college of supervisors' normally meets once a year, convened by each lead regulator. There is no UK equivalent of the Council of Financial Supervisors to consider policy issues relevant to the supervision of conglomerates or other issues.
- In South Africa, a statutory co-ordinating body, the Policy Board for Financial Services and Regulation (PBFSR), was established in 1993. The PBFSR co-ordinates regulatory requirements as they apply to banks and non-bank financial institutions. Its main task is to avoid situations where some institutions could gain a competitive advantage as a result of different regulatory regimes. The PBFSR is chaired by the Governor of the South African Reserve Bank, and although other representatives from regulatory authorities may be invited to its meetings, the private sector - the regulated financial institutions and markets - provides the majority of members. The PBFSR acts as an adviser to the Government on financial services, financial markets, regulatory structures, new and amended financial legislation, and changes in financial supervision. As such, it can be viewed as a formal 'think tank' on these topics. Responsibility for the execution of financial

⁶ Council of Financial Supervisors' Annual Report 1993 (p.35); an appendix described co-ordination arrangements in selected countries.

regulation policy is shared by the South African Reserve Bank (for banks) and the Financial Services Board (for all other financial institutions, services and financial markets).

It is clear that different models can and do work in different countries. The most relevant question is always which model is likely to be best suited to Australian conditions. In the view of its members, the Council is an effective approach to co-ordination. Its relative informality and flexibility are well-suited to dealing effectively with the rapid change in our financial system. Confining its membership to the main regulatory agencies enhances its operational efficiency.

At the same time, consideration could be given to improving the Council's approach by:

- formalising its constitution - this could help to raise the public profile of the Council, hopefully without compromising its flexibility; and
- engaging in regular consultations with relevant industry bodies (such as the ABA and LISA), and with other agencies having an interest in the financial system (such as the ACCC).

Contact details

To seek further information please contact Bryan Fitz-Gibbon (Council Secretary):

Telephone: 02 9551 8740

Facsimile: 02 9551 8024

E-mail: Bryan.Fitz-Gibbon@FSMail.RBA.Telememo.Au