CHAPTER 6: THE STRUCTURE OF FINANCIAL SUPERVISION

6.0 INTRODUCTION

Previous chapters of this submission have emphasised the need for increased co-ordination between regulatory agencies. Technological change, globalisation and the evolution of products and delivery systems raise the prospect that functionally diversified groups, operating across international boundaries, will inevitably account for a large proportion of the local financial system. Regulators must be able to supervise these complex international organisations just as effectively as they can supervise more traditional, functionally specialised institutions focussed on domestic or regional markets. The changes that the National recommends to financial services regulation are designed to ensure that our regulatory system also achieves a greater degree of competitive neutrality across products and institutions. Regulation should not unnecessarily impede the development of internationally competitive, diversified financial groups in Australia, nor should it advantage them against the smaller niche participants who will remain important in the local financial sector.

Admittedly, co-operation between the Australian regulatory agencies has increased in recent years. Following the recommendation in the House of Representatives Standing Committee on Finance and Public Administration's 1991 Report on Banking and Deregulation[1], the creation of the Council of Financial Supervisors (COFS) has strengthened the linkages between the various agencies. For its part, the COFS has established guidelines for co-operation among the agencies involved in the supervision of entities in financial conglomerates. The adequacy of these COFS arrangements must, however, be questioned in view of the extent to which the financial system is becoming increasingly integrated through product blurring and the emergence of financial conglomerates. Our recommendations in relation to the new system - as set out in Chapter 4 - mean that a gradual evolution toward better co-ordination is no longer sufficient.

[1]House of Representatives Standing Committee on Finance and Public Administration, 1991, "A Pocket Full of Change: Banking and Deregulation".

The growth of financial conglomerates has triggered an international debate on whether traditional structures of financial system supervision remain appropriate. Historically, most OECD countries have relied upon a clear division of supervisory responsibilities between highly specialised agencies. These regulatory authorities tended to have only limited inter-action and focussed on the minutae of business practice in their specific areas. The increasing blurring in the boundaries between financial institutions as they extend product ranges, and as traditionally distinct products develop similar characteristics, has led to a growing international realisation that exclusive reliance on a specialised institutional structure for financial supervision is no longer appropriate.

There has been pressure for the reorganisation of regulatory agencies in several economies where supervision has traditionally been functionally specialised. In Canada, the Office of the Superintendent of Financial Institutions was formed in 1987 from an amalgamation of banking and insurance supervisors. There has been persistent criticism of the United Kingdom's functionally specialised system of supervision and calls for the replacement of the existing lead regulator model by a supervisor covering the entire financial system. In the United States, senior Treasury officials have bemoaned the multiplicity of financial regulatory agencies. The Chicago Mercantile Exchange have also developed a model for reforming United States financial regulation which advocates the consolidation of numerous regulatory agencies into a single authority with a divisional structure.

Australia's current institutionally based regulatory system seems unlikely to provide the best framework for achieving the optimal combination of systemic stability, economic efficiency and competitive neutrality. Increasingly, similar financial products are faced with differing regulatory regimes, violating the principle of competitive neutrality. There is a widening mismatch between our corporate and regulatory arrangements. Diversified financial conglomerates are increasingly prevalent in the financial system, but regulation remains essentially fragmented along traditional functional lines (see Table 6.1 below), potentially restricting the gains from

Table 6.1: Legal Basis And Responsibilities Of Financial System Regulatory Bodies

Regulatory Body	Legal Basis	Responsibilities
Reserve Bank	• Reserve Bank Act 1959 • Banking Act 1959 • Bank (Shareholdings) Act 1972 • Financial Corporations Act 1974	Regulatory oversight of Banks, Building societies, credit unions, Merchant Banks, Authorised Dealers, and all other financiers and intermediaries.
Australian Financial Institutions Commission (and State authorities)	• Australian Financial Institutions Commission Code Act 1992 (Queensland) • The Australian Financial Institution Commission Act 1992 (Queensland)	National co-ordinating and standards setting body for state supervisors of building societies and credit unions.
Insurance and Superannuation Commission	• Superannuation Industry (Supervision) Act 1993	Prudential supervision of the life insurance and superannuation industries to protect policy holders and fund members, and ensure compliance with the Commonwealth Government's retirement income standards.
Office of the Life Insurance Commissioner	• Life Insurance Act 1995 • Insurance (Agents & Brokers) Act 1984 • Insurance Contracts Act 1984	Oversight of all life insurance companies and superannuation funds.
Australian Securities Commission Reserve Bank of Australia	Corporations Act 1989	Excluded corporations able to accept deposits through issue of debentures.
Other Relevant Commonwealth Regulatory Organisations		
Australian Competition and Consumer Commission	• Trade Practices Act 1974 • Prices Surveillance Act 1983	All Industries.
Australian Securities Commission	• Corporations Act • Australian Securities Commission Act 1989	General regulatory oversight of all companies; specific regulation of broker, dealers, investment advisers, ASX, SFE: – policy statements – investigation of potential violations – prosecution.
Australian Stock Exchange	• Corporations Act 1989 • ASX listing rules • ASX business rules	Regulatory oversight over brokers and listed companies: – investigation – disciplinary proceedings – administration.
Foreign Investment Review Board	• Foreign Takeovers Act 1975	Review of all foreign investment.
Office of the Insurance Commissioner	• Insurance Act 1973 • Insurance (Agents & Brokers) Act 1984 • Insurance Contracts Act 1984 • Insurance (Deposits) Act 1984	Oversight of all general insurance companies.

economic efficiency and ensuring that the prudential supervision of conglomerates is even more challenging than it should be.

In the National's view, the new regulatory structure should promote:

- **prudential security**. This involves the avoidance of systemic instability rather than misguided efforts to remove all risk from financial products. Efforts to eliminate risk would merely distort competition as both depositors and financial institutions face a moral hazard that may unduly increase their willingness to bear high risk in seeking high returns. United States experience[2] illustrates the potential pitfalls of trying to protect participants in the financial system from the consequences of their high-risk strategies. Based on that experience, the National does not support mandatory deposit insurance schemes;

- **efficiency.** Particularly dynamic efficiency. It is important that the regulatory structure does not unnecessarily limit the capacity of the financial system to evolve. In particular, regulation should not unnecessarily prevent market entry, or inhibit established firms from responding effectively to changes in their competitive environment through, for instance, encouraging the preservation of outmoded patterns of institutional specialisation. The outcome of such efforts will be a less efficient and less internationally competitive Australian financial sector; and

- **competitive neutrality** in the treatment of products and institutions. Consistency in the regulatory treatment of similar financial products and firms is a key step towards securing the improvements in allocative efficiency that can flow from competitive neutrality. As the Campbell Committee noted, the best way of achieving equality in regulatory burden is by adopting a functional approach.[3] Financial intermediaries performing similar activities should face comparable levels of prudential regulation.

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[2]See Mishkin, F.S., "An Evaluation of the Treasury Plan for Banking Reform", *Journal of Economic Perspectives*, 1992, pp.133-153; and Berger, A.N., Kashyap, A.K., and Scalise, J.M., "The Transformation of the US Banking Industry", *Brookings Papers on Economic Activity*, 1995, pp.55-104.
[3]Australian Financial System, 1981, Final Report of the Committee of Inquiry, p5.

In 1991, the Australian House of Representatives Standing Committee Report on Banking and Deregulation outlined two approaches that could secure greater co-ordination between supervisors - the appointment of a “lead” regulator and the creation of a “mega-supervisor”. The Committee suggested that the COFS designate one agency as “lead regulator”, but that supervision of the individual units of a conglomerate remain with the individual agencies. The Committee was not convinced that the establishment of a mega-supervisor was necessary at that time to ensure adequate depositor protection; but it also recognised that the financial system was evolving rapidly and there ought to be a need to reconsider the case later.

Each of these options provide a more integrated structure of supervision than the existing COFS model; but each also has potential advantages and disadvantages. Given that both models can be seen in operation in OECD economies, and that the whole issue of co-ordinating financial supervision has been widely debated among international supervisory agencies, the reform of Australian financial supervision can benefit from consideration of overseas experience.

6.1 LEAD REGULATOR MODEL

Under the “lead” regulator model, a single agency can take responsibility for assessing the risk profile and capital adequacy of the entire operation of a diversified group. It would gather and disseminate information about that conglomerate from and to other regulatory agencies and co-ordinate the inter-agency handling of problems affecting the group. These inter-agency arrangements can be formalised through the use of Memoranda of Understanding or protocols which identify the lead regulator and specify the responsibilities of the various agencies. The choice of lead regulator can reflect the distribution of conglomerate activity across business lines. Thus, in the case of a group whose largest business was banking, the RBA would be the lead regulator, while the ISC would take the lead role where insurance was the group’s largest single activity.

In the Australian context, COFS have proposed a framework for the supervision of conglomerates headed by special purpose holding companies which would include a formally nominated convenor or lead regulator. The Deputy Governor of the RBA has suggested that this model would be suitable for other conglomerates as well.[4]

The 1995 report of the Tripartite Group supported the international adoption of such a lead regulator or "convenor" model for the supervision of financial conglomerates.[5] An approach of this type has been operating for United Kingdom domestic supervision for some years. There are also precedents for international co-operation using the lead regulator model. Experience to date, however, shows that this approach has not been without its deficiencies and critics.

The lead regulator model offers the **potential advantage** that it retains the specialist expertise of the existing agencies. Significant differences in the supervision of banking business, as opposed to regulating insurance or securities are frequently stressed. The lead regulator model can avoid the dilution of focus on institutional specifics that could exist in a poorly managed mega-supervisor.

There are, however, several **potential disadvantages** with the lead regulator approach;

- it can perpetuate fragmentation in regulatory arrangements and competition between regulatory agencies - particularly if the central role of the lead agency is not exercised effectively, or generally accepted by the other regulators;

- even if the lead agency is effective, financial conglomerates may still have to answer to several separate regulatory agencies, each with their own objectives, styles, methods of operation, staff, computer systems and personnel. If agencies are unable to delegate their statutory responsibilities to each other, the scope for reducing the extent of multiple regulatory coverage is limited.

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[4]Thompson, G.J., "The Wallis Inquiry: Perspectives from the Reserve Bank", September 1996.
[5]The Tripartite Group of Bank, Securities and Insurance Regulations, 1995, "The Supervisors of Financial Conglomerates".

United Kingdom experience highlights numerous problems with the lead regulator model. Dale (1992)[6] and the London Centre for the Study of Financial Innovation (CSFI)[7] have identified several weaknesses:

- the proliferation of regulatory agencies with very different aims and approaches. This requires a considerable degree of co-ordination and could give rise to potential conflicts of interest, as agencies seek to discharge their statutory responsibilities (eg, banking authorities may be anxious to support an institution in difficulties to avoid systemic problems, while securities regulators may want to close it for misconduct). The United Kingdom authorities have moved to strengthen co-ordination by having officials of the Bank of England and the SIB sit on each other's Boards;

- the absence of a "level playing field" between banks and other financial institutions through what the CSFI consider to be the less than perfect co-ordination of prudential supervision between the Bank of England and the SIB;

- the influence of conglomerate patterns of corporate structure on choice of supervisory agency, giving rise to concerns about competitive equality between players and the scope for what the Tripartite Group (1995) called "regulatory arbitrage". In the United Kingdom, the arrangement has been that the Bank of England supervises the securities activities of banks that are actually conducted within the Bank while the SIB supervises bank securities activities that are conducted in separately incorporated securities subsidiaries; and

- an alleged incompatibility between functional regulation and the integrated activities of diversified financial conglomerates - "functional regulation does not coexist easily with a regime in which risks are assumed to flow freely between different parts of the same financial group.....if risk exposure is viewed as a matter affecting the institution as a whole, how can it make sense to apply prudential rules on a

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[6] Dale, R., 1992, International Banking Deregulation, Blackwell Finance.

[7] Hilton, 1994, UK Financial Supervision: A Blueprint for Change, Centre for the Study of Financial Innovation.

functional basis to individual subsidiaries within the Group .... ..bearing in mind that the objectives of bank and securities regulators may differ and that their own prudential requirements will reflect any such differences - it would seem impractical to try to resolve this problem by establishing coordinating machinery in the form of a college of regulators" (Dale (1992) p.113).

The CSFI's response to the United Kingdom experience with a lead regulator has been support for a single prudential "mega-supervisor" for the entire financial system. The CSFI called for the creation of a Financial Services Supervisory Commission in 1994. In 1996, it repeated its concerns and called for a "twin peaks" model, concentrating all prudential and all consumer protection responsibilities into separate agencies.[8]

The unhappy experience of using an **international college of supervisors** to supervise the BCCI was outlined in the 1991-92 Report of the United Kingdom Treasury and Civil Service Committee.[9] The Luxembourg authority found it impossible to exercise adequate consolidated supervision of the BCCI, almost all of whose activities fell outside its jurisdiction and no other banking supervisor was prepared to take responsibility as parent authority. Finally, after what the Bank of England termed a nine year period of "trying to reach a position where someone could be the lead regulator of a consolidated group", the world's first "college of regulators" was established in 1987. The college first met in June 1988, in accordance with the provisions of the Basle Concordat. The Luxembourg authorities concluded that the college performed satisfactorily but it had also been grossly deceived by the BCCI. The BCCI was closed in 1991 and the United Kingdom Parliamentary Committee found the College of Regulators, as then structured, to be "clearly a second best solution with serious difficulties". The Parliamentary Committee supported adoption of a single lead regulator but the best solution was clearly the consolidated supervision of the entire group by one agency.

6.2 MEGA-SUPERVISOR MODEL

[8]Taylor, 1996, Twin Peaks : A Regulatory Structure for the New Century.

[9]Treasury and Civil Service Committee, "Banking Supervision and BCCI: International and National Regulation", 1992.

While there is a recognised need to focus supervision on the functional characteristics of financial services, that does not mean that the institutional element of supervision can be ignored. The situation has been well summarised by the Governor of the Bank of England, who envisaged a continued need for a matrix approach to supervision, which combined institutional and functional regulation of the financial system.[10] The growing importance of financial conglomerates and the rapid evolution of financial products suggests that consolidating the institutional element of prudential supervision in a single agency, rather than continuing to rely on historic institutional distinctions as the basis for supervision by a group of agencies, should be seriously considered.

Learning from the Canadian experience[11], this supervisor should have a clear statutory mandate to promote the stability of the entire financial system and maintain public confidence in that stability. The mandate should not be restricted to protecting specific types of institutions. Given this clear mandate, the mega-supervisor model offers several **potential advantages.** In particular, it could:

- enable more consistent and in-depth supervision of the diverse financial groupings that are evolving in Australia. Much of this supervision should focus on risk management systems and profiles across a range of systemically important financial groups, as opposed to writing detailed prescriptive regulations. The extent to which systemic risk is synonymous with banks as institutions is increasingly being questioned. It is still possible, however, to argue that banks remain of prime systemic importance, because the course of financial instability runs through the banking *system.* Despite this, it is important that *all* systemically important firms are adequately and consistently supervised, irrespective of the functional mix of their business. Weighing-up the size and distribution of aggregate risk in a diversified financial conglomerate can be performed more effectively and consistently in a mega-supervisor than relying on the potentially varying approaches of a group of regulatory agencies;

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[10]George, 1996, “Some Thoughts on Financial Regulation”, *Bank of England Quarterly Bulletin,* May.
[11]Auditor-General of Canada, Report on Office of the Superintendent of Financial Institutions, 1995.

- facilitate the continued detailed assessment of individual functions in the specialist divisions of the supervisor. Experts in the supervision of particular products (eg. derivatives) would work across each of these specialist divisions. Supplementing this with an institutional/co-ordination division would enable the monitoring of the financial position of diversified groups. Focussing the specialist divisions on the nature and risk of financial products would offer the chance to remove inconsistent regulatory treatment of similar products and assist to achieve competitive neutrality. Conducting all this within a single organisation offers the opportunity to avoid the scope for bureaucratic delay and inconsistency that can exist in the lead regulator model;

- overcome or "internalise" many of the bureaucratic difficulties associated with the lead regulator approach. It would, for instance, not be necessary to appoint a lead regulator, conduct time-consuming negotiations over Protocols, governing agencies, respective responsibilities, negotiate information-sharing arrangements, assess whether individual supervisors could act as agents for each other etc. North American experience shows how supervisory systems involving distinct agencies can result in business facing overlapping regulatory requirements which can lack clarity. For instance, even in the quite centralised Canadian system, the Auditor General has called for clarification and rationalisation of the operations of the OFSI and the Canadian Deposit Insurance Corporation.[12] Administrative arrangements can be simplified and bureaucratic inconsistencies resolved by the senior management of the mega-supervisor, rather than fed through differing systems for eventual resolution at senior levels at a potentially much later date;

- diminish the scope for "regulatory arbitrage", as business realise that there is no benefit in establishing corporate structures to ensure that they fall within the ambit of the relatively "light-handed" agencies; and

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[12]Op. Cit. See also Barnett, R.E., "A Different Regulatory Scheme", *The Bankers Magazine*, July/August 1996.

- show greater flexibility in its ability to handle changes in the institutional configuration of delivering financial services. Aggregate risk profiles across a wide variety of conglomerates would be assessed in the mega-supervisor's institutions division.

In terms of ability to achieve the optimal combination of maintaining systemic stability, improved economic efficiency and competitive neutrality, the National believes that **the mega-supervisor model offers clear advantages over the lead regulator model;**

- the consolidated supervision of diversified financial groups is more effectively undertaken within a single organisation, contributing to systemic stability;
- adopting a functional basis for the regulation of financial services in a mega-supervisor provides a greater degree of competitive neutrality than relying on the varying rules of a cluster of regulatory agencies; and
- a mega-supervisory structure provides greater freedom for the evolution of financial institutions, in accordance with shifts in their competitive environment, allowing greater dynamic economic efficiency.

If the mega-supervisory model is to be adopted, it is important to ensure that the traditional potential shortcomings of such an approach are addressed. Two such potential shortcomings typically highlighted are:

- a risk that consumers may mistakenly believe that all financial products issued by firms which answer to a single regulatory authority carry the same degree of risk. The National believes that consumer education through the provision of adequate information about the risk attached to individual products and institutions is the best way to address these issues. Our suggestion for improved mandatory information disclosure, as set out in Chapters 7 and 8, should assist to eliminate these problems; and
- a risk that the supervisor adopts a "one hat fits all" approach. This should however be easily overcome in a well managed board by incorporating existing expertise into the new structure.

The amalgamation of supervisory responsibilities in a single agency could involve either;

- the adoption of a "twin peaks" model, where all prudential supervision is concentrated into a single body, while another is responsible for consumer protection. The CSFI (1996) have suggested such an approach for the UK but the two proposed independent authorities would have some overlap in membership[13]; or
- the creation of a single regulatory authority, with consumer issues handled in a specific division. **This is the National's preferred model.**

6.3 MEGA-SUPERVISOR - LINKS WITH OTHER AGENCIES

Whatever the precise form of regulatory structure that emerges from this Inquiry, the supervisory authorities will have to maintain a close relationship with the Reserve Bank. The Central Bank, through its lender of last resort facility, provides liquidity to an individual institution experiencing difficulties, or to the entire system. As the RBA Governor noted, information obtained in on-going supervisory duties can help the Central Bank in making decisions on whether or not to provide assistance to institutions in difficulty. If the Central Bank no longer had supervisory responsibilities, it could still have to assess the financial position of the banking sector in case assistance were ever promptly needed.

This presents the risk that the Central Bank would continually feel it had to "second guess" the mega-supervisory board to ensure that its emergency assistance was not wasted on hopeless propositions which offered little systemic risk. The CSFI (1994) argue that it is possible to devise mechanisms to remove the risk of being lender of last resort from the Central Bank, either by providing it with a guarantee from Treasury that it would bear any costs, or by raising a levy from industry.[14] Both options appear problematic and it seems more likely that the Central Bank would run some risk that it

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[13]Taylor, Op. Cit.
[14]Hilton, Op. Cit.

could not always necessarily remove the financial consequences of last resort operations.

It has also been argued that Central Banks should not be permitted to retain supervisory responsibilities because of a potential conflict of interest with their mandate to maintain price stability. The concern is that the Central Bank may increase the flow of liquidity to the system to assist a troubled bank which may undermine the thrust of monetary policy through easing monetary conditions by more than is warranted to maintain price stability or, more realistically, by deferring required interest rate increases to avoid financial system instability. Goodhart and Schoenmaker (1995)[15] have reviewed the evidence and found no clear sign of this conflict of interest in practice. As the Governor of the RBA has noted, such conflicts of interest could occur and have to be resolved, even if banking supervision were removed from the Central Bank.[16]

National's view is that the RBA should have close working relations with the proposed "mega-supervisory" board. The Governor of the RBA should be the Chairman of the board to ensure that the required close linkages exist between the two organisations. While this appointment would strengthen links between the RBA and the supervisory body at senior management level, there is also merit in ensuring that co-ordination and information exchange extends further and deeper than RBA officials having access to the supervisor's Board papers. Noting the recent United Kingdom initiative to strengthen co-ordination between agencies, the National believes that a Standing Committee should be established comprising the RBA, Treasury's Financial Institutions Division and officials of the mega-regulator. This committee should meet at least quarterly, be attended at Deputy Secretary/Deputy Governor level when required, and provide a mechanism to exchange information on the evolution of policy and co-ordinate views on developments in financial institutions.

[15]Goodhart, C. and Schoenmaker, D., "Should the Functions of Monetary Policy and Banking Supervision be Separated?", *Oxford Economic Papers*, 1995.
[16]Fraser, B., "Financial Regulation and the Financial System Inquiry", 1996.

The 1995 Canadian Auditor General's report on the OFSI illustrates the problems that could emerge from exclusively relying on committees of senior officials for supervisory co-ordination. The OFSI Act specifies the mandate and (very high level) composition of a Financial Institutions Supervisory Committee, designed to exchange information on problem areas, devise strategies for dealing with troubled institutions and the implications for financial institutions of Government policies. With the exception of taking action on troubled institutions, this committee has not been overly effective. The involvement of senior officials is essential in securing decisions on how to handle financial institutions in difficulty, but we would also emphasise the need to build strong and ongoing links between officials at a variety of levels in the proposed mega-supervisor, Treasury and the RBA.

On balance, the National considers that consumer issues should also be handled within the mega-supervisor. This would require that the ACCC also have close working relations with the appropriate division of the supervisor. Basically, the allocation of responsibilities between the ACCC and the mega-supervisor would be that the former would assess disclosure information from the perspective of competition policy while the latter would focus on prudential matters and consumer advice and complaints.

6.4 STRUCTURE OF THE PROPOSED MEGA-SUPERVISOR

The proposed mega-supervisor would have a divisional structure along the lines outlined in the chart below. Separate divisions would have responsibility for:

- banking;
- exchange of value/payments;
- insurance, superannuation and mutuals;
- financial markets;
- institutional co-ordination and general legal administrative policy;
- consumer issues.

Table 6.2

MEGA-SUPERVISORY BOARD

Division	Core Institution	Other Financial Institutions	Market Oversight	Exchange of Value	Institutional Co-ordination & Policy	Consumer
Coverage	Core Institutions	Life/Super/ Mutuals	ASC and ASX type regulations	Payments, Stored Value, Forex and Futures	Conglomerates General/Legal Administrative Policy	Product, Institutional, Advisor

The overall system would, therefore, comprise:

- the RBA, with responsibility for the formulation of monetary policy;
- the mega-supervisory board, responsible for stability of the financial system, prudential supervision, consumer advice and information disclosure;
  - the Board would consist of the heads of the functional units above (see table 6.2), together with the Governor of the Reserve Bank; and
- the ACCC, with responsibility for competition policy generally, including the financial sector.

The linkages in this framework are:

- the RBA Governor's Chairmanship of the mega-supervisory board;
- the standing committee of officials from the RBA, Treasury and the mega-supervisor; and
- a protocol between the ACCC and the mega-supervisor, setting out responsibilities with regard to Section 52 of the Trade Practices Act. The National advocate that the ACCC look at these issues from the perspective of competition policy while the mega-supervisor looks at them from a product/institutional disclosure perspective.

This institutional framework and the key linkages are set out in the chart below.

Chart 6.1