APPENDIX 2: THE REGULATION OF FINANCIAL CONGLOMERATES - INTERNATIONAL EXPERIENCE

One particularly important global trend is the increased delivery of financial services through financial conglomerates, as opposed to functionally specialised institutions. "Universal Banks", operating across a wide range of markets, have historically dominated several Continental European financial systems. This Universal Bank model has been adopted in European Union directives for the delivery of financial services. There has also been an evolution in several major OECD countries away from their traditional reliance on functionally specialised institutions and toward the delivery of financial services through conglomerates. Changes in regulatory approach have enabled the emergence of diversified financial institutions in the United Kingdom, Japan and Canada, economies whose financial systems were previously dominated by specialised providers. Even in the USA, where legislation has long enforced functionally based specialisation in delivering financial services, there has been pressure for reform to enable the easier development of conglomerate holding companies.

Common pressures and trends in the delivery of financial services have resulted in the financial authorities across many OECD jurisdictions facing broadly similar issues as they assess the consistency of their existing regulatory structures with finance industry evolution. These issues centre around:

- the appropriate corporate structure for financial conglomerates - to what extent should risks in the various components of the conglomerate be segregated by separate legal structures, separate capitalisation and "firewalls";

- the extent to which the supervisory regime should be institutionally or functionally based and how to ensure competitive neutrality between financial conglomerates and functionally specialised firms; and

- the institutional structure of financial regulation/supervision ("lead" or "mega" regulators) and the degree to which the supervision of the various businesses in a conglomerate should be consolidated.

CORPORATE STRUCTURE - DIVERSIFICATION BENEFITS AND RISK TAKING

International discussion of the benefits of financial conglomerates focuses on:

- whether combining banking with other financial services enables the potential creation of diversified businesses able to offer superior risk-return performance to that of more specialised firms; and

- the extent to which it is possible to segregate a financial conglomerate into legally distinct business units, thereby containing risk within individual operating units and preventing contagion between financially troubled and healthier units of a conglomerate.

US studies provide most of the evidence on the potential impact of creating financial conglomerates on corporate returns and risks. The separation of commercial banking from "securities business" under the 1933 Banking Act (Glass-Steagall) and the prohibitions on banks entering the insurance industry have resulted in a functionally fragmented financial services industry, unlike the "Universal Banks" of Western Europe.

The weight of recent empirical evidence supports the view that this fragmentation of the US financial services industry was unnecessary. Moreover, it has impeded the creation of more diversified firms which offered the potential to secure higher returns and lower risks. The Federal Reserve have concluded that the legislation prohibiting US commercial banks from fully entering markets like insurance and securities has distorted the development of the financial system and weakened the pressure of competition and that there was no reason, on the basis of risk management, for banks to be excluded from full participation in these markets.

The separation of commercial banking and securities business in the US followed a spate of bank failures in the Depression and a Senate report which blamed the mixing of banking and securities business for some bank collapses. In particular, it was alleged that this mixing resulted in banks facing a conflict of interest which had led to their securities affiliates taking advantage of poorly informed small investors.

Studies of the US banking system in the period prior to passage of the Glass-Steagall Act show that these concerns, which formed the basis of that Act's separation of commercial banking and securities, were quite unfounded. The balance of evidence now suggests that:

- there is no evidence that bank affiliates had underwritten and sold unsound and speculative securities or published misleading prospectuses. In fact, bank affiliates underwrote higher-quality issues which performed better than comparable issues from other financial institutions (Kroszner and Rajan (1994));

- the securities operations of commercial banks did not damage their stability. Commercial banks with securities operations had no higher variance in earnings or lower capital ratios than banks without those operations. Moreover, banks with securities operations were less likely to fail than were specialist banks (White(1986)).

Not surprisingly, this legislated fragmentation of the US financial services industry has provoked debate with banks arguing that it represents an unfair and unwarranted distortion that limits competition. A considerable amount of empirical work has been undertaken in the US to assess the extent to which allowing commercial banks to enter other financial services markets would improve performance. Early studies produced mixed results but the weight of evidence in more recent work clearly supports such diversification, resulting in the creation of financial conglomerates, as it would allow the achievement of higher returns and lower risks.

Brewer (1989) found that increases in the extent to which bank holding company assets were held in non-banking affiliates reduced the variability (risk) in holding company returns and lowered the probability of company failure. It was particularly evident that banks whose business was above average in terms of risk could and were using non-bank activities to lower that risk. Wall (1987) also found that, even though they had higher risk than banks, the existence of non-bank subsidiaries could lower the risk faced by bank holding companies as a group because returns in bank and non-bank operations behaved differently. While most banks used their non-bank operations to moderate the risk profile of their entire group, however, a small minority of the riskiest banks owned non-bank operations that actually added to group risk overall. Boyd, Graham and Hewitt (1993) assessed the impact on risk of mergers between bank holding companies and firms in insurance, securities and real estate. They found that mergers with insurance firms offered the prospect of risk reducing diversification but that mergers with securities and real estate businesses increased the risk of bank holding company failure.

One problem with their approach was that they only modelled pairwise mergers between companies in different financial sectors, they did not measure the diversification gains that could be realised if bank holding companies were to combine with companies across a number of other finance sectors. Litan (1985) introduced a superior methodology, enabling the assessment of the risk consequences of forming conglomerates encompassing a wider range of financial functions. He found that conglomerates comprising banking, insurance and securities outperformed banking in terms of risk/return combinations. Two more recent studies have adopted Litan’s portfolio approach and provided updated estimates of the risk effects of creating diversified conglomerates.

Saunders and Walter (1994) tested the impact that the creation of conglomerates covering between two and five market areas of financial services would have on returns and risks. They found that insurance offered less volatile returns than commercial banking but that returns from securities trading were more volatile. They also found the correlation between returns obtained in banking and in other financial services was sufficient for diversified conglomerates to potentially offer greater stability in overall returns than was the case for specialised banking businesses.

They modelled the implications of differing combinations of financial service provision for conglomerate returns and risks. The conclusion was that allowing banks to offer insurance and securities products resulted in the creation of conglomerates whose earnings were more stable than were those of specialist banks. For example, a conglomerate comprising a money centre bank (15% weight), regional banks (25% weight), life insurance (25% weight), casualty insurance (30% weight) and securities broking and dealing (5% weight) offered reductions of 30 to 40% in risk from the profile of returns that specialist banks could expect. The main benefits in risk reduction came from combining banking and insurance into single businesses. The 5% weighting that they found for securities in the risk minimising portfolio of activities for a financial conglomerate was similar to estimates made in other studies.

Wall, Reichert and Mohanty (1993) conducted the other major recent study of the impact the creation of financial conglomerates in the US would have on risks. Again, they found that some insurance returns were less volatile than was the case for banking, while security and real estate transactions proved more volatile. The correlations between returns in banking and in a range of other financial services were again less than +1, indeed some were negative - offering the prospect of counter-cyclical/offsetting revenue streams for conglomerates.

They also constructed a series of synthetic conglomerates, allocating weights across a range of finance sectors to assess the impact on risk and returns and found that conglomerates could be assembled with lower variability in returns than bank holding companies had on their own. Insurance activities again featured prominently in the most efficient conglomerates built around commercial banks.

Securing these benefits from diversification has lain behind repeated attempts to remove the legal impediments to US commercial banks expanding the range of markets they are able to compete in. Entrenched interests in the US financial system have, however, managed to block all efforts to repeal or reform the key provisions of the Glass Steagall Act. The then Chairman of the Board of Governors of the Federal Reserve System, Paul Volcker, in testimony to the House of Representatives in 1986 bemoaned the fact that Congress had been debating much needed changes to the outdated restrictions of the Glass-Steagall Act for years but all efforts for legislative reform had been halted by vested interests. That has continued in the decade since that testimony. The "Proxmire-Garn" Bill of 1987, approved by the Senate but not passed by the House of Representatives, would have repealed important provisions of the Glass-Steagall Act and allowed Bank Holding Companies to own separately capitalised securities affiliates.

Similarly, the ill-fated US Treasury proposals of 1991 would have allowed well-capitalised banks to have separately-capitalised securities, mutual fund and insurance affiliates with "firewalls', restricted access to the deposit insurance safety net and "umbrella oversight" of the financial services holding company. The Treasury proposals were particularly interesting in that they required banks who wanted to diversify into financial services holding companies to hold greater amounts of capital than firms which remained functionally specialised. This overlooks the evidence that diversified conglomerates can offer lower risk than specialised institutions, the evident ability of existing US banks to significantly increase the risks they were taking in normal banking business (Boyd and Gertler (1994)) and the tendency for US financial failures to be most prevalent among small and specialised institutions. House Banking Committee Chairman Leach introduced another bill to reform the regulatory structure of US banking, proposing increased competition across a range of markets, but this initiative also appears to have stalled.

The policy of the US Federal Reserve toward allowing commercial banks to enter a wider range of markets is quite clear. The Federal Reserve has long supported the repeal of the Glass-Steagall Act, thereby removing legislation that has resulted in the unnecessary fragmentation in the delivery of US financial services and reduced competition. For instance:

- John Laware, a member of the Board of Governors, told the Senate Banking committee at hearings on 5 October 1993 that "The Board has consistently supported the provision of insurance agency activities by banks and bank holding companies and believes that increased bank participation will enhance competition and improve customer convenience without adversely affecting safety and soundness. Thus, the Board sees no argument on either competitive or risk management grounds to retain or impose limitations on insurance agency activities....insurance underwriting activities should be authorised for banking organisations so long as the activities are conducted in a separate holding company subsidiary";

- Chairman Greenspan supported the draft "Financial Services Competitiveness Act of 1995", which would have authorised the affiliation of banks and securities firms and allowed banks to own affiliates in most other areas of US financial services. Greenspan emphasised that the statutory fragmentation of the US financial services industry was inefficient, at odds with the way the markets were moving, out of step with regimes in the rest of the G10 and an impediment to the development of competition. He noted how, through the section 20 arrangements, the Fed had already moved away from a strict separation of banking and securities business. He favoured the use of holding companies to limit the direct risk of securities activities to banks and the safety net. In his opinion "almost all bank holding companies that have set up section 20 subsidiaries believe that the diversification of revenues will result in lower risks for the organisation...it seems likely that some bank holding companies could achieve risk reduction through diversification of their financial services";

- the Federal Reserve has recently proposed increasing the proportion of their revenue that bank holding companies' security subsidiaries are allowed to earn from underwriting corporate bonds and stocks from the existing 10% to 25%, as well as removing some of the "firewalls" that have existed between these companies' commercial banking and securities business (American Banker, 6 August, 1996).

CORPORATE STRUCTURES AND FIREWALLS

Regulatory requirements and securing scope economies have resulted in the emergence of a number of corporate structures across national financial systems. Under the "pure" Universal Bank model, banking and securities business may be fully integrated within the same legal entity. The functionally fragmented US system stands at the other end of the spectrum. In between, there are models where financial conglomerates can take the form of holding companies with affiliates spread across a range of distinct product markets or where banks themselves own subsidiaries operating in markets such as securities.

The precise form of corporate structure adopted can affect the extent to which it may be possible to segregate risks as well as the nature of legal obligations of the individual components of the conglomerate. US discussion favours a holding company model on the grounds that activities should, to the extent feasible, be able to survive on a stand-alone basis through risk-segregation. Moreover, the courts are less likely to assign the financial obligations of a holding company's non-bank affiliate to a bank affiliate than they would be to assign those obligations from a bank's non-bank subsidiary to the parent bank. Successive Chairmen of the Federal Reserve have acknowledged that conglomerates may well be unwilling to allow non-bank affiliates to actually fail, because of the impact on the standing and reputation of the entire group, and that markets may fail to fully differentiate between the collapse of one arm of a conglomerate and other areas of that business. Nevertheless, on balance, the Federal Reserve believe that the holding company offers the best model because it reduces the scope for contagion and conflicts of interest between activities of a conglomerate, isolates any losses from non-bank affiliates away from the bank's accounts and is consistent with functional regulation.

In an effort to avoid the possibility that the courts might assign liability between supposedly separate units in a conglomerate, the US Comptroller of the Currency suggested in 1987 that banking law should be amended to prohibit banks from being held liable for the obligations of their affiliates, unless these had already been specifically assumed. Such an approach has been criticised as running counter to the principle that the obligations of corporate parents to their subsidiaries should exceed what has been legally specified. Nevertheless, the Canadian 1985 Green Paper on financial regulation had also reached a similar conclusion on legal separateness in its suggestion that, whilst the proposed financial holding companies could be looked to for support by affiliates experiencing difficulty, only the resources of the separately capitalised affiliate would be available to compensate creditors and shareholders in the event of liquidation.

In Australia, the RBA require that banks "unambiguously inform" holders of securities issued by non-bank subsidiaries that the capital of the bank does not secure obligations incurred by the subsidiary. This sits uneasily with the inference of liability between subsidiaries and corporate parents in company law. Moreover, as Deputy Governor Thompson has noted "It would be totally unrealistic for us to take no further interest in the subsidiaries of a bank since it is inconceivable that a bank would not be tainted, at least, by a serious problem in a close associate". Segregation approaches similar to those adopted by the RBA and suggested by the US Comptroller of the Currency do however have considerable merit in that they provide a greater degree of ex-ante legal certainty about the precise nature of the obligations incurred within a conglomerate. That legal certainty should not prevent conglomerates seeking to minimise reputational damage from voluntarily accepting an even greater degree of financial responsibility for affiliates facing failure.

Limiting the extent to which the courts can "pierce the corporate veil" and assign financial obligations across legally separate units in a financial holding company has been one of the rationales for "firewalls" in the US. Alan Greenspan in 1987 testimony to the Congress Banking Committee saw financing and supporting a securities affiliate with the resources of an affiliated bank as one of the key factors that the US courts had used to allocate financial obligations across the components of a holding company. Avoiding contagion through limiting the transfer of risk between units of a holding company, preventing conflicts of interest between bank and non-bank operations in a conglomerate and avoiding extension of the Federal Bank safety net to conglomerates' non-bank operations are, however, the main rationales for firewalls in the US system.

There are a number of types of firewall in the US:

- funding firewalls place restrictions on intra-group financial transactions through seeking to avoid contagion on the assets side of the balance sheet (eg, banks are not allowed to lend to or purchase assets from their securities affiliates);

- separate identity firewalls are intended to prevent contagion between the affiliates of a group (by prohibiting the joint marketing of financial products, banning the use of similar business names etc); and

- separate management firewalls are intended to maintain the principle of corporate separateness and avoid conflicts of interest. They include prohibitions on officers and directors of a securities affiliate serving at the same time on an affiliated bank.

Arrangements similar to firewalls exist in some other jurisdictions - but they have not been widely adopted outside the US. Japanese banks and securities firms are now allowed to expand into each other's markets but firewalls intended to prevent conflicts of interest and undue marketing influence have been constructed (Dale (1996)). UK financial regulation generally tends toward the less prescriptive end of the spectrum, but life insurance is an exception. The Department of Trade and Industry (DTI) requires that the insurance manufacturing operations of financial conglomerates are undertaken in fully capitalised stand-alone subsidiaries and that the insurance subsidiary's funds are held and managed independently of the bank. In fact, Lleyellyn notes that capital that is allocated to an insurance subsidiary by a bank is deducted in full from the bank's own capital base, even if the sum allocated exceeds the DTI's requirements for the capital adequacy of that subsidiary. This issue of intra-conglomerate allocation of capital was discussed in the Tripartite Group's report where it was concluded that capital in a subsidiary that exceeds the regulatory requirements of the solo supervisor should, in principle, be permitted to cover risks at the parent/group level. Unfortunately, the members of the Group were unable to agree on the precise conditions governing the intra-group usage of excess capital.

The effectiveness of firewalls in segregating risk has been questioned in the US, the jurisdiction where they have been most extensively used, on the grounds that:

- firewalls impose costs on financial institutions and run counter to the economies of scope that contributed to the initial creation of financial conglomerates;

- preventing the cross-funding of separate affiliates of a conglomerate during a period of financial stress can add to the risk of organisational failure;

- ensuring compliance with the restrictions imposed by firewalls, especially in periods of stress, has proved very difficult in the US. A decade ago former Federal Reserve Chairman Volcker told Congress that it was naive to expect that passing increasingly onerous legislation to enforce corporate separateness could, in itself, always be expected to stop intra-group transactions designed to prevent failure in a financial conglomerate. Subsequent events have supported his view;

- most seriously of all, experience suggests that firewalls have not stopped market perceptions that failure in one area of a financial conglomerate potentially affects the viability of the entire group. As Dale (1992) notes “while funding firewalls seek to prevent contagion through the assets side of a bank’s balance sheet, the more serious problems are likely to arise on the liabilities side- that is through confidence-induced deposit withdrawals. Even if effective asset insulation were achieved this would not ensure protection on the liabilities side”.

This last concern has clearly been acknowledged in the Federal Reserve. Former Chairman Volcker had clearly concluded by 1986 that the markets considered Ubank holding companies as integrated entities and that problems could be transmitted between components of those groups, regardless of the niceties of legal separateness.

Experience since then has supported his assessment. The current Chairman of the Federal Reserve, testifying to Congress in 1990 on the collapse of Drexel Burnham Lambert, commented that "Drexel was a holding company with both regulated and non-regulated subsidiaries, separately incorporated and capitalised, although engaged in complex transactions among themselves. Problems in one area of the firm could not be isolated and quickly spilled over into other areas, some of which may have been fundamentally sound. The government securities affiliate seems to have been adequately capitalised, and engaged in no unusually risky activities. Yet it, too, found its access to credit curtailed when questions were raised about the health of the parent company and other affiliate".

Greenspan then raised the evident failure of firewalls to limit the extent of collapse in this case - "recent events have raised serious questions about the ability of firewalls to insulate the unit of a holding company from funding problems of another. ..It is clear that high and thick firewalls reduce synergies and raise costs for financial institutions. If they raise costs and may not be effective, we must question why we are imposing these kinds of firewall at all".

US experience therefore suggests that firewalls are unable to prevent financially sound components of conglomerates being caught-up in the collapse of less sound affiliates of the same group. Rather than imposing watertight restrictions that seek to stem the flow of funds across a supposedly integrated business, reliance should be on ensuring that conglomerate business units are properly managed and separately capitalised entities, able to survive on their own resources if necessary and governed by a clear and well understood legal framework that allocates liabilities. Such an approach offers the best avenue for avoiding contagion across the group.

While the ability of some US firewalls to effectively segregate risk is open to doubt, others may offer models that contribute towards conglomerate financial stability and competitive neutrality in the delivery of financial services:

- in the US, transactions between commercial banks and their non-bank affiliates have to be on terms and conditions that are substantially the same as transactions undertaken with non-affiliated companies;

- transactions between affiliates of a holding company have to be on terms and conditions that are consistent with safe and sound banking practices; and

- an explicit prohibition on affiliates in a conglomerate from helping other entities in the group if the provision of that assistance results in the providers breaching their own capital requirements is an option discussed by the Tripartite Group. Depending on the circumstances, such a firewall could either help or hinder contagion. It could contribute to the emergence of problems by depriving conglomerate units of capital injections from within the group but it could also assist in convincing the markets that the viability of financially sound affiliates could not be jeopardised in the event of financial difficulties in one group affiliate.

FUNCTIONAL AND INSTITUTIONAL REGULATION.

The convergence toward financial conglomerates across OECD financial systems has, inevitably, triggered an international debate on the extent to which traditional functionally-oriented frameworks for regulation and supervision remain appropriate. As Borio and Filosa (1995) comment "contagion risk indicates that group interdependencies must somehow be taken into account; it also provides an argument against excessive reliance on intra-group operational restrictions: they may not work when they are most needed but they risk undermining any potential "synergies" between combinations of activities". The 1995 report of the Tripartite Group *on The Supervision of Financial Conglomerates* concluded that only supervising the components of a conglomerate on an individual basis would be ineffective - it was necessary to complement such an approach with assessments made on a group-wide basis.

The design of regulatory systems in several OECD economies where financial conglomerates are present faces the problems that:

- institutionally based regulation can result in the same function being regulated differently if it is undertaken in various types of financial institutions - violating the principle of neutrality in the treatment of competing providers;

- functionally based regulation can result in individual institutions falling within the jurisdiction of several regulatory authorities while the risk profile of the conglomerate in total may not be adequately addressed; and

- addressing the overall risks in a conglomerate can be far more complex than monitoring individual functions - the extent to which diversification has offered the business lower risks, management's degree of risk aversion across that range of markets, the legal separateness of the affiliates in the conglomerate, their capital adequacy and the extent of cross-funding may all be relevant in reaching a view on the aggregate risk in a conglomerate.

Inevitably, international discussion has concluded that sensible regulatory arrangements will have to combine a blend of functional and institutional assessment. Both approaches offer valuable insights into the prudential strength of financial systems. The functional approach offers the advantage that financial functions have tended to show greater stability than the configuration of institutions in financial systems. Adopting the functional approach as the basic building block of assessment ensures greater consistency of approach across institutions marketing essentially similar financial products, levelling the competitive playing-field. Moreover, this approach does not prejudge the institutional structure of financial systems, firms can adapt to competitive changes and modify their product ranges without having to overcome the inertia of a regulatory regime which specifies the type of functions that institutions of a certain "type" have traditionally performed.

The institutional approach, on the other hand, accepts the potential that risks can flow across the components of a financial conglomerate and the relevance of the conglomerate's aggregate position in prudential supervision. Experience in the US and UK shows that the markets and the public can view problems in one area of a conglomerate as evidence of potential difficulties across the entire group. Despite the best efforts of legal separateness and firewalls, contagion has been repeatedly evident across the operations of holding companies whose affiliates encounter difficulties.

Accordingly, even in the case of the US and the UK, where functional specialisation has been favoured, the authorities inevitably have to consider the strength of non-bank affiliates in making assessments of the prudential situation of banks. The US Federal Reserve's willingness to adopt an "umbrella supervisor" role, as specified in the Leach Bill, reflected its continued concern that the correct evaluation of the risks to a supervised US bank required an overview of the risk profile of the entire operation of which the bank was only a component. In the case of the UK, solo-plus consolidation in Bank of England supervision provides a mechanism through which they can make an assessment of the overall strength of a group to which a bank belongs.

Dale (1996) has stressed the importance of deciding whether risks within a financial conglomerate are to be pooled or segregated in the determination of choice about functional or institutional regulation. He sees institutional regulation and consolidated supervision as most appropriate where risks are pooled within the group. By contrast, where banks are more insulated from the risks incurred by related non-bank entities, functional regulation is more appropriate and consolidated supervision is less relevant. Experience in the US, where there is an elaborate regulatory apparatus designed to segregate risk but contagion effects still exist, suggests that the situation is less clear-cut and regulatory regimes need both institutional and functional elements, even where there are stronger efforts to segment risk.

The situation was well summarised by the Governor of the Bank of England earlier this year when he envisaged a continuing need for a "matrix" approach to supervision, involving both institutional and functional regulation of the UK financial system, regardless of the precise division of supervisory responsibilities between the various UK regulatory agencies.

Changing corporate structures in OECD financial systems might, it has been argued, require an even greater need for the thorough prudential assessment of a wider range of institutions. In particular, the move away from functionally specialised financial institutions and the development of a range of conglomerates - whether built around banks, building societies or insurance firms - has led to questioning whether an exclusive focus on banking in regulation designed to protect against systemic risk is still appropriate.

The traditional view has been that systemic risk is particularly associated with banking and the failure of other financial institutions is much less likely to lead to systemic difficulties. However, this unique alignment of systemic risk with a particular category of financial institution has been questioned. A recent paper from the London Centre for the Study of Financial Innovation (CSFI) argues that banks are no longer the only institutions of systemic importance and that securities houses, insurance companies and large building societies are of potentially equal importance. Moreover, each of these functionally specialised institutions may offer less potential for systemic risk than the large conglomerates. The key concept, in this view of the financial world, is the "systemically important" firm, which calls for the supervision of these businesses by a single regulator. Moreover, the degree of systemic risk faced by different types of financial institutions can hardly be expected to remain unchanged over time. For instance changes to payments systems offer the prospect of some reduction in the systemic risk faced by the banking system.

Authorities in some major OECD countries certainly do not discount the capacity for systemic risk to arise in other types of financial institution. The Chairman of the Federal Reserve Board sees the increased similarity in the activities undertaken by financial institutions as raising the prospect that disruption and pressures in non-banking financial markets could create systemic risk similar to that faced in banking. The Governor of the Bank of England, in a recent speech, after acknowledging that banks remain particularly vulnerable to contagion added that "it is a real possibility that, in today's far more complex and highly integrated markets, systemic threats can also arise from the failure of other types of financial institution". This highlights the continued relevance of institutional assessment in the monitoring of systemic risk in even those OECD economies whose supervisory arrangements are strongly functionally-oriented

LEAD AND MEGA-SUPERVISORS

Inevitably, the increased importance of conglomerates in OECD financial systems has led to debate on the extent to which there should be a parallel concentration in regulatory and supervisory responsibilities. The main institutional trends evident are:

- increased information exchange between the individual regulatory agencies with responsibility for supervising components of a conglomerate;
- the designation of a "lead regulator", responsible for coordinating the supervision of a conglomerate across a number of agencies; and
- the formation of "mega-regulators", single administrative bodies which cover entire national financial systems.

"Lead" and "mega" models each offer advantages and disadvantages:

- the lead regulator approach can enable the development and retention of specialised skills required for the effective supervision of financial functions,
- retaining distinct functionally-based regulators can result in higher compliance burdens and duplication as conglomerates have to report to a series of agencies, each with their own objectives, methodologies, forms and staff;
- as one agency takes responsibility for coordinating supervision of a given institution, the outcome should be clear lines of responsibility;

- however, if a conglomerate is broadly-based with a fairly evenly distributed pattern of activities across financial sectors, it can become less than obvious which regulator should take the lead in its supervision;

- under a mega regulator, territorial disputes between agencies would be kept in house and it should be easier to coordinate functional supervision between divisions of one authority than between independent agencies, each with specific statutory responsibilities to discharge and which they may not legally be allowed to delegate to each other;

- it may be easier to develop the skills and databases necessary to assess the aggregate risk profile of an integrated but diversified conglomerate within a mega-regulator, rather than relying on the more ad hoc coordination processes that could occur under the lead regulator model;

- supervising all financial institutions and products by a single agency may give the public the misleading impression that these institutions and products are all equally "safe" and that, if institutions encounter financial difficulties, all will be supported equally by the authorities;

- the Tripartite Group report sees a risk of "supervisory arbitrage", through which conglomerates shift activities within the group to avoid the relatively strict supervisory agencies. This would clearly be less feasible with a mega-regulator.

The UK experience provides evidence on the lead regulator model, a number of Scandinavian countries and Canada have developed arrangements more along the lines of the mega-regulator. In the UK, the pure functional basis of regulation/supervision (with the Bank of England responsible for banks, the DTI responsible for insurance firms and the SIB for securities houses) was modified by the arrangement between the Bank and the SIB that the former would be the lead regulator for all mixed banking/securities entities. This ensured that supervision then depended on conglomerate group structure as well as function and required the settlement of additional procedures to handle regulatory overlap.

While the lead regulator approach was endorsed by the 1995 Tripartite Group report as a model for coordinating the international supervision of conglomerates, the UK experience with this type of regulatory structure within a single jurisdiction has aroused some concern:

- a CSFI paper concluded that the system perpetuated the proliferation of regulatory agencies (one bank had to answer to six separate bodies), competitive inequality between banks and other financial institutions, differing regulatory styles and purposes between the various agencies and an unduly complex structure. The rationalisation of these functional regulators into an independent Financial Services Supervisory Commission was recommended;

- the establishment of coordinating mechanisms and the time-consuming negotiation of procedures to be adopted when firms encounter difficulties and their operations fall within the jurisdiction of more than one regulator seem unduly cumbersome and bureaucratic - particularly as contagion can result in the rapid unravelling of large conglomerates;

- Dale (1992) saw a more fundamental problem with UK regulatory arrangements - an inconsistency between functional regulation and a corporate regime where risks are assumed to flow between the various parts of the same financial group. In his view “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 functional basis to individual subsidiaries within the group?”.

In view of these concerns there is merit in establishing a mega-supervisor with strong functional divisions and an institutional focus where an assessment of overall group strength can be made. Such an organisation could operate more effectively in the more functionally integrated financial system that is evolving and the creation of a domestic mega-regulator would in no way preclude the Australian authorities from playing a role in the "Lead Regulator" model preferred by the Tripartite Group for coordinating international financial supervision.

CONCLUSION

The international evidence and trends are that:

- there is a clear move toward the construction of financial conglomerates in economies that have traditionally emphasised functional specialisation in the provision of financial services. The main exception to this trend is the US where repeated attempts to repeal the Glass-Steagall Act and allow the creation of diversified financial services holding companies have been blocked;

- nevertheless, US evidence shows that the creation of financial conglomerates would permit the achievement of better combinations of risk and return than are available to specialised providers of financial services and that there is no basis for its legislated separation of banking, insurance and securities business;

- funding firewalls are a costly and ineffective mechanism that have repeatedly failed to segregate risk and avoid contagion between the units of a conglomerate when difficulties are encountered - they merely deprive the group of synergy benefits;

- clarity in the legal position of a conglomerate and its affiliates for liabilities incurred is necessary - legal separateness can help alleviate contagion within the group;

- institutional and functional supervision each offer advantages and disadvantages, sensible procedure is to combine elements of both in a "matrix" approach;

- the growing importance of conglomerates supports the case for a "mega-supervisor", able to apply consolidated supervision to the entire group while retaining strong functional divisions in its structure to maintain expertise. The "lead regulator" model appears to have greater coordination difficulties and an arbitrary element.

It is already possible to create financial conglomerates in Australia but, until the CML/SBNSW link, the holding company has been required to be a bank. It is important that the new Australian regulatory regime does not impede local firms from participating fully in the international trend toward diversified financial groups. Remaining restrictions on ownership and market entry should be abolished and the new regulatory regime should not include restrictive provisions such as funding firewalls, which overseas experience has shown are of dubious effectiveness but which limit the extent to which conglomerates are able to secure the synergies that will help Australian firms compete. International regulatory trends have clearly evolved toward making the creation and integrated operation of financial conglomerates less difficult and Australian regulatory practice should follow the same course.