



Aligning Financial Supervisory Structures with Country Needs

Edited by
Jeffrey Carmichael
Alexander Fleming
David Llewellyn

WORLD BANK INSTITUTE

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Foreword

On December 4–5, 2003, at its headquarters in Washington, D.C., the World Bank Institute held a conference entitled *Aligning Financial Supervisory Structures with Country Needs* in which some 77 participants from 52 countries took part. This book, which presents the proceedings of that conference, contributes to a growing volume of literature in a field—determining financial supervisory structure—where very little existed just five years ago. The book adds value by synthesizing the range of views, setting out the frame of reference for assessing possible changes in supervisory structure, and offering a rich set of case studies elaborated by leading practitioners from the countries concerned.

Increasingly, governments have been asking themselves whether their current financial supervisory structure is appropriate for overseeing their quickly evolving financial sectors. Such financial sectors are often characterized by a brisk pace of innovation and by significant institutional changes,

including the emergence of financial conglomerates offering a wide range of financial services. In response to these changes, governments are examining the options for aligning their supervisory agencies with the evolving financial sector. One concern driving this issue is whether the far-reaching developments in financial markets are providing scope for regulatory arbitrage: that is, the possibility of financial institutions purposely redirecting business through channels that require less supervisory oversight and perhaps lower capital costs. Governments are also pondering whether changes in financial supervisory structure will lead to improvements in the efficiency and effectiveness of their financial supervisory function. The conference provided participants with the opportunity to cross-fertilize ideas on issues of financial supervisory structure and to understand why and how some countries have initiated structural changes. It also sought to identify the pros and cons of different financial supervisory models.

The World Bank Institute set out to design a conference program that would yield a balanced set of views on the question of appropriate supervisory structure. Given the selection of papers from countries that had decided in favor of change and that, for the vast majority, had elected to amalgamate some or all of their regulatory agencies, it is inevitable that the general messages from the conference appear to favor some degree of regulatory integration. That said, there was considerable debate over the optimal extent of integration and the importance of tailoring the structural model to a country's specific cultural and economic circumstances. The overview (chapter 1) and the discussion of basic issues (chapter 2) attempt to address the rival views on this contentious topic in an evenhanded way, taking into account the

wide range of structural options open to countries. In keeping with the approach adopted at the conference, neither the World Bank Institute nor the editors endorse any particular model of supervisory structure in this book of proceedings.

We would like to recognize a number of people who have been instrumental in the preparation of this book. We are grateful to those who participated in the conference as speakers and subsequently turned their speeches into the text for this book. Colleen Mascenik did an excellent job of organizing and running the conference on which this book is based and efficiently shepherded the book through its production phase. Michael Taylor and Donato Masciandaro reviewed the manuscript, Elizabeth Forsyth copyedited the papers, and James Quigley designed the cover and typeset the text.

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Chapter 1

Summary of the Discussion

Jeffrey Carmichael

This book is the result of a World Bank conference on regulatory structure organized to give policymakers an opportunity to reflect on the worldwide trend toward structural change and, in particular, the amalgamation of regulatory agencies. Within this trend, a number of competing models of regulatory structure have emerged, each with its group of proponents. These models range from an institutional structure in which each regulatory agency is assigned to a group of industry participants, through varying degrees of regulatory integration, to a unified structure in which all key regulatory responsibilities are combined within one agency. Rather than highlight one—or more—model as necessarily superior to the others, the conference sought to take an objective and balanced approach to the topic. This objective is reflected in a number of the presentations gathered here, including chapter 2, which, by providing a balanced overview of the alternatives, outlines the spectrum of possibilities and the range of

issues that might influence the decision to choose a particular structure in a given situation.

The conference was structured around three themes: the choice of an appropriate structure for regulation, problems relating to management of the transition to a new structure, and issues involved in implementing the new regime effectively.

Choosing an Appropriate Regulatory Structure

Discussion and debate about the merits of different regulatory structures continued throughout the conference. Interest revolved primarily around the extent to which different degrees of integration of agencies might materially improve regulatory effectiveness and the risks that might accompany such changes.

A number of presenters put forth the position that no perfect structural model is applicable to all countries. Although this position was generally maintained throughout the conference, two polar perspectives were expressed. At one end of the spectrum, the case for preserving an institutional regulatory structure was strengthened by concerns about legal impediments to integration in many emerging-market economies. Whereas developed economies typically have well-developed legal systems and are committed to the rule of law, this is not always the case in emerging-market countries. Examples were cited of countries where attempts to establish a regulatory agency independent of the central bank encountered constitutional difficulties. The resulting agencies lacked the legal powers and authority to regulate effectively. The same legal constraints faced attempts to consolidate non-bank regulatory functions within the central bank.

Exploration of this proposition led to agreement that, while legislative constraints are an impediment in some countries, in many others, particularly those with a common law legal heritage, they are not a hindrance to implementing and benefiting from regulatory integration, where other factors support such a change. This raised a common theme: namely, that the appropriate regulatory structure at any point in time cannot be defined without considering the legal and cultural heritage of the country.

At the other end of the spectrum, the case was put that, legal impediments aside, a fully integrated regulatory structure is likely to be superior to a fragmented structure for the following reasons:

- Integration better matches the industry structure in most countries.
- Integration offers economies of scope (synergies) between different functional areas of regulation in terms of both staff skills and regulatory neutrality.
- Integration offers economies of scale and a more efficient use of scarce regulatory resources.
- Integration better facilitates international cooperation.

At the risk of overstating the degree of convergence, most participants in the discussion probably would have supported the proposition that, in the majority of cases, there are likely to be significant gains from some integration of a heavily fragmented regulatory structure. There would have been much less agreement about the appropriate form and extent of integration. Put differently, there was general acceptance that the structural choice should not be painted in terms of the extremes of full integration or total fragmentation. Inte-

gration is a spectrum and can take many forms. The optimal form and extent of integration are likely to be specific to the country and situation. In particular, issues such as whether or not integration should necessarily amalgamate prudential and market conduct regulation and whether or not the integrated agency should reside within or outside the central bank cannot be resolved independent of context. In particular, emerging-market countries in general face different issues and motivations for their regulatory structures than do developed countries.

Notwithstanding the general support for at least some form of integration, participants raised three reservations for discussion. First, the timing of integration can be important. In some situations, due to crisis or the strains of other recent changes, economic stability may be improved by dealing with the more immediate issues and holding integration until the system is better able to absorb the inevitable disruptions that accompany structural change. Second, while integrated agencies offer theoretical gains in regulatory effectiveness, none has yet been adequately tested in crisis. This is an important consideration in that more or less any institutional structure can work in calm times; the real test is how well structures manage the strain in a crisis. Third, there is a risk in large centralized agencies that industry differences may be lost in the drive to find a common approach to supervision; such an outcome could retard the development of important non-bank financial institutions.

Within the discussion of different forms of integrated structures, the appropriate role of the central bank was the most difficult and contentious issue. One important message was that removing banking supervision from central banks is rarely the result of deciding that the central bank is not a

competent—or even the best—regulator of banks, but, rather, the result of deciding that significant gains can be extracted from combining banking supervision with other forms of prudential supervision. Although this usually leads to the decision to move banking supervision to a separate agency, this is not always the case, and participants showed particular interest in the Irish model, in which a semi-independent, fully integrated prudential and market conduct regulator was established as part of a restructured central bank. In this model, the regulatory agency resides within the central bank but has its own governance and policy board.

Conflicts of interest were raised as an argument for separating banking supervision from the central bank (especially where there is central bank ownership of financial institutions); also raised was the potential for reputational damage to monetary policy arising from institutional failure in the supervised sector. On the other side of the debate, it was argued that central banks are better positioned to manage crises if they are both the lender of last resort and the supervisor of banks. At a minimum, it was widely agreed that crisis management requires good cooperation and coordination between the central bank and prudential regulator and robust sharing of information between them. The Scandinavian experience with simulations of crisis situations involving both the central bank and financial regulator was noted positively in this context; potentially critical misunderstandings or confusions about where particular responsibilities lie often can be exposed through simulations that “fire test” a particular crisis situation. Finally, it was suggested that the independence and credibility of a central bank might be more likely to withstand a crisis intact, whereas a new integrated agency without the history and constitutional support of the central bank may have more difficulty.

No simple resolution of this issue was either expected or found; the appropriate role of the central bank in the structure of financial regulation will remain a country-specific issue.

It was also interesting, though not surprising, to hear speakers reflect on the extent to which structural decisions are influenced by the circumstances at the time. Thus Australia's decision to focus on reducing the cost of supervision was a consequence of its concerns about financial sector mobility in the face of lower-cost regimes in the region. Had the decision to pursue reform been made after the Asian crisis rather than before it, the emphasis on lower costs as a factor in the design may have been downplayed relative to regulatory effectiveness. Indeed, the importance of adequate resources for regulatory effectiveness was a consistent theme throughout the discussion. In South Africa, changing circumstances, including a banking crisis, not only have delayed implementation of the decision to undertake structural reform but also have reopened the debate. In Republic of Korea, the decision to reform the regulatory structure was closely tied to the need to make financial supervision and monetary policy more independent of government. In each country, the circumstances contributed significantly to the structural outcome.

Managing the Transition

The conference offered participants a welcome opportunity to share a range of practical experience on dealing with transitional issues. There is a huge gulf between deciding on an optimal regulatory structure and implementing it effectively. The universal message from presenters was that implementation takes time, patience, and careful planning. A theme

common to several countries was that those who designed the new regulatory structure were often (at least partly) disappointed with the way in which the structure was implemented and the difficulties in achieving the objectives and expectations of the designers.

Various issues were identified as worthy of careful consideration in any transition from a fragmented regulatory structure to a more integrated one.

First, there is a challenge in integrating different cultures. Those who had been through the transition generally agreed that, within the prudential sphere, banking supervisors adjusted more readily to supervising other institutions than did insurance supervisors. In part this may be a consequence of the greater sophistication of banking supervisory techniques (especially the greater risk-based focus of banking supervision). In part it may be a consequence of the narrower, liability-focused approach of insurance supervision. Although differences remain between industries and supervisory approaches, the similarities are much more marked than the differences (especially after the terminological differences have been removed). In the United Kingdom, the inherited cultures were widely different, but the desired culture of each group showed a surprising degree of convergence. A second challenge—where all forms of regulation are combined under one roof—is the integration of prudential and market conduct cultures. A third cultural challenge arises when some inherited staff are used to working with a governing board, while others are not. Both Australia and Estonia shared interesting experiences in this respect.

Second, there is a challenge in ensuring that no areas are neglected during the transition. A number of participants were concerned that the less developed areas of supervi-

sion (such as pensions and insurance) may suffer neglect, while the more advanced areas (such as banking and securities) receive higher priority; however, experience generally supports the opposite proposition. Integrated agencies established in recent years appear to have concentrated primarily on upgrading and strengthening the less developed areas of supervision, with the result that banking supervisors have, in some cases, felt neglected. Maintaining a balance among capacity building, consistency of supervision across sectors, and staff morale is a significant challenge. Interesting, although perhaps not surprising, that balance apparently has been easier to strike in countries where integrated agencies have been staffed more by new hires than by inherited staff.

Third, internal structures do appear to matter. Internationally, there are almost as many different internal structures as there are integrated regulatory agencies. Experience, especially in Canada and the Nordic countries, supports the proposition that extracting the higher-level synergies from integrated regulation requires an internal structure that breaks down the traditional boundaries of industry and refocuses on functions or risks. Experience with these more radical structures remains limited but promising. That given, participants agreed that it is still possible to extract significant lower-level synergies (such as efficient use of resources and better supervision of financial conglomerates) from an institutionally based structure. One important characteristic of internal structure in any integrated agency is that it must facilitate adequate oversight of financial conglomerates, including both the individual entities and the conglomerate as a whole. The Swedish experience with internal structures and attempts to build an integrated culture reflect the experience

of a number of countries by demonstrating that outcomes involving people rarely happen the way the designers expect them to.

Fourth, staff training can never be done quickly enough. Changing the regulatory structure inevitably requires the development of skills different from those of the predecessor agencies. The experience of El Salvador is particularly instructive in this respect in that supervision was devolved from a centralized agency within the central bank to a decentralized structure. Notwithstanding this movement against the worldwide trend, the failure to develop appropriate staff skills quickly enough is widely regarded as a significant factor contributing to the financial crisis that followed.

Fifth, there is a need to manage personal insecurities. In most countries that elect to change their regulatory structure, the transition typically begins well before the date of implementation. This can be a period of great insecurity as individuals worry about whether or not they will have a job in the new institution(s). For example, in moving to an integrated structure, Estonia and Korea chose to work primarily with the staff they would inherit from the existing agencies and to involve them as much as possible in the decision-making and institution-building that took place. In both cases, staff appear to have been strongly committed to the new common culture. In Korea, as in a number of other countries, insecurity probably related less to job tenure than to the hierarchy of staff in the new structure.

Making Structures Work

Two main themes ran through the discussion of how best to make regulatory structures work: the need to provide a suit-

able legislative framework for the regulator and the need to communicate adequately with stakeholders.

The need for appropriate legislation surfaced repeatedly throughout the conference. There was considerable discussion and interest in the linked concepts of independence and accountability. Independence was argued to require both the ability to set and implement regulatory policy free from direction by the government (other than in the national interest and then in a transparent manner) and protections for staff and the agency's finances.

The other key component of a sound legislative framework is supervisory power. Discussion covered two extremes: detailed and framework legislation. In the former, regulatory policies are detailed fully in the law. In the latter, the law contains broad powers only, with the detail provided through regulations or by-laws developed wholly or largely by the regulator. Framework legislation was generally agreed to be both more flexible and more appropriate given the complex and fluid nature of financial regulation. The difficulty, as several participants noted, is that many emerging-market countries are reluctant to confer such wide-ranging powers on unelected regulatory bodies.

A second legislative issue, particular to integrated agencies, concerns the inconsistencies that can arise between the underlying sectoral laws and the objectives of integrated regulation. The example was given of the difficulty of attempting to build a consistent framework for consolidated supervision for bank and insurance holding companies where the banking and insurance laws give the regulator fundamentally different powers. A repeated theme was the need to address the appropriateness of the entire legislative framework at the time an integrated regu-

lator is established rather than to leave legislative reform to a later round.

Several contributors underlined the need to communicate with stakeholders and to maintain that communication. The Hungarian experience and, to a lesser extent, the Australian experience both highlighted the dangers of failing to maintain good communications with and the support of government. This danger is especially marked for agencies that are granted a high degree of independence, because the need for regular communication with government (and the government's demand for regular communication) is usually reduced when the regulator has a board to act as a "buffer" between the agency and the government and its bureaucracy. In the Hungarian case, the government is in the process of attempting to take back the independence previously granted to the regulator; the action appears to be a consequence of a dispute over the appropriateness of actions taken by the regulator. In the Australian case, the government reduced the independence of the regulator by taking back the power to make regulatory policy following the failure of a significant financial institution.¹ One possible lesson from these experiences is that independent regulatory agencies are probably more vulnerable to having their powers and independence reduced by government than are central banks. Central banks have a much longer history, have earned their independence, and, in many cases, have their independence enshrined in the country's constitution. Of course, not every central bank can claim such a revered position in the financial system. In El Salvador, the decision to decentralize regulatory power away from the central bank was taken at least partly because of the perception that the central bank had failed in its financial management responsibilities. Perhaps the broader lesson

is that credibility is hard to earn but easy to squander and therefore must be guarded jealously.

The experience of the U.K. Financial Services Authority (FSA) on the subject of communicating with stakeholders is particularly interesting. FSA is one of the few regulatory agencies in the world that has elevated communications with stakeholders to a major objective, devoting considerable resources to public education about regulation. It conducts regular surveys of staff on topics such as the agency's vision and the ideal culture for such an agency. Communications and consultations with industry are even more extensive. In some cases, the response from industry indicates that FSA may even have provided an overload of consultation and communication. While communications at this level are costly and time-consuming, the net outcome appears to be that FSA has weathered recent problems better than agencies that have committed fewer resources and less effort to communication.

Other Issues

The issue that struck the deepest chord during the course of the conference was speculation about the future of the overall regulatory structure in Europe. Just as market integration within the European Community led eventually to the unified European Central Bank, some regulators can see the same inevitability in the area of financial regulation. Experience in the Nordic countries illustrates the incongruity of having national regulators attempt to supervise transnational financial conglomerates whose country of incorporation or central operations can shift with the stroke of a pen. The situation is comparable to a state-based system of banking regulators attempting to supervise nationally operating banks. The chal-

lenge is compounded in the European case by the fact that the financial institutions in question are often conglomerates spanning multiple sectors and countries, while some of the regulators involved are specific to both a country and a sector. The potential for a centralized European financial regulator and the shape that such a regulator may take are likely to be significant constraints on the direction of regulatory restructuring in European countries in coming years.

Conclusions

Several key messages were emphasized at the end of the conference.

First, there is no perfect model of regulatory structure. Every model has both problems and challenges. This lack of perfection should not be used as an excuse for inaction. If there are benefits from change, then change should be considered.

Second, no matter which model is chosen, arrangements for strong internal governance are needed if the system is to operate effectively. These arrangements should cover at least the agency's independence, accountability, and transparency. The need for good governance increases as the size of the institution and the breadth of its regulatory canvas increase.

Third, focusing on the finer points of regulatory structure should not deflect attention from the basic objectives of regulation. The ideal regulatory structure at any point in time is that which provides the best cost-benefit ratio for providing systemic stability, safety and soundness of financial institutions, and market efficiency and fairness.

Fourth, timing matters. While for some countries the benefits of moving to a stronger regulatory structure may be

significant, they may be dominated at different points in time by the exigencies of the immediate situation. Given the transitional and cultural issues that need to be handled in changing any regulatory structure, there is a strong case for doing so in a period of reasonable financial stability.

Fifth, the legal framework is critical. Where regulatory integration is pursued, integrated legal powers may be necessary if the regulator is to maximize the synergies available from the new structure. Given the reluctance of politicians to revisit legislative change more than they have to, it is important to recognize a period of structural change as an opportunity for legislative change. It is an opportunity that should not be passed up lightly.

Finally, people matter. Change requires management. For a change of regulatory structure to be successful, it must include careful consideration and management of the human elements.

All of these themes are reflected in this book, which gathers the presentations made during the course of the conference. Chapter 2 presents a detailed overview of the issues for and against different regulatory structures. Chapter 3 addresses the choice of structure, including papers on the experience of Australia, South Africa, and Ireland. Chapter 4 addresses the speed of change and the need to balance the risks, including papers on Sweden and Korea. Chapter 5 deals with transitional issues in emerging markets, highlighting experience in Hungary and Ecuador. Chapter 6 discusses the critical issue of making regulatory structures effective, with a paper on legal issues and papers on the experience of Estonia and the United Kingdom. Chapter 7 presents the keynote addresses.

Notes

1. While the failed institution, HIH insurance company, was the second largest general insurance company in Australia, it accounted for less than one-third of 1 percent of prudentially regulated assets and even less of prudentially regulated financial institutions.

Chapter 2

Institutional Structure of Financial Regulation and Supervision: The Basic Issues

David T. Llewellyn

Around the world, many countries are considering the institutional structure of regulatory and supervisory agencies in the financial sector on the grounds that the existing structures, which were often established in a markedly different market and institutional environment than exists today, may have become inappropriate. In this context, the objective of this chapter is to consider some of the issues involved in reorganizing the institutional structure of financial supervision. It is designed to set the background for the more detailed chapters in this volume. In particular, the chapter focuses on six key issues:

- The reasons why institutional structure is important in the design of optimal regulatory regimes and why the issue has arisen at the present time
- The range of alternative options within a *regulation matrix*
- The advantages and potential hazards of unified or integrated agencies

- The role of the central bank in alternative institutional structures
- A review of international experience
- Corporate governance arrangements of regulatory and supervisory agencies and their contribution to the effectiveness of regulation and supervision.

The paper is structured as follows. After outlining a set of general perspectives about the role of regulation and supervision in the financial sector, the paper discusses the origins of the current debate about institutional structure and some of the key issues to consider. This is followed by a brief discussion of why institutional structure is a significant issue and the various options for institutional structure in the framework of a regulation matrix. The paper then reviews the advantages and potential hazards of integrated versus multiple agencies, the “twin peaks” model favored in some countries, and the concept of a mega agency that incorporates all prudential and conduct-of-business regulation. The role of the central bank in institutional arrangements is discussed next, followed by a brief review of international experience with respect to the choice of institutional structure. A final section reviews some of the issues related to corporate governance arrangements, and an appendix discusses issues related to the supervisory treatment of financial conglomerates.

The question of institutional structure of financial regulation has become a major issue of policy and public debate in several countries. Three strategic issues in particular arise: (1) whether to have unified or integrated agencies for prudential and systemic stability regulation encompassing all financial firms and markets (the creation of integrated or unified agencies) or whether to conduct regulation and supervi-

sion on the basis of specialist agencies for banking, securities, insurance, and so forth; (2) the role of the central bank in this area; and (3) whether conduct-of-business regulation should be included within a single all-embracing agency or conducted by a dedicated agency.

While many countries have moved in the direction of a unified agency for prudential regulation and supervision, the case for integrating conduct-of-business regulation and supervision within the same agency is less powerful and considerably less common.

In this context, increasing emphasis is being given to the question of whether the efficiency of regulation and supervision in achieving their objectives may be influenced by the particular institutional structure in which they are conducted. In most countries, the traditional structure has been to have separate agencies and arrangements for regulating and supervising banks, insurance companies, and securities trading. This is largely because, traditionally in many countries, these have been separate activities conducted by specialist institutions with little overlap between them. In this model, there is little distinction between *institutional* regulation (that is, regulating the safety and soundness of institutions) and *functional* regulation and supervision (that is, regulating the activity) because institution and function are synonymous. However, this is less valid when financial conglomerates emerge and firms across the board diversify into each other's traditional territory.

Institutional Structure

In many countries governments have been reviewing their institutional structure of financial regulation, and in some

countries major changes have been made. For an historical perspective on this, see Taylor and Fleming (1999) who emphasize the variety of experiences of different countries, including, for instance, the contrasts between Scandinavian countries with similar institutional models.

Institutional structure refers to the number and structure of agencies responsible for the regulation and supervision of financial institutions and markets, which includes the role of the central bank in this area. While it is universally agreed that the central bank has a major responsibility for maintaining systemic stability, the definition and legal authority for this are often blurred. Financial stability usually refers to the risks to the financial system as a whole and the integrity of the payments system. However, there is much controversy over how financial stability (and therefore the mandate of the central bank) is to be defined (see Oosterloo and de Haan 2003 for a survey of alternative definitions). Only a few countries have any formal legal basis for giving the central bank a role in systemic stability.

However institutional structure is defined, the central bank is universally accepted to have oversight of the stability of the system as a whole. Yet the central bank is not necessarily the supervisory agency for individual banks or other financial institutions and markets. In some countries, this debate is also linked to issues related to the independence of the central bank with respect to the conduct of monetary policy.

A central issue in the debate is the extent to which financial regulation between different types of business should be integrated and whether responsibility for financial regulation and supervision should be vested in a single agency. One of the most radical changes in institutional structure

was the decision of the United Kingdom in 1997 to abolish the plethora of specialist regulatory and supervisory agencies and to merge all regulation into a single agency. Responsibility for the supervision of banks was taken away from the Bank of England and vested, along with all other regulation of financial institutions and markets, in the Financial Services Authority (FSA). Many other countries have also recently changed the institutional structure of financial regulation and supervision, with the general trend being to reduce the number of agencies involved. However, no common pattern has emerged in detail. In particular, while some (including Denmark, Hungary, Iceland, the Republic of Korea, Latvia, South Africa, Sweden, and the United Kingdom) have adopted the single-agency approach (at least as far as prudential supervision is concerned), this has not been a universal model when change has been made. Of the countries that have made changes, Australia is a notable exception to the single-agency model, opting for the “twin peaks” model.

A review of international experience indicates the wide variety of institutional structures (see Goodhart and others 1998). There is a spectrum of alternatives rather than an either-or choice, and there is considerable variety within the spectrum and even within the same basic model. National differences reflect a multitude of factors: historical evolution, structure of the financial system, political structure and traditions, and size of the country and financial sector. Although there is no universal pattern, there is a general trend toward reducing the number of separate agencies, integrating prudential supervisory arrangements, reducing the role of the central bank in prudential oversight of financial institutions, placing more emphasis on the role of the central bank in sys-

temic stability, and, if a unified agency is created, making this an agency other than the central bank.

Some Initial Perspectives

To set the context, let me offer some initial perspectives before considering more detailed arguments about the alternative models for institutional structure.

Regulation, the Financial System, and the Economy

A stable and efficient financial system has a potentially powerful influence on a country's economic development, not the least because it may have an impact on the level of capital formation, efficiency in the allocation of capital between competing claims, and the confidence of end users (consumers) in the integrity of the financial system. The stability and efficiency of the system have both supply-side and demand-side effects on the economy. In turn, a well-structured regulatory regime contributes to the efficiency and stability of the financial system. A central issue, therefore, is whether the institutional structure of financial regulation and supervision has any bearing on the efficiency of financial regulation and supervision itself and on the wider economy.

Over-regulation

While the economic rationale of financial regulation is well established (see, for instance, Llewellyn 1999a), there is, nevertheless, an ever-present potential to over-regulate and in the process to impose avoidable costs on the system and on

the suppliers and consumers of financial services. There is almost an inherent tendency to over-regulate because regulatory and supervisory services are not provided through a market process but are imposed externally. Consumers have no choice with respect to the amount of regulation for which they must pay. This means that regulation has a *cost* but not a *price*. In this case, consumers will rationally perceive regulation to be a free good and hence will over-demand it. If this is coupled with a risk-averse regulator (who is blamed when there are regulatory failures but not praised when there are none), it is almost inevitable that over-regulation will emerge, as it will be both over-demanded and over-supplied. In this case, there is the issue of whether particular institutional arrangements for regulation and supervision may themselves be able to address this issue more effectively.

Objectives of Regulation

One way to guard against the danger of over-regulation is for the objectives of regulation, and the remit of regulatory and supervisory agencies, to be both clearly defined and limited. Four key objectives are traditionally identified: (1) systemic stability, (2) the safety and soundness of financial institutions, (3) consumer protection against hazardous behavior of individual financial institutions, and (4) the maintenance of consumer confidence in the financial system and the integrity of financial institutions. Additions to this might include protecting against the moral hazards attached to safety net arrangements (lender of last resort and deposit insurance) and maintenance of market integrity.

Although these objectives may vary from country to country in how they are defined and formulated in practice,

they form the basis of regulation and supervision in the financial system in virtually all countries. The temptation to extend the remit of financial regulation needs to be resisted. In this context, different institutional structures may be more effective in contributing to the central objectives of regulation and supervision. Within a broad spectrum of alternatives, the arguments range from, at one end of the spectrum, a view that a mega agency responsible for all aspects of regulation and supervision in the financial sector is most likely to deliver on the objectives to, at the other end of the spectrum, the view that specialist and focused institutions responsible for different objectives are more likely to succeed.

Universal Functions

The basic functions performed by regulatory agencies are universal and cover 10 main areas:

- Prudential regulation for the safety and soundness of financial institutions
- Stability and integrity of the payments system
- Prudential supervision of financial institutions
- Conduct-of-business regulation (that is, rules about how firms conduct business with their customers)
- Conduct-of-business supervision
- Safety net arrangements such as deposit insurance and the lender-of-last-resort role performed by the central bank
- Liquidity assistance for systemic stability; that is, liquidity assistance for solvent institutions
- The handling of insolvent institutions
- Crisis resolution
- Issues related to market integrity.

Regulatory and supervisory agencies need to address these universal areas in one way or another. The debate about institutional structure is, therefore, not about which activities are to be conducted, but which agencies are to be responsible for which functions.

Role of the Central Bank

Irrespective of what role, if any, is assigned to the central bank with respect to the prudential regulation and supervision of financial institutions, the central bank must always be the agency responsible for stability of the payments system, liquidity assistance to markets and solvent institutions, and systemic stability. One dimension of the debate about institutional structure is whether these functions can be effectively performed by the central bank if it is not also responsible for the prudential supervision of the individual institutions that make up the system. There are several dimensions to this issue, including the independence and authority of the central bank, its skills, and whether its role in monetary stability might be compromised by failures in the regulation and supervision of financial institutions if it is given this role. This is discussed in a later section and also in several other papers in this volume: notably, the experience of South Africa, as outlined in the paper by Andre Bezuidenhout.

No Universal Model

Given the wide diversity of institutional arrangements for financial regulation and supervision that exist in the world (for two surveys of this, see Healey 2001; Llewellyn 1999b),

there is no single model for optimal institutional structure. Equally, there is no single model that all countries are converging on. There are advantages and disadvantages to all forms of institutional structure, including unified agencies. Nevertheless, many countries are reducing the number of regulatory agencies.

No System Is Perfect

It is an illusion to believe that there is a single, superior model of institutional structure that is applicable to all countries. To some extent, the optimal structure may depend on the structure of a country's financial system. Equally, it is an illusion to believe that any structure is perfect or guarantees effective and efficient regulation and supervision of the financial system. Changing the institutional structure of regulation should never be viewed as a panacea or as a substitute for effective and efficient conduct of regulation and supervision.

Two Questions and a Possible Dilemma

Two related, though different, questions feature in the debate about institutional structure: (1) should the central bank be the supervisor of banks, and (2) should there be a single, unified agency for all financial institutions? The two questions are related, and a dilemma may arise in the answers. For instance, as is recognized in many countries, there may be a case for the central bank to regulate and supervise banks. However, for reasons outlined in later sections of this paper, there may also be a case for having integrated or unified regulatory agencies and perhaps even a single agency cover all

aspects of the financial system. A dilemma can arise because, while it may be argued that central banks should regulate and supervise banks, there are strong reasons why it would be hazardous for the central bank to regulate all aspects of the financial system and all types of financial institutions. One reason is the perception that the safety net might be extended to the full range of financial institutions. In fact, only in Singapore does the central bank have such a wide regulatory and supervisory role. The dilemma arises if a country would normally choose to have the central bank regulate and supervise banks but also, for other reasons, would prefer to have a single agency. In the United Kingdom, for instance, the reason for creating a single regulatory agency and moving banking supervision from the Bank of England was not because of a judgment that the central bank should not be the supervisor of banks, but because of the strong case in favor of a unified regulator and the opinion that such an agency should not be the central bank.

There are several reasons why countries have not vested the powers of a single unified agency in the central bank. A major factor, most especially when the central bank is independent of government in the operation of monetary policy, is that, if it were also to be the unified regulatory and supervisory agency, it would become an extremely (possibly excessively) powerful institution. Because the central bank is always the lender of last resort, if it were also the single unified regulator this might be perceived as extending the lender-of-last-resort role to the full range of financial institutions. This would also extend the moral hazard that can exist when it is perceived that financial institutions or their customers will be compensated in the event of loss due to insolvency. Many analysts believe that this moral hazard is

too serious, even without extending it to other institutions as well.

Use of Resources

A central issue facing all countries relates to the use of supervisory resources, as these are in short supply and can be expensive. This has induced some regulatory agencies (notably FSA in the United Kingdom) to focus on risk-based supervision whereby resources are applied disproportionately to those firms considered to be most at risk, whether that be in terms of solvency or conduct of business with consumers. This also has the effect of creating incentives for regulated firms to be compliant by lowering their own costs of supervision as they are treated more flexibly than are more risky firms. The institutional structure of regulatory and supervisory arrangements may have an impact on the efficiency with which scarce supervisory skills and resources are used.

Skills and Remuneration

Linked to this is the issue of the skills of the regulatory agencies and the remuneration of skilled staff. In many cases regulatory agencies are at a competitive disadvantage when bidding in the market for the necessary skills because those same skills are also demanded by regulated firms, which are usually in a position to offer considerably more attractive remuneration packages for skilled people. Effective regulation cannot be secured on the cheap because the necessary skills are very demanding. This means that agencies must be adequately resourced if they are to match the skills of those they

are regulating. This, in turn, requires that regulatory and supervisory personnel be adequately remunerated even if this means moving outside the salary range of, for instance, civil servants. To cut costs by under-resourcing regulatory agencies and not paying market-related salaries is likely to be a false economy. Money will be saved, but at the expense of effective and efficient regulation and supervision.

Accountability

Regulatory agencies have considerable power for both good and ill. As already noted, and unlike other goods and services, regulatory services are not provided through market mechanisms. In addition, the regulator acts as a monopolist. This means that the discipline of the market is not present to constrain the regulator, as it is with most other goods and services. There is, therefore, a need to establish proper accountability mechanisms for regulatory agencies. The three key issues are to whom, in what way, and when are regulatory agencies to be accountable? While the precise optimal arrangements will vary between countries, some form of credible accountability mechanism has to be established. However, care is needed in this area, because to make regulatory agencies too accountable might also be to make them excessively risk averse. A balance needs to be struck.

Political Independence

However, it is also important for regulatory agencies to be politically independent and not subject to political interference. Quintyn and Taylor (2002) offer useful analysis of this issue.

There are several reasons for this. It is important for agencies to be seen as politically independent, because such independence is essential for consumer and industry credibility, and political authorities may wish to influence a regulatory agency for purposes other than regulation (such as favoring certain types of lending) or for short-term political advantage. It also is important for regulatory agencies to behave consistently over time and between institutions. This means that a careful balance needs to be struck between legitimate demands for regulatory agencies to be accountable and the need for them also to be independent of political influence.

Corporate Governance

A major issue to consider is the set of corporate governance arrangements with respect to regulatory and supervisory agencies and the extent to which sound governance arrangements can enhance the effectiveness, reputation, and credibility of an agency. A later section emphasizes, in particular, the issues of transparency, accountability, independence, and integrity.

Origin of the Debate

While the debate about the institutional structure of regulation and supervision in particular countries inevitably reflects country-specific factors and the prevailing institutional structure, the debate has recently emerged for more general reasons.

In many countries, the structure of regulatory agencies was devised for a financial system with a different structure than exists now. Financial innovation and structural change

have challenged many of the assumptions made at the time current structures were created. This raises the issue of whether the structure of regulatory institutions should mirror the structure of the financial system and the business of regulated firms.

The emergence of financial conglomerates has challenged traditional demarcations between regulatory agencies and has made the business of regulation more complex. This is discussed in more detail in the appendix to this chapter. In particular, the issue arises as to whether a structure based on specialist agencies supervising different parts of the business of a financial conglomerate may lose sight of the institution as a whole.

Over time, changes in institutional structure have often responded to particular financial failures, and a pragmatic, piecemeal structure has emerged that would not necessarily be created from scratch and without the legacy of existing institutions. It is appropriate from time to time to review what has emerged and to consider whether a more coherent structure might be put in place.

In many countries the objectives of regulation have become more complex and extensive. For instance, conduct-of-business issues have become more significant. This is notably the case in the United Kingdom where, prior to creation of the Financial Services Authority, several agencies were responsible for the conduct of different types of financial business and institutions. This raises the issue of whether an excessive number of institutions adds unnecessarily to complexity, uncertainty, and the costs of regulation. The government in the United Kingdom clearly took this view in 1997.

Financial innovation, and the emergence of new financial markets, has made the risk characteristics of financial

firms and the financial system generally more complex. In particular, the systemic dimension to regulation and supervision may no longer be focused exclusively on banking. Banks have lost some of their uniqueness, which has traditionally been a case for supervision by the central bank.

The increasing internationalization of financial operations has accentuated the international dimension of regulation, which, in turn, has implications for the institutional structure of agencies at both the national and international level.

The trend toward liberalization in financial systems has changed the market environment (and the structure of financial institutions) in which regulation and supervision operate. This, in turn, has led to the emergence of new risks.

For all these reasons, some of the traditional assumptions about institutional structure of regulatory and supervisory agencies have come to be challenged, and in many cases new structures have been considered and implemented.

Some Key Issues

When considering reform of institutional structure, some of the issues are specific to individual countries, as no two countries are precisely the same. Nevertheless, some general issues are universal and should be considered:

- What is the appropriate number of regulatory agencies and, in particular, should there be a series of specialist regulators, integrated agencies responsible for more than one sector of the financial system, or a single, all-embracing agency responsible for all aspects of regulation in the financial system?

- Should prudential and conduct-of-business regulation be separated or combined within a single agency?
- What role should the central bank have in the regulatory and supervisory process?
- In the absence of a single, mega regulator, what structure of agencies is most appropriate, which functions and firms should be allocated to which agencies, and how should the objectives for each agency be defined? In particular, how should *functional* and *institutional* dimensions of regulation be allocated among agencies?
- What specific objectives should each regulatory and supervisory agency have?
- What degree of coordination is required between different agencies, and what mechanisms are needed to ensure effective coordination, cooperation, and information sharing?
- What degree of political independence should regulatory and supervisory agencies have?
- Does institutional structure have a significant bearing on the costs of regulation?
- Insofar as regulation has consequences for competition, what role, if any, is there for competition authorities in the regulatory process?
- To what extent is concentration of power an issue to consider in establishing the optimal institutional structure of regulation and supervision?
- What role, if any, should be given to self-regulation and mechanisms for practitioner input?
- Given the international dimension to regulation, what institutional mechanisms are most efficient at facilitating international coordination and cooperation between national regulatory agencies?

- Given their power, how much independence and accountability should regulatory agencies have?

The Importance of Institutional Structure

Institutional structure of regulatory and supervisory agencies is important for several reasons and not a minor administrative matter. Therefore, it is important to have an active debate.

Above all other considerations, institutional structure may have an impact on the overall effectiveness of regulation and supervision because of the expertise, experience, and culture that develop within particular regulatory agencies and the approaches they adopt. One school of thought argues that focused, rather than diversified or conglomerate, regulators are more effective simply because their mandates are clearly defined. It is partly for these reasons that transaction costs are associated with change in the structure of institutions. There is a danger (though this is by no means inevitable) that expertise, collective memory, and experience can be lost when changes are made. On the other hand, others argue that regulation is more likely to be effective if a single agency is responsible for all aspects of regulation and supervision.

Closely related to effectiveness is the clarity of responsibility for particular aspects or objectives of regulation. This, in turn, raises the question of inter-agency rivalry and disputes.

Seldom does regulation have a single objective, and, when multiple objectives are set, conflicts can arise between them. Although this is true irrespective of institutional structure, different structures may be more or less efficient at handling conflicts. A particular issue is whether conflicts are better handled within a single agency or between agencies where

responsibilities for particular objectives are more clearly defined. It becomes a question of whether transaction costs are lower when conflicts are resolved internally (for example, between different divisions of a single agency) rather than externally between different agencies.

Different structures have implications for the costs of regulation. On the one hand, if there are economies of scale and scope in regulation, there should be advantages in having a small number of agencies or even a single authority. On the other hand, if a single regulator (encompassing a wide variety of financial institutions) adopts an inappropriate regulatory regime (perhaps because its remit is too wide and unfocused), the *compliance* and *structural* costs of regulation would rise, even though the purely *institutional* costs of regulatory agencies (that is, the costs of running supervisory agencies) might be lower (see Goodhart and others 1998, ch. 8).

A major issue relates to overlap and underlap and whether a particular structure causes an unnecessary duplication of regulatory activity and hence places unnecessary costs on firms or whether some aspects of business or some institutions fall through the net altogether.

A multiple-agency regime, most especially if it allows regulated institutions an element of choice, creates the potential for regulatory arbitrage and inconsistent regulation between different institutions conducting the same type of business.

Public perceptions and credibility may also be a significant issue in that, with multiple agencies, it may not be clear to the consumer which agency is responsible for a particular issue of regulation or to whom complaints should be addressed.

For these reasons, the institutional structure of regulatory agencies has more significance than simple bureaucratic tidiness. However, the importance should not be exaggerated. It is not difficult to devise a wide range of viable institutional structures: according to the governor of the Bank of England, “There are many ways of skinning this particular cat ... and in any event no structure can be set in stone—the markets continue to evolve and so too must the regulatory structure” (George 1996, p. 215). A crucial point is that institutional structure does not in itself guarantee what really matters: the effectiveness of regulation in achieving its objects in an efficient and cost-effective manner. In its published regulatory plans, the Personal Investment Authority (one of the regulatory agencies in the United Kingdom that was superseded by the Financial Services Authority) made a distinction among *effectiveness*, *efficiency*, and *economy* in the assessment of regulation (see, for instance, Personal Investment Authority 1997).

A Regulatory Matrix

Four areas of regulation and supervision need to be accommodated within an institutional structure:

- *Systemic* regulation and supervision (designed to oversee the stability of the financial system as a whole and, most especially, the banking and payments system)
- *Prudential* regulation (focusing on the safety and soundness of individual financial institutions, whether banks, insurance companies, or securities traders, that may also be included within a financial conglomerate)
- *Consumer protection* (focused on conduct-of-business arrangements designed to protect the consumer from

factors such as incomplete information, bad practices by financial firms, and unfair practices)

- *Competition* (designed to ensure that there is an appropriate degree of competition in the financial system and that anticompetitive practices by financial firms are abandoned). A major issue in this regard is how to fit competition issues into the overall institutional structure of regulation and supervision of financial firms and, in particular, the extent to which this should be the responsibility of a supervisory agency or whether it should fall within the domain of an agency for competition policy for the economy as a whole. When the objectives of the Financial Services Authority in the United Kingdom were being drafted, there was considerable dispute over this issue, and a compromise was eventually reached. Enhancing competition was not included as one of the statutory objectives of the Financial Services Authority, although it was mandated to keep in mind the implications of its regulation and supervision for competition.

It is also customary to distinguish three broad types of financial business: *banking*, *insurance*, and *securities trading*. In practice, many other areas (such as fund management and financial advice) might also be addressed by regulation and supervision and need to be accommodated within the institutional structure.

A central distinction is between prudential and conduct-of-business regulation and supervision and whether they are to be incorporated within the same agency (the mega agency model) or kept separate. In the discussion that follows, *integrated-unified* agencies refer to the model where prudential

Table 2.1: Regulatory Matrix

Option	Prudential				Consumer protection	
	Banks	Insurance	Securities	Systemic	Consumer protection	Competition
1	Non-central bank agency for banks	Insurance agency	Securities agency	Central bank	Consumer protection agency	Competition agency
2	Mega agency	Mega agency	Mega agency	Central bank	Mega agency	Competition agency
3	Banking, insurance, and securities agency	Banking, insurance, and securities agency	Banking, insurance, and securities agency	Central bank	Consumer protection agency	Competition agency
4	Banks and securities agency	Insurance agency	Banks and securities agency	Central bank	Consumer protection agency	Competition agency
5	Banks and insurance agency	Banks and insurance agency	Securities agency	Central bank	Consumer protection agency	Competition agency
6	Non-central bank agency for banks	Insurance and securities agency	Insurance and securities agency	Central bank	Consumer protection agency	Competition agency
7	Central bank	Central bank	Central bank	Central bank	Consumer protection agency	Competition agency
8	Central bank	Insurance agency	Central bank	Central bank	Consumer protection agency	Competition agency
9	Central bank	Central bank	Securities agency	Central bank	Consumer protection agency	Competition agency
10	Central bank	Insurance agency	Securities agency	Central bank	Consumer protection agency	Competition agency
11	Central bank	Insurance and securities agency	Insurance and securities agency	Central bank	Consumer protection agency	Competition agency

supervision (but only prudential supervision) of more than one sector of the financial system is conducted within the same agency. This includes the model where the prudential supervision of all financial sectors is located within a single agency. In contrast, a mega agency refers to the arrangement where all aspects of regulation (both prudential and conduct-of-business aspects) are located within a single agency.

The central issue is how the four areas outlined above are addressed in the institutional structure. There is a spectrum of institutional arrangements with various degrees of integration-unification for prudential and conduct-of-business regulation and supervision. At one end of the spectrum is a highly fragmented structure with a large number of specialist agencies. At the other end of the spectrum lies a highly concentrated structure with a small number of agencies. In one extreme case (the United Kingdom), there is a single agency for all financial institutions, which covers both prudential and conduct-of-business issues.

Table 2.1 summarizes the options. At one end of the spectrum, there are dedicated agencies for each area, with prudential supervision split between separate agencies for banking, insurance, and securities trading (option 1). At the other end of the spectrum lies the mega model where all prudential and conduct-of-business regulation and supervision are vested in a single institution. In terms of the distinction between integrated and mega agencies, the former is represented in option 1 and the latter in option 2. However, what in a later section is referred to as the twin peaks model (where all prudential regulation and supervision are conducted by one institution and all conduct-of-business regulation is conducted by another) is represented in option 3. The one constant in the matrix is that the central bank

is always responsible for systemic stability. While aspects of this role might be shared with the Ministry of Finance, the central bank is always involved.

Alternative Frameworks

There are three broad ways of categorizing institutional arrangements for regulation and supervision: by *institution*, by *function*, or by *objectives*. Thus different types of institutions may be regulated differently and by different agencies. Alternatively, different functions may be regulated differently and by different agencies irrespective of which institutions are performing those functions. There are hazards in both alternatives. In the case of institutions, the danger is that different regulatory agencies may apply a different type and intensity of regulation, which, as different institutions are performing several functions, may give rise to issues of competitive neutrality. Focusing on functions means that a given firm (especially if it is a financial conglomerate) will be subject to many different types of regulation and be under the authority of different regulatory agencies.

The ultimate criterion for devising a structure of regulatory agencies must be the *effectiveness* and *efficiency* of regulation: effectiveness relates to whether the objectives are met, while efficiency relates to whether they are met in an efficient way and without imposing unnecessary costs on consumers and regulated firms. On this basis, one school of thought argues that the most appropriate basis for organizing the institutional structure is in terms of the *objectives* of regulation. There are two main reasons for this. First, regulatory agencies might be most effective and efficient when they have clearly defined, and precisely delineated, objectives and when their

mandate is clear and precise. Second, accountability might be more effective and transparent when particular agencies are responsible for clear objectives.

In the final analysis, the ultimate objectives and rationale for regulation and supervision in finance are based on various market imperfections and failures that potentially compromise consumer welfare and systemic stability (Llewellyn 1999a). Carmichael (2003) also argues that unregulated markets and institutions may produce suboptimal outcomes due to a combination of anticompetitive behavior, market misconduct, information asymmetry, and externalities or systemic instability. As Carmichael (2004) notes, "What is interesting about these four sources of market failure is that, by and large, they require different regulatory tools to counteract the market failure." The Wallis Committee in Australia (which reported in 1997) proposed an internationally unique structure of regulatory institutions for Australia based on the nature of market failure. Four institutions were suggested on the basis of this criterion:

- A single prudential supervisory institution to be responsible for the prudential supervision of all financial institutions; the relevant market failure is asymmetric information
- A single conduct-of-business (consumer protection) agency to address issues related to the weakness of consumers in some financial contracts
- A competition agency to address potential weaknesses of competition in the provision of financial services
- An institution focused on the integrity and stability of the payments system and liquidity support for the banking system to address the externality issue.

The government accepted this model and in 1997 created a corresponding institutional structure based on four institutions, each responsible for regulating and supervising all institutions and market participants that are prone to a particular type of market failure. But each institution focuses exclusively on that particular failure: the Australian Prudential Regulation Authority (APRA), the Australian Securities and Investment Commission (ASIC), the Australian Competition and Consumer Commission (ACCC), and the Reserve Bank of Australia, which remains responsible for stability of the system as a whole and of the payments system in particular.

In reality, a strict dichotomy between *functional* regulation and *institutional* regulation, and between institutions based on *objectives* or *market failure*, is misleading, as each type of regulation serves a different purpose. In practice, institutions—not functions—fail or become insolvent, and therefore institutions per se need to be regulated for safety and soundness. The overall institution must be the focus of such regulation and supervision. *Functional* regulation focuses on how an institution conducts the various aspects of its business and how it behaves toward customers. If competitive neutrality of regulation is to be upheld, such functional regulation must apply to particular aspects of the business irrespective of which type of institution is conducting it.

Regardless of institutional structure, there is, in practice, no alternative to a *matrix approach*. Firms may be hazardous either because they become insolvent or because they behave badly with respect to their customers. This means that, because institutions (and not functions) become insolvent, all institutions where safety and soundness are relevant considerations must be subject to *prudential* regulation and supervision. On the other hand, functions are to be subject

to *conduct-of-business* regulation. Regulated firms, therefore, are subject to both forms of regulation. Again the question arises as to whether, within the broad spectrum of options, prudential and conduct-of-business regulation and supervision are to be included within the same agency or whether dedicated, specialist agencies are to be created.

Integrated Versus Multiple Agencies: The Case for Integration

The arguments in favor and against various structures can be outlined by considering the case for and against the integration-unification model of prudential regulation: the case for and against a fully unified prudential agency. One school of thought argues in favor of a single agency for the prudential regulation and supervision of all financial institutions irrespective of their function.

I do not here consider the issue of incorporating conduct-of-business regulation and supervision within the same agency responsible for prudential arrangements. The focus is on integrating prudential supervision. Nevertheless, several arguments might favor the creation of a single unified agency for prudential regulation and supervision of all firms.

There may be economies of scale within regulatory agencies (most especially with respect to skill requirements and recruitment of staff with appropriate skills and qualifications). If so, the smaller the number of agencies, the lower should be the *institutional* costs. A single regulator might be more efficient due to shared resources and, in particular, shared information technology systems and support services. The argument for economies of scale might apply particularly to the “small-country” case.

It is likely to be easier to achieve an optimal deployment of staff within a unified agency than within a specialist and fragmented institutional structure. Similarly, there might also be economies of scope (or synergies) to be reaped from having different areas of prudential regulation for different types of institutions.

As noted, the distinction between functional and institutional regulation does not apply in the case of a financial system made up of specialist institutions. In the case of financial conglomerates, a unified agency enables a group-wide picture of the risks of an institution to be observed more clearly and thus supervised. This is most especially the case when financial conglomerates themselves adopt a centralized approach to risk management and risk taking. In this case, there is merit in having an institutional structure of supervision that mirrors the practice of regulated institutions. As a result, a more rapid response to emerging group-wide problems should be possible.

There is less scope for incomplete coverage, with some institutions or lines of business slipping through the regulatory and supervisory net because of confusion about which agency is responsible. There may even be damaging disputes between agencies in a multiple-agency structure.

There might be merit in having a simple regulatory structure that is readily understood and recognized by regulated firms and consumers. Some of the traditional distinctions between different types of institutions have become increasingly blurred, which undermines some of the traditional arguments in favor of separate regulation and supervision of different types of financial institutions.

There might be advantage in having a structure that mirrors the business of regulated institutions. To the ex-

tent that financial institutions have steadily diversified, traditional functional divisions have been eroded. Although there are various ways of addressing overall prudential requirements for diversified institutions, a single, conglomerate regulator might be able to monitor the full range of institutions' business more effectively and be better able to detect potential solvency risks emanating from different parts of the business.

Equally, the distinctions between different financial products have become increasingly blurred, which questions the case for regulating them differently. The potential danger of a fragmented institutional structure is that similar products (products providing the same or similar service) are regulated differently because they are supplied by different types of financial firms. This may impair competitive neutrality. It is more likely that a consistent approach to regulation and supervision of different types of institutions will emerge.

A single agency should, in principle, avoid problems of competitive inequality, inconsistencies, duplication, overlap, and gaps that can arise with a regime based on several agencies. This should make it easier for similar products offered by different types of institutions to be regulated and supervised in a consistent manner.

A single agency should also minimize regulatory arbitrage. A potential danger with multiple agencies is that overall effectiveness may be impaired as financial firms engage in various forms of regulatory and supervisory arbitrage. Abrams and Taylor describe the problem in the following way: regulatory arbitrage "can involve the placement of a particular financial service or product in that part of a given financial conglomerate where the supervisory costs are the lowest or where supervisory oversight is the least

intrusive. It may also lead firms to design new financial institutions or redesign existing ones strictly to minimize or avoid supervisory oversight” (Abrams and Taylor 2000, p. 14). This can also induce “competition in laxity,” as different agencies compete in order to avoid the migration of institutions to competing agencies.

If expertise in regulation is in short supply, it might be utilized more effectively if it is concentrated within a single agency. Such an agency might also offer better career prospects. Accountability of regulation also might be more certain with a simple structure, if for no other reason than that it would be more difficult for different agencies to “pass the buck.”

The costs imposed on regulated firms might be reduced to the extent that firms would need to deal with only one agency. This was a particularly significant issue in the United Kingdom when, prior to creation of the Financial Services Authority, a financial conglomerate might be regulated and supervised by and required to report to nine regulatory agencies. There also can be economies, and greater effectiveness, when all information about financial firms is lodged within a single agency.

A senior official of the newly created Financial Services Authority also argues that creating a single agency carries an additional benefit: a more consistent and coherent approach to risk-based supervision across the financial services industry, enabling supervisory resources and the burdens placed on regulated firms to be allocated more efficiently on the basis of the risks facing consumers of financial services (Briault 1998).

A major study by Luna Martínez and Rose (2003), based on a survey of around 80 countries, analyzes the reasons given by countries that recently adopted an integrated supervisory agency, even though most stopped short of creating a

**Table 2.2: Main Reasons for Adopting Integrated Supervision
(agencies indicating any of the following reasons)**

<i>Reasons</i>	<i>Number of agencies</i>	<i>Percentage of all agencies</i>
Improve the supervision of a financial system moving toward universal banking	14	93
Maximize economies of scale and scope	12	80
Solve problems resulting from poor communication and lack of cooperation among existing supervisory agencies	4	27
Minimize gaps in the regulation and supervision of financial intermediaries by establishing a single authority accountable for the supervision of all financial institutions	3	20
Facilitate operational restructuring of regulatory agencies (in particular, after a financial crisis)	3	20
Overcome other weaknesses in the overall quality of financial regulation and supervision	2	13

mega agency. The two dominant reasons were the need to supervise more effectively a financial system that was moving toward a universal banking model and the desire to maximize economies of scale and scope (see table 2.2).

The Potential Hazards of Integrated Agencies

There is clear merit in these arguments, and there is a certain *prima facie* appeal to the concept of an integrated-unified prudential regulator. However, several reservations may be voiced about such an agency.

One of the arguments in favor of a single prudential agency is that, as financial firms have increasingly diversified, the traditional functional distinctions between institutions have been

eroded. Although this is generally the case in industrial countries, it may not be true of all countries or even of all institutions in industrial countries. In very many countries, there remain, and will remain for the foreseeable future, major differences among banks, securities firms, and insurance companies.

Firms in all subsectors of the financial system have diversified, but their core business almost invariably remains dominant. The nature of the risks may be sufficiently different to warrant a differentiated approach to prudential regulation. The Reserve Bank of Australia puts the issue as follows: "Insurance companies have long-term liabilities with ill-defined value, while assets are generally marketable with readily ascertainable values. Banks, in contrast, tend to have relatively short-term liabilities with assets which are difficult to liquidate and to value. Consequently, the applicable prudential supervisory regimes are different and there would be few (if any) efficiencies in bringing their supervision together" (Thompson 1996, p. 249).

Accountability of the single agency might be more difficult because of the problems of defining clear objectives for the agency.

There is a danger within a single agency that the necessary distinctions between different products and institutions will not be made. A single agency might not have a clear focus on the objectives and rationale of regulation and supervision and might not make the necessary differentiations between different types of institutions and businesses. Even if the different regulatory requirements of different types of firms are managed within specialist divisions of an integrated regulator, there is no guarantee that supervisors within the same organization (but responsible for different types of business) will necessarily communicate and coordinate more

efficiently and closely than if they were within different, specialist regulatory agencies. There is always a tension in an integrated agency between, on the one hand, having the advantages of a common approach to regulation and supervision of banking, insurance, and securities trading and, on the other hand, making necessary distinctions, because the nature of the businesses are different. Irrespective of the institutional structure that is chosen in a particular country, the ultimate skill lies in balancing these two conflicting pressures.

A fully integrated regulator can be extremely powerful, and this power might become excessive. As Taylor (1995, p. 43) argues, a single regulator “with a remit covering both prudential and conduct-of-business regulation in banking, securities, and insurance and with the power to undertake civil proceedings against those it suspected of insider dealing or market abuse could potentially become an over-mighty bully, a bureaucratic Leviathan divorced from the industry it regulates.”

A potential moral hazard is that the public will believe that the spectrum of risk among financial institutions has disappeared or become blurred. In particular, the distinction could become obscured between deposits that are redeemable on demand at face value and investments (such as life insurance) where the value of an institution’s liability is a function of the performance of the institution in managing its assets. A recent International Monetary Fund study describes the argument this way: “Perhaps the most worrisome of all the criticisms of unified regulation is ... that the public will tend to assume that all creditors of institutions supervised by a given supervisor will receive equal protection” (Abrams and Taylor 2000, p. 20).

There is a danger that a large unified regulator might become excessively bureaucratic in its procedures and slow to react to problems as they emerge.

The creation of a single regulator might involve a loss of potentially valuable information because a single approach is adopted. In effect, there might be merit in having a degree of competition and diversity in regulation so that lessons can be learned from the experience of different approaches. In some respects, the case for not having a monopoly regulator is the same as with any monopolist.

Further, some may doubt whether there are, in fact, economies of scale to be derived from an integrated regulatory agency. The economics literature demonstrates quite clearly that diseconomies of scale can also arise in some circumstances. Put another way, what economists refer to as *X-inefficiencies* (that is, inefficiencies that are due to sub-optimal resource allocation and not to lack of economies of scale) may arise in a monopolist regulator. It is not self-evident that a single, unified regulator would, in practice, be more efficient than a series of specialist regulators based on clearly defined objectives and focused specifically on regulation to meet those clearly defined objectives. In addition, as in Ireland and Finland, economies of scale in infrastructure, information technology, and services can also be achieved by locating separate agencies within the same building and sharing common resources, while nevertheless maintaining strict separation of regulatory and supervisory policy and execution.

A single, all-embracing agency may also be subject to the hazards of the “Christmas tree” effect (see Taylor and Fleming 1999) in which a wide range of miscellaneous functions are loaded onto it, and overburden it with activities divorced from its primary function and objectives.

Irrespective of the nature of the change made to institutional structure, there are always potentially serious trans-

Table 2.3: Problems in Establishing Integrated Supervisory Agencies (agencies indicating any of the following problems)

<i>Problem</i>	<i>Number of agencies</i>	<i>Percentage of all agencies</i>
Legal constraints (need to amend a number of pieces of financial sector legislation)	10	67
Departure of experienced personnel	9	60
Delays in integration of information technology systems and infrastructure of merged agencies	8	53
Demoralization of staff of the merged entities	8	53
Lack of mission and clarity in the newly merged institution	2	13
Budgetary problems (insufficient funds to complete the integration of agencies)	2	13

Note: The following countries are included: Australia, Canada, Denmark, Hungary, Iceland, Republic of Korea, Latvia, Luxembourg, Malta, Mexico, Norway, Singapore, Sweden, and the United Kingdom.

Source: Luna Martínez and Rose (2003).

action costs to consider. There is a degree of unpredictability in the process of change itself. Abrams and Taylor (2000) note several dimensions to what they term the “Pandora’s box” effect: a bargaining process is opened between different interest groups, the legislative process might be captured by vested interests, key personnel may be lost, and management may be diverted from the core activity of regulation and supervision.

The arguments for and against unified prudential agencies are finely balanced, and the optimal structure is likely to vary between countries depending on the structure of their financial system (and, in particular, whether the system is populated by specialist or conglomerate institutions), past traditions, the political environment, and the size of the country. If a single agency is created, the issue of internal struc-

ture arises. Given the arguments that have been outlined, the objective within a single agency must be to create an internal structure that maximizes the potential advantages, while at the same time guarding against the potential hazards.

A recent World Bank study of institutional structure (Luna Martínez and Rose 2003) also surveyed the problems encountered in creating integrated agencies. These are summarized in table 2.3. In particular, legal constraints were highlighted, including the need for the law to define the mission, objectives, powers, and scope of the agencies.

The Mega Regulator-Supervisor

The arguments outlined in the previous two sections relate to a single unified prudential agency. A more extreme case of integration within the institutional spectrum is the mega agency, which combines both prudential and conduct-of-business regulation for all financial institutions and markets.

The incoming government of the United Kingdom adopted this approach in May 1997, announcing a wide-ranging reform of the country's institutional structure of regulation. There were five main elements of the approach:

- Prudential regulation and supervision of banks were transferred from the Bank of England to the newly created Financial Services Authority.
- The previous self-regulatory organizations under the oversight of the Securities and Investments Board were merged into a single agency, ending the two-tier system that the government believed was inefficient, confusing for investors, and lacking accountability and a clear allocation of responsibilities.

- The Bank of England retained its role as lender of last resort and its responsibility for systemic stability.
- The prudential regulation and supervision of all financial institutions were transferred to the FSA.
- Not only was prudential regulation of all institutions vested in a single agency, but also all conduct-of-business regulation and supervision were transferred to FSA.

As the new, single regulator is responsible for both prudential and conduct-of-business regulation and supervision and for all financial institutions and markets, the United Kingdom has clearly adopted the mega regulator concept. Because of its coverage and scope, FSA has become the most powerful financial regulator in the world.

Briault (1998) outlines arguments for a mega agency that apply in addition to those which apply to the unified model:

- The advantages of harmonization, consolidation, and rationalization of the principles, rules, and guidance issued by the existing regulators or embedded within existing legislation, with recognition that what is appropriate for one type of business, market, or customer may not be appropriate for another
- A single process for the authorization of firms and for the approval of some of their employees, using standard processes and a single database
- A more consistent and coherent approach to enforcement and discipline, while recognizing the need for appropriate differentiation
- In addition to a single regulator, a single scheme for handling consumer complaints and compensation and a single independent appeals tribunal.

Briault's article also contains an excellent statement about the approach adopted by FSA. In this regard, see also Llewellyn (1998).

However, there are also powerful arguments against creating a single mega agency responsible for all aspects of regulation and supervision and in particular for both prudential and conduct of business.

Prudential, systemic, and conduct-of-business dimensions to regulation require fundamentally different approaches and cultures, and there may be doubt about whether a single regulator would, in practice, be able to encompass these to the necessary degree. Again, as Michael Taylor notes, "There are already profound differences between the style and techniques appropriate to prudential and conduct-of-business regulation, and these are likely to become more pronounced as prudential regulation moves further in the direction of assessment of firms' own internal risk control systems. It would be difficult to combine two such different cultures within a single organisation."

As Abrams and Taylor (2000) note, there is a potential conflict of interest between prudential and conduct-of-business regulation and supervision because of differences in the nature of their objectives. The former is focused on solvency, while the latter is focused on consumer interests. The mega regulator might give priority to one over the other.

As in the case of the integrated prudential supervisor, a single agency might not have a clear focus on the different objectives and rationales of regulation and supervision and might not make the necessary differentiations between different types of institutions and businesses.

It is possible that significant cultural conflicts may emerge within the organization if a single agency is respon-

sible for all aspects of regulation and for all types of financial institutions. Would, for instance, a single conduct-of-business regulator adequately reflect the fundamentally different requirements, rationale, and approach needed for the regulation of wholesale as opposed to retail business? With respect to a mega agency (combining both prudential and conduct-of-business regulation), the Reserve Bank of Australia argues as follows: "The differences in objectives and cultures would produce an institution which was difficult to manage and unlikely to be clearly focused on the various tasks for which it had responsibility" (Thompson 1996, p. 258).

As with the case of the unified prudential regulator, it might be argued that specialist agencies with a clear mandate and a clear set of objectives are easier to monitor and make accountable for their actions and that it is easier to test their performance against a simple set of regulatory objectives.

An argument equally relevant to both the unified and mega agency models is that, at times, the different objectives of regulation may come into conflict with each other. One of the issues to consider, therefore, is what institutional structure is best suited to resolving such conflicts. In a single agency, conflicts and their resolution are internalized. However, Taylor (1995) argues that this is undesirable because the resolution of conflicting objectives involves judgments about important issues of public policy, and these judgments and decisions should be made at the political level, in a publicly accountable way. One merit of focusing institutional structure on regulatory functions is that it requires significant conflicts between different objectives to be resolved at the political level.

Taylor (1995), referring specifically to the United Kingdom, argues that the multiplicity of regulatory agencies

caused problems associated with regulatory overlap and underlap, duplication, duplicate rule books, a potential for regulatory arbitrage, lack of coordination between regulatory agencies, bureaucratic infighting, and lack of transparency. In his words, “These examples show why structure does, and should, matter, if we wish to create an efficient, effective system of financial services regulation.”

Twin Peaks Model

The previous sections have considered the arguments related to the unified and mega agency models. These are not the only options being considered around the world. One of the intermediate models in the regulatory matrix (table 2.1) is the twin peaks structure. Goodhart (1996), Goodhart and others (1998), and Taylor (1995, 1996) have all proposed an alternative approach to regulation and supervision based on the objectives of regulation. This involves creating two integrated agencies: one for prudential and conduct-of-business regulation and one for supervision. Both distinguish the two main *objectives* of regulation (systemic stability and consumer protection) and argue that systemic considerations do not relate exclusively to banks but include a wider range of financial institutions.

In the context of the United Kingdom, Taylor argues for a single prudential supervisory agency and a single conduct-of-business agency. The former would apply prudential measures not only to banks but to all types of financial institutions (including securities firms, fund managers, and insurance companies). The case, according to Taylor, is that (1) a wide range of financial institutions are potentially systematically significant, (2) the regulatory arrangements

in the United Kingdom at that time often raised issues of competitive neutrality between different types of financial institutions, (3) the emergence of financial conglomerates requires a group-wide perspective, and (4) there is a need to pool scarce regulatory expertise. In particular, Taylor (1966, p. 7) argues, "A regulatory system which presupposes a clear separation between banking, securities, and insurance is no longer the best way to regulate a financial system in which these distinctions are increasingly irrelevant." Taylor recognizes the gray areas within the overall structure proposed but believes that "any system is bound to have its anomalies and illogical ties; it is sufficient that the *Twin Peaks* model has fewer than the alternatives."

The Wallis Committee in Australia recommended something very much like the twin peaks approach in April 1997, and the recommendations were accepted by the government. Historically, the Reserve Bank of Australia had been the prudential regulator of banks, but not of other financial institutions. The Wallis Committee argued against the single prudential regulator being the central bank. However, it also argued that systemic stability (with respect to the payments system) would remain a responsibility of the Reserve Bank of Australia. The central bank would remain the lender of last resort for institutions involved with the payments system. Canir Bakir (2003) offers useful background on the Australian reform process.

This issue also arises in the United Kingdom, as the Bank of England retains responsibility for systemic stability. The International Monetary Fund has argued, "As regards risk, the separation of banking supervision and lender-of-last-resort facilities will require the FSA and the Bank of England to act in close coordination in the event of a crisis." Whether,

in the event of a crisis, it is viable for the central bank to retain responsibility for systemic stability without also being responsible for prudential supervision of banks remains to be seen.

The Role of the Central Bank

A key issue in any institutional structure of regulatory and supervisory agencies is the position and role of the central bank. In the vast majority of countries, the central bank has historically been responsible for both systemic stability and the prudential regulation and supervision of banks. In only a very small minority of cases has it also been responsible for the supervision of non-bank financial institutions. Even so, and as noted by Healey (2001), there are several alternative models for the role of the central bank dependent on whether it is involved in monitoring the payments system, providing emergency liquidity to the markets, supervising banks, managing deposit insurance, or playing a role in provision of the safety net or crisis resolution.

Nevertheless, almost universally the central bank is allocated at least some role in maintaining systemic stability even if it is not involved in the prudential supervision of the banks that make up the system. It is ironic, therefore, that there is no universal definition of or agreement about what constitutes systemic stability, and in very few countries does the central bank have formal legal authority to undertake this task (Oosterloo and de Haan 2003). It is equally ironic that, while many central banks have some role in crisis management, they do not have the financial resources to mount significant rescue operations. Such emergency solvency support requires not only significant financial resources but also

the avoidance of conflicts of interest and the protection of the central bank's balance sheet.

The first issue to be addressed is that of power. A survey of international experience is given in Goodhart and others (1998, ch. 8). Of the eight countries in the world at the time of the survey that had a single, all-embracing financial regulatory authority (including the United Kingdom), all but one was separate from the central bank; the sole exception was the Monetary Authority in Singapore. This is not accidental. Particularly if the central bank has independent powers to set interest rates, the combination of a widespread regulatory function with monetary control might be thought to place excessive powers within the hands of unelected officials. It might also create the public perception that any "safety net" that might apply to banks will also be extended to a wide range of financial institutions.

The next issue is that of possible conflicts of interest. This is frequently advanced by academic economists as the main argument against allowing the central bank to participate in regulation, in the belief that a central bank with responsibility for preventing systemic risk is more likely to loosen monetary policy on occasions of difficulty (for example, Brimmer 1989; Cukierman 1992; Heller 1991). Indeed, there is a slight statistical relationship between responsibility for regulation and higher inflation. However, there is no reason why assistance to individual banks in difficulty need affect the aggregate provision of reserves or level of interest rates. Any lender-of-last-resort assistance can, in the aggregate, be offset by open market operations. Furthermore, cases where the banking system of a country gets into serious difficulty (United States, 1930–33; United Kingdom, 1974–75; Japan, 1992 to date; Scandinavia, late 1980s and early 1990s) are much more

likely to be periods of deflation than inflation, and the serious sin of omission is to provide insufficient support in such cases. Goodhart and Schoenmaker (1995) identify a few cases where the concern of a central bank for the solvency of its banks has been a major factor in an excessively expansionary monetary policy.

Indeed, the question of conflicts of interest might be an argument in favor of giving the central bank such regulatory responsibilities. The question here is, if not the central bank, then which other body will have such powers, and what conflicts of interest might they have? If the central bank does not play this role, will it then be given to a body more subject to direct political influence? If public policy conflicts do arise, they will do so irrespective of whether supervision is a responsibility of the central bank. Such conflicts may arise whatever institutional structure is created, and they must be resolved somehow. The key issue is whether the transaction costs of resolving them are higher or lower when they are resolved internally rather than externally. A particular view on this issue is offered by the Reserve Bank of Australia: "By supervising banks, [the central bank] gains first-hand knowledge and 'feel' for financial market conditions and for the behaviour of those institutions which are a key element in the transmission of monetary policy changes to the general economy. This can be an important input into monetary policy decisions. There are more likely to be complementarities between supervision and monetary policy than conflicts, and any conflicts that do arise will need to be resolved however the various responsibilities are allocated" (Thompson 1996, p. 253).

The arguments for and against separating monetary policy from bank supervision are discussed in detail in Goodhart and Schoenmaker (1995). The advantages of having the cen-

tral bank also serve as the supervisory agency of banks in the financial system may be summarized as follows.

As the central bank has responsibility for oversight of the system as a whole and also for stability of the payments system, there are powerful synergies in being the supervisory agency for the institutions that make up the system. Some analysts doubt that, in practice, when stability is under strain, it is feasible for an agency to be responsible for the system, but not the individual firms. This is the view, for instance, of De Nederlandsche Bank.

The central bank necessarily gains information about banks by virtue of its monetary policy operations. There are, therefore, information synergies between the conduct of monetary policy and the prudential supervision of banks.

The central bank needs information about the solvency and liquidity of banks when considering its role as lender of last resort.

The central bank often has an independent status in the economy that might not be replicated by other regulatory or supervisory agencies. Moreover, the central bank usually has considerable authority in an economy, and this enhances the credibility of regulation and supervision if it is allocated this task.

From time to time, conflicts of interest can arise between the requirements of monetary policy and the prudential position of banks. It can be argued that such conflicts are better resolved internally within a single agency than externally between different agencies. Monetary policy operates largely through interest rates that also affect the financial position of banks.

In addition, economies of scale may be derived from combining responsibility for monetary policy and pruden-

tial supervision of banks. Moreover, the status of the central bank may enhance its ability to recruit the necessary skills for bank supervision.

Oosterloo and de Haan (2003, p. 24) summarize many of the basic arguments in their survey of central banks around the world: "According to the Dutch central bank, having banking supervision, oversight of the payments system, and monetary tasks under 'one roof' eases the exchange of information, co-ordination, and co-operation between the monetary and financial stability functions, on the one hand, and the supervision of institutions, on the other."

There are, however, arguments against having the central bank as the supervisory agency of banks. Such an arrangement may be viewed as concentrating excessive power in the hands of an unelected central bank whose accountability may be weak. Regulatory failures may compromise the authority of the central bank in other areas of its activity. For example, the central bank's objective of ensuring monetary stability may conflict with its objective of securing the safety and soundness of banks.

The Reserve Bank of South Africa has devised a working compromise between the opposing arguments regarding the location of bank supervision. This has been achieved by establishing an "arm's-length relationship" between the Office of the Registrar (of banks), which is located within the Reserve Bank, and the Reserve Bank itself, particularly in its role as lender of last resort. Despite being a senior Reserve Bank official, the registrar has some autonomy and independence in the administration and implementation of his functions but also has clearly defined restrictions when it comes to decisions on monetary policy. This seems to accept a degree of inevitability that, at least in the current circumstanc-

es of South Africa, the central bank must have some role in bank supervision, although an attempt has been made to guard against some of the potential hazards involved in such arrangements. For more detail about the arrangements in South Africa, see the paper by Bezuidenhout in this volume. Similar arrangements have been adopted in several Latin American countries as well, including the Superintendency of Banks in Argentina.

The paper by Liam O'Reilly in this volume describes another interesting compromise. In a recent reform of institutional arrangements for financial regulation and supervision, the government of Ireland has embedded prudential regulation of banks and other financial institutions within the central bank (which was already responsible for banks and securities) but at the same time changed the structure of the bank. Supervision and monetary stability are now separated and run as independent arms within the central bank. However, as Ireland is a member of the European Monetary Union, the monetary policy powers of the central bank are very limited.

In practice, no bank regulator could, or should, ever be totally independent of the central bank. The central bank is the monopoly provider of the reserve base and the lender of last resort. Any serious banking problems are bound to lead to calls for the central bank to use its reserve-creating powers. Moreover, the central bank, in its macro policy operational role, must have a direct concern with the payments and settlements system, the money markets, and the development of monetary aggregates. Any serious problem with the health of the banking system will touch on one, or more, of these concerns. So there are bound to be, and must be, very close relationships between the bank regulator and the

monetary policy authority. Establishing such relationships is one of the priorities in structural reform.

This need for coordination might suggest unifying the functions within the central bank. But, for a variety of reasons (including the need for confidentiality) when the central bank combines both roles, the supervisory department is usually separate from the monetary policy department. Coordination is only regarded as necessary between the top officials. Such regular meetings of senior officials can be organized just as easily whether their subordinates are in separate, or the same, building and whether their organization is formally separate or not. Perhaps the only real difference is that disagreements between senior officials would be settled (quietly) within the central bank in the case of unification and outside the bank, presumably by the minister of finance, with more likelihood of publicity, in the case of separation. However, it is hard to identify actual cases of publicly observed disagreement between the central bank and the bank regulator in countries where there is such a separation.

A final issue relates to the finance of bailouts, should they occur. Owing to fraud, mismanagement, or simply extreme volatility in asset markets, some banks, including perhaps very large banks, may become insolvent. It used to be possible, at least on some occasions, to resolve such situations by a rescue—a “lifeboat,” organized by the central bank and paid for by a voluntary levy on the remaining commercial banks. Originally, the lifeboat operation was organized for liquidity purposes, but it later evolved into a scheme of solvency support. The increasing diversity within, and competition among, the banking sector will make that almost impossible to arrange in future years. Such rescues depend on the existence of a well-defined “club” of banks that are prepared and

able to spend shareholders' funds to protect the reputation and privileges of the club. With a mixed array of niche, specialist, universal, domestic, and multinational banks, agreement to pay out funds to revive an ailing competitor could not be achieved.

The implication is that any large rescues within the banking field will, in the future, have to be financed by taxpayers' funds (see Goodhart and Schoenmaker 1995). If so, the central government, politicians, and ministries of finance will have to be involved in any large failures or rescues. This, in turn, will have a bearing on the relationship between the central bank and the body charged with prudential regulation and supervision.

The bottom line is that banking realities will force considerable coordination and interaction between the senior officials dealing with monetary policy and with bank supervision. There must always be a close link between the central bank and the supervisory authority. In the case of the United Kingdom, the treasury, the FSA, and the Bank of England have signed a memorandum of understanding regarding arrangements for maintaining financial stability. In addition, a standing committee with members from the three institutions meets monthly. The question of whether the banking supervisory body is formally within, or outside, the central bank is then essentially a subsidiary issue, depending on perceptions of the appropriate locus of power and responsibility. These perceptions will vary depending on the accidents of history and culture. There is no single, best approach under all circumstances, as is clearly evidenced by the variety of regulatory structures in different countries.

Whatever institutional structure is created, there will always be an important need for effective coordination be-

tween the central bank, the regulatory agency (or agencies), and the Ministry of Finance. In particular, cooperation, coordination (especially when intervention is made), and, perhaps above all else, information sharing are needed around the world. Mechanisms are needed to ensure that this takes place whatever institutional structure is created for regulation and supervision.

The Bank of England recently conducted a survey of the role of central banks in several countries. As Sinclair (2000, p. 384) notes in a summary of the survey's results, while practice with respect to responsibility for regulation and supervision varies considerably, "the maintenance of financial stability is, and remains, a core function for all central banks."

The following are the main findings of the survey with respect to responsibility for the payments system, safety net provision, and crisis resolution:

- All central banks have responsibility for the payments system.
- There is a remarkable degree of similarity between all countries with respect to the role of the central bank in the area of safety net provision.
- In all but two cases, the central bank provides emergency liquidity assistance to the market.
- In all but two cases, the central bank provides emergency liquidity assistance to deposit-taking institutions, and one of the exceptions operates a currency board that effectively precludes the operation of lender-of-last-resort facilities by the central bank.
- The position with respect to emergency liquidity assistance to non-deposit-taking institutions is more complex. In six industrial and two developing coun-

tries, central banks may provide some such assistance, suggesting a widening of the lender-of-last-resort role from its traditional focus on banks.

- Only one central bank (that of Chile) offers emergency solvency assistance to banks, and none at all offers such assistance to non-deposit-taking institutions.
- In only seven cases does the central bank itself offer deposit insurance.
- “Honest brokering” is a central bank function in all industrial countries and most developing countries. In some countries (notably the United Kingdom), this is mainly restricted to cases of systemic risk and involves cooperation with other supervisory agencies.
- Although there is a high degree of commonality with respect to the role of the central bank in safety net provision, there is less commonality of experience with respect to the role of the central bank in crisis resolution. In the majority of industrial countries, the central bank is not involved with, for instance, the sale of assets of insolvent institutions. However, in the majority of developing countries, the central bank is involved with crisis resolution and the sale of assets of insolvent institutions. Overall, in four industrial countries and 10 developing countries, this aspect of crisis resolution is at least in part a responsibility of the central bank. The Bank of England notes that, in its case, “the central bank’s role in crisis resolution would be coordinated with other agencies and will doubtless evolve with experience.”

The overall conclusion is that safeguarding financial stability is a core function of the modern central bank, even

though it may not be responsible for regulating and supervising banks and other financial institutions. Irrespective of the decision about the role in regulation and the supervision of individual financial institutions, the central bank must necessarily be centrally involved in safety net arrangements, liquidity support, the payments system, and the maintenance of stability in the financial system as a whole. In cases where it is not responsible for regulation and supervision, its responsibility for financial stability requires cooperation with and from those agencies that are responsible for regulation and supervision. This issue cannot be ducked, and explicit arrangements are needed.

International Experience

As noted, there are many different models for the structure of regulatory and supervisory institutions for the financial sector and no commonality of experience. Different countries have chosen different models, which in itself suggests that there is no single “best” model. The optimal model may be different for different countries, depending on the structure and size of the financial system, the specific objectives of regulation and supervision, a country’s specific historical evolution, and political traditions. No consensus has emerged, although there is a general tendency for the number of separate institutions to decline and for there to be more integrated supervision. There have been several surveys of international practice, most notably by Healey (2001), Llewellyn (1999b), Luna Martínez and Rose (2003), and Masciandaro (2003).

Great care is needed when interpreting such studies. First, the landscape is changing rapidly, and empirical studies soon become dated. Several countries (notably Bulgar-

ia, Indonesia, Kazakhstan, Poland, Slovakia, Slovenia, and Ukraine) are in the process of reconsidering their institutional arrangements in this area. Second, caution is needed when interpreting descriptions of structures, in addition to the general problem of encapsulating complex structures in a simple form. The nuances cannot be captured in a simple tabulation. Third, the practice is not always as precise or as straightforward as might be suggested by formal structure: demarcations and responsibilities are frequently not as precise as the formal structure of agencies might suggest. For instance, in many countries where the central bank is not the primary supervisor of banks, its role in practice may nevertheless be influential. This is true, for instance, in France and Germany. It is also often the case, and irrespective of formal structure, that the Ministry of Finance and other government departments have significant roles in the regulation and supervision of financial firms and markets. Fourth, there are varying degrees of coordination, cooperation, and information sharing between regulatory and supervisory agencies when responsibilities overlap, and in some cases agencies have joint responsibility in some areas.

Institutional structure is also complicated in some countries by the existence of both federal and regional or state agencies. This is notably the case in Australia, Canada, and the United States. In Canada, for instance, while prudential supervision is conducted by the Office of the Superintendent of Financial Institutions, securities regulation and insurance-related consumer protection are provided separately by provincial agencies. Moreover, securities companies and credit unions are supervised by both federal and provincial agencies.

The important differences relate to three main areas: (1) the number of agencies responsible for prudential supervi-

sion, (2) the extent to which arrangements are based on dedicated specialist institutions or are, to some extent, unified, and (3) the role of the central bank in prudential supervision. As noted, care is needed in the use of the terms “unified” or “integrated,” as they can refer to different arrangements. In particular, unified is sometimes used to describe options 3 and 7 in table 2.1 (all three sectors are prudentially supervised by a single agency) or options 4, 5, 6, 8, 9, or 11 (where only two of the three sectors are supervised by one agency). In general, more countries have linked the regulation and supervision of banks with securities companies than have integrated either with insurance. This is largely because there is an element of commonality between banking and securities (in that the risks of both emanate from the assets side of the balance sheet), whereas risks in insurance are based largely on the liabilities side.

Historically, the norm has been to have institutional arrangements based on separate agencies for different institutions. This partly reflects the norm that banking, insurance, and securities trading have been conducted by specialist institutions. However, in recent years there has been a trend toward more integration and concentration of power, even though no single model has emerged.

The international experience (based on a sample of 77 countries in 2002) is summarized in table 2.4, taken from the detailed World Bank study by Luna Martínez and Rose (2003). At the end of 2002, a total of 46 countries had some form of integrated supervision (three or two of the sectors), although this number had increased significantly over the previous six years. Of these, 22 countries had adopted the single supervisor model (option 3 in table 2.1), and at least one country—the United Kingdom—had integrated all pru-

dential supervision and conduct-of-business regulation and supervision (option 2). Thus the single supervisor model in table 2.4 is not homogeneous, and marked differences exist among countries within this group. Overall, close to 30 percent of the sample had adopted the single supervisor model (with recent additions including Estonia, Germany, Ireland, and Malta), while 38 percent maintained separate institutions for each sector. There is no obvious pattern in that, for instance, the United States maintains a multiple-agency approach, whereas many other industrial countries (for example, Japan, the Scandinavian countries, the United Kingdom) have a fully unified structure.

Based on a sample of 69 countries included in Masciandaro (2003), table 2.5 focuses on the institutions that supervise banks. In the majority of cases, the central bank is responsible for supervising banks, and in half the cases the central bank is responsible for only bank supervision. In only one case (Singapore) is the central bank responsible for prudential regulation of all three sectors, and in only five other cases is the central bank responsible for supervising more than banks. Considering the countries where an agency other than the central bank is the supervisory authority of banks, in the majority of cases (83 percent) that agency is also responsible for supervising securities or insurance or both. Taking the two together, in more than half the sample banks are supervised by a dedicated agency that is not responsible for any other sector.

More detail is given in table 2.6, taken from Masciandaro (2003), where a concentration index is constructed based on weights assigned to the number of sectors for which an agency is responsible. The higher is the financial authorities' concentration (FAC) ratio in table 2.6, the more con-

Table 2.4: Structure of Supervision in 77 Countries, 2002^a

Indicator	Single supervisor for the financial system	Agency supervising two types of financial intermediaries			
		Banks and securities firms	Banks and insurers	Securities firms and insurers	Multiple supervisors ^a
Countries	Austria, Bahrain, Bermuda, Cayman Islands, Denmark, Estonia, Germany, Gibraltar, Hungary, Iceland, Ireland, Japan, Latvia, Maldives, Malta, Nicaragua, Norway, Singapore, Rep. of Korea, Sweden, United Arab Emirates, United Kingdom	Dominican Republic, Finland, Luxembourg, Mexico, Switzerland, Uruguay	Austria, Belgium, Canada, Colombia, Ecuador, El Salvador, Guatemala, Kazakhstan, Malaysia, Peru, Venezuela	Bolivia, Chile, Egypt, Mauritius, Slovakia, South Africa, Ukraine	Argentina, Bahamas, Barbados, Botswana, Brazil, Bulgaria, China, Cyprus, Egypt, France, Greece, Hong Kong (China), India, Indonesia, Israel, Italy, Jordan, Lithuania, Netherlands, New Zealand, Panama, Philippines, Poland, Portugal, Russia, Slovenia, Sri Lanka, Spain, Thailand, Turkey, United States
Percent of countries in the sample	29	8	13	9	38

Note: Sample includes only countries that supervise all the three types of intermediaries (banks, securities firms and insurers).

a. At least one for banks, one for securities firms, and one for insurers.

Source: Luna Martínez and Rose (2003).

Table 2.5: Bank Regulators in 69 Countries

<i>Sector regulated</i>	<i>Central banks</i>	<i>Another agency</i>	<i>Total</i>
Banks alone	34	5	39
Banks and securities	4	6	10
Banks and insurance	1	6	7
Banks, securities and insurance	1	12	13
Total	40	29	69

Source: Masciandaro (2003).

centrated is financial supervision. The maximum score of 7 (where all three sectors are supervised by a single agency) is found in 16 percent of the sample. However, when this is subdivided into industrial and developing- or emerging-market economies, the proportion rises to 31 percent for industrial countries. This implies that industrial countries have a greater tendency toward integrated supervision than do other countries in the sample.

The Masciandaro study also examines the role of the central bank. In general, the role of the central bank tends to be limited to banking supervision. In the sample of 69 countries, in only one case is the central bank responsible for all three sectors; in only four cases (Ireland, Italy, Malaysia, and Portugal) is the central bank responsible for two of the sectors. This confirms an earlier judgment that, while there is some trend toward integrated supervision, this usually does not include the central bank, even though historically it might have been responsible for the regulation and supervision of banks. More generally, the Masciandaro study finds, "The probability that a country will increase the degree of concentration of powers of financial supervision ... is higher: (1) the lower is

Table 2.6: Supervision Authorities in 69 Countries, 2002

<i>Country</i>	<i>Banking sector</i>	<i>Securities sector</i>	<i>Insurance sector</i>	<i>Rating</i>	<i>Weight</i>	<i>FAC index</i>
Albania	CB	S	I	1	0	1
Argentina	CB	S	I	1	0	1
Australia	BI	BI, S	BI	3	1	4
Austria	G	G	G	3	0	3
Belarus	CB	G	G	3	0	3
Belgium	BS	BS	I	5	0	5
Bosnia	CB	S	n.a.	1	0	1
Brazil	CB	S	I	1	0	1
Bulgaria	CB	S	I	1	0	1
Canada	BI	G	BI	3	0	3
Chile	B	SI	SI	3	0	3
Colombia	BI	S	BI	3	0	3
Croatia	CB	S	I	1	0	1
Cyprus	CB	S	I	1	0	1
Czech Republic	G1	S	G2	1	0	1
Denmark	U	U	U	7	0	7
Ecuador	BI	S	BI	3	0	3
Egypt	CB	S	I	1	0	1
Estonia	U	U	U	7	0	7
Finland	BS	BS	I	5	0	5
France	B, CB	B, S	I	1	0	1
Georgia	CB	S	n.a.	1	0	1
Germany	U	U	U	7	0	7
Greece	Cb	S	I	1	0	1
Hong Kong (China)	B	S	I	1	0	1
Hungary	U	U	U	7	0	7
Iceland	U	U	U	7	0	7
India	CB, B	S	I	1	-1	0
Ireland	CB	CB	G	5	0	5
Israel	CB	S, G	G	1	1	2
Jamaica	CB	SI	SI	3	0	3
Japan	U	U	U	7	0	7
Jordan	CB	S	I	1	0	1
Korea, Republic of	U	U	U	7	0	7
Latvia	U	U	U	7	0	7
Lithuania	CB	S	I	1	0	1
Luxembourg	BS	BS	I	5	0	5
Macedonia	CB	S	n.a.	1	0	1
Malaysia	CB	S	CB	3	0	3
Malta	U	U	U	7	0	7
Mauritius	CB	SI	SI	3	0	3
Mexico	BS	BS	I	5	0	5
Moldova	CB	S	n.a.	1	0	1
Netherlands	CB	CB, S	I	1	1	2
New Zealand	CB	S	I	1	0	1
Norway	U	U	U	7	0	7
Pakistan	CB	SI	SI	3	0	3
Peru	BI	S	BI	3	0	3
Philippines	CB	S	I	1	0	1

Poland	B	S	I	1	0	1
Portugal	CB	CB, S	I	1	1	2
Romania	CB	S	I	1	0	1
Russia	G1	S	G2	1	0	1
Singapore	CB	CB	CB	7	0	7
Slovak Republic	CB	SI	SI	3	0	3
Slovenia	CB	S	I	1	0	1
South Africa	CB	SI	SI	3	0	3
Spain	CB	S	I	1	0	1
Sri Lanka	CB	S	I	1	0	1
Sweden	U	U	U	7	0	7
Switzerland	BS	BS	I	5	0	5
Thailand	CB	S	G	1	0	1
Trinidad & Tobago	CB	S	G	1	0	1
Tunisia	CB, G	S	G	1	1	2
Turkey	B	S	G	1	0	1
Ukraine	CB	S	n.a.	1	0	1
United Kingdom	U	U	U	7	0	7
United States	CB, B	S	I	1	-1	0

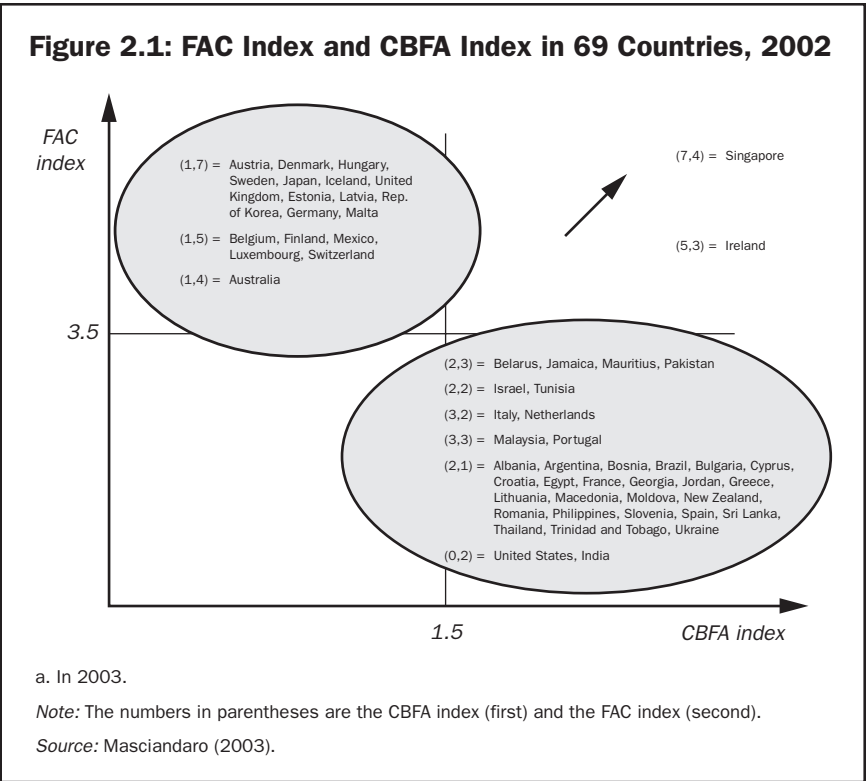
n.a. Not applicable.

Note: The FAC (financial authorities' concentration) index is based on weights assigned to the number of sectors for which the agency is responsible. The codes are as follows: B, authority specialized in the banking sector; I, authority specialized in the insurance sector; S, authority specialized in the securities markets; U, single authority for all sectors; BS, banking and securities markets; BI, banking and insurance; CB, central bank; SI, insurance and securities markets; G, government department.

Source: Masciandaro (2003).

the involvement of the central bank in these powers, (2) the smaller is the financial system, (3) the more equity-dominated is the private governance model, (4) the more concentrated is the intermediation system, and (5) the more the public governance is good" (Masciandaro 2003, p. 25).

Masciandaro relates in a matrix the degree of concentration of supervision and the role of the central bank (figure 2.1). A clear relationship emerges in that the higher is the degree of concentration of supervision (the FAC index), the lower tends to be the role of the central bank in financial sector supervision. Conversely (with the notable exception of Ireland), the greater is the role of the central bank, the less concentrated tends to be supervision. Again this dem-



onstrates the almost universal conclusion that, when financial supervision is concentrated (that is, a single agency is responsible for a wide area of supervision), the institution tends not to be the central bank. This also highlights the issue raised earlier that the possible preference for having the central bank as the supervisory agency for banks may be in conflict with another preference for having a unified supervisory agency.

There are three main reasons for this observed tradeoff. First, it might be feared that a central bank that is already responsible for the conduct of monetary policy might become too powerful if it is also responsible for a wide range of supervision in the financial sector. This is most especially the case if the central bank also has a high degree of independence. Second, although challenged by Goodhart and Schoenmaker (1995), there might be concern that conflicts of interest could arise within the central bank between the two main areas of responsibility and that this conflict might be resolved by having an excessively lax monetary policy in order to safeguard the position of individual banks. Third, the central bank is always and everywhere the lender of last resort to banks largely because of the importance of banks in the financial system generally and the payments system in particular. If its powers of supervision were extended to other financial institutions, the public might believe that the safety net had been extended to all financial institutions in the system. As noted, this would extend the potential moral hazard attached to the safety net.

It is also the case that more central banks in developing countries are responsible for bank supervision than is the case in industrial countries, where the proportion has been falling (for example, bank supervision has recently been taken away from the central bank in Australia, Austria, and the United Kingdom) as more countries have adopted the integrated agency but have chosen for this not to be the central bank. Many of the arguments in favor of the central bank being responsible for bank supervision (notably economies of scale, independence, authority, moral suasion authority) apply particularly to developing and emerging-market economies. It is also the case that in many such countries the finan-

Table 2.7: Scope of Unified Supervisory Agencies

Country	Name of agency	Year of creation ^a	Intermediaries supervised by the unified agencies					Intermediaries not supervised by the agency
			Banking	Securities	Insurance	Other non-bank financial institutions		
Australia	Australian Prudential Regulatory Authority	1997	—	—	—	—	Finance companies and merchant banks	
Canada	Office of the Superintendent of Financial Institutions	1986	—	—	—	—	None	
Denmark	Danish Financial Supervisory Authority	1988	—	—	—	—	None	
Estonia	Financial Supervisory Authority	1999	—	—	—	—	Savings and loan associations and currency exchange offices	
Hungary	Hungarian Financial Supervisory Authority	2000	—	—	—	—	None	
Iceland	Financial Supervisory Authority	1988	—	—	—	—	Nonlicensed collective investment firms	
Korea, Rep. of	Financial Supervisory Centre	1997	—	—	—	—	Deposit and insurance activities of the National Post Office, community credit cooperatives, and other ^a	
Latvia	Financial and Capital Market Commission	1998	—	—	—	—	Leasing companies	

Luxembourg	Commission de Surveillance du Secteur Financier	1999	—	—	n.a.
Malta	Malta Financial Services Centre	2002	—	—	n.a.
Mexico	National Banking and Securities Commission	1994	—	—	Pension funds
Norway	Kredittilsynet	1986	—	—	None
Singapore	Monetary Authority of Singapore	1984 ^a	—	—	Credit cooperatives and leasing companies
Sweden	Finansinspektionen	1990	—	—	None
United Kingdom	Financial Services Authority	1997	—	—	Mortgage advisers and general insurance brokers

n.a. Not applicable.

a. Refers to the year in which the decision to establish the agency was made or the law allowing its creation came into force.

b. Also includes mutuals and businesses of the National Agricultural Cooperative Federation and National Federation of Fisheries Cooperative.

c. Monetary Authority of Singapore took over the regulation of the insurance industry in 1977 and the regulatory functions of the securities industry in 1984.

d. Starting in 2004, mortgage advisers and general insurance brokers are under the supervision of the Financial Services Authority in the United Kingdom.

Source: Luna Martínez and Rose (2003).

Table 2.8: Powers of the Integrated Supervisory Agencies over Banks

<i>Regulatory and supervisory agencies</i>	<i>Number of agencies</i>	<i>Percentage of all agencies</i>
Conduct on-site examinations	15	100
Conduct off-site examinations and surveillance	15	100
Impose sanctions and fines for noncompliance with rules and regulations	15	100
Set prudential regulation on market, credit, operational, and liquidity risks	12	80
Set accounting rules and information disclosure requirements	11	73
Set rules on the composition of capital	11	73
Approve and revoke a license to a financial intermediary	11	73
Set minimum capital requirements	10	66
Set licensing requirements	9	60
Consumer protection (assist to resolve claims for abuses against users of financial services)	9	60

Source: Luna Martínez and Rose (2003).

cial system is dominated by banks, with non-bank financial institutions tending to be specialist in nature.

Luna Martínez and Rose (2003) also consider the scope and powers of unified supervisory agencies. The main finding is that, as observed earlier, there is substantial diversity in experience, again confirming the conclusion that unified agencies are by no means homogeneous in that both their scope and their power vary (tables 2.7 and 2.8).

Corporate Governance Issues

Whatever institutional structure of agencies is created in a particular country, important issues of corporate governance arise and need to be settled because they are likely to have an impact both on the agencies' effectiveness and efficiency and on its public credibility. Referring more generally to corporate governance arrangements, the OECD defines corporate governance as "the system by which business corporations are directed and controlled ... It involves the set of relationships between a company's management, its board, its shareholders, and other stakeholders. Corporate governance also provides the structure through which the objectives of the company are set and the means of attaining these objectives and monitoring performance are determined" (OECD 1999, p. 34).

With respect to regulatory agencies, there are 10 key issues in corporate governance arrangements relating to the following:

1. The legal nature and legitimacy of regulatory agencies and the legal route through which they are created
2. Transparency—in particular, the clarity of the agencies' objectives, rules, responsibilities, and procedures
3. Independence—the extent to which an agency is independent of external influence in its rule setting and adjudications. Carmichael (2002, p. 7) describes this position as follows: "The regulator should have the capacity to develop, implement, and enforce regulatory policy without inappropriate interference from the national legislature, government, or industry." The difficulty is in defining "inappropriate." On the one

hand, the elected political authorities, and the legislation that establishes an agency, have the right to set the broad objectives of regulation. On the other hand, there should not be interference in the way these are applied to particular regulated financial institutions. Disputable issues may arise between these two ends of the spectrum.

4. The structure of any managing board that is created within the agency and the nature, security, and source of appointments to it (a particular issue relates to whether, as in the United Kingdom, the board includes representatives of the industry itself)
5. Appointment procedures of senior staff of the agency
6. The terms of appointments and the security of staff members of the agency
7. The integrity of the agency and its board and staff and the procedures to monitor this area
8. The extent of legal immunity of staff members acting in a bona fide manner
9. Competence of the agency and its personnel
10. Accountability arrangements, meaning arrangements to settle issues such as accountability for what, when, how and to whom.

Das and Quintyn (2002) emphasize four prerequisites for good regulatory governance in regulatory and supervisory agencies: *independence*, *accountability*, *transparency*, and *integrity*.

There are also internal governance arrangements to settle, which include mechanisms and procedures for authorization of financial firms, mechanisms for dispute resolution and appeals in the event that an agency takes sanctions against a regulated

institution, the funding arrangements of agencies and in particular the extent to which the agency is funded by the industry (in which case, the nature of the formula needs to be considered), the resources available to the agency, and the remuneration of agency employees. With respect to remuneration, there is often a dangerous tendency to underpay regulatory staff relative to the firms being regulated. This tendency needs to be resisted, as effective regulation and supervision cannot be bought on the cheap: false economy needs to be resisted.

Several links reinforce the various components of the corporate governance nexus outlined above. For instance, transparency can assist in maintaining independence and can also reinforce accountability mechanisms. The integrity of an agency is also likely to be reinforced through more transparent arrangements. As Das, Quintyn, and Chenard (2003, p. 44) note, "Legal protection of agency staff as well as clear rules for appointment and removal of agency heads support both their independence and their integrity." Accountability is also a mechanism for monitoring and inculcating integrity.

Corporate governance arrangements are important in regulatory agencies for three main reasons: they determine the effectiveness and efficiency of the agencies' operations; they have a powerful impact on the agency's credibility, authority, and public standing; and they have an important impact on the authority and credibility of an agency's attempt to encourage and require effective corporate governance arrangements within regulated firms.

Good corporate governance is an important dimension in the regulation and supervision of financial firms, and supervisory agencies have a potentially powerful role in establishing good practice, rules, and requirements with respect to corpo-

rate governance in regulated institutions. Regulatory and supervisory agencies have a key role in promoting and monitoring sound corporate governance practices in regulated firms. This role is severely impaired and lacks credibility and authority if the agency itself is not subject to effective corporate governance mechanisms and arrangements. According to Das, Quintyn, and Chenard (2003, p. 42), "Good regulatory governance practices help reinforce the credibility and moral suasion authority of the regulatory agencies in promoting practices among market participants ... By failing to apply good governance principles, regulatory agencies lose the credibility and moral authority to promulgate good practices in the institutions under their oversight. This could create moral hazard problems and contribute to unsound practices in the markets."

There is also statistical support for the value of arrangements for good corporate governance within supervisory agencies. Das, Quintyn, and Chenard (2003) construct indexes of financial stability and sound corporate governance within regulatory agencies for a large sample of countries. They find statistical relationships confirming the importance of good regulatory governance for the soundness of the financial system. These requirements are relevant whatever institutional structure is in place.

Conclusions

The institutional structure of regulation and supervision has recently become an issue of public policy debate in several countries, which indicates a certain unease with prevailing structures. International experience indicates a wide variety of institutional regulatory formats, suggesting that there is no universal ideal model. A key issue is the extent to which regu-

latory structure affects the overall effectiveness and efficiency of regulation and supervision, since this should be the ultimate criterion when choosing among alternative formats. This is why the issue of institutional structure is important.

However, in itself institutional structure does not guarantee effective regulation and supervision, and it would be hazardous to assume that changing the structure of regulatory institutions is a panacea. What institutional structure does is to establish the framework in which to optimize a regulatory regime. In effect, institutional structure provides the architecture of regulation and supervision. As Carmichael (2004) puts it, "New structures do not guarantee better regulation. More appropriate structures may help, but, fundamentally, better regulation comes from stronger laws, better-trained staff, and better enforcement. Any country that thinks that tinkering with the structure of agencies will, by itself, fix past shortcomings is doomed to relive its past crises."

With the emergence of mixed financial institutions, the case for unified agencies has strengthened, as they more closely mirror the emerging structure of financial systems and the business of financial firms. However, there are reservations, and some countries still opt for an institutional structure focused closely on the objectives of regulation. Whatever decisions are made, it is important to recognize that a perfect institutional structure is a chimera, and it might be necessary to accept the inevitability of working within an imperfect structure.

Appendix: Financial Conglomerates

There is a problem in allocating *functional* and *institutional* regulation when financial institutions conduct a wide range

of business. Historically, financial systems in many countries have been based on functionally defined institutions: banks, insurance companies, and securities traders, with each being regulated and supervised separately by dedicated prudential regulatory agencies. In many countries, this has given way to financial conglomerates because, across the board, institutions have diversified away from their traditional specialist activities. A useful working definition of a financial conglomerate is given in the report of the Tripartite Group of Bank, Securities, and Insurance Regulators (Tripartite Group 1995, p. 65): a financial conglomerate is “any group of companies under common control whose exclusive or predominant activities consist of providing services in at least two different financial sectors (banking, securities, insurance).”

One of the issues with financial conglomerates is whether mixing different types of business (for example, banking, insurance, fund management, securities trading) raises or lowers the overall risk characteristics of the institution. If the risks attached to different parts of the business are weakly or, even better, negatively correlated, then, depending on the magnitude of the separate risks and the size of each component business, the overall risk profile of an institution is reduced when different business areas are mixed within the same institution. A second issue is how financial innovation has eroded some of the traditional distinctions between different types of financial products and contracts.

In combination, these two issues challenge some of the traditional approaches to regulation and supervision, which become more complex when financial institutions encompass a wide range of business activities with different and complex risk characteristics. In particular, the traditional distinction between functional and institutional approaches

is delineated less clearly. In those countries with specialist prudential regulators for banks, insurance companies, and securities traders, financial conglomerates may be subject to several prudential and conduct-of-business agencies.

Financial conglomerates raise several regulatory and supervisory issues: the structure of the group may be complex; due to complex intra-group exposures, there may be a lack of transparency and, in the absence of effective firewalls, a risk of contamination and contagion; specialist supervisors may not always have access to necessary information; and so forth. Above all, there is a danger that prudential regulation might fail to capture the risk characteristics of the institution as a whole. In effect, the totality of risks may be *greater* than the sum of the parts, while the totality of effective risk capital available to cover risks may be less than the sum of the parts contained within each business of the conglomerate. A key supervisory issue, therefore, is whether risks arising within the group as a whole are adequately addressed by any of the specialist prudential supervisory agencies that undertake their work on a solo basis.

One approach to these problems is to replace the separate banking, insurance, and securities prudential regulators with a single (conglomerate) regulator to mirror the emerging structure of a significant number of—though by no means all—financial institutions. There may be a case for an institutional structure of regulation that mirrors the structure of regulated institutions.

The issues raised by the emergence of financial conglomerates are comprehensively reviewed and analyzed in the report of the Tripartite Group (1995). This informal group of regulators was formed to address issues related to the supervision of financial conglomerates and, specifically, whether

the traditional organization, procedures, and instruments of prudential supervision enable the various supervisory authorities to meet their objectives (Tripartite Group 1995). The report was emphatic that a group-wide perspective is needed in the supervision of financial conglomerates. However, in 1995, it endorsed the tendency in current arrangements for solo supervision to be the main focus for the supervision of the component parts of conglomerates and did not judge that there was any pressing need to create prudential supervisory agencies for conglomerates. However, the report also recognized the need for close cooperation, collaboration, and exchange of information among the different prudential supervisory agencies of a financial conglomerate. Solo supervision alone is not sufficient.

The Tripartite Group surveyed six alternative approaches to monitoring the risk characteristics and solvency of financial conglomerates as a whole. The group judged that monitoring could be achieved either through balance sheet consolidation or by a solo-plus approach. In balance sheet consolidation, the assets and liabilities of the component companies are aggregated, and capital adequacy requirements are defined in terms of the group's aggregate position. Under the solo-plus alternative, capital requirements are related to the balance sheet position of each component of the group (the "solo" component), after which adjustments are made with a view to the conglomerate as a whole (the "plus" component). This allows for any double counting of capital within the group.

The group recommended that lead regulators be established to facilitate solo-plus regulation without creating a single prudential agency. (This arrangement is already the norm in many countries.) The lead regulator is responsible

for taking a group-wide perspective on the risk profile of the financial conglomerate as a whole and for coordinating the process of supervision, both on a regular basis and in crisis situations. The lead regulator is also responsible for assessing the capital adequacy of the group as a whole, for transmitting and demanding relevant information to and from other supervisors, and generally for coordinating any necessary action that involves more than one supervisory agency.

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Chapter 3

Making the Structural Decision

Australia's Approach to Regulatory Reform

Jeffrey Carmichael

In early September 1997 the Commonwealth Government of Australia announced that it would be implementing extensive reforms to the structure of regulation in the country's financial system, including the amalgamation of existing regulatory bodies and a streamlining of the regulatory process. That decision was no accident. It followed a thorough and wide-ranging review of the financial system over a period of almost 12 months and an exhaustive period of public discussion and debate.

This paper provides an overview of Australia's decision-making process. The intention is to focus on the process itself and how the decisions were reached rather than to assess the merits or otherwise of the outcomes. The paper starts with some background on why the review was set up in the first place. It then moves on to the philosophical approach followed and finally to how that shaped the outcome.

Setting Up the Inquiry

In mid-1996 the Australian government formed a commission of inquiry to review the Australian financial system and its regulatory structure. The Wallis inquiry, as it came to be known—after the chairman of the committee—was the first full-scale review of the Australian financial system since the Campbell inquiry in the late 1970s and only the third such review in the country's history. The circumstances of the two more recent inquiries could not have been more different.

The Campbell inquiry, 30 years earlier, was faced with a financial system that was under intense strain, as outdated regulatory structures were breaking down in the face of financial innovation and freedom. Against that background, the Campbell committee faced an almost universally supported mandate for reform. Deregulation was inevitable. The only question was the precise shape that it would take.

In contrast, the Wallis committee was asked to propose reforms for a system that was coping adequately with existing pressures. Furthermore, large sections of both the financial industry and the regulatory community were quite vocal in expressing their resistance to change.

The focus of the Wallis inquiry was underscored by the treasurer's terms of reference, which charged the committee with (a) taking stock of the results of deregulation since the early 1980s, (b) analyzing the forces for change in the industry, and (c) recommending a regulatory framework to best ensure an efficient, flexible, and competitive financial system.

The terms of reference emphasized change and the benefits of competition and efficiency. In this way, the inquiry was asked to be forward looking in its recommendations, seeking to avoid a future crisis rather than to deal with an existing one. The objectives of safety and efficiency were the guiding principles be-

hind many of the committee's recommendations. Indeed, with its emphasis on competition and efficiency, the Wallis report, unlike its predecessor, was not primarily deregulatory. Instead, the report focused on realigning and streamlining regulation to make it more efficient and conducive to competition rather than on removing regulations *per se*. This model of establishing a commission of inquiry before restructuring the regulatory system is something of an oddity in the international context.

In some countries that have undertaken similar reform, the design work has been done behind closed doors. In the United Kingdom, the governor of the Bank of England, Eddy George, appeared to be genuinely surprised by the government's announcement that it intended to establish the Financial Services Authority. Although it is completely expected that a central bank will resist losing banking supervision, that is not a valid reason to exclude it from the discussions. Good reforms are usually based on a degree of consensus.

In many countries, major regulatory restructuring has taken place following a financial crisis. This has been the case in a number of Scandinavian countries, where the financial system was almost completely destroyed in the late 1980s. Similarly, in the late 1990s, the governments of Indonesia, Republic of Korea, and Japan announced wide-ranging reforms almost as a way of penalizing agencies that were seen as having failed in their regulatory responsibilities. Restructuring in response to regulatory failure is probably the weakest grounds for reform. This is not to argue that there have not been some regulatory failures in recent years but simply that regulatory shortcomings need to be addressed at the source. New structures do not guarantee better regulation. More appropriate structures may help, but, fundamentally, better regulation comes from stronger laws, better-trained

staff, and better enforcement. Any country that thinks tinkering with the structure of agencies will, by itself, fix past shortcomings is doomed to relive its past crises.

The Evidence Produced by the Inquiry

In Australia the case for reform ultimately rested on two factors: perceived inefficiencies in the financial system and changes in international financial markets that posed potential problems for the regulatory structure in the future.

Inefficiencies in the Financial System

The first motivation for reform was perceived inefficiencies. The committee estimated that Australia's financial system cost consumers and other users in excess of \$A40 billion a year during the mid-1990s. This ranked the finance industry as one of the largest industries in the Australian economy.

The committee found that, while some segments of the financial system appeared to be competitive, by international comparison the overall picture was not encouraging. At the broadest level, the cost of \$A40 billion represented a charge of around 4 percent on the total asset base of the system. This ratio put Australia at the middle to upper range of costs for comparable developed countries. In comparison with these countries, the committee found Australia to be relatively inefficient in the density and cost of its banking branches, the mix of payment instruments, the expense ratios of general insurance, and the costs of funds management.

Although these inefficiencies were not all directly attributed to regulatory interference, the committee identified a

number of regulatory impediments to cost-efficiency. Furthermore, there was an overall presumption that Australia's fragmented regulatory structure, with considerable duplication and ambiguity, did little to encourage competition or cost-efficiency across sectors.

In reviewing the evidence, the committee concluded that redesigning regulation by removing impediments and stimulating competition would benefit many areas of the financial system. Emphasizing that regulation had an indirect rather than a direct impact on efficiency, the committee also noted that, although reform would not remove all excess cost from the system, it could facilitate competition.

The Changing Financial Landscape

The second motivation for reform came from changes occurring in the financial system. Change in the financial system implies the need to adapt regulations imposed on financial institutions and markets. Of particular concern was the potential for the existing regulatory framework to encounter problems associated with change that, in the limit, could have challenged the integrity and stability of the financial system. The committee identified three main drivers of change in Australia's financial markets: consumer needs, technological innovation, and regulation itself.

Changing Customer Needs

Changes in customer needs and profiles are gradual but powerful influences on financial sector development. The impact of these changes was seen as particularly strong in two areas.

First, the role of the financial system in the economy over the preceding couple of decades was “deepening,” with households increasing both their holdings of financial assets and their borrowing from the financial sector. The growing demand for financial services reflected increasing wealth and changing financial needs arising from demographic and life cycle changes, including (a) the aging of the population and increasing expectations of higher retirement incomes and (b) increasing diversity in life cycle experiences, including greater job mobility, longer periods spent in training and education, shifts in work-leisure preferences, and changes in family structures and experiences.

Second, customer behavior was changing in two particular ways that together were promoting a more competitive marketplace: (a) better access to information and the weakening of traditional supply relationships were raising consumer awareness of product and supplier value, thereby increasing competitiveness in markets, and (b) greater familiarity with the use of alternative technologies meant that more households were pursuing lower-cost and more convenient means of accessing financial services.

Technological Progress

The second driver of change was technological progress. Technological innovation was probably the major force shaping the delivery of financial services over the preceding two decades. Systems for processing, communicating, and storing information—essential parts of the infrastructure supporting financial activities—had all undergone substantial and irreversible changes as a result of technological advances.

Technology made it easier to access markets and products both domestically and internationally. Technology also made it possible to analyze and monitor risk more effectively, to disaggregate it on a broad scale, to price it more accurately, and to redistribute it more efficiently. While the pace of innovation could not necessarily be predicted, the committee judged that it was likely to accelerate over the next few years for two main reasons: (a) the continuing fall in the cost of technology and (b) anticipated innovations that would increase the ease and security of electronic transactions. These factors were seen as facilitating the conduct of financial activities through homes, workplaces, and other sites physically remote from service providers, further reducing costs and lowering the entry barriers for new suppliers.

Regulation

The third driver of change was regulation itself. Governmental and regulatory environments profoundly influence the structure and scale of financial sector activities. This influence is by no means confined to direct financial sector regulation and, in the Australian context, included:

- The increased opening of the Australian economy to the global marketplace, including the financial system
- The introduction of compulsory superannuation
- Changes in the role of government (in particular, the almost complete departure of government from the financial services sector as an owner of financial institutions and the associated removal of explicit government guarantees of financial sector liabilities)
- The impact of the taxation system on investment choices and international competitiveness.

Deregulation in the 1980s had refocused innovation on the delivery of financial services and away from the unproductive activity of circumventing outdated regulations.

Summary

Together, the forces arising from changing customer needs, technological innovation, and deregulation had reshaped the financial landscape, with the result that the Australian financial system of the late 1990s showed a greater business focus on efficiency and competition, increasing globalization of financial markets and products, and a growing trend toward conglomeration of financial services providers.

Regulatory Implications

The regulatory implications of these three drivers of change were seen as significant. In particular, the committee was concerned that, if the trend toward global markets continued, there would be an increasing focus on competition and efficiency, with boundaries among products and markets continuing to blur. In such an environment, the existing regulatory structure might be severely limited in its capacity to maintain financial safety and integrity.

In evaluating the capacity of the existing regulatory framework to cope with change, the committee considered two alternative views of the future. At the conservative end of the spectrum, the committee considered the view that change would remain incremental. According to this view, change would impinge less on the basic functions of the financial system than on peripheral issues, such as the mode of service

delivery (for example, electronic rather than personal), and on back-office functions, such as the efficiency of data storage and retrieval. At the more revolutionary end of the spectrum, the committee considered the view that the financial system was about to undergo a “paradigm shift,” involving a sharp discontinuity from past trends. According to that view, financial processes and structures would be transformed by the rapid emergence of much lower-cost information technology and its equally rapid dissemination into homes and workplaces. That shift not only would dramatically alter the channels of service delivery but also would redefine the character and boundaries of markets.

This alternative view incorporated developments that increasingly transcended existing institutional patterns. For example, the committee foresaw a world in which financial claims, including loans and bonds, might bypass intermediaries to be bought and sold by electronic auction through global bulletin boards at minimal cost. It was a world in which even retail users and suppliers of financial claims could be networked together to exchange real-time data and documents. Payments systems might extend beyond the deposit-based stores of wealth to broader credit-based systems linked to the security of other forms of wealth, perhaps including illiquid assets such as real estate and motor vehicles.

While the committee did not take a position on the likely path of change between these two extremes, it did nominate a series of key changes that it saw as likely to occur over the next decade, regardless of which view of the world was correct. These changes, if they occurred, would not alter the rationale for financial regulation, but they would shift much of its focus. These changes included the following:

- Advances in information technology, which could erode the traditional roles of financial institutions
- Increasing entry of new participants offering financial services from abroad
- Emergence of new payment instruments and payment service providers, possibly divorced from traditional deposit products and using new technologies and channels of delivery
- Continued evolution of large financial conglomerates, using their brand and other strengths to provide a wide range of financial services
- Continuous changes in the way services are designed, bundled, and allocated among companies in a group to minimize regulatory costs
- An increasing share of household financial wealth held in the form of market claims, particularly through superannuated savings and retirement income products.

Given these considerations, the committee saw its challenge as formulating an approach that responded to the changes that were either in place or known to be imminent but that also provided the regulatory framework with the flexibility to deal with more revolutionary change, if and when it occurred.

Before I move on to what the committee decided, it is worth taking a moment to reflect on the view of the world just described. While the committee did not state that the more radical view of a financial paradigm was necessarily about to happen, committee members clearly thought that it was more than just a remote possibility. With the benefit of hindsight, we know that, while some of the elements outlined in the more radical view have come to pass, most

have not. Financial markets still function largely as they did in 1997 when the committee's report was being written. The critical factor in this outcome is the 1997 Asian crisis, which occurred not long after the report was delivered. Foremost in the committee's thinking in late 1996 and early 1997 was the possibility that lightly regulated, low-cost, Asian financial markets, which were growing rapidly at the time, would take business away from Australia. In fact, light regulation in Asia turned out to be under-regulation, and the subsequent crash of the Asian markets removed, at least temporarily, the threat of market erosion in Australia.

If the commission of inquiry were sitting today, rather than nearly a decade ago, it would almost certainly still issue broadly the same recommendations. However, the thinking probably would not be driven by the fear of competition and the need to keep regulatory costs down. Rather, it would be driven much more by the need to achieve regulatory effectiveness and the need to remove regulatory arbitrage. The recommendations on structure would probably be the same, but the implications for resources would be substantially different.

From Implications to Objectives

Based on its assessment of the changing financial environment and regulatory challenges ahead, the committee set itself some target outcomes. In particular, it sought to provide a set of recommendations that would accomplish the following:

- Create a flexible regulatory structure capable of responding to the forces for change operating on the financial system
- Clarify regulatory goals

- Increase the accountability of the agencies charged with meeting those goals
- Provide more effective regulation for financial conglomerates in order to facilitate competition and efficiency
- Ensure consistent regulation of similar financial products
- Introduce greater competitive neutrality across the financial system
- Establish more contestable, efficient, and fair financial markets, resulting in lower costs to consumers
- Facilitate the international competitiveness of the Australian financial system.

Note again the emphasis on efficiency and cost in the committee's thinking.

Philosophical Framework

The committee believed that it was important to understand how regulation worked before proposing a new structure. It believed that the regulatory structure should be aligned in some way with the roles of regulation if it were to be efficient and effective. In following this line of thinking, the committee looked not so much at the outcomes that are often stated for regulation, but rather at the root causes of why regulation is needed in the first place.

In line with academic thinking, the committee agreed that the primary rationale for regulation has to be some form of market failure. In the absence of market failure, regulation can only reduce efficiency. In broad terms, markets fail to produce efficient, competitive outcomes for one or more of the following reasons: anticompetitive behavior, market misconduct, information asymmetry, and systemic instability.

By and large, different regulatory tools are needed to counteract each of these four sources of market failure.

Anticompetitive Behavior

Governments generally foster competition in the financial sector because of the benefits it brings to the economy overall. These benefits include improved access to capital for business, cheaper credit and housing loans to consumers, a better match between the financing needs of deficit and surplus units, cheaper transactions, and a greater ability to manage risks. Market forces are the main determinant of competition. The role of competition regulation is to ensure that these forces operate effectively and are not circumvented by market participants. The key measures used in competition policy are (a) rules designed to deal with the structure of industries (merger or antitrust laws), (b) rules designed to prevent anticompetitive behavior (for example, collusion), and (c) rules designed to ensure that markets remain contestable (by ensuring that there is relatively free entry and exit).

Market Misconduct

Financial markets cannot operate efficiently and effectively unless participants act with integrity and unless there is adequate information on which to base informed judgments. The two areas of misconduct most common in financial markets are unfair or fraudulent conduct by market participants and inadequate disclosure of information.

Regulation to address these sources of market failure is usually referred to as market conduct regulation. This form of

regulation seeks to protect market participants and, through this, to promote confidence in the efficiency and fairness of markets. Market conduct regulation typically focuses on five areas: (a) disclosure of information, (b) conduct-of-business rules, (c) entry restrictions through licensing, (d) governance and fiduciary responsibilities, and (e) some minimal conditions of financial strength (capital requirements where the nature of financial promises warrants it).

Asymmetric Information

The third source of market failure—information asymmetry—arises where products or services are sufficiently complex that disclosure, by itself, is insufficient to enable consumers to make informed choices. This arises where buyers and sellers of particular products or services will never be equally well informed, regardless of how much information is disclosed. The issue is one of complexity of the product and of the institution offering it. This problem is common in areas such as drugs and aviation, and it is particularly relevant in the area of financial services.

The form of regulation involved in counteracting asymmetric information problems is usually referred to as “prudential regulation.” Prudential regulation overcomes the asymmetric information market failure in part by substituting the judgment of a regulator for that of the regulated financial institutions and their customers. Prudential regulatory measures include entry requirements, capital requirements, liquidity requirements, governance requirements, and customer support schemes (such as deposit insurance and industry guarantee funds).

Systemic Instability

The fourth, and final, source of market failure is systemic instability. Parts of the financial system operate efficiently only to the extent that market participants have confidence in their ability to perform the roles for which they were designed. Systemic instability arises where failure of one institution to honor its promises can lead to a general panic, as individuals fear that similar promises made by other institutions may also be dishonored. A crisis occurs when contagion of this type leads to the distress or failure of otherwise sound institutions. The payments system is perhaps the most vulnerable to systemic crisis.

The primary defense against systemic instability is the maintenance of a sustainable macroeconomic environment, with reasonable price stability in both product and asset markets. This responsibility falls directly to government in its formulation of monetary and fiscal policy. Systemic stability is also supported by the existence of a prudentially sound system of financial institutions. Beyond these general macroeconomic and prudential measures, the additional regulatory tools most appropriate to resolving this type of market failure are the lender-of-last-resort facility and direct regulation of the payments system.

Implications for Regulatory Structure

The main implication that the committee drew from its analysis of the underlying reasons for regulation was that layers of regulation are required within the financial system. In particular, all financial markets and participants require regulatory oversight of competition to ensure that they are competitive. Similarly, all financial markets and participants require regu-

latory oversight of conduct to ensure that they function efficiently and fairly. Not all financial markets and participants require prudential regulation. Prudential oversight is much more intrusive and paternalistic. Consequently, it is more costly and could potentially interfere with the competitiveness and efficiency of the system.

The committee chose as a rule of thumb that institutions should only be subjected to prudential regulation if the financial promises they offer are difficult to keep, difficult to understand, or, in the event of a failed promise, likely to cause significant financial distress or to have a significant impact on the economy. In the Australian context, prudential regulation was seen as being appropriate only for the promises made by banks, non-bank deposit takers, insurance companies, and pension funds. Finally, while banks are undeniably important to systemic stability in the broader sense, the committee argued that prudential regulation of general banking activities should provide a sufficient level of oversight to meet the systemic threat. The one exception to this rule is the involvement of banks in the payments system. Thus the committee saw the payments function, rather than the institution itself, as the activity to be regulated for systemic purposes. Indeed, the committee argued that access to the payments system should be extended beyond the banks, provided an adequate regulatory framework was put in place.

Structural Options Considered

The committee considered three main options for Australia's regulatory structure. The first was to retain essentially the existing structure of multiple industry-based regulators. The second was to create a structure based on the four sources of

market failure. The third was to amalgamate most, if not all, regulatory functions within a single super regulator.

Industry-Based Regulators

The central characteristic of the existing structure was that each regulator had responsibility for resolving most, if not all, the sources of market failure to the extent that they related to its particular group of institutions. Thus, for example, the Reserve Bank of Australia not only was responsible for the prudential soundness of banks but also largely supervised their market conduct, competitive behavior, and impact on systemic stability.

The main case for staying with the existing structure was that it was working adequately at that time. The main arguments against it were that it was duplicative and costly, did not deal adequately with financial conglomerates, and was poorly equipped to deal with major financial innovation, should it occur. Additionally, to be effective, it required a high degree of coordination and cooperation among different agencies.

The Market Failure-based Model

The second model the committee considered was internationally unique. The idea was to create four separate regulators, each responsible essentially for regulating all institutions and market participants subject to a particular type of market failure. Thus the prudential regulator would regulate all institutions subject to significant information asymmetry but would regulate those institutions only from a prudential

perspective. Other regulators would supervise their market conduct, competitive environment, and any involvement in liquidity support or payments services.

The main strength of this model was its focus. Each regulator would have one objective: to establish a set of rules, regulations, and enforcement mechanisms designed to counteract just one source of market failure. In this way, each regulator would be able to maximize the synergies from amalgamating all regulation of a given type under the one roof. Under this model, there would be no gaps, no overlaps, and no competition for turf.

The model also had weaknesses. It would require a significant rearrangement of regulatory resources within the country. It would remove banking regulation from a well-established and credible regulator and place it under a new institution that would need time to establish its credibility. It would not necessarily deal completely with financial conglomerates, since conglomerates could conceivably include some subsidiaries that fell inside the prudential net and others that fell outside it. Fourth, there was a risk that failure in one area of regulation by one of the new agencies could damage the agency's credibility in other areas. For example, the prudential regulator would have responsibility for supervising banks, non-bank deposit takers, insurance companies, and pension funds. With such broad responsibility, the failure of a single insurance company might bring into question the competence of the agency for regulating banks and pensions.

The Super Regulator Model

The third model considered was the super regulator model in which at least prudential regulation and market conduct regulation would be brought together under the same roof.

Internationally, the super regulator had taken on different forms. In Scandinavia, for example, the amalgamation of functions stopped at prudential and market conduct regulation. In Singapore it went further to include systemic stability regulation by bringing the primary regulatory functions within the central bank. A limited survey of countries at the time did not reveal any country that combined all four types of regulation in one agency.

The main attractions of the super regulator model were that it offered economies of scale and a clear means of coping with financial conglomerates. Again, there were several arguments against it. As with the market failure-based model, it ran the risk of “credibility contagion” and required a major reallocation of regulatory resources. Unlike the market failure-based model, it would have a single agency with multiple and possibly conflicting objectives. It also ran the risk of creating a clash of cultures between conduct and prudential regulators. Finally, it would concentrate enormous responsibility and power in just one agency. To add to the case against the super regulator model in the Australian context, the Reserve Bank indicated that it lacked the expertise to regulate financial institutions other than banks and that extending its responsibilities beyond its expertise could be a major distraction from its core activity of setting monetary policy.

The Committee Recommendations

Ultimately, the committee decided that the market failure-based model offered the best balance among the options, given the challenges that the Australian financial system would face over the coming decade. The recommendations to streamline Australia's regulatory structure into four pillars were contained within a to-

tal of 118 recommendations designed to improve the competitiveness and effectiveness of Australia's financial system.

Following publication of the committee's report, there was an extensive period of public debate about the recommendations. Not all interested parties agreed with them. As expected, some of the agencies that faced being absorbed into a new agency or whose functions would be removed altogether were hostile and fought to retain their responsibilities and staff. The government took note of the debate but ultimately made its own decision based on what it saw as the best interests of the country.

The government decided to accept the committee's recommendations, and Australia now has four regulators, each aligned with correcting one source of market failure:

- The Australian Competition and Consumer Commission, responsible for competition
- The Australian Securities and Investment Commission, responsible for market conduct (and thereby for consumer protection)
- The Australian Prudential Regulation Authority, responsible for prudential regulation of deposit taking, insurance, and pensions
- The Reserve Bank of Australia, responsible for overseeing systemic stability through its influence over monetary conditions and through its oversight of the payments system.

Conclusions

This paper has been primarily about process: how Australia went about making the decision to rearrange its regulatory

structure. In our experience, the advantages of following a deliberate process of review by an independent committee, with public input and debate, is that all affected parties have an opportunity to state their views and to join the exchange before the decision is made. This brings all the issues into the open and does so in a logical, structured way.

In contrast, where the decision to change the structure is made without adequate review and debate, there is often a high fear factor within the industry and public, driven by the absence of information and analysis. This fear has, in some cases, been used by the “likely losers” among the existing agencies to mount a rearguard resistance to the changes. The net effect is usually confusion and distrust, neither of which is conducive to an effective regulatory system.

Two final observations should be made in closing. First, there is no perfect regulatory structure. No matter which regulatory structure is chosen, there will be problems and challenges. Choosing a good regulatory structure is largely about finding the best fit for a given situation at a particular point in time. Making it work is largely about identifying the chosen structure’s weaknesses and implementing solutions that address those weaknesses. Second, changing regulatory structure does not guarantee overcoming regulatory failures. While structure can help greatly, regulatory success is ultimately about having well-trained and experienced regulatory staff, who are capable of identifying problem institutions and who have the courage and support to act on what they find.

The South African Case

Andre Bezuidenhout

South Africa has made the decision to move to an integrated financial regulator but has not acted on that decision yet. There was a process to review the financial regulatory environment, after which the minister of finance announced his intention to move to a single regulator. Subsequently, the governor of the South African Reserve Bank (SARB) expressed concern about moving to a single regulator, and, since then, no firm action has been taken. There is still considerable uncertainty about what will happen, which is not an ideal situation. My hope is that this conference will enable us to take a fresh look at the issue and will serve as a catalyst for us to find a unified approach that will satisfy both the minister of finance and the governor, while also allaying the concerns of SARB.

This paper relates South Africa's review process and the considerations that are pertinent to South Africa. In particular, it focuses on six country-specific circumstances that

point to a financial supervisory structure that is not the obvious fully integrated or mega regulated one, but more of an objective-driven structure, possibly something like the approach of Australia or Ireland.

South Africa's Financial Environment

South Africa's financial system is both highly developed and developing, and this dual nature might lead the country to adopt a slightly peculiar solution. On the one hand, there is a highly developed financial sector with sophisticated and liquid markets, a strong, well-capitalized, albeit highly concentrated, banking system, and well-managed, full-service financial institutions that are internationally active. In other words, we have a financial system befitting a country with investment-grade ratings and generally sound macroeconomic and fiscal fundamentals. On the other hand, the country still has many characteristics of an emerging-market country. We have particularly high unemployment and, as a result, suffer from numerous poverty- and crime-related problems. We have a low savings propensity, which is a structural problem in our economy, and, in particular, very limited access to basic financial services. An estimated 40 percent or more of the population cannot afford or cannot access the financial services being offered by the financial system. Then there are the usual socioeconomic issues of health and the high rate of HIV/AIDS infection. More recently, we have experienced volatility in our currency exchange rate.

The current financial regulatory structure is as follows. One partially integrated financial services regulator—the Financial Services Board (FSB)—performs the full scope of conduct-of-business and prudential regulation of insurance,

securities trading, and pension funds. FSB resides under the minister of finance and has no involvement in supervising banks. The regulation and supervision of banks reside with the central bank—SARB—which focuses on prudential and systemic supervision. The conduct-of-business supervision of banks follows a self-regulatory approach and is done by an industry association—the Banking Council.

The Process to Review the Regulatory Environment

Around 1998 several considerations pointed toward the need to review the country's financial regulatory structure. The technical and product innovations that other countries experienced also took place in South Africa, along with globalization, deregulation, and some conglomeration. Concerns about regulatory effectiveness in a more integrated financial system arose, as did the feeling that the objectives of regulation needed to include broader access to financial services. The central bank was considered too focused on monetary policy and unable to accommodate ancillary objectives, such as facilitating broader access to finance, reducing financial crime, and promoting public awareness and education.

As a result, the minister of finance initiated a round-table process of open debate facilitated by several international consultants regarded as authorities on the issue. The parties involved included the Banking Supervision Department of SARB, the minister of finance and the national treasury, FSB (the integrated regulator for all financial services except banking), the Parliamentary Portfolio Committee on Finance (the parliamentary committee that has to consider all financial legislation), the Banking Council and other industry associations, as well as international consultants. This

process took place in April 1999 and culminated in the following consensus.

Systemic regulation should stay with SARB, but prudential and conduct-of-business regulation of banks as well as non-bank financial institutions should be integrated in one financial services regulatory agency. The thinking was that SARB would be a mega regulator; in other words, it would regulate across all sectors, but also across the objectives of prudential and conduct-of-business regulation. In February 2000 the minister of finance announced his intention to have a single regulator.

The Policy Board for Financial Services and Regulation, a statutory advisory body to the minister of finance, commissioned a team including international consultants to prepare a consultative paper entitled "Alternative Financial Regulatory Architectures for South Africa." A broad multilateral workshop of stakeholders was held in December 2000, and a second paper, entitled "Financial Stability and the Regulatory Architecture" was prepared, encompassing all the comments received at the workshop. A second workshop was held in March 2001, after which the policy board submitted its recommendations to the minister in May 2001.

In contrast to the roundtable consensus, the policy board concluded that, although integration is likely to aid the supervision of conglomerates and improve the perception of public accountability, it may also reduce the effectiveness of banking supervision and consequently increase systemic risk. The recommendation was not to follow a "big bang" approach, but to develop institutional capacity first and then to implement formal coordination and integration gradually over a number of years. It was recommended that the minister appoint a team to manage the change process. Unfortunately, this was not accepted, although the minister, in February 2002, reaffirmed his intention

to create a single integrated financial services regulator. It was generally assumed that the single regulator would not be housed in SARB, for obvious reasons relating to the moral hazard of non-banks relying on liquidity support from the central bank.

A Mild Bank Liquidity Crisis

Uncertainty reigned. The governor of SARB, in his August 2002 annual address, expressed grave concerns that changing to a single regulator could cause problems in a crisis situation. This was said in light of the mild banking liquidity crisis that South Africa experienced between February and August 2002.

In short, the crisis can be described as follows. In our highly concentrated banking system, the four largest banks hold 80 percent of the banking system. During 2001, serious management error and fraud were discovered in the seventh largest bank, Saambou Bank; its share price plummeted, and the bank rapidly lost vast amounts of its large deposits. By early 2002, SARB had to consider providing liquidity assistance to Saambou, but the circumstances required a guarantee from the government. The minister of finance decided not to issue such a guarantee because the bank in question was considered too small to pose a systemic risk. Although it was the country's seventh largest bank, with approximately 500,000 depositors and around R20 billion in assets, there was a very big gap between it and the four largest banks. The minister placed the bank under curatorship.

Unfortunately, the line between the systemically important banks and other banks was unclear. As soon as Saambou was placed under curatorship, depositors began to withdraw their deposits from other large banks. The country's sixth

largest bank, which was undoubtedly systemically important, with a vast base of depositors and R40 billion in assets, experienced withdrawals at such a rate that it became clear that a major crisis of confidence was under way. The governor and the minister responded by issuing a blanket guarantee that all deposits in the banking system would be covered. This stemmed the outflow of deposits.

During this period, which lasted several months, there were less than ideal coordination and communication between the bank supervisor and SARB, on the one hand, and the minister of finance, on the other. This prompted the governor of SARB to write, “The capacity to perform effective banking supervision is crucial to price and financial stability. After careful consideration of the issues, I am convinced that it is in the best interest of the economy that banking supervision should remain the responsibility of the SARB.”

Country-Specific Features Informing the Structural Decision

Returning to the structural decision, it is now thought that at least six country-specific characteristics about South Africa’s financial system guide the choice of architecture. These may be instructive to other countries in Africa and to countries in other regions with similar circumstances.

Openness of the Economy and the Discretion of the Central Bank

First, South Africa has a small, but open, economy by most standards. This usually means that the country “imports” a

considerable amount of policy. In our case, with a central bank guaranteed its independence in the constitution, a floating exchange rate, and some remaining exchange controls, we have managed to have a high degree of independent monetary discretion. Monetary policy is executed essentially through the banking system, and SARB is very conscious of how crucial the banking system is as a conduit for the implementation of monetary policy. As the banker of banks, SARB controls interest rates and exerts a strong influence on monetary affairs.

In addition, there is a strong link between price stability and inflation targeting, on the one hand, and financial system stability, on the other. Any disturbance in the banking system would be immediately reflected in monetary aggregates and also harm SARB's ability to use this conduit to influence monetary matters. As a result, SARB considers that having banking supervision as part of its functions is not just a convenience but also a necessity.

Concentration in Banking

Second, the concentration in banking has blurred the borders between micro and macro prudential issues, and there is little distinction between systemic and prudential regulation. In the extreme case of a monopoly bank, even the smallest micro disturbance is systemic in nature, and SARB, for this reason, will always want to retain some oversight of banks. In any case, SARB has been independently assessed, through the International Monetary Fund and the World Bank Financial Sector Assessment Program, and found to be a very effective supervisor of banks. So there is understandable reluctance in SARB to relinquish the banking supervision function.

Settlement System and Time to React

The quality of a settlement system is sometimes a double-edged sword. South Africa has a sophisticated real-time gross payment system, which means that a very high percentage of interbank transactions flow through SARB's settlement system. However, massive amounts of funds can be switched from a bank in distress to a safer haven in a very short period of time, as became clear in the recent banking crisis. This means that the central bank, as the monitor of the payments system, has to act very quickly to ensure that creditors are not disadvantaged. For quick action in times of crisis, an ongoing, intimate knowledge of the prudential affairs of a bank is crucial. If the central bank first has to engage with another prudential supervisor to understand the finer nuances of the prudential aspects of a bank, it loses the benefit of having real-time information on which to act. SARB believes that its close link with the banking supervisor, as an integral part of the central bank, has allowed it to manage difficult situations that, otherwise, would have resulted in a much bigger crisis.

The Financial Safety Net and Deposit Insurance

The South African financial safety net is a little peculiar. Without an explicit deposit insurance scheme, SARB is clearly the only source of liquidity in a crisis. But SARB cannot make unsecured loans, which, in practice, means that, if the bank concerned has insufficient collateral, SARB requires a government guarantee before it can give meaningful support to resolve a possible systemic problem. As a result, it has a natural tendency to retain effective oversight of banks and knows intimately and continuously the exact prudential po-

sition of banks. SARB feels that, given the time constraints in a crisis, it cannot rely on another organization to provide detailed information about the solvency and asset quality of a bank. In the past, and also recently with the problem of Saambou Bank, the close working relationship between the Banking Supervision Department and all other departments in SARB with an interest in financial stability has proven to be a major asset in the process of resolving problems.

A project is under way to implement a South African Deposit Insurance Scheme (SADIS), which could make it easier for SARB to part with the bank supervision function, since SADIS would enhance the level of supervision and increase the number of options available for crisis resolution.

Lack of True Integration in Financial Groups

Unlike some other jurisdictions, South Africa has not experienced a proliferation of integrated financial services institutions or even complex financial conglomerates. The market change to “all-finance” was not all that distinct in South Africa. Although there is a lot of cross-selling of banking, insurance, and securities services in financial groups, the different risks are separately managed on each institution’s balance sheet. There is little evidence of a problem with regulatory arbitrage, so this is not a strong argument for integrating the regulatory environment.

Notwithstanding this, in South Africa, unlike in some other countries, insurance companies tend to own and control the banks. Because of this, conglomeration might increase, and, if it does, this will be a more compelling argument for unifying prudential supervision. Since the Saambou saga, there is a feeling that the single prudential inte-

grated regulator should not necessarily be outside the central bank. It could be modeled on something like the Bank of Ireland approach. In any event, because of these country specifics, it is likely that SARB will continue to be a powerful influence in banking supervision, much like the German and the French situation.

The Role of State-Owned and Foreign-Owned Banks

Finally, state-owned and foreign-owned banks are not a big feature of the South African financial system. In some countries, such banks have probably been part of why central banks have happily parted with the supervisory function, because most of the banking system is foreign owned or state owned anyway. That is not the case in South Africa, so the power of the supervisor is considerable, which increases the risk of moving it away from the only truly independent organization, the central bank. Combine this with a general shortage of regulatory resources, and it is more understandable why it is politically and administratively quite attractive to have the unified regulator be part of the central bank.

Rationale for an Objective-Based Approach

Given these six country specifics, the current environment may still be a viable architecture for South Africa. That is, systemic oversight of the financial system is done by the Financial Stability Department of SARB, prudential supervision of banks is done by the Bank Supervision Department of SARB (which, through statute, has an arm's-length relationship with the rest of the central bank), and prudential super-

vision of all other financial firms as well as all conduct-of-business supervision is performed by the Financial Services Board as an integrated statutory regulatory body.

The alternative is to integrate prudential and conduct-of-business regulation for all sectors in a single financial services regulator outside the central bank. The merits of this approach are that it enables more effective supervision of conglomerates, involves less regulatory arbitrage, promotes transformation in the financial sector and access to financial services for all, and offers a structure that is perceived as more modern and accountable. These potential benefits are considerable and part of the reason why the minister of finance favors the mega regulator approach.

Recently, a third alternative has received more consideration in light of the Saambou crisis as well as international developments like Ireland's restructuring. This is more of an objective-driven approach in which systemic supervision would remain with the Financial Stability Department of SARB, prudential supervision for all financial sectors would move to a prudential regulatory authority within SARB (that is, a strengthened and augmented, but arm's-length, Bank Supervision Department, much like the Irish model), and conduct-of-business supervision for all sectors would be performed by the remainder of the existing Financial Services Board. The merits of this alternative are that it recognizes the six country-specific reasons why banking supervision in South Africa should be linked as closely as possible with monetary policy and financial stability, yet it places the considerable benefits of integration within reach without undue risk. This architecture would be more effective in pursuing the objectives of systemic stability, would give superior integration of monetary and regulatory objec-

tives, would bring less risk in a crisis, and would still pursue the benefits of regulatory integration with less risk and less cost of duplication.

A Model for Good Times and Bad?

Among the parties to the debate in South Africa, there is a growing consciousness that any of these models can be made to work, especially in good times, when all is running smoothly. In a crisis, however, we found the availability of ready information to be a very important factor. More is required than just formal information given in terms of a service-level agreement or a memorandum of understanding; also needed is an intimate understanding of the prudential aspects of firms that comes only with continuous supervision. Even assuming such good information, interagency cooperation is still vital, and that is clearly where we fell short in the past. Whatever the architecture chosen, formal arrangements for improved cooperation between the various players in the safety net system are important. The integrated regulator, wherever placed, is only one of the players in the whole safety net system.

Conclusions

We are conscious that South Africa is on the international radar screen regarding our approach to financial supervision. The decision regarding the future regulatory structure is complicated by the country's dual financial system. On the one hand, we need to maintain systemic stability at all costs and to be, as well as be seen to be, a responsible financial

system that adheres to international standards. On the other hand, we need to transform the financial services industry into something more suited to ensuring a broader delivery of affordable basic financial services to the majority of South Africans. The secret is to achieve the considerable benefits of integrated financial regulation without the considerable risks (in our context) of removing banking supervision from the steady hands of SARB. While it is acknowledged that the mega regulator model can be made to work, the objective-driven split that I have mentioned, in light of Ireland's experience, deserves some consideration. In the final analysis, however, the form is not as important as the substance of the mechanisms for cooperation that are put in place or as important as the management of change to be carried out.

The New Structure of Financial Regulation in Ireland

Liam O'Reilly

This paper concentrates on the rationale for the new structure of financial regulation in Ireland, outlining both why this structure is suitable for a small open economy and how the structure operates in practice. The first section outlines recent international trends and influences. The second section provides the rationale for reviewing the structure of financial regulation in Ireland, while the third describes the process leading to the government's decision to pursue reform. The fourth section outlines why the model chosen is appropriate for Ireland. The remainder of the paper discusses how the new regulatory structure is operating in practice and the legislative powers that are needed to enhance the regulation of financial services in Ireland.

International Trends and Issues in Financial Regulation

The institutional arrangements for financial regulation have been the subject of much debate in recent years. Historically, central banks were charged with prudential supervision of banks because it complemented their functions in the areas of monetary policy operations, oversight of payments systems, and lender-of-last-resort role.

Over time, however, a number of developments altered the role of central banks in the area of prudential supervision. Mainly as a result of the emergence of complex groups, the scope of prudential supervision broadened to include insurance undertakings, securities and investment business, and funds management. The traditional role of the central bank did not easily extend to the prudential regulation of these financial sectors, and, as a consequence, other regulatory bodies were established outside the central bank. Another factor was the advent of consumer protection and conduct-of-business regulation and whether that should be separated out or combined with prudential supervision.

The central issue is that the institutional arrangements for financial regulation must be put into the context of the particular model of financial regulation that is suitable for a particular country. In making such a decision, several issues need to be addressed:

- How to achieve economies of scale in merging regulatory functions (by reducing duplicate regulatory rules and regulations between the different regulatory bodies and facilitating the flow of information between supervisors focused on the conduct of business and those focused on the safety and soundness of financial institutions)

- How to handle the emergence of complex groups and oversee the operation of such groups as a whole in addition to the individual parts of the group
- Which model of financial regulation is the most efficient and effective for the particular country
- Whether a single regulatory authority will provide a more even-handed approach to supervision and reduce the risk of regulatory arbitrage
- How best to use available regulatory expertise
- In the case of a central bank, how to avoid conflict between the monetary policy functions and financial regulation
- How to create synergies between the central banking functions and banking supervision
- How to strike a balance between the conduct-of-business element, on the one hand, and the stability and soundness of institutions and their customers' funds, on the other.

The relative importance of each of these factors will vary from country to country, depending on the structure of the financial sector, the objectives of regulation, the traditional approach to financial supervision, and general political debate on issues relating to the financial sector.

Rationale for Reviewing the Structure of Financial Regulation in Ireland

During 1998, a government subcommittee concluded that existing legislation and regulations were inadequate and recommended establishing an independent new regulator to supervise all financial institutions. Previously regulation

of financial services had been carried out by several different bodies.

At an international level, the move was toward having a single regulator in response to the emergence of complex financial groups. The conclusion was being reached that different elements of a financial group could not be adequately regulated as distinct components, when the safety and soundness and risk in the whole were greater than the sum of the individual parts. The question also arose as to whether it was possible to coordinate group activities closely if different regulators were involved. At a national level, the main issues related to the role of banks in the collection of withholding tax and their transparency in charging customers for services. As well as these specific issues, there was concern about the treatment of consumers of financial services and the perception that they were not being adequately protected in their financial dealings. This particular issue was compounded by the assertion that competition was inadequate in the Irish banking system.

Process Involved in Implementing the Government Decision

Having made the decision to establish a single regulatory authority for financial services, an implementation advisory group, chaired by Michael McDowell, was established. Membership of this group included representatives from existing regulators, other government officials, and senior legal and accountancy representatives. The primary issues discussed were:

- How consumer protection would be improved and be at the heart of financial regulation

- How consumer protection and prudential supervision would be integrated
- What relationship would exist between a new regulatory structure and the central bank
- How the perceived gaps in existing regulatory systems would be addressed and how existing regulatory systems would be integrated and aligned.

In May 1999 the implementation advisory group published the McDowell report, which recommended establishing a single authority to regulate all financial institutions in Ireland. This new authority would have a statutory role in relation to consumer protection, which would include establishing a new statutory position of consumer director. The report recommended the following:

- Transfer all existing consumer-related functions to the new regulator
- Have the new regulator operate existing compensation schemes
- Establish a single ombudsman scheme for all financial services
- Establish an independent appeals tribunal to hear and determine appeals regarding the imposition of sanctions
- Establish consumer and industry panels to provide a forum for discussion on the performance of the regulator and provide an opportunity for industry and consumer groups to suggest initiatives and respond to initiatives put forward by the regulator
- Make arrangements for the maximum cooperation between prudential regulation and monetary policy functions.

While the McDowell report recommended that this single regulatory authority should be a new independent organization outside the central bank, a minority of the group members preferred to locate the new structure within a restructured central bank by establishing a separate division or wing to undertake prudential and consumer protection functions. The subsequent government decision, in early 2001, was to link monetary policy and related functions with regulation of financial services into a restructured central bank and to establish the Financial Services Authority of Ireland within it as an autonomous, single financial services regulator.

Why This Model Is Suitable for Ireland

Various factors influenced the final decision. First, this model addressed the *need for change* by providing autonomy for the regulation of financial services in the form of one independent governing authority, while still preserving the functions and systems that had worked well to date. As the central bank was the prudential regulator of banks, investment firms, funds, and brokers and oversaw some consumer protection, it was appropriate to optimize the regulatory mechanisms already in place and to integrate all remaining elements of prudential regulation and consumer protection into that model. The model provides for independence and a singularity of purpose, as was recommended in the McDowell report in relation to micro prudential supervision and consumer protection.

Second, the structure combines responsibility for prudential supervision and for consumer protection, maximizing the sharing of information in these areas. This allows information relevant to each area to be identified at an early

stage (for example, possible below-cost selling may have implications for solvency, while the manner in which retail lending is approached may have both consumer and prudential dimensions). Combining these two responsibilities also ensures that codes of practice, authorization rules, and other regulatory procedures capture elements important to both areas and avoid both duplication and gaps in the structure. In addition, efficiency gains from on-site inspections cover both prudential and consumer issues. Supervising individual institutions is more manageable because most firms are subject to both conduct-of-business and prudential requirements. Furthermore, the structure facilitates the analysis of industry and market-wide issues.

There has been much debate about the implications of combining responsibility for consumer and prudential regulation. By prudential supervision, I mean the solvency and soundness of institutions. In this regard, solvency requirements serve to protect consumers' funds whether they be investments, deposits, or insurance policies. Thus I do not see any tension between the roles of prudential supervision and consumer protection. Indeed, sound prudential regulation is the first line of protection for the consumer. Any tensions that arise relate to competing types of consumers—the holders of funds and the borrowers of funds. These tensions would have to be resolved whether a single agency or two separate agencies have responsibility for the matters in question. Ultimately, these tensions should be resolved in the public interest, and having one agency make the final decision facilitates their proper consideration.

Third, the model minimizes the cost of regulation in a small economy. Recruitment is less expensive, because different bodies are not competing with each other for a limited

number of skilled personnel, and skills can be easily “borrowed” by the area with the greatest need. There is no need for liaison units, which improves the ability to manage efficiently and effectively the considerable overlaps that arise between financial stability, prudential supervision, and consumer protection.

The New Structure in Operation

With the enactment of the Central Bank and Financial Services Authority of Ireland Act, 2003 on May 1, 2003, the new regulatory structure came into existence. The central bank was restructured and renamed the Central Bank and Financial Services Authority of Ireland (CBFSAI), and an autonomous and separately accountable authority, the Irish Financial Services Regulatory Authority (the financial services regulator), was formally established within the CBFSAI.

Figure 3.1: Board Membership

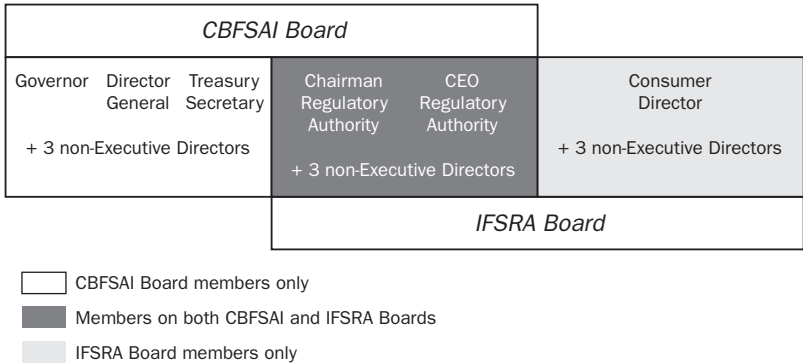
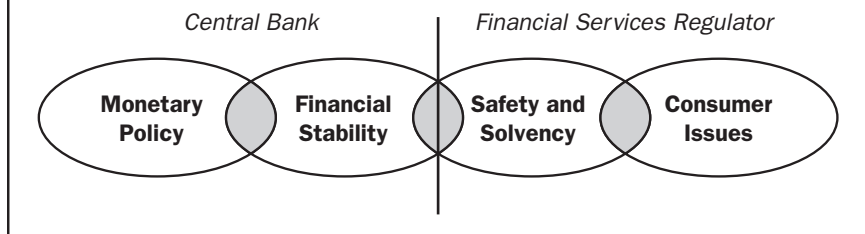


Figure 3.2: Relationship between Central Bank and Financial Services Regulator



There are two boards within CBFSAI. First, the board of CBFSAI comprises the governor, the director general of the central bank, the secretary general of the Department of Finance, the chairperson and chief executive of the financial services regulator, and seven other public interest directors appointed by the minister of finance, of whom four are also members of the board of the financial services regulator. Second, the financial services regulator is organized as an authority with its own separate board. The minister of finance appoints the chairman and members of the board. Statutory positions of chief executive officer, consumer director, registrar of credit unions, and secretary to the authority have been created, all of which must be approved by the minister for finance. A new position of prudential director was also established within the financial services regulator. The chief executive officer and consumer director are executive members of the board, with the remaining eight being public interest nonexecutive directors. In total, the board has 10 members, six of whom (including the chairman and chief executive) also sit on the board of CBFSAI. Figure 3.1 illustrates the overlapping board membership.

CBFSAI and the financial services regulator have a relationship in the areas of financial stability and the provision of all support services, including human resources, information technology, accommodation, corporate services, statistics, and internal audit. Figure 3.2 illustrates the relationship between the central bank and financial services regulator.

Financial Stability

There are two broad, yet complementary, approaches to analyzing issues pertaining to financial stability: macro prudential and micro prudential perspectives. Broadly speaking, the macro prudential perspective, which assesses the strengths and vulnerabilities of the financial system, is the responsibility of CBFSAI. The micro prudential perspective, which regulates the safety and soundness of the individual institutions, is the responsibility of the financial services regulator. In order to manage the interdependency between these elements, a memorandum of understanding between CBFSAI and the financial services regulator sets out the guiding principles for cooperation, defining the role of each agency and how they will work together toward the common objective of financial stability. In addition, a cross-organizational committee of senior management and expert working groups has been established in the area of financial stability to further cement this extremely important relationship.

In the area of financial stability, the governor and the CBFSAI board share the following responsibilities:

- Contribute to the stability of the monetary system, as part of the euro system monetary policy functions

- Ensure that the financial system infrastructure provides for the smooth operation of the payments and settlements system
- Monitor and evaluate the domestic financial system as a whole; the governor or the board will advise all relevant parties on the implications for financial stability of developments in domestic and international markets and payments systems and assess the impact on monetary conditions of events in the financial sector
- Undertake official financial operations in exceptional circumstances in order to limit the risk that problems affecting particular institutions will spread to other parts of the financial system
- Promote improvements in the international financial system mainly through involvement in international forums.

Regulation of All Sectors

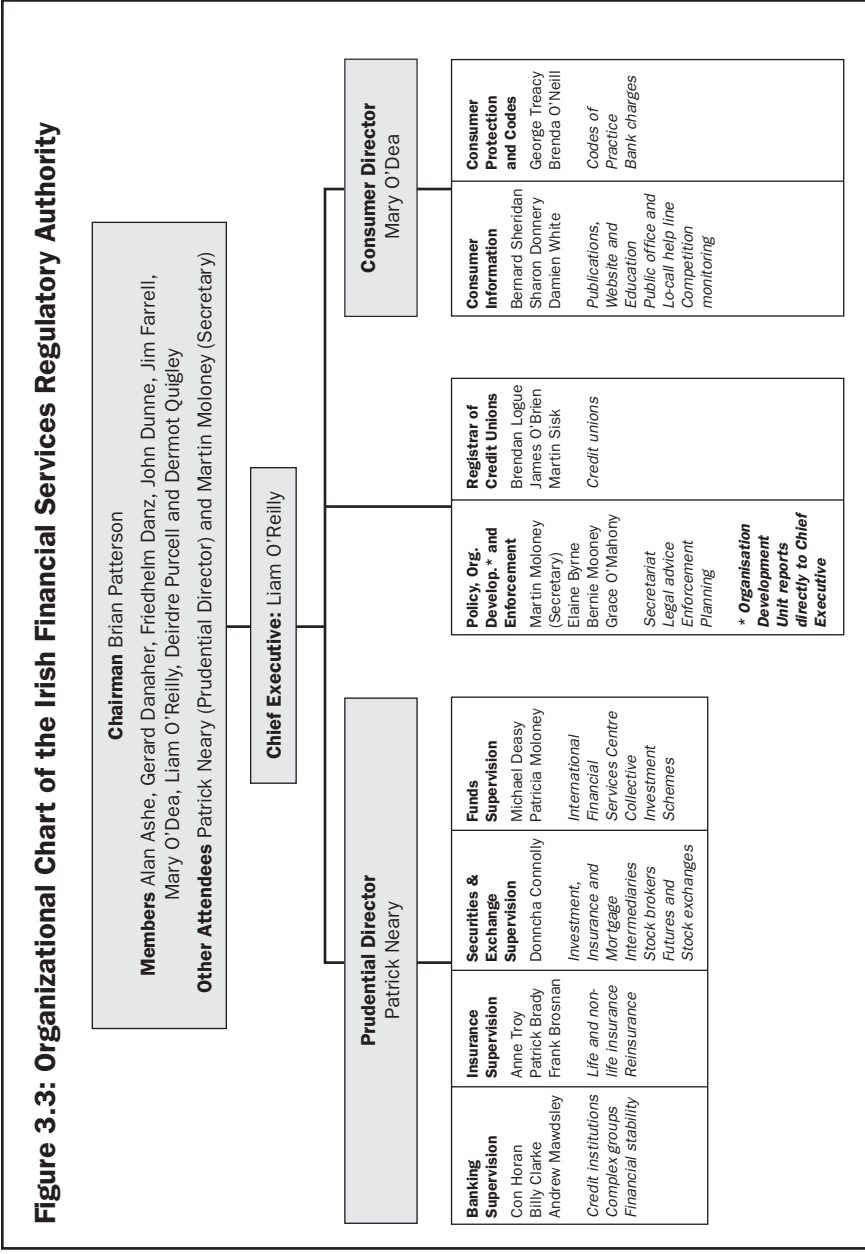
The financial services regulator now regulates all financial services in Ireland, including banks, insurance companies, investment firms, stock exchanges and member firms, credit unions, collective investment schemes, and investment and insurance brokers and intermediaries. It also has a statutory role in the area of consumer protection.

Its responsibilities are clearly defined in the new legislation. The main tasks can be summarized as helping consumers to make informed decisions on their financial affairs in a safe and fair market and to foster sound, growing, and solvent financial institutions that give consumers confidence that their deposits and investments are safe. Both of these tasks are intended to protect the interests of consumers.

The primary change in establishing the new financial services regulator was the integration of four existing regulatory bodies:

- The Central Bank of Ireland, which regulated banks, building societies, investment firms, stock exchanges and member firms, investment and insurance intermediaries, collective investment schemes, and bureaux de change
- The Department of Enterprise, Trade, and Employment, which regulated insurance companies
- The Director of Consumer Affairs, which regulated money lenders, mortgage intermediaries, bank charges, and consumer credit
- The Registrar of Friendly Societies, which regulated credit unions.

Within the financial services regulator, an executive board comprises the chief executive, the consumer and prudential directors, and the registrar of credit unions (see figure 3.3). Four prudential departments report to the prudential director (banking, insurance, securities, and funds supervision); two consumer-related departments report to the consumer director (consumer information and consumer protection and codes). In addition to the department responsible for regulating credit unions, the remaining area comprises a regulatory policy and enforcement area and an organizational development unit. A prudential committee and a consumer committee coordinate cross-functional issues in the prudential and consumer areas. An executive board manages the interrelationships between the prudential and consumer directorates, among other responsibilities.



One of our primary aims is to build a cohesive organization both in terms of our own statutory functions but also in terms of the interrelationship with CBFSAI. In this context, the agenda for organizational change is extremely important in both building and developing the organization in the most efficient and effective way and in developing the mechanics of our relationship with CBFSAI regarding the provision of services.

In terms of accountability, the financial services regulator is accountable to Parliament, with the chairman, chief executive, consumer director, and registrar of credit unions being required to appear before parliamentary committees on request. In addition, the annual budget, strategic plan, and annual report require prior approval from the minister of finance.

Strategic Plan, 2004–06

In January 2004 a single integrated strategic plan was published for the financial services regulator, incorporating the strategies of the consumer director, the prudential director, and the registrar of credit unions. This plan spells out a number of high-level goals, describes the strategies to be adopted and the actions to be taken to achieve these goals, and identifies indicators of progress and target dates. This strategic plan gives clarity and purpose to our activities.

Seven high-level goals and associated strategies to address both our mandate and the building of the new organization in the medium term were identified:

- Help consumers to make informed choices through education and codes of practice in a fair financial services market

- Have a regulatory system that fosters safe and sound financial institutions, while operating in a competitive and expanding market of high reputation
- Develop an appropriate regulatory system for credit unions
- Develop an adaptable, efficient, and flexible organization with motivated and skilled staff
- Continuously enhance and develop the regulatory system
- Aim for best practice
- Implement an industry funding regime.

Central Bank and Financial Services Authority of Ireland Bill, 2003

A second piece of legislation, designed to complement the Central Bank and Financial Services Authority of Ireland Act, 2003, is being finalized by Parliament. It is anticipated that this legislation will be enacted in late spring or early summer of 2004. Some of the main features of the bill are as follows:

- *Statutory financial services ombudsman.* The ombudsman was established to deal with consumer complaints against financial services providers. The draft legislation provides that, while the ombudsman's office will be entirely independent of the financial services regulator, there must be close cooperation between the two in the handling of consumer complaints.
- *Consultative panels.* The draft legislation provides for the establishment of consumer and industry panels and requires the financial services regulator to consult

with each panel on policy matters. The financial services regulator will be required to take account of any advice received from the panels and explain the reasons for not doing so, where this arises.

- *Sanctions.* The draft legislation provides the financial services regulator with the power to impose a broad range of sanctions on regulated institutions as a result of the breach of a requirement of an act, regulation, code of conduct, or any other condition or requirement imposed by it. Previously, the financial services regulator was required to apply to the courts in order to confirm a direction or enforce a penalty, and, in general, the only powers available were significant sanctions that were not appropriate to less serious infringements.
- *Auditing and compliance.* The financial services regulator has the power to seek independent certificates of compliance from the auditors of regulated institutions with respect to the compliance by institutions with company, tax, and related law and with regulations of the financial services regulator.

Confidentiality Rules

Under existing central bank legislation, strict confidentiality requirements apply to financial regulation in Ireland. Under pain of severe penalties, no current or former director or officer of the central bank may disclose information about individual persons or entities to third parties other than in exceptional circumstances that are specified in legislation. Irish law on confidentiality in financial regulation implements European Union law, which requires a common standard of professional secrecy for financial regulation among European

Union member states. It also reflects wider international regulatory practices. If such a standard does not exist, financial regulation, which inevitably involves cross-border issues and frequently requires intensive regulatory cooperation, will fail. No regulator is permitted to transfer information to another regulator unless that information is used solely and strictly for prudential regulatory purposes.

Under the Central Bank and Financial Services Authority of Ireland Act, 2003, all existing confidentiality rules continue to apply. In addition, two significant additional requirements have been implemented:

- A new obligation on the financial services regulator to report any suspicion that a regulated institution may have committed a criminal or company law offense to the revenue authorities or police authorities, as appropriate
- A new obligation that effectively forces a regulated institution to disclose information to another agency if the financial services regulator is prohibited from disclosing that information under European Union law.

Funding Arrangements

The Central Bank and Financial Services Authority of Ireland Act, 2003 empowers the chief executive of the financial services regulator, with the agreement of other members of the agency, to make regulations prescribing the payment of levies and fees by regulated institutions to the regulator. The purpose is to enable the regulator to have sufficient funds to enable it to perform its functions and exercise its powers. Prior to enactment of this legislation, the exchequer funded most of the regulatory functions.

The financial services regulator is currently involved in a public consultation on the proposed funding arrangements, and the proposal is that the industry would fund 51 percent in the first year of operation. The overriding guiding principle in imposing industry funding is that any charges levied by the financial services regulator should not have a disproportionately negative impact on domestic competition and international competitiveness. Industry funding will be introduced in mid-2004.

Conclusions

The financial services regulator was established as an independent component of the Central Bank and Financial Services Authority of Ireland. This structure facilitates the exchange of information and expertise, in particular in the area of financial stability. The governor retains responsibility for holding and managing the foreign reserves of the state, promoting efficient and effective operation of payments and settlements systems, and discharging central bank functions. The financial services regulator is independently responsible for regulating the financial sector, including consumer protection matters.

Effective regulation is very important in fostering stability in the financial system as a whole and helping consumers to make informed decisions on their financial affairs in a safe and fair market. By fostering Ireland's current standing as a well-regulated jurisdiction in which to undertake financial services business, our medium-term vision for this new organization is that we will have made an impact on the following:

- *Consumers*, who will be more satisfied with the provision of financial services generally, will receive more and better information, and will conduct their financial business in a fairer market that gives better value
- *Industry*, which will have a cost-effective and responsive regulator that facilitates innovation, competitiveness, and growth.

Our long-term objective of building the necessary regulatory structure to achieve our vision is set out in our strategic plan. We see a very close relationship between the different objectives set down. A financial institution with a culture of good risk management, good internal corporate governance, and high ethical standards is likely to set high standards in its dealings with consumers. We are committed to consumer protection. We are committed to a principles-based approach to regulation, and our aim is to have a regulatory environment that engenders an ethical and competent industry with appropriate risk systems in place.

The supervisory structure adopted by Ireland addresses not only the macro but also the micro regulatory issues facing a small open economy. The interlinkages among monetary policy, financial stability, prudential supervision, and consumer protection are being coordinated in a unique, efficient, and innovative way. The structure enables us to provide the regulatory service the government requires in a manner that meets consumer needs, is responsive to industry, and uniquely suits the institutional structures and relative size of the Irish financial sector.

Chapter 4

The Speed of Change: Balancing the Risks

Issues in the Unification of Supervision: Lessons from the Swedish Experience

Stefan Ingves

In the past few years, the move to unify supervision of the different sectors under one agency has gained momentum and is on the policy agenda for discussion or implementation in several countries, as part of their efforts to align supervisory structures with their country needs.¹ This redesign is seen as a means to provide supervisors with an integrated approach to supervision of the financial system. However, experience based on the work of the International Monetary Fund in many countries suggests that the quest for aligning supervisory structures does not necessarily feature unified supervision as an essential component in all countries.

Indeed, authorities should keep certain key considerations in mind when deciding whether or not to embark on the path to unified supervision and should seek the appropriate internal structures to address the tricky managerial challenges that often arise following unification. Ideally, countries should find the solution that fits their system as it is, or as it

is expected to evolve over the medium term, and should ensure that the necessary resources are available to the supervisor without compromising its independence. These issues are spelled out in the following sections, using the Swedish experience of unification as a case study.

Key Considerations

The forces encouraging the unification of supervisory agencies are well known. The growth and spread of financial sector conglomerates and the innovations in complex cross-sector instruments and products require supervisors in one sector to have a keen understanding of developments in other sectors. At the same time, the techniques of supervision, especially in the measurement and management of risk in each sector, as well as the set of skills required for effective supervision, have begun to converge. An additional pressure comes in the event of a crisis, as the affected countries are forced to rethink their supervisory strategy and begin to see unified supervision as a panacea for future distress.

The responses to these forces have not been uniform, and countries have evolved structures that represent the existing dynamics in their jurisdictions. Thus some countries have integrated fully (banking, securities, and insurance) under one agency, some have integrated partially (banking and insurance, banking and securities, or securities and insurance), while some have integrated either at the base level through shared support functions or at the apex level through an oversight board to which all agencies report.

Certain considerations should be kept in mind in order to determine the appropriateness of unification in a financial system. Based on experience gained in the work of the Inter-

national Monetary Fund in many of its member countries, certain considerations deserve the attention of policymakers.

The size of the financial sector varies enormously from country to country and is probably a good starting point. In very small countries, having different supervisory agencies would require the limited supervisory resources to be spread too thinly to be effective. Another consideration is the relative size of the various sectors in the economy. If the banking sector totally dominates the other parts of the financial system, as is the case in several developing economies, and if the insurance and securities sectors are either too insignificant or nonexistent, then the policy debate will be entirely different from that in an economy where they have a significant presence. Similarly, if the financial markets are totally segmented and have very little contact with one another, then it is highly likely that a structure with different agencies will be favored; if the markets are in the process of integrating or are not segmented in the first place, then it is more likely that unification will be preferred. Of course, an overriding issue is the availability of resources, and the structure should seek to use these optimally if they are limited. It is difficult to run small agencies and to get skilled people to work in small agencies, and this, from a managerial point of view, favors unification.

Politically, two issues that often determine the structure ultimately chosen are the concentration of power and the independence of agencies. There may be hesitation to create a structure that embodies too much decisionmaking power outside the government over a broad ambit of the economy, and this may act against unification even where all the key considerations signal this to be the appropriate structure. And, finally, agency independence is always a delicate issue,

and an alignment of supervision may be accompanied by a funding or board structure that would keep the umbilical cord intact.

Managerial Challenges

Once the decision is made to unify supervision, the next task is to overcome the managerial challenges that accompany the creation of a single agency.

A key managerial challenge is to integrate the different approaches that the agencies involved in supervising different sectors and markets take to dealing with issues in their sector. For instance, central bankers frequently look at the issues from the macro side, keeping systemic aspects in mind. In contrast, bank supervisors tend to deal with these issues on a bank-by-bank basis, digging deep into the banks themselves.

Similarly, bank and insurance supervisors also have distinct approaches. In many countries, insurance supervision has been dominated by the actuaries, and their way of running the business is different from the way banks are supervised. In many cases, insurance supervisors have developed a different vocabulary for similar concepts, which creates obstacles to meaningful communication between bank and insurance supervisors. And, finally, security supervision presents a different aspect because it is focused more on how transactions are executed and not so much on whether brokerage firms are solvent and what they look like on the inside.

The unification of these different agencies then requires meaningful communication across supervisors with different backgrounds. It also creates the need to integrate different career paths and make people with different backgrounds get along, in order to carry out the work in an efficient way.

Attention should also be paid to the tasks of managing the change process. This can be crucial to its success because change is expensive, and it takes many years to accomplish; during this period, unrealistic expectations can be created about the outcome of the process. This reinforces the advice that change should not be for change's sake and that, in some cases, it may be better to focus on fine-tuning the existing structure to assess the risks than to invest in new structures.

The work of the International Monetary Fund invariably shows that improving the framework for coordination and information sharing should be an important priority. It is remarkably easy for people to refuse to talk to one another, and those deficiencies almost always show up too late, when the system has already run into a crisis. At the cost of repetition, it pays to improve the framework for coordination, and this can be supplemented by working toward consistency and convergence in regulation across sectors to facilitate the task of supervision.

The Swedish Experience

In Sweden the desire for change in the supervisory structure was not predicated by the banking crises of the early 1990s but, in fact, predated the crisis. By the late 1980s, when the impetus for change in financial sector supervision had gathered momentum, Sweden had been maintaining a quantitatively based regulatory framework longer than most other industrial countries in the world. Banking and insurance supervision was handled by different agencies, but the feeling had gained ground that this model was not sustainable. A forward-looking exercise was initiated to look at how the financial sector had evolved in markets that had liberalized

earlier, and it became obvious that Sweden would soon foster an environment where banks would be allowed to own insurance companies, insurance companies would be allowed to own banks and mutual funds, and hybrid cross-sector products like unit-linked insurance would develop.

This led to the conclusion that there would be a pressing need to have the insurance supervisors talk to the banking supervisors and vice versa. This was not an easy task, especially since banking supervision had evolved far more than insurance supervision, as was the case in many other jurisdictions. And, politically, it was a more palatable solution to merge the two than just to close the one and start a new one from scratch, which was the only alternative to present itself at that stage.

This forward-looking exercise was consummated in the early 1990s with the setting up of the financial supervisory authority, Finansinspektionen (FI), which is a unified regulator and supervisor for banks, securities, and insurance. The central bank, Sveriges Riksbank, continues to be responsible for monetary policy and the payments system. The authority and responsibility of each is clearly defined in the present laws, and both are independent in their operation. FI reports to the Ministry of Finance, but the minister of finance does not have the right to interfere in individual decisions. In fact, the law prohibits government interference in day-to-day decisionmaking. In theory, this construct could compromise the independence of the agency, but in practice such abuse is prevented by the strong tradition of moving decisionmaking powers down into independent authorities, a process that has been occurring for at least 150 years in Sweden.

In retrospect, unifying the supervisory bodies has proved to be the most appropriate approach for the country, given

how the financial system has evolved. Today, the financial system is dominated by the major financial groups that are active in banking, securities, and insurance. At the end of 2001, just four of these groups accounted for four-fifths of the financial sector assets and two-thirds of the bank deposits and mutual fund assets; in addition, each group owned an insurance company and was operating across many borders.

However, just having the right structure in place does not ensure success, and Sweden has learned this lesson, too. Although these entities were merged successfully externally, the internal harmonization has taken far more time. And that is because there are serious managerial challenges in keeping current with the developments in many different sectors and countries, while, at the same time, achieving a reasonable blend of competencies. So the authorities once again have embarked on the exercise of creating the right internal structures, and one of the acts of the newly appointed director general has been to reshuffle all senior staff. This is a serious attempt to get things right so that the unified regulator will be able to leverage off the desired competencies. Creating the appropriate internal structures that will achieve this is a challenge for managers, and, as can be seen from the Swedish experience, it is an exercise that may have to be indulged in again and again before getting it right.

In all fairness, although this may seem to be a lengthy process, it should be viewed in historic perspective. These agencies had existed as separate agencies for more than a century and had developed their own methods of operation and work processes. This weight creates its own inertia and cannot be wished away in a short period. This is the challenge that managers face and is what they should be prepared to deal with and build into the expectations of politicians and the public.

This new structure and the changed environment also carry risks. All of the four major financial groups have significant overseas operations and are systemically important entities in several of the countries in which they operate. Hence, cross-border propagation of shocks from foreign operations clearly matters for both the insurance side and the banking side. So does interbank contagion from common large exposures because, if there are a very limited number of banks and if all of them have lent to the same companies, all of the banks are going to run into the same type of trouble if the borrowers run into difficulties. There is also the issue of contagion or possible contagion from life insurance companies facing demographic changes, and there are the operational risks inherent in large and complex institutions.

Another challenging issue is the oversight of hybrid institutions that are in-between banks and insurance companies, such as the many mutual funds that are fairly similar to life insurance companies, in the sense that people use them for savings purposes. If many of them run into trouble, then, in one way or the other, a large number of people are going to be affected, with the troubles feeding back into the banks or vice versa. Although this has not yet happened, in the past a life insurance company owned a holding company, which owned a bank; when the bank folded up, it was unclear how much of the life insurance company's money should be plowed into the failed bank. This creates a moral hazard issue, with only the bank depositors having access to deposit insurance. The complexity of such a resolution or rescue, if one is attempted, would be complicated even further if the operations of these entities were across borders.

And, of course, a key challenge is addressing the lack of resources for such specialized supervision and the lack of

skilled and experienced staff. It is no secret that the public sector often cannot compete with the private sector for the services of finance professionals, and this gap is widening as the complexities in supervision are increasing. The government does not pay that much, and if a professional is adept at these issues, he is more likely to trade options on his own account. Fortunately, people are still motivated by the idea of public service, and that keeps the agencies going, although the battle may be uneven.

Another issue is the repertoire of actions available to supervisors for dealing with the issues that may arise in this environment of cross-sector and cross-border operations. Historically, there has been a lack of legal authority to take corrective action and various enforcement measures appropriate to the situation, because basically the only deterrent has been to close the institution. Instead, a system is required that gets tougher and tougher when a bank runs into trouble. Large and complex institutions, as in the Swedish case, may be too big to fail and, given the size of their balance sheets, may also be too big to rescue! One can only hope that they are not too big to supervise or too big to manage, since these tasks will take a lot of resources and, most of all, a lot of skills.

Undoubtedly, if this kind of structure is present in the financial sector, a unified agency aids in consolidated cross-sector, cross-border supervision because internal coordination and consensus for action are easier to obtain. What may be more helpful is the existence of joint cross-border supervisory groups for the largest institutions, with one national supervisor acting as the lead supervisor, as has been the case in the largest of these groups. This model can be replicated in other countries, so that, in the case of cross-border conglomerates active in many countries at the same

time, it is known in advance who is in charge. Again, it is important to focus on the risks, particularly the large risks, and to use a risk-focused approach to assist systematically important institutions.

A key issue that needs to be addressed going forward is that, if one of the large groups fails and cannot be rescued, how should the authorities deal with its orderly winding up in a cross-border context? Of course, legal aspects regarding the bankruptcy regimes, winding up processes, or insurance schemes will apply. However, the underlying issue is who will bear the costs of the resolution and how these costs will be divided among the taxpayers and creditors of the different countries in which they operate. Being systemically important institutions, it is quite likely that their resolution will eventually end up with the finance ministries, which calls for a greater understanding of the implications of these arrangements on their part.

Conclusions

In sum, creating a unified regulator was the right approach for Sweden, given the way the financial system has developed, despite the managerial challenges that are continually arising and being resolved. However, this may not necessarily be the appropriate structure for all countries. The view within the International Monetary Fund, based on the work it does in its large base of member countries, is that there is no single optimal structure. Very often, staff advice focuses on doing what works best for consolidated or integrated supervision, if these issues are material to the financial system. On the one hand, many countries with separate supervisory agencies continue to carry out their responsibilities effectively. On the

other hand, some unified structures have not worked well, in part because the internal channels of information and experience sharing have not developed. The key is to create and foster such channels within the formal organizational structure and, to put it very simply, to always talk and share, talk and share. And, as can be learned from the Swedish experience, it is essential to create such channels with foreign supervisors because banks that bring benefits across boundaries also bring substantial costs when they fail.

Of course, much of the talk about creating new structures can be meaningless if supervisors lack resources in the first place, and this is a serious issue in many countries. Hence, it may be more appropriate to keep supervision where it will not be starved of resources. By implication, this means that countries can end up with structures that are second-best organizationally but that are likely to be more effective only because they have the resources needed to take on the increasingly complex and costly task of financial sector supervision. This also suggests that, at times, it may be best to put supervision into the central bank, because it may be the only institution with access to the needed skills and budget.

Finally, there seems to be a trend where, after a crisis, people feel, if not least for political reasons, that major changes in the organization of supervision are necessary. So the action contemplated is either to move supervision in or out of the central bank or to create a unified supervisory agency. Whatever course is finally chosen, it is important to keep any restructuring agency separate from the supervising agency. Further, either the government should not own banks, or it should not own banks and supervise them out of the same regulatory entity at the same time. It should also avoid using central bank funds to nationalize weak institutions, because,

in the end, this blots the balance sheet of the central bank. At the same time, crisis provides an opportunity for supervisors to obtain from lawmakers the teeth they need, since legislative support is often easier to obtain during crisis. Nevertheless, care should be taken to dispel any unrealistic expectations that crisis can be prevented in the future solely by passing new laws or reorganizing the agencies.

In conclusion, the very simple but practical hands-on advice that can be offered is to recognize that, while more than one structure may be appropriate for the situation in a given country, the key to attaining the objectives of unified, integrated, or consolidated supervision is the ability to have mechanisms for continuous communication between all the parties involved. And, ultimately, at the end of the day, whatever supervisory structure a country devises has to relate to what kind of a financial sector the country happens to have or is in the process of developing, so that it firmly fits with what exists on the ground.

Notes

1. Although unified, integrated, and consolidated supervision are often used interchangeably, in this paper unified (across agency) supervision refers to the merger of supervisory agencies for different sectors into one entity to improve the practice of integrated (across sector) supervision. Consolidated supervision (across group) is taken to mean the ability to supervise financial groups in their entirety, including across sectors and across borders.

The Integration of Financial Supervisory Bodies: The Korean Experience

Seok-Keun Lee

Until 1997 the Ministry of Finance and Economy (MOFE) dominated financial supervision in the Republic of Korea. It had almost every kind of supervisory authority, including lawmaking, licensing, and policymaking. It controlled the Securities Supervisory Board, which supervised securities companies and capital markets, the Insurance Supervisory Board, which supervised insurance companies, and the Non-bank Supervisory Authority, which supervised non-banking financial companies. In addition, MOFE influenced the Office of Bank Supervision: the minister of finance and economy chaired the Monetary Board, which controlled the Bank of Korea (the central bank), including the Office of Bank Supervision. Even though the minister did not participate in the work of the Monetary Board, nobody believed that the central bank was independent at that time. These four supervisory agencies—the Securities Supervisory Board, the Insurance Supervisory Board, the Non-bank Supervisory

Authority, and the Office of Bank Supervision—were directly and indirectly under the control of MOFE.

Although MOFE had supervisory authority over almost all types of financial companies, it did not control day-to-day supervision, which was left to the four agencies under its control. Each of the four agencies supervised financial institutions under its jurisdiction but did not exercise authority over licensing. MOFE directly supervised some financial institutions: specialized banks (government-owned banks), merchant banks, credit card companies, credit unions, mutual savings banks, trust businesses of commercial banks, and lease companies. However, MOFE did not have enough staff to execute all of its responsibilities and so delegated examining authority to the Office of Bank Supervision and to the Non-bank Supervisory Authority regarding credit unions, mutual savings banks, and lease companies.

The Need for Change and the Decision to Integrate

Scholars and policymakers have long criticized Korea's MOFE-dominated financial supervisory system. First of all, conflicts were common regarding the independence of the central bank from MOFE and the independence of the Office of Bank Supervision from the central bank. Even inside the government, this was a topic of debate.

Many scholars also insisted that supervision should be more independent because the government and politics could interfere with financial supervision. In addition, they insisted that the existence of fragmented supervisory functions could give rise to poor and ineffective supervision, especially for non-banks. They argued that integrated financial

supervision was needed to address the growing convergence of financial services. For their part, bankers and capital market professionals argued that financial supervision was too far removed from the market. They insisted that it should be more market oriented and should be done by an independent agency.

In response to these criticisms, the government established special committees to address the subject of reform. The first committee was the Financial Industry Development Committee under MOFE, which consisted of professors, former government officials, and professionals in the financial industry. In January 1997 the president established the Presidential Committee on Financial Reform, and in June of that year committee members issued three main recommendations. First, they recommended establishing an independent central bank and separating the bank supervisory function from the central bank. Second, they recommended integrating the four supervisory agencies into one agency. Third, they recommended making the integrated agency independent of MOFE.

Based on these recommendations, the government crafted the Act on Establishment of Financial Supervisory Organizations and proposed it to the National Assembly in August 1997. Although the bill was not passed during the regular session, an economic crisis erupted shortly after the session, spurring passage of the bill at a special session on December 29, 1997.

According to the act, on April 1, 1998, the Financial Supervisory Commission (FSC) was established as an independent commission, and the Office of Bank Supervision was separated from the central bank. The governor of the central bank became chairman of the Monetary Board. Nine months

later, the four supervisory agencies were integrated into a single independent supervisory body: the Financial Supervisory Service, an executive arm of FSC.

The Process of Integration

Three months after passage of the bill, FSC was established according to schedule. Under the Office of the Prime Minister, it is a government agency that consists of nine commissioners (chairman, vice chairman, standing commissioner, and six non-standing commissioners) appointed by the president for a three-year term. The deputies of MOFE and the central bank and the president of KDIC (Korea Deposit Insurance Corporation) participate in FSC as non-standing commissioners. FSC formulates financial policies and performs supervisory functions in the following areas: financial supervision, oversight of financial restructuring, licensing, and delegation of supervisory authorities to the Financial Supervisory Service.

The Securities and Futures Commission was also established on April 1, 1998. It consists of five commissioners (including the vice chairman of FSC as chair, a standing commissioner, and three non-standing commissioners) appointed by the president for a three-year term. It oversees the securities and futures markets.

As scheduled, nine months after FSC was established, the four supervisory agencies were physically integrated to form the Financial Supervisory Service, a special entity under FSC. The Financial Supervisory Service consists of 10 officers (a governor, three deputy governors, five assistant governors, and an auditor) who serve a three-year term. It supervises and examines all financial institutions except financial busi-

nesses of the National Post Office, community credit cooperatives, and similar entities.

MOFE still controls KDIC and has the authority to draft legislation on financial supervision; as a deputy prime ministry, it also coordinates financial sector policies. However, the central bank reports directly to the National Assembly, so FSC and the central bank now have the same level of authority as MOFE.

The Planning Process

During the nine months of planning, financial restructuring constituted the most important work of FSC and the four supervisory agencies. Five small banks with negative capital ratios were closed, two large banks were nationalized, two banks were merged with other banks, and the ownership of nine out of 27 commercial banks was changed. Much work was done in the area of corporate restructuring, too. For example, FSC and the four agencies required banks to review the creditworthiness of their heavily indebted companies, and this work was intended to support the work to be pursued more actively after integration.

With the help of a large international consulting firm, a task force crafted the new organizational structure and the new decisionmaking structure of the Financial Supervisory Service. The key managers from the four agencies participated in that task force. After much debate, the task force established a single human relations system by unifying the structure of seniority in the four agencies. Many workshops were held for staff in an effort to create a coherent team and to share knowledge. All staff had to learn the basics of all four areas of work: bank supervision, securities

company supervision, insurance company supervision, and non-bank supervision.

In addition, the new integrated body streamlined the number of staff when it integrated the four departments for personnel management, budgeting and accounting, research, and public relations into one department in each area. This was accomplished through retirements. Buildings and equipment were also integrated, which allowed the government to use only about half of the buildings used before and to sell the other buildings and excess equipment.

FSC and the four agencies also sought to harmonize and integrate supervisory practices by building cooperative mechanisms such as the joint examination and sharing of information. They made supervision more efficient by formulating new criteria for systematic supervision and reforming outdated and distorted financial practices. They also adopted functional supervision that eliminates gray zones in regulation rather than institutional supervision. For example, they adopted similar supervisory practices in all kinds of asset management businesses, regardless of the type of institution.

Organizational Structure of the Financial Supervisory Service

The first organizational structure drafted by the task force and decided by FSC was basically a process-entity structure; in other words, a process-industry structure. This meant that the upper level of organization was structured by core processes such as authorization, policymaking, examination, and enforcement, and the lower level of organization was structured by type of entity, such as bank, securities company, insurance company, and non-bank financial company. Each of

the three deputy governors was responsible for one or two processes, and each departmental director was responsible for a certain type of entity.

To strengthen coordination in the high-level structure, one coordination office was established for the policymaking function and one for the examination function. Each deputy governor also supervised the coordination office in his area.

Lastly, the layers of reporting were also reduced, which improved the efficiency of the organization.

The Benefits and Challenges of Integration

Integration brought many benefits to the Korean economy. First of all, it supported financial restructuring, which was crucial to Korea at that time. When one of the big conglomerates confronted financial problems and needed debt restructuring, all kinds of financial companies experienced liquidity problems. Under the integrated system, the entity-based supervisory departments of the Financial Supervisory Service could easily cooperate with one another because they were under the same deputy governor for prudential supervision in each financial industry.

Integration also raised the prudential standards of a certain financial industry to the highest standards of the other ones.

The supervision of financial conglomerates was more effective because the various companies within a financial conglomerate were examined simultaneously. In the past, some areas were overlooked as a result of the growing convergence of financial services. The active cooperation of several supervisory departments helped to address those gray areas.

Integration also promoted fair trading in the capital markets by creating procedures enabling the department investi-

gating unfair traders, for example, to request and receive help from the bank examination department.

Korea integrated its financial supervisory bodies in a relatively short period of time, and many difficulties arose in the process. First, given Korea's climate of high unemployment, it was difficult to streamline the organizations. Most promotions of staff were decided by seniority. Individuals with more working experience inside the agency usually were promoted more quickly than those with less internal experience because there was almost no outsourcing at that time. However, integration called for shrinking the size of the organization, which meant more retirements and fewer promotions. The staff and labor unions of the four agencies lobbied actively to get more departments for their own business area in the new organization.

Reducing the number of staff was also difficult because the job market in Korea was inflexible and the unemployment rate was very high at that time. For example, in the banking industry, the number of employees of commercial banks decreased 34 percent during one year. Under these circumstances, the four supervisory agencies had to reduce the number of departments from 64 to 42 and reduce the number of staff from 1,700 to 1,200. This was a politically difficult move.

Another big difficulty was the need to unify the four personnel management systems. The promotion standards were different in each. For example, an individual with 10 years of experience could be a manager in one agency, but only an assistant manager in another agency. In addition, financial restructuring had to be tackled at the same time as unification, placing added stress on employees.

Key Factors for Successful Integration

Korea completed the integration within a short period of time, despite the challenges. To complete the tasks associated with financial restructuring and integration simultaneously and successfully, these tasks were separated from routine work. Special task forces were organized, and they tackled the two big jobs, while the rest of employees did the routine work.

Having strong and competent leadership was also important. The MOFE official nominated to chair the Financial Supervisory Commission and serve as governor of the Financial Supervisory Service had ample experience in both the financial services industry and in government.

Two other ingredients to success were extensive discussions within the four agencies, followed by the involvement of neutral outsiders, such as consultants, scholars, and government officials and public support for financial restructuring.

The Big Bang Approach in Korea and Elsewhere

Although the integration in Korea was completed rapidly, it followed many discussions about the need for change. This made it possible for the law to set the upper-level structure of the integrated agency before the real work of integration began.

According to the law, FSC was established nine months before and the chairman of the Financial Supervisory Service was nominated 10 months before final integration occurred. The law also addressed the structure of senior management (for example, designating the number of high officers) of the integrated agency. As a result of those preparations, it was

only necessary to determine the lower-level structure of the integrated agency during the preparatory nine months.

The bottom line is that the financial crisis did not allow government the luxury of debating the appropriate speed of integration. Instead, it forced the National Assembly to pass the financial services act and precluded the gradual approach to integration.

Determining the proper speed with which integration should occur is heavily dependent on the characteristics of the country. The culture, customs, and public sentiments are important factors in determining the speed of integration, as are specific circumstances such as economic crisis or political changes.

In Korea the relatively rapid integration brought many benefits. It helped the country to overcome the financial crisis quickly, to enhance the quality of financial supervision quickly, and to improve the quality of Korea's financial industries quickly. A slow process of integration might have made the process of restructuring more difficult and had negative consequences for the nation's economy. These consequences would have strengthened the arguments against integration and made it difficult to complete the integration later.

In conclusion, rapid integration was necessary at the time in Korea, and the major problem was the short-term hardship imposed on employees, especially supervisors, of the four agencies.

Chapter 5

Transitional Issues in Emerging Markets

The Organizational Structure of Financial Supervision: The Salvadoran Case

Ana Margoth Arévalo

Nowadays a great deal of attention is devoted to issues related to the organizational structure of financial supervision. Not only has the debate on the advantages and disadvantages of having integrated or separate supervision gained interest, but also the number of countries adopting integrated supervision has grown rapidly (see Luna Martínez and Rose 2003). The idea of a single supervisor is certainly very attractive. After all, at least in theory, a single supervisor may be more effective at supervising financial conglomerates, be more cost-effective, and create economies of scope, to name a few of its advantages. There is also the argument that, for small, resource-scarce, developing countries, supervision must fall within the central bank, particularly since central banks tend to be relatively independent.

El Salvador is a small country where the financial system is supervised by three specialized agencies. While the central bank plays an important role in regulation, it does not

directly supervise any financial sector. Indeed, the structure of financial supervision is the result of pragmatic decisions reflecting the economic and political reality that the country was experiencing when the structure was created. Given changes in the landscape of the financial sector, it is very likely that the structure would be different if the decision were made today rather than a decade ago. However, it could be argued that, from the point of view of effectiveness, the organizational structure of supervision is not the first priority in El Salvador. Instead, other essential requirements must be fulfilled if supervision is to be effective.

Time Frame and Rationale for Separation

The process of establishing specialist agencies was completed in different stages. First, the supervision of banks was separated from the central bank in 1990. Second, the regulation and supervision of securities were separated from the Superintendency of the Financial System (SSF) in 1996. Lastly, with creation of a new pension system, the supervision of public pension funds became the responsibility of a new institution.

The separation of the bank supervisor, SSF,¹ from the central bank responded to a comprehensive reform program that sought to redefine the role of the central bank in monetary, credit, and exchange policy and to modernize the financial system. The decision to create two new agencies responded to specific needs. One related to the development of the securities market; the other related to the establishment of a new system of pension funds.

From the Central Bank to an Independent Agency

At the end of 1989—a decade after being nationalized and becoming first illiquid and then bankrupt—the financial sector was a political and centralized regime. During nationalization, the government had complete control of the system, managing each institution, directing a cost-differentiated credit policy, and using the system to finance its budget deficit. The central bank also played a major role in the management of nationalized institutions, including the appointment of their boards.

To avoid the collapse of the financial system, a process of financial liberalization started in 1989. The policy program included a new role for the central bank, the privatization of banks and savings associations, and the creation of a new regulatory framework. During 1990 and 1991, a set of financial laws was drafted and approved, including a new law for the central bank and a new law for an independent SSF.² There was no hesitation regarding separation of the supervisory function from the central bank. After all, SSF had been physically separated from the central bank following the 1986 earthquake. But above all, there was the desire to have a central bank focused on monetary policy and relieved of the concerns of regulation and supervision. The reforms gave the central bank more autonomy and the mandate to promote a stable, efficient, and competitive financial system. They also prohibited it from financing the government either directly or indirectly and from fixing interest and exchange rates.

The law also granted SSF legal and administrative autonomy from the central bank and ended the intricate administrative arrangement under which the superintendency had been functioning. SSF was created as part of the central bank and, since 1973, had formally depended on the Monetary

Board. Its superintendent was accountable to the minister of economy, who was part of that board and whose ministry was in charge of licensing financial institutions. In practice, given that the secretary of the board was the president of the central bank, directions came from the central bank. SSF performed supervisory activities only.

The law also gave the superintendency new powers to establish requirements for granting licenses to institutions under its control, to approve them, and to revoke them. In addition, it gave it powers to set prudential regulation and accounting rules and powers to impose sanctions and fines for noncompliance.

The reorganization also targeted the obsolete system of supervision. Activities included strengthening its administrative and organizational ability and technically strengthening the supervisory capacity of existing departments, of banking and non-bank financial intermediaries, and of insurance companies and pension funds. Also contemplated was the organization of a securities supervisory unit.

Supervision of the Securities Market and Pension Funds

The creation of the two new agencies occurred almost simultaneously in 1996 but responded to different rationales. The Superintendency of Securities was created to develop the money and capital market, as its organic law asserts. That said, it was also the product of intensive lobbying by the stock exchange. Although the law regulating the securities market and creating the Public Stock Exchange Registry came into effect in 1994, the stock exchange began operating in April 1992. Potential issuers complained that processes were not

flexible or rapid enough and that it was easier for them to issue stocks in other countries of the region than in their own country. They also argued that authorities paid less attention to the securities market than to banks, hindering its development. The new superintendency was created relatively quickly. The Organic Law of the Superintendency of Securities passed in September 1996, and the new institution began operating on January 1, 1997. Around half of its personnel came from the former Securities and Other Institutions Department of SSF.

Conversely, the need for a third agency—the Superintendency of Pensions—derived from the pension fund reform, whose planning started in the early 1990s. The new pension funds system, approved in 1996, introduced the figure of the pension fund administrator. The pension system was never intended to be supervised by SSF. When creation of the new system was being considered, debate about placing the supervision of securities outside of SSF was already under way. Instead, responsibility for supervising public pension funds was moved to the Superintendency of Pensions.

Assessment of the Process

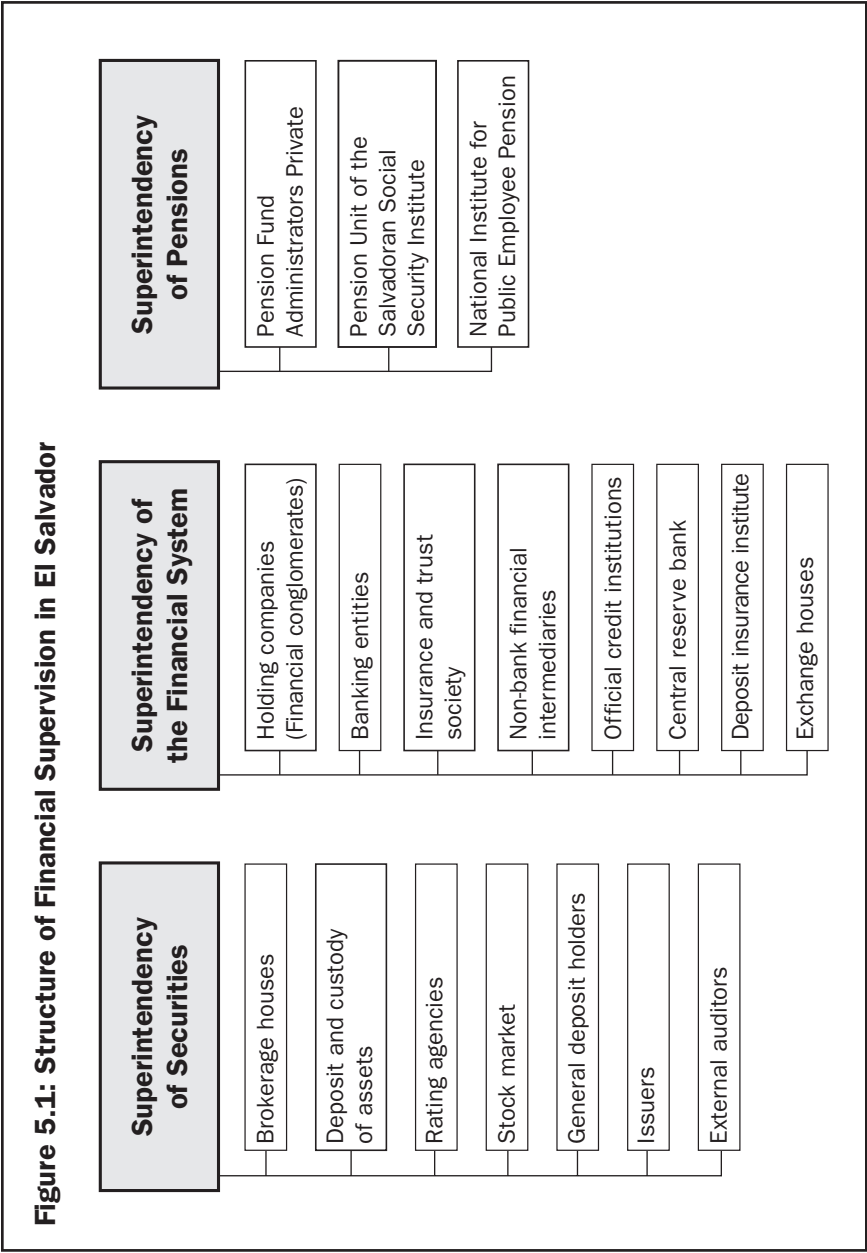
There is consensus that the supervisory agencies are technically stronger and have more power now than when they were under the central bank. Supervisors of the specialized agencies believe that their separation has allowed them to establish supervisory methods, develop sector-specific regulation, and acquire training at a faster pace than if they had remained as part of the central bank or been unified with the banking supervisor. Besides, it meant that they did not have to merge managerial issues.

Of course, the administrative cost of supervision is higher because each institution has its own departments for administration and information technology as well as other support units. The transaction costs for the regulated institutions are also higher, as the supervised sector must satisfy regulatory requirements from several agencies and probably face over-regulation, not only because several regulators tend to produce more regulation than a single one but also because governance mechanisms in regulated entities are not well established. Regulatory arbitrage is an issue as well.

Furthermore, building supervisory capacity cannot be done instantly, even with the financial and technical support of international organizations.³ In 1997 two situations of financial fraud were discovered related to unauthorized deposit taking. The most important of them, which landed the head of SSF in jail for a short period of time, involved a regulated financial institution, its parallel illegal institution, and its related economic group; losses were estimated at around 1.2 percent of GDP. This situation prompted a deep review of the supervisory capacity of SSF, which led to its reorganization. It also highlighted the need to ensure the accuracy of accounting records. Considerable efforts were made to verify that the quality of assets and provisions to cover losses were well established and to check financial statements for consistency. Furthermore, it highlighted the need for consolidated supervision and for supervisors to be independent and protected.

The Agencies

The three supervisory agencies follow mainly an institutional approach (see figure 5.1). SSF, the biggest one, continues to be



responsible largely for prudential regulation and the supervision of banks and insurance companies. More important, it is responsible for the supervision of financial conglomerates. In addition, since 2000 it has been responsible for the regulation and supervision of non-bank financial intermediaries. Conduct-of-business regulation is performed mostly in the insurance sector. The Superintendency of Securities oversees the stock market and its participants. It is also legally responsible for facilitating the development of the securities market. Finally, the Superintendency of Pensions supervises pension fund administrators and the public pension fund system. Both institutions implement a combination of conduct-of-business and prudential supervision.

All three are autonomous agencies, although SSF is legally integrated with the central bank, basically for budgetary purposes. They are headed by a superintendent appointed by a counsel of ministers, after being nominated by the president. However, only two of them—SSF and the Superintendency of Securities—have a board of directors. Members of these boards are appointed by the central bank and the Ministry of Finance. Some of them come from industry and professional associations. Only the Superintendency of Pensions is required to present its annual report to the president and to Congress for approval.

Regulatory autonomy differs among the agencies. Whereas regulation of banks is approved by the SSF board of directors, regulation of the securities market and pension funds must be issued by the president, from proposals made by the superintendencies.

Regarding the cost of financing supervision, all institutions receive funds from supervisory fees paid by the entities supervised, but these fees cover only part of their budget.

The rest of the cost is covered by the central bank in the case of SSF and the general government budget in the case of the other two agencies. This difference means that SSF tends to be better financed than its counterparts.

Role of the Central Bank

The central bank regulates the payments system and provides clearing and settlement services for payment transactions. With implementation of the Monetary Integration Law in January 2001, which introduced the U.S. dollar as legal tender, it lost its ability to make monetary policy and its role as lender of last resort. Instead, it performs general monitoring of the financial system and drafts financial laws. It does not have supervisory duties. However, favorable opinion from the central bank is needed for, among others, revoking temporarily or permanently a bank license, updating minimum capital requirements, or imposing additional capital requirements. Financial regulation also requires supervisors to inform the central bank if specified events occur. In the case of systemic risk, the decision to allow the Deposit Guarantee Institute, an agency created in 1999, to financially support restructuring a bank must receive a favorable opinion from a committee in which the central bank president presides as a coordinator. The head of SSF and the finance minister are also members of that committee.

Coordinating Mechanisms

Both the Organic Law of the Superintendency of Securities (1996) and the Law of the Saving System for Pensions (1996)

established mechanisms to facilitate coordination. The first created the Superintendent Committee, which includes the superintendents of all supervisory agencies of the financial system and considers matters such as the adoption of common supervisory criteria and policy, the revision of laws and regulations, the coordination of the supervision of financial groups, and the application of common criteria to verify these groups' compliance with legal provisions applicable to them. This law also mandates them to keep adequate mechanisms for exchanging information and allows them to establish common administrative units and outsourcing services together.

The Pension System Law created the Risk Commission, which encompasses the Superintendent Committee and includes the president of the central bank. This commission meets at least yearly to determine limits on investment by type of instrument, terms, and rating requirements for the investments of pension funds and to determine the obligations that insurance companies must meet to operate in the system.

Later on, the Banking Law (1999) enhanced the powers of the agencies and enabled the consolidated supervision of financial conglomerates. This law also established SSF as lead supervisor, placing holding companies under its jurisdiction and giving it powers to inspect other members of financial conglomerates that are not directly under its control. Other supervisors must submit regular reports to SSF, with information regarding minimum requirements, compliance, or any other matter required. In addition, SSF, at its discretion, may examine entities outside its direct control. To do that, it must coordinate with other supervisors or may delegate these exams to them.

Presently, a joint committee, composed of members of the Risk Committee and the president of the Deposit Guarantee Institute, meets frequently for coordinating purposes. Technical committees oversee information technology, legal, and other issues of common interest. Furthermore, considerable efforts of coordination are realized to achieve comprehensive consolidated supervision of financial conglomerates. To that end, a program is being implemented to reduce regulatory gaps and unnecessary duplication by establishing planning and control mechanisms for every agency and between them, by reviewing their structures, and by creating an integrated information technology infrastructure.

The Changing Financial Sector Landscape: Implications for the Regulatory Structure

By the end of 1996, when the two additional specialist supervisory agencies started functioning, the financial system was dominated by banks and savings and loan institutions. In addition, the legal framework for securities markets and its participants as well as for private administrators had recently passed. Seven years later, the economy is dollarized, banks still dominate the Salvadoran financial system, the security market consists mainly of money market operations in which banks are the main participants, and private pension funds are managed by two fund administrators linked to international banks.

Not only does the banking system continue to dominate the financial system, but it also has become more concentrated and characterized by a conglomerate structure. As of December 2003, intermediation was carried out mainly by 13 banks and one savings and loan institution. Credit

cooperatives also provide financial services but have a very small share of the system's assets. As a result of the recent trend toward consolidation, the four largest banks, all private domestic banks, hold around 80 percent of assets, deposits, and loans. Although banks cannot engage directly in financial activities, such as securities trading, they may do so through subsidiaries. Banks may be part of a financial conglomerate, where they may be either a holding company or a subsidiary of one. Except for the two state-owned banks and a small foreign bank branch, all banks in El Salvador are part of financial conglomerates, some of them with cross-border activities and holding companies located abroad. These conglomerates normally include a brokerage house and a credit card issuer. They may also include insurance companies and other types of financial firms. Currently, 21 brokerage houses and 19 insurance companies are in operation.

The securities market is dominated by institutional investors, mainly banks, insurance companies, and pension fund administrators. Most transactions consist of fixed-income securities, of which more than 70 percent are repos. The primary market is dominated by public sector issuers. Banks are also large issuers and the main investors in repos.

Regarding the pension fund sector, five private fund administrators started operating in 1998; of those, only two administrators remain in the market. Both of them are tied to banks, as their main stockholders are linked to the Spanish bank BBVA and to Citibank.

Certainly the structure of the financial sector is now more complex, and, even though there are firewalls between banks and other members of the group, consolidated supervision has become more difficult. In addition, the fact that

the banking system has become more concentrated increases the likelihood of systemic risks; at least two institutions are considered “too big to fail,” blurring the line between micro-level and macro-level financial stability. Furthermore, the fact that the central bank can no longer be lender of last resort has also changed the arrangements for crisis management, imposing more stringent liquidity requirements and stricter supervision.

As described above, financial laws have established the mechanisms for coordination, and considerable efforts have been made to achieve comprehensive consolidated supervision of financial conglomerates. However, given that the structure of financial conglomerates keeps growing more intricate, it is necessary to define clearly the jurisdiction of each institution to avoid inaction or duplication and ensure accountability. There is also the need to improve the mechanism for coordinating the harmonization of regulation so as to reduce regulatory arbitrage and over-regulation. Above all, it is essential to protect supervisors. Rules regarding the removal of superintendents need to be clear, and the mechanism for ensuring accountability needs to be improved. Unifying the agency might address some of these issues.

Given the complexity of financial conglomerates and the fact that the agencies have gained supervisory capacity in their own field, a decision to unify them might be taken in the near future. At least one prominent political party has raised this issue. When choosing the path to integration, issues such as funding and regulatory autonomy have to be considered. Integration without harmonizing sector regulation will not produce the desired benefits. Furthermore, care must be taken to ensure that the right managerial skills are present, to avoid losing sector specificities, and to ensure that

adequate resources are channeled to the supervision of non-bank financial firms.

Finally, following the small developing-country argument, should the agencies be unified under the umbrella of the central bank? Certainly, the possible conflict of interest between ensuring a stable monetary policy and being responsible for supervision no longer exists. By the same token, the economic and political weight of the central bank as well as its ability to use its reserve-creating power to resolve any serious banking problem as lender of last resort are no longer relevant either.

Reference

The word “processed” describes informally produced works that may not be commonly available through libraries.

Luna Martínez, José, and Thomas Rose. 2003. “International Survey of Integrated Financial Sector Supervision.” Policy Research Working Paper 3096. World Bank, Washington, D.C. Processed.

Notes

1. In addition to supervising banks, SSF also supervised insurance companies and other non-bank credit institutions.
2. The Ley Orgánica de la Superintendencia del Sistema Financiero was approved in November 1990, the Ley Orgánica del Banco Central de la República was approved in April 1991. In addition, laws were passed to regulate

exchange houses, to restructure and strengthen financial institutions, to privatize banks, and to govern banking.

3. Aside from the time needed to train personnel and build technological support, time is required to learn to use international resources, even if they come in the form of a donation. The processes required to hire international consulting firms can be long and wearisome.

The Single Financial Supervisor: The Hungarian Case

László Balogh

Before introducing the Hungarian experience with establishing a single supervisory authority, it is important to underline some key components of a supervisory structure. First of all, when opting for a specific supervisory structure, one should not disregard the national specificities of the financial sector, the character of the local legal framework, the historical development of the institutional setup, or the traditional division of responsibilities among them. Four years ago, Hungary accomplished a successful and efficient integration of supervisory responsibilities into a single institution. However, it was a successful solution *under Hungary's given circumstances*. Many elements of this option may be considered, studied, and even utilized by others, but it is not a panacea or a technique to be reproduced automatically under "all conditions." Local specificities should always be carefully considered.

In this paper, I address the practicalities rather than the theory of Hungary's experience, although the two aspects of-

ten go hand in hand. Some preliminary conclusions are important and deserve to be highlighted at the beginning:

- There is no optimal and exclusive supervisory structure.
- A single supervisory structure is not an aim in itself; rather it is a tool for effective consolidated supervision.
- While harmonizing and unifying supervision, sectoral specificities should be addressed and treated appropriately.
- The country's legal, institutional, cultural, and historical environment should not be disregarded.
- Clear strategy, reasonable flexibility, and good managerial skills are important during the transition.

Features of the Hungarian Financial Landscape

The main features of the Hungarian financial sector in 1999, when the policy decision was made to merge the country's supervisory bodies, are important. At that time, financial markets were considered to be open due to the early liberalization of capital movements. Hungary became a member of the Organisation for Economic Co-operation and Development (OECD) in 1996, taking up the standards of the OECD liberalization codes. The liberalization was motivated by recognition that the economic transition could not take place without a strong private financial system. As a result, by 1999 there was substantial foreign participation in the markets: foreign capital constituted about 70 percent of capital in the banking sector and 80 percent in the insurance sector. In 1999 universal banking started to expand as the regulatory framework evolved. Financial groups became

dominant (controlling 80 percent of the local market) and, in line with global trends, began to offer cross-sectoral products and entities.

Against this background, and contrary to the experience of many countries, Hungary did not have a long history of supervision. Until the late 1980s Hungary had no commercial banking system *per se*, so there was no need to have a prudential supervisory agency. Of course, once a genuine commercial banking system was established, the need for a supervisor emerged. The same was true for the capital markets and for insurance.

In 1987 Hungary's commercial banking system was established by splitting the structure and staff of the central bank (which provided some commercial banking services) and creating commercial banks. The decision was made to separate supervision from the central bank because of possible conflicts of interests. In Hungary, the central bank never performed the role of banking supervisor. Banking Supervision was established in 1989 within the Ministry of Finance, Securities and Exchange Supervision was established in 1990, Insurance Supervision was established in 1986, and Pension Fund Supervision was established in 1994. Hungarian Banking Supervision was made an independent entity in 1991.

However, already in 1997 a first step toward supervisory integration had been taken: Banking and Capital Market Supervision was established through the merger of Banking Supervision and Securities and Exchange Supervision. Insurance Supervision and Pension Fund Supervision remained apart at that time.

This early merger brought some lessons for the future. When banking supervision and securities supervision were pulled together within the new institution, two separate sec-

toral lines were maintained, one for banking and one for capital markets. This administrative action was not a genuine supervisory integration. In fact, banking supervisors and securities supervisors were working under the same roof, but not cooperating as expected. Even their information technology systems remained apart.

Before describing the establishment of the Hungarian Financial Supervisory Authority (HFSA) in 2000, it is instructive to look at the situation of financial supervisory activities in Hungary at the end of 1998. The main features of financial supervision before 1998 may be summed up as follows:

- Supervisory structures remained fragmented.
- They responded relatively slowly to legal regulations (which remained the responsibility of the Ministry of Finance).
- They had different levels of operational independence.
- They took different approaches to supervision.
- Regulatory impact was sector specific and not coordinated.
- Sectors disposed with different regulatory background to off-site and on-site examinations.

The supervisory institutions themselves were at different levels of the hierarchy within the public administration. For example, a supervisory measure was final in banking and in securities, and there was no remedy in the administrative process, only in the courts; in contrast, a supervisory resolution in insurance and pension funds could be appealed with the minister of finance. Another example illustrates the difference in sectoral approach: banking law required the conduct of a comprehensive supervisory ex-

amination of credit institutions every two years. No such examination was required in the insurance industry, although comprehensive examinations eventually were required every five years.

Regulation remained the responsibility of the Ministry of Finance, and the supervisory agencies exerted little influence on regulation, had a very low international profile, despite Hungary's highly internationalized banking sector, and rarely cooperated either domestically or internationally. As a consequence, despite all declared intentions, financial supervision remained isolated until 1999.

Hungary had both the disadvantage and advantage of not having a long history of supervision. When the possibility of merging specific authorities was considered, the various sector-specific supervisory cultures were not yet cemented, they were not rigid, and this made implementation somewhat easier.

During the second half of the 1990s, financial groups started to expand in Hungary. The need for good-quality consolidated supervision became imperative.

The Objectives of Integration

The key policy objective when designing supervisory integration is to promote efficient consolidated supervision. What are the prerequisites of good consolidated supervision? In principle, a mechanism is needed to ensure good and rapid exchange of information among different supervisors. On that basis, good cooperation among supervisors is indispensable. An appropriate supportive legal background is also essential. To live up to these new supervisory demands, the acting supervisory institution (or institutions) needs to have significant operative independence.

Responding to that need, Hungary established a single financial supervisor. Similar solutions and good results in the Nordic countries and in the United Kingdom played an important role in convincing policymakers that this was the right step to take.

When setting up the single supervisor in Budapest, the following objectives were set:

- Channel all available information into one supervisory body
- Group all supervisory knowledge in one place
- Take advantage of synergies
- Build supervisory structures that mirror market structures
- Follow evolving financial market structure
- Make use of economies of scale.

To achieve the basic objectives, it was indispensable to strengthen the operative independence of all three structures after the merger. This had to be done to minimize the possibility of political interference in supervisory decisionmaking and to avoid market capture. The process of setting up the new institution offered an excellent opportunity to bring the framework and practice of supervision more in line with international standards and practices. At that time, we were just a year away from the 1997–98 East Asian and Russian financial crisis, which led to the revision of global standards of supervision.

These elements coincided with recognition in Hungary of the need to prepare the country's supervisory structures for participation in the European Union (EU) single market, to upgrade its international profile, and to establish an international network of supervisory cooperation.

The Process of Integration

As far as the process of decisionmaking is concerned, the policy decision and the preparation of the decision did not take long (see box 5.1 for the timetable). A professional consultation about the merger involved market participants, regulators, the ministry of finance, and the central bank. The process was rapid, focused, and concentrated. The government made its decision in October 1999, and the relevant law was adopted in December 1999.

Altogether, preparation of the idea, the discussion, and the voting into law took six to seven months, which is not a long time. After December 1999, the law itself established an interim period of four months. This interim period was a time of planning, programming, and clarifying specificities and keeping the old structures functioning. The new institution formally started to function in April 2000.

The establishment of the unified supervisory authority was just a starting point in April 2000. Although legally a merged institution, HFSA needed roughly two years to put the most important policies, human resource management

Box 5.1: Timetable for Setting up the Single Financial Supervisor in Hungary

- Policy decision: September 1999
- Government decision: end of October 1999
- Relevant law adopted: December 1999
- Interim management of the transition: December 1999–March 2000
- Establishment of the merged supervisory authority: April 2000

issues, managerial issues, and methodologies in place; nevertheless, the law required management to start working in an integrated form beginning in April 2000.

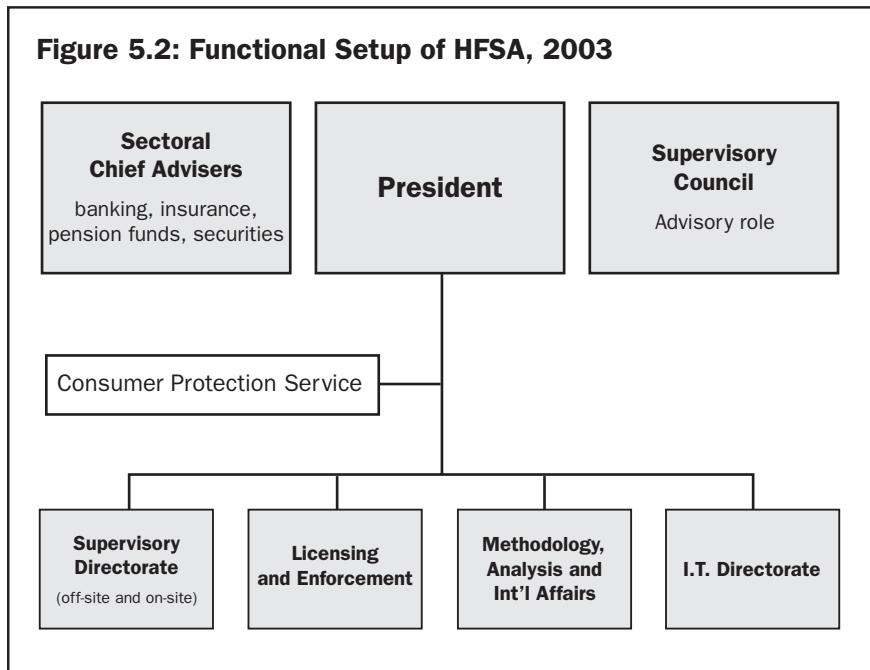
A key issue was the organization of the institution. One practical solution was to allocate staff along their former sectoral lines and to set up a silo type of unified supervision in which the unit responsible for banking, the one for capital markets, the one for pension funds, and the one for insurance were all found under the same roof. This might have brought a smooth transition but did not constitute genuine integration of different sectors. In the Hungarian context, Banking Supervision and Capital Market Supervision had been integrated in this way, and it did not bring the desired results. The earlier lessons strongly encouraged decisionmakers to opt for a functional setup rather than a sectoral breakdown. As a result, the decision was made to organize HFSA around four pillars: one for on-site and off-site supervision, one for licensing and enforcement, one for methodology, analysis, and international affairs, and one for information technology. Consumer protection was added somewhat later.

Integrating different supervisory activities should not mean uniform application of supervisory tools. Each and every sector has its own specificities, and these should be neither overlooked nor overstated. To address this need, the position of chief sectoral adviser was created and placed alongside the president. These advisers scrutinize all proposals originating from the functional directorates to see whether they meet all sector-specific requirements and report (and comment) directly to the president. In this way, supervision is harmonized with enforcement, neutrality and coherent policy implementation are achieved among

sectors, and decisionmakers are advised to recognize important sectoral issues. The chief advisers are basically responsible for their sector in both operative and strategic decisions. The Supervisory Council, which consists of highly respected representatives of market participants and public institutions like the central bank governor and the minister of finance, meets to discuss long-term, broad supervisory policy issues; it concentrates on the financial sector as a whole rather than on specific sectors. See figure 5.2 for an organizational chart of HFSA.

The process of integration provided an opportunity to upgrade compliance with relevant international standards

Figure 5.2: Functional Setup of HFSA, 2003



like the Basel Core Principles on Effective Supervision. One should not forget that the merger took place in 1999, when all existing supervisory principles were under revision, and new methodologies, new approaches, and new definitions were under way. It also coincided with efforts to prepare the Hungarian supervisory authority for a future role in the European Union, that is, to play a responsible supervisory role within the internal market of the EU.

International Road Map for Further Development

Earlier in 2000 Hungary participated in the Financial Sector Assessment Program (FSAP) conducted jointly by the International Monetary Fund and the World Bank in 11 countries. This was a pilot project at that time. (Since then, more than 50 member countries have taken part in the FSAP process.) FSAP was very helpful in identifying the weaknesses, vulnerabilities, and strong points of the financial sector, including the supervisory system, and in identifying the level of compliance with different types of international standards. FSAP resulted in specific recommendations that constituted a road map of assessments for the years ahead (see box 2). The FSAP recommendations became a major reference point and were instrumental in helping Hungary to set institutional strategies and define internal legislative needs.

The EU Commission also launched its own peer review of financial supervision in the context of Hungary's accession to the European Union, using the recommendations of FSAP. The European exercise led to a stronger, more formalized commitment on the part of the Hungarian authorities to follow the FSAP recommendations. The commission asked for an action plan that clearly outlined the steps to be fol-

Box 5.2: International Road Map of Assessments

- Permanent international monitoring: compliance with supervisory standards
- IMF and World Bank FSAP: pilot project (2000 and follow-up in 2002)
- Basel Core Principles: self-assessment exercise
- International Association of Insurance Supervisors: self-assessment exercise
- International Organization of Securities Commissions: self-assessment exercise
- OECD: Regulatory Reform Project (2000)
- OECD: country review, structural chapter (2001)
- EU: peer review (2001 and 2003)

lowed and their sequencing. This action plan was elaborated and, taking into account the need for important legislative steps (as regards, for instance, the further strengthening of supervisory independence), was signed by the finance minister representing the government. In most areas, the steps defined in the EU action plan were fully implemented by early 2003, as determined by the follow-up EU review.

In addition, the OECD Regulatory Reform Project addressed in a broad sense the regulation and supervision of regulated markets in Hungary and the specific role of independent regulatory agencies, including financial supervisory authorities. The OECD report focused more on regulatory aspects of the so-called network industries, like telecommunications and energy distribution, although it did touch on financial supervision.

Issues Considered in the Integration of Supervision

Integration was prompted by many considerations, most notably the following:

- The Hungarian financial market is dominated by financial groups, and this made consolidated supervision indispensable.
- Supervision was weak and needed to be made more effective.
- Sectoral regulations diverged from supervisory practice, giving rise to the need for harmony.
- It was desirable to improve regulatory responsiveness.
- Upgrading supervision vis-à-vis industry groups was necessary to avoid industry capture.
- The creation of a new type of entity delivered an opportunity to establish a genuine independent regulatory agency.
- In light of the EU accession it was evident that Hungary needed a strong, professional supervisor capable of assuming all responsibilities necessary to its future role in the European internal market.
- A better cost-efficiency with the institution was also targeted.

The rationale behind integration may seem obvious, but a few comments may be useful. First, it was thought that an integrated HFSA could play an important role between the market and the Ministry of Finance (and the legislators) by making credible proposals to correct the deficiencies and inconsistencies in the legal regulations. Second, HFSA could share with policymakers international developments in reg-

ulation in order to enable their rapid incorporation into the Hungarian regulatory system. The intention was to accelerate this process. Third, having a single supervisor was seen as important to harmonizing laws across sectors, so that inspection, licensing, registration, and sanctioning requirements were similar for banking, capital markets, and insurance. Fourth, it was clear that the integrated institution had to comply with all the requirements of a European-based supervision and to cooperate fully with supervisory authorities within the international network. This cooperation had to be achieved by the time of Hungary's accession to the European Union. In 2000 that date was still unknown. Fifth, HFSA also was expected to participate in and contribute to the ongoing supervisory activities and discussions in different professional committees and working groups, both within the European Union and within other international organizations.

This independent regulatory agency was a new type of public entity in Hungary. Hungary's public administration is considered to be rather conservative and very hierarchical. Communicating this new entity to the public, to the policymakers, and to legislators was a challenge. In particular, the effort to convey the new agency's role within government was not successful, and this issue still needs to be addressed.

Supervisory Independence

The period between 2000 and mid-2003 was characterized by a growing level of independence for HFSA. In this section, I address the issues of institutional autonomy, budgetary autonomy, administrative autonomy, regulatory autonomy, and accountability and transparency.

Institutional Autonomy

The president of HFSA is elected by the Parliament after being nominated by the prime minister for a fixed six-year, renewable term. Supervisory decisions are final and cannot be appealed to a higher administrative body. The only recourse is to appeal to the courts. The law clearly grants HFSA autonomy from political or other pressure: HFSA cannot be instructed, and it can only undertake tasks as specified in the relevant laws and legal rules. HFSA's internal operational rules are approved only by the president of HFSA, not by the minister of finance.

Institutional independence was achieved by protecting daily responsibilities from possible political or industry influence. This effort proved to be quite successful.

Budgetary Autonomy

HFSA is not financed out of the public budget. Almost from the beginning, the supervisory authority was financed by the financial industry. The law clearly stipulates that HFSA's budget—all or in part—is separate from that of the Ministry of Finance. The law also establishes the schedule of fees to be paid by the sector. However, the Ministry of Finance has proposed a decrease in these fees, completely disregarding the professional objectives of HFSA. Budgetary independence also means autonomy in allocating expenses according to needs, although some new restrictions are emerging. Recently, with reference to the law on civil service, it was decided that HFSA could not use savings within its own budget to increase the remuneration of staff. One element needs to be mentioned: supervisory fines cannot be used to cover op-

erational costs; in other words, the institution has no direct or vested interest in penalizing supervised institutions.

Administrative Autonomy

The supervisors working with the Hungarian supervisory authority are considered to be civil servants. During recent years, major allowances and some exceptions have been made with regard to the civil service payment scheme; as a result, the income level of supervisors has improved substantially. Liability legally rests with the president of the authority, and supervisors are enjoying legal protection as civil servants. The income level of supervisors is higher than the average income of civil servants and is quite close to that of professionals in the central bank, but it is still far lower than market levels. This limits the ability of HFSA to obtain the best experts in certain professions.

Regulatory Autonomy

HFSA has not been particularly successful in the area of regulatory autonomy. HFSA is not entitled to issue secondary regulations. All secondary regulations are issued by the government or the minister of finance in the form of decrees, even if they are extremely technical in nature. These decrees are often proposed and elaborated by HFSA and discussed with the active involvement of HFSA. However, this is a slow, rigid, burdensome, and costly process. Nevertheless, the decisions issued by HFSA are enforceable, and sanctioning power is also ensured. HFSA issues regular supervisory guidelines for market participants recommending best practices and

methods to be followed, but these guidelines are not legally binding. Once supervised institutions decide not to abide by such guidelines, there is no legal ground for sanctioning them. However, to a large extent, the guidelines are followed. This is an unresolved issue, and in the coming years legislators should be persuaded that HFSA requires the powers needed to regulate. Such powers have been fully endorsed by the European Union and the International Monetary Fund.

Accountability and Transparency

Institutional independence of the supervisor is important, but it must go hand in hand with strong accountability. HFSA, by the force of law, is accountable to the government through the Parliamentary Commission. HFSA's president is obliged to report regularly to the Parliamentary Commission and makes this report public afterward. It also informs the Supervisory Council, which includes many market representatives. In that sense, even the industry is involved in the accountability process.

HFSA's economic management and its compliance with public finance regulations, by the force of law, may be (and effectively is) examined by both the Government Inspection Bureau and the State Audit Office. This is an important element of accountability.

In addition, the deliberate policy of the institution has been to improve its transparency on a voluntary basis. At a very early stage, HFSA decided to improve its communication of supervisory decisions regarding different institutions. Since 2001 such communication has become a matter of policy in each and every sector. HFSA was determined to remain neutral and impartial among market participants.

Neutrality in imposing measures, sanctions, and consistency in supervisory examinations is key. It was thought that one of the best ways to avoid capture by the industry was to make all HFSA supervisory decisions transparent. (Obviously individual data and sensitive business secrets are not published.) Transparency is the best way to avoid rumors and unfounded accusations. It has the advantage of educating market participants about the specific interests of supervisors and about mistakes, committed by others, to be avoided in the future. Such information was not well received by all sectors at the beginning. Nowadays the market is recognizing that it has value, and supervised institutions are eagerly examining not only their own results but those of others as well.

HFSA reports back to the industry on the basis of data the industry provides (for example, market analysis reports). These reports are well received. HFSA also issues and makes public its own sanctioning policy. HFSA published its mission statement in 2000 in an effort to achieve predictability: markets can foresee what steps might be taken in typical cases. I am convinced that this is part of transparency and accountability. According to the recent representative surveys, ordered by HFSA, about 80 percent of the supervised entities are aware of and rely on the supervisory guidelines in setting their own strategies and operations.

Practical Challenges of Integration

Managing a merger requires ongoing discussion and persuasion as well as the involvement of middle managers and other key personnel. The following points are based on the Hungarian experience.

Creating a unified supervisory structure requires managers with outstanding skills, dedication, and cooperation, especially during the transition.

The identity of the new institution should be defined early in the process and should avoid merely combining earlier identities.

In identifying the new institutional objectives, a mission statement may prove useful, especially if the elaboration involves key staff throughout the institution.

In-house training of staff on common policy is advisable.

Some staff may strongly oppose the structural changes, and targeted efforts to persuade and retain experienced staff may be needed. However, staff who remain opposed to change should be permitted to leave.

All efforts should be made to harmonize salary levels. Staff with different sectoral backgrounds should be remunerated equally. Although prompt solutions are often not feasible, a reasonable strategy and a tangible timetable have to be set to harmonize remuneration levels within a foreseeable time span. This has to be widely accepted by staff. This means that employees in the best-paid sector will temporarily suffer from a lower rate of increase than employees in the other sectors. This has to be addressed. Remuneration should be close to market levels.

The integrated institution should be fully financed by the market in a proportionate manner. Relative neutrality among sectors in establishing supervisory fees should be ensured.

Finding a single headquarters for all staff is of key importance! Despite the best managerial decisions, integration is not possible unless all employees are working in the same location. (In Hungary staff were distributed in seven different premises in Budapest. It took 16 months to find and move them to the new headquarters.)

Unification of information technology systems is also important. In Hungary, this was accomplished in two steps. As a short-term temporary solution, the insurance, banking, and capital market information technology systems were targeted for integration. As a second step, a comprehensive, cross-sectoral, and flexible information technology system was envisaged. This major investment took three years to be finalized.

Integration provides an excellent opportunity to revise and redefine supervisory policy. This process involves the harmonization (and unification where warranted) of sectoral supervisory policies and tools.

The revision of supervisory policies leads inevitably to revision of the sectoral framework for regulation. This revision resulted in elaborating and proposing important legislative and regulatory changes in sectoral laws with a view to harmonizing processes, measures, and sanctions. The other objective was to identify and minimize the opportunities for regulatory arbitrage within the financial sector as a whole.

Supervisory manuals, methodologies, guidelines, data provision rules, regulations, and sanctions need to be revised or established. All these need to be formulated (and implemented) to express the harmonized policies and strategies.

The new institution and policies require self-assessment regarding compliance with international standards. The process of integration offers an excellent opportunity for improving standards to international best practice.

With its new identity and new policy objectives, the integrated institution needs to build new international contacts and be incorporated in the global supervisory network. In HFSA's case, adhesion to the European supervisory structures and network was especially important in light of Hungary's decision to seek EU membership.

Once the key supervisory policies and strategies are set, the framework of cooperation with the central bank has to be settled through a memorandum of understanding, where the bank's main responsibility is to oversee systemic stability.

Conclusions

The unified supervisor in Hungary has a good chance to ensure a better quality of consolidated supervision. It can provide for more interaction and information exchange between sectoral experts within the institution, which raises the possibility of a better understanding of cross-sectoral market attitudes and risks. Cross-fertilization of divergent supervisory experience and knowledge has brought important synergies. The unavoidable integration of information technology systems has created a good opportunity to reassess the overall need for and quality of data and even to redefine and streamline effective reporting requirements.

In Hungary, the single financial supervisor has a better overview of the financial industry and a better overview of regulatory deficiencies and inconsistencies; consequently, it is in a better position to initiate appropriate legislative modifications to correct the situation.

Hungary's experience offers the following organizational lessons:

- A well-prepared policy decision is needed.
- Once a decision is made, quick implementation is advisable.
- Appropriate time is needed for implementation; mergers cannot be accomplished overnight.

- Determined, devoted, and skillful management of the transition may be an important driving force.
- The timing of integration is of key importance; policy-makers should select a relatively stable period on the financial markets.
- Public communication and awareness raising are needed throughout the integration process.
- There is no perfect, predefined track for achieving supervisory integration. Flexibility and, eventually, a re-evaluation of some elements are needed. It is a “learning by doing” exercise.
- The integrated supervisor runs the risk of overlooking issues specific to a particular sector; moreover, given the weight of different sectors in the economy and the level of supervisory sophistication, over-dominance of banking may prevail, and this has to be counterbalanced.

Overall, the policy decision in 1999 to merge sectoral supervisory institutions and their implementation proved to be a good, forward-looking decision that contributed to the improvement of effective consolidated supervision, raised the quality and consistency of financial regulation, improved supervisory independence, and integrated Hungarian authorities into the international supervisory network. As a consequence, the quality of supervision has improved, and supervisory policy has become more proactive and more responsive to market developments. These elements have strengthened the stability of Hungary’s financial system.

Chapter 6

Making Regulatory Structures Effective

Establishing Legal Consistency for Integrated Regulation

Peter R. Kyle

The advantages and disadvantages of integrated regulation of the financial sector have been the subject of much recent debate. For the most part, the literature has focused, quite rightly, on the economic, financial, and institutional arguments for and against. Legal issues, to the extent that they have been addressed at all, have generally been regarded as technical: sometimes difficult but always surmountable. This is not surprising given the relatively developed legal systems of those countries that have embarked on the road to integrated regulation. Typically, such countries have the benefit of well-drafted, comprehensive, and consistent laws, an efficient mechanism for amending the legal regime, a functioning and respected judiciary, a robust legal profession, and a strong commitment to the rule of law.

In many parts of the world, however, most, if not all, of these key attributes are missing. Such legal systems are much less sophisticated, and the legal challenges confronting the advocates for integrated regulation are rather more daunt-

ing. Indeed, the legal obstacles can materially influence the decision to establish an integrated regulator, the process by which integration is undertaken, and the desired structure and operation of the new regulator.

A recurring theme of many of the assessments carried out pursuant to the Financial Sector Assessment Program of the World Bank and International Monetary Fund over the last four years is whether the quality of supervision would be enhanced by transferring regulatory authority to a new entity either by establishing a single supervisor for the entire financial sector or by centralizing in one agency all the powers necessary to supervise at least two of the main intermediaries (such as banking with insurance, banking with securities, or securities with insurance).

Here I focus on the less developed members of the international financial community and highlight some particular legal hurdles that such countries have to confront should they decide to embrace the new order. My central themes are that, in such jurisdictions, the legal obstacles are, arguably, much more intractable than those faced by the advanced economies, that the U.K. model of a wholesale makeover of the legal framework is far beyond the political, institutional, and legal capacity of most developing countries, and that, if the goal of integrated regulation is to be adopted, it needs to be phased in on a graduated basis over a lengthy period of time with a great deal of care, thought, and patience.

Constitutional Limitations: Independence of the Central Bank and Role of the Judiciary

In contrast to the situation of countries that have established integrated regulatory authorities, in a number of the World

Bank's developing member countries proposals to introduce unified regulation of the financial sector must contend with a range of constitutional constraints. Unlike the Scandinavian countries in which the banking supervisory function has historically been carried on outside the central bank, banking regulation is a key central bank function in developing countries. Typically, the status of the central bank and its guarantee of independence are enshrined in the country's constitution. Proposals to divorce the bank supervisory function from the central bank are regarded as a serious and generally unacceptable dilution of this guaranteed status and, potentially, unconstitutional. By the same token, attempts to expand the reach of the central bank's supervisory jurisdiction to include either or both of the securities and insurance sectors are also perceived as inappropriate intrusions on the functions and independence of the central bank and, therefore, undermines the country's constitution.

To resolve this dilemma, policymakers must find other ways to create an entity that enjoys the degree of authority and autonomy comparable to that of a central bank without, at the same time, contravening any constitutional safeguards. Even here, however, the way forward can be fraught with difficulty. In Azerbaijan, the ability of the executive to create a securities commission and endow it with powers and functions analogous to those of the country's central bank was frustrated largely on the grounds that the constitution provides for the establishment of certain key public sector institutions, including the central bank, but does not expressly envisage the creation of a securities regulator. A securities regulator was eventually created by law, but it lacks the special status and guaranteed independence of the central bank and is viewed, in substance and in form, as an institution with in-

ferior status. The perceived difference in legal status between the central bank and the securities and insurance regulators is often cited as an impediment to a potential merger of regulatory authorities. A similar question arises, of course, in the case of proposals to attach the supervisory function of a central bank onto a newly created integrated regulator.

Another issue that has given rise to a range of legal problems relates to the separation of powers incorporated in a number of constitutions adopted over the last two decades. Several countries in Central Asia and the former Soviet Union, in particular, have taken the view that the removal of a banking license, the dismissal of a manager, or the imposition of a fine amount to the removal or infringement of a property right protected by the constitution. Such rights, it is argued, can only be removed or enforced by judicial act as opposed to executive or administrative fiat. A related dimension of this argument is the belief, on the part of judges in that part of the world, that, notwithstanding statutory language confirming the independence of the central bank and giving the governor or board full and exclusive power and responsibility to apply the provisions of the relevant legislation, decisions that appear to violate the rights of individuals may be reviewed and, if appropriate, reversed by a court of law. Such reversals can apply to decisions on matters of substance as well as procedural irregularities. In Kazakhstan and Armenia, for example, shareholders have successfully appealed central bank decisions purporting to terminate a banking license on the grounds of insolvency. Such rulings, by which judges with limited banking or commercial experience are able to substitute their judgment for the technical judgment of central bank management, would not be countenanced in more mature jurisdictions. They are justified on the basis

of the separation of powers guaranteed in the constitution and the perceived right of a judge to act as the final arbiter on issues involving the protection of personal freedoms and property rights.

Financial regulators that lack the clear and unequivocal authority to enforce the provisions of the governing legislation are unlikely to be taken seriously by the financial community. The absence of effective powers of enforcement not only undermines the authority of the regulator but, potentially, puts the stability of the financial sector at risk. There is some anecdotal evidence that, on issues of technical banking practice, the courts are beginning to defer to the technical judgment of central bank authorities, but the level of trust and confidence in regulators has some way to go before judges in the transition countries will completely cede their role in this area.

Constitutions can, of course, be amended, but this is not a process to be undertaken lightly. Notwithstanding the most compelling arguments, it is unlikely that the need to establish an integrated regulator will be perceived to be of sufficient importance as to justify the upheaval involved in seeking a constitutional amendment. And yet, if that is not done, an integrated regulator runs the risk of not having the independence and authority essential to achieve its objectives.

Legislative Environment

A defining feature of the World Bank's developing member countries over the last decade has been the plethora of financial sector-related legislation adopted. Laws and regulations dealing with subjects as diverse as leasing companies, credit unions and cooperatives, microfinance, investment houses,

investment brokers, investment intermediaries, mortgage banks, and money laundering, to name but a few, typically now form part of the financial legal armory. In contrast to the experience of more developed countries, such laws and the implementing institutions have often been created as a result of loan conditionality to deal with a specific need without a great deal of thought as to how such entities can or should be integrated into the country's overall structure of financial supervision. Such laws were usually drafted with the help of foreign consultants and inevitably reflect their experience and personal bias. The quality of drafting is weak, inconsistencies and gaps are common, the linkages with related laws and institutions tend to be poor, and unclear objectives tend to produce uncertainties over institutional boundaries.

All too often, the process is extremely drawn out, and the eventual outcome unpredictable. The result is a patchy and fragmented legal framework comprising an array of new and relatively inexperienced regulatory officials and institutions, laws of widely divergent quality, differing legal regimes for the banking, securities, and insurance industries, and, frequently, an environment in which cooperation and collaboration within and across sectors are weak. Faced with this reality, the challenges confronting those who seek enhanced financial sector integration are indeed daunting. It is tempting to suggest that the preferred course might be to replace sector-specific laws and other laws affecting the financial sector with a single piece of new legislation, but that is unrealistic in these jurisdictions. Although the economic rationale for integrated regulation may be obvious in such countries, the extensive consolidation and rationalization of the laws and institutions that will need to take place suggest that the process will need to be very gradual, with a series of

small steps within the context of a long-term integration plan rather than the U.K. model of a fully integrated common legal framework.

Another aspect of the situation of developing member countries that differentiates it from the experience of the developed countries is the very different levels of development and sophistication that exist between the banking, securities, and insurance sectors. The experience of the Financial Sector Assessment Program suggests that, in terms of legislative and regulatory reform, central banks and the banking sectors of developing member countries have fared rather well. For the most part, central bank and banking legislation is reasonably sound and broadly consistent with international best practices. Many countries underwent a substantial revamping of their core financial sector legislation in the 1990s with the help of the International Monetary Fund, the World Bank, and other consultants and advisers. The review process has continued, accelerated by banking crises and the need to keep up with technological developments and new banking practices and structures.

The legal framework for the securities sector is of much more recent origin. In the transition countries, in particular, capital markets and stock exchanges are less than 10 years old, and regulatory experience is very limited. The relevant laws, usually drafted by foreign consultants, often reflect practices and concepts drawn from overseas jurisdictions that are not well understood by the market players. The securities industry in such countries is still very much in an embryonic state, and the form and scope of regulation are neither well understood nor well applied. Regulation is characterized by mechanical compliance with rule-based requirements, questionable application of fit-and-proper criteria, and inadequate disclosure and sharing of information.

The insurance sector is the weak link in the financial sector. Most developing member countries have, at best, a very narrow and limited insurance sector and no meaningful pension or contractual savings regime. What little oversight exists is carried out typically by a poorly resourced division within the Ministry of Finance. Insurance laws of widely varying quality exist but are poorly implemented. This sector is receiving much more attention from the international development community, but the scope and sophistication of its regulatory framework are still far behind those of the banking and securities sectors.

The radically different stage of development of the three sectors is in marked contrast to the experience of those countries that have opted for a unified approach to regulation. Integration has been facilitated in these cases by the broadly comparable levels of legal development and regulatory compliance that have evolved within and among the banking, securities, and insurance sectors. This is not to say that the process of legal integration in developed countries has been straightforward. The oft-quoted U.K. experience clearly indicates that the process of legal change can be difficult and drawn out, although, of course, the extent of fundamental change in that example was much more ambitious than was the case with countries that opted for a single regulator model, but with separate, sectorally divided, legal regimes.

The extreme differences in development that characterize the situation of developing member countries suggest that the objective of integrated regulation should be deferred until at least minimum standards of accountability, operational autonomy, and prudential regulation have been achieved across all three components of the financial sector. Widely divergent stages of development of the three core sec-

tors greatly complicate the task of achieving a comprehensive and coherent legal framework for an integrated regulator.

Specific Legal Issues

Regulatory authorities need to be accountable, independent, and free from political interference. Such notions are readily understood and accepted in developed countries, but not in many of the countries in which the World Bank operates. It is difficult to reach agreement on accountability for what, to whom, in what form, and when. Similarly, while politicians and officials routinely emphasize the importance of—and claim the existence of—political independence, the reality is usually rather different. Credible accountability mechanisms and safeguards against inappropriate political intervention are critically important features of a regulatory regime but are difficult to achieve in environments in which self-interest has for so long been a dominating force.

In response, sometimes to very specific privacy concerns, a number of developing countries have enacted laws imposing very high levels of secrecy on financial sector institutions and severe sanctions for infringements. In Azerbaijan, for example, the Law on Bank Secrecy was introduced three years ago to enhance trust in the financial sector and prevent a flight of capital out of the country. The law sought to prohibit any inquiry into the source of funds or the ownership of capital in a bank. Such laws run counter to prevailing notions of bank secrecy, but they have become an important aspect of bank governance, and their removal or modification, which should be a prerequisite for the establishment of an integrated regulator, is both politically and legally difficult.

A corollary of the secrecy issue is the reluctance to share information. In consequence, partly, of the legal prohibition on disclosure of information, the authorities in many jurisdictions go to extreme lengths to restrict the flow of information. Some laws do impose positive obligations to exchange information and to collaborate across sectors and institutions, but the reality in developing countries is that such laws are implemented with difficulty and rarely enforced. As the experience of encouraging these countries to introduce comprehensive anti-money laundering laws and regulations over the last few years demonstrates, removing or modifying such laws is both culturally and legally difficult.

In the developed world, legal protection for bank supervisors is an accepted feature of the legal framework. However, among developing countries, the rationale for exempting public sector officials from legal liability runs counter to prevailing norms of accountability. This is particularly true in the transition economies, where officials tended for decades to abuse their powers with little or no risk of ever being held liable or accountable. In these parts of the world, the notion that a public sector official is beyond scrutiny by the courts, even where it can be established that the official was acting in the normal course of his or her duties, is difficult to grasp, let alone accept.

Salary levels and conditions of service are issues that always need to be addressed in the context of enhanced integrated regulation. In many parts of the world, central bank employees enjoy a special employment status vis-à-vis other parts of the public sector. Understandably, supervisory staff will be reluctant to transfer to an entity that does not offer comparable employment benefits. This is a major stumbling block in developing member countries. Experience to date

suggests that creating differences in terms and conditions of service among different components of a public sector is legally complicated and extraordinarily difficult, much more so than appears to have been the case with developed countries.

The prevailing view is that integrated regulators should be financed by way of an industry levy rather than through direct budgetary support. Although there may be compelling economic and institutional reasons for this approach, there is no tradition among developing member countries for private sector financing of a public sector function. Companies, particularly in the securities and insurance sectors, tend not to have long-term stability, and the logistics of introducing a regime to implement industry financing requires a level of legal sophistication and development that is significantly beyond the present capacity of most of the World Bank's developing member countries.

Conclusions

The legal issues outlined in this paper are not unique to developing member countries. They are present in one form or another in most parts of the world. The difference is that efficient mechanisms to resolve or mitigate these legal constraints are not readily available in the countries with which the World Bank is primarily concerned. Law-drafting skills are weak, politicians frequently do not appreciate the technical complexities and nuances of the legislation and are prone to industry capture, and judges lack the training and background necessary to resolve complex issues of public policy in sector regulation. In these jurisdictions, even the so-called "easy" option of piecing together existing sectorally based legal regimes is an ambitious undertaking. For these countries,

once the policy decision has been made to embrace the option of a single regulator, a careful and very detailed action plan for achieving this objective will need to be developed. Such a plan will need a long time horizon. Malta, which took the initial steps to introduce integrated regulation in 1994, did not complete the process until early in 2004. Mauritius, a country with a relatively small financial sector, is midway through a three-year transition to a single regulator model. All countries that have opted to change their supervisory arrangements have found that the process is long and difficult.

A key issue for these countries is the extent to which financial regulation among different types of businesses should be integrated and whether responsibility for financial sector regulation and supervision should be vested in a single agency. As the copious literature on this subject illustrates, the resolution of these issues is necessarily country specific, and there is no commonly accepted or ideal model. More and more countries are choosing to integrate their supervisory functions, but relatively few have chosen to follow the so-called mega example of the Financial Services Authority in the United Kingdom and adopt a single governing law. The preferred approach seems to be an authority that retains the sector-specific laws but seeks to harmonize the supervisory functions, perhaps with a view to a moving to a single law in due course. The test, of course, is whether the effectiveness of the regulation and supervision is improved. That depends to a large extent on the governing legal framework. For the reasons outlined here, in the context of developing countries, policymakers and international institutions should not underestimate the difficulty of legal reform. A long-term, well-planned, and gradual approach with some flexibility for dealing with evolving circumstances will be key to bringing exist-

ing and future institutions and laws into harmony with the desired objectives of integrated regulation.

Creating an Effective Regulatory Culture in Estonia

Andres Trink

In 2001 the Estonian Financial Supervision Authority took over the functions of the former securities, banking, and insurance supervisors. The objectives of merger were to get a consolidated view of risks, to achieve equal quality of supervision across various sectors, to pool knowledge and resources, to increase our independence, to have less duplication and fragmentation, and to improve the coordination of supervisors. One aspect of the merger, which was quite important from the cultural point of view, was the spin-off of banking supervision from the central bank.

The transition carried the risk of interrupting financial sector supervision, losing credibility for the supervisor as a whole, losing external support from the other authorities involved, and potentially demoralizing and driving away key staff. But a more fundamental risk was that the expected synergies would not occur and that the organization, though formally integrated, would remain fragmented.

So right from the outset, we determined that the Financial Supervision Authority would not be a continuation of the three old organizations, but rather an entirely new institution. We made it clear that we would develop our own common identity, separate from the central bank, which had handled banking supervision, and from the Ministry of Finance, which had handled securities and insurance supervision previously. We had to merge three different organizations, and there was a lot of discussion about how things were done before, about the habits, and about the rules of the game. Obviously, the fundamental regulatory cultures of the three organizations were a factor. In addition, the Financial Supervision Authority would have to communicate its role and authority to the general public in order to build credibility and legitimacy on the outside.

The Process of Integration

In retrospect, the merger can be divided into three main phases: (1) the preparation, which was a very active six-month period; (2) the formal launch, which occurred about two years ago; and (3) the transition, which continues today. We are about to move to a longer-term planning horizon.

Preparation Phase: Selecting Staff and Preparing People

The process of building the organization started before the new structure was actually implemented. We had to identify key people and negotiate their role in the future organization. Given the small size of the separate supervisory bodies that

had existed previously and the few skilled staff available, we faced a tough choice of whether to build an ideal structure and add the people to it or instead to design a structure based on the kind of people we had. The Financial Supervision Authority seemed to combine both approaches: we considered what the structure should look like in the ideal sense, but also kept in mind the kind of people we had to assume these functions.

When we started implementing our merger, the Financial Supervision Authority built on its existing people and hired about 30 percent of its total staff as new hires. This had a positive effect from a cultural perspective, because the new hires were in a better position to ask “stupid” questions, and they were not tied to the philosophies and approaches of the past. In searching for managers to lead the merger, we also had the option to use insiders or outsiders, and we took a very practical approach. Regulation and supervision are not disciplines that are frequently taught in universities, and so there were few people in the market to choose from. We decided to build on the existing people to manage the merger.

This meant that we had to do a lot of balancing among the staff from the three agencies in order to get along with one another and agree on how to move ahead. We had to manage a lot of feelings of insecurity, as have other supervisors that have changed structure.

Formal Launch

When the formal launch took place in 2001, a new interim management board was formed, consisting of the heads of the three merging agencies. Immediately, the board was faced with a delicate balancing act, and quick communication was

essential. In order to establish the authority and mandate of the Financial Supervision Authority both internally and externally, the board had to articulate quickly the organization's core principles. To maintain staff morale and build cooperation, the board had to communicate these objectives to staff immediately. The new supervisory structure had to maintain a careful balance among staff within the agency itself and also redefine its relationship with the Ministry of Finance and the central bank.

Transition Phase

Redefining its relationship with the central bank, in particular, and, to a lesser extent, with the Ministry of Finance has been an ongoing challenge. Cultural differences between the central bank and the new supervisor have been strained at times, with the two agencies treating each other as "us" and "them." Also, the Financial Supervision Authority is developing a new internal culture that is based on a greater degree of independence. Previously, some of the organizations that were part of the merger were very much subordinated to the Ministry of Finance, so the increased independence has created some awkwardness and tension in our communications. At times, when staff from one agency has called staff from another agency with a question, the contact has been seen as interference. In this sense, building a "culture of cooperation" in this triangle of the Ministry of Finance, the central bank, and the Financial Supervision Authority has been very important.

Another important step in moving beyond the formal launch has been assembling a permanent, five-person management board. The challenge was to compose a board that would reflect the overall objectives and emphases of the new

organization, and I think we have done well in this respect. The board needed professionals with diverse capabilities and experience: someone who represented the prudential approach of supervision, someone who represented an approach more inclined toward conduct of business, someone who understood banking, someone who understood the securities market, someone who understood insurance, someone with a legal background, and someone with a financial background. At the end of the day, we ended up with a relatively balanced board, and the organization accepted this new leadership.

We also have moved to a different decisionmaking process. Each of the three previous supervisory agencies was run by one director general making the key supervisory decisions. Now we have a five-member management board with many more responsibilities in various areas of supervision. In addition to running the organization, the new board makes all the supervisory decisions, makes decisions on licensing and delicensing, and handles administrative sanctions.

Another important challenge during the transition phase has been our effort to develop common values across the organization. Building a common corporate culture to fit the new supervisor has been extremely important, but not simple. Our size has made this task difficult. Although our organization is relatively small by any international comparison—we have close to 70 people today—the Financial Supervision Authority is a bigger organization than the three small agencies. We have not been as successful as Howard Davies was at the United Kingdom's Financial Services Authority in measuring corporate culture. Instead, our experience has shown us that imposing common values for the organization from the top down via management is not always easy. We

have tried to take more of a bottom-up approach, to let new ideas and new methods settle, and to register the core elements of the corporate culture in the new organization. This has been a learning experience for us and clearly something we will work on in years ahead.

Challenges Encountered

During the transition period, the Financial Supervision Authority has encountered several challenges arising from differences in the backgrounds, expectations, skills, and relationships of staff with clients. A few of the most critical challenges are listed below.

Lack of Common Benchmarks of Performance

In the new integrated structure, people did not understand who their peers were and could not readily compare themselves to their colleagues, so a financial analyst in the former banking supervision department could not measure his performance against an analyst from the former securities or insurance supervisor. Also we had people with very different levels of experience. Very few people had actually experienced a financial crisis, which is a very important perspective for supervisory staff to have. Such staff bring a forward-looking approach, not just a short-term approach, to supervision.

Differences in Compensation

In the absence of common benchmarks, and in the presence of staff with very different skills, determining fair compensa-

tion became a difficult challenge. We had to deal with winners and losers in the process, establish a basis for comparability, and maintain staff morale in the process.

Fear of New Leadership and Hierarchy

The arrival of new decisionmakers from other supervisory agencies or from the outside market created uncertainties in the career outlook for some staff. We had to manage those fears while plowing ahead with new approaches. In addition, the new structure made some staff feel threatened, because it redefined their role in the organization. With the change of functions, people still had a lot of informal roles. The hierarchical moves created anxiety about what the status of a particular staff member had been before and what it would be in the future.

Differences in Supervisory Approach, Scope, and Methods

Bringing together professionals from three different fields and three organizations was not easy. Not only did staff members have different skills, but they also had different relationships with the financial institutions that were their clients. Some individuals were well known by financial practitioners in the market and did not have to use formal tools to get the information they needed. Instead, they had a strong and direct communication with market participants. Others did not have the same credibility in the market and had to rely on formal tools to get things done, which was not attractive from the market participants' point of view.

Inherent Conflicts in Regulatory Cultures

The Financial Supervision Authority had to deal with conflicts among different types of regulators and supervisors. One of them is the conflict between market conduct and prudential supervision. In a stable environment, public awareness and interest in consumer protection increases, and market conduct activities have much more visibility. This will continue to occur as the financial sector continues to develop the trend toward branching and as consumer protection issues assume increasing importance. As a result, we had to balance traditional banking or prudential supervision with market conduct supervision. In addition, we saw insurance becoming a very special part of the business, which had not been the highest priority before. We also saw conflicting views between the legal approach and the financial approach to supervision.

Enforcement Policy in a Transitional Supervisor

The Financial Supervision Authority probably shares this challenge with supervisors in many other transition economies. The past several years have witnessed a rapid change in market development, corporate governance, social values, and the capacity of the supervisor. Supervisors in many transition countries have to deal with breaches of rules that happened five years ago, because they have new regulatory tools at their disposal and different values about supervision than previously. In the midst of these changes, having a balanced enforcement policy is difficult.

While it is important to recognize that these conflicts are real, it is important not to over-emphasize their existence. Different types of supervisory agencies share common fun-

damental objectives. Our organization is relatively small, which has enabled us to balance those interests, at least on the management board. The key is to explain these differences to staff, who need to understand and translate them into longer-term principles for decisionmaking.

Practical Solutions Applied

The transition has been challenging, but a few practical steps have been very effective in dealing with these issues.

- *Active training program.* Investing in staff skills and abilities has helped to create a common framework for the whole organization. It has brought people together. An important part of this has been offering introductory training for new staff.
- *Uniform compensation levels.* It would have been very difficult to explain different compensation levels over a long period of time, so it was critical to harmonize compensation levels as quickly possible. In our case, it took about one year to adjust the compensation levels and to make people feel comfortable and understand the organization's evaluation criteria. Perhaps it could be done even quicker than that.
- *Communication, communication, communication.* Communication is critical, particularly with regard to the internal organization. During a merger, management may focus on issues that are more important from the outside point of view, and they may emphasize external more than internal communication. There is a very high price to be paid later on for this approach.

- *Mixing people.* By rotating staff through different functions, the Financial Supervision Authority increased staff skills, flexibility, and understanding of how the organization works. Rotating staff to new functions is often difficult, but finding those opportunities is important and necessary. We also developed many horizontal projects, building teams across financial industry groups and working groups to develop common rules of the game.
- *Transparency in decisionmaking.* To alleviate the anxiety associated with new decisionmakers and a new hierarchy, we learned that explaining management decisions is key. By openly sharing their decisions, managers build confidence among staff and dispel uncertainties.
- *Outward communication.* External communication, particularly with the central bank has been crucial, and we continue working very hard to maintain a close and collegial relationship with the Bank of Estonia and other policymaking authorities.

Conclusions

As the chairman of the Financial Supervision Authority, I have learned that the integration process is a major adjustment for everybody and has to be carefully managed. The management board also has to accept that building a new organization and creating a new identity takes time, and we have to accept some mistakes along the way.

What have been some of the lessons learned? There is no ideal formula for building a regulatory culture, but our experience is that it requires continuous balancing of interests and differences, and it is very important to communicate with staff about decisions and objectives.

Communicating with Stakeholders: Issues to Consider

Howard Davies

The experience of the Financial Services Authority (FSA) in the United Kingdom suggests that a structured approach to communicating with stakeholders is worthwhile. Such an effort can be organized by identifying the relevant stakeholders and choosing the means of communication, the message, and the measure of success in stakeholder communications.

Who Are the Relevant Stakeholders?

The answer will depend, to some extent, on the duties and coverage of the regulator itself. For example, a regulator that is responsible for conduct-of-business issues will need to consider direct communications with investors. A prudential regulator can afford to do less in that context.

Some of the stakeholder groups for financial regulators are relatively obvious, for example, financial firms and their representative bodies, savers-investors (especially if the regula-

tor oversees conduct of business), and elected representatives. Some other stakeholders are less obvious but can be equally important. For example, other domestic authorities may need to understand your approach in some detail, especially law enforcement agencies with related powers. Overseas regulators are important, too. Some of them will place reliance on your work in carrying out their own responsibilities. It is important, therefore, to set out a clear list of the stakeholders with whom you need to communicate, at the outset.

How to Communicate?

The means of communication will depend on the groups targeted. Direct means are likely to work well with firms themselves, but those communications may have to be intermediated by trade associations or professional bodies, given the numbers involved. This makes it important to have a particularly good relationship with trade bodies. For example, in the United Kingdom the Financial Services Authority organized regular briefings for trade associations. And even with direct communication, firms will be influenced by what they read in the media, which can often be a distorting lens.

In the case of investors, the challenge is especially difficult. It may be possible to communicate directly in some areas, particularly by requiring firms to pass material from the regulator to individual clients at the point of sale. FSA has used its powers in that area to good effect. Sometimes, advertising can be appropriate; FSA has carried out a large-scale television campaign, for example. But if direct feedback from investors is needed, this will be hard to achieve by direct means. Some of the representative bodies for small investors are not well organized or competent. It may be neces-

sary to construct—and conceivably to fund—a mechanism to articulate investors' views. FSA established and supports a consumer panel, constructed through open advertisement, which acts as a sounding board on the development of regulatory policy. There was also a practitioner panel, with the same function, but not funded by the regulator. A similar panel structure is now in place at the European level.

What to Communicate?

The message delivered to different stakeholder groups must, of course, be consistent. But different groups have different needs and interests. Firms are interested in regulatory cost, especially if—as in the United Kingdom—they pay directly for regulation. They also want to understand the details of the enforcement process, any appeal mechanisms, and the organizational structure of the regulator. Investors are less interested in those aspects and more concerned about securing a rapid response to perceived problems and receiving personalized advice (which it will be hard for the regulator to provide).

The key starting point is to explain the reasonable expectations that both sides may have of the regime and the limitations on what can be achieved. Otherwise any mis-selling, and any corporate failure in a financial firm, will be seen as a failure of regulation.

In the United Kingdom, FSA developed a series of communications under the general heading of “explaining the reasons for a non-zero failure regime.” This has attracted some support in political circles and in the media, although the campaign has been only partially successful in setting realistic expectations.

How to Measure Success in Stakeholder Communications?

It is important to build in some criteria for success and some feedback mechanisms. External surveys may help (as they have in London), but they are no substitute for a focused mechanism asking the questions of particular interest to the regulator.

FSA's practitioner panel carries out regular surveys of the opinions of financial firms on the regulator and the regulatory environment, informed by in-depth discussions with a sample of firms at the outset. They do not always make comfortable reading but are nonetheless valuable, especially to top management.

In the case of consumers, measures of success are more difficult to define, but nonetheless possible. FSA's consumer panel carries out research on, for example, prompted and unprompted awareness of the regulator. It also carries out research on the extent to which the communications put out by FSA are understood by consumers and are having an impact on their behavior or on the behavior of regulated firms. These measures will become more useful as a time series of data emerges.

Lastly, a regulator needs to be aware of the risks of communication overload. While consultation is extremely useful, it is possible to consult too much, and one criticism is that FSA has erred in that direction. Striking a balance, and being selective, is therefore also important.

Chapter 7

Keynote Addresses from the Conference

Integrated Regulation in the United Kingdom and the Lessons for Others

Howard Davies

The World Bank invited me to share what the Financial Services Authority (FSA) has achieved in London over the last five years. I first describe what the reform program entailed in practice, since this is not always well understood overseas, and I then address the possible lessons for other countries contemplating regulatory reform.

Creation of the Financial Services Authority

Why did the new Labour government in 1997 decide on this change? It seemed an unusual priority for an incoming center-left government after almost 20 years in opposition.

Some incorrect analyses of the reasons have been offered, particularly by those who feel threatened by our reform. It is sometimes suggested that the government announced the change because of the failures of the previous regime, particularly the so-called Bank of England failures in relation to

BCCI and Barings. Two things are wrong with that analysis. First, there was no failure in relation to Barings. Indeed, most bank supervisors around the world think that the Bank of England's decision not to rescue Barings was excellent and strengthened financial market discipline everywhere.

But, second, the government's main concern was not, in fact, with regulation at all. What government wanted was an independent Bank of England to run monetary policy, unencumbered by preoccupations with financial regulation that would distract it from its task and possibly create the opportunity for collateral damage when problems arise—as happens in financial markets. The other leg of the argument is related to the changing shape of Britain's financial sector and particularly the creation of multifunctional firms that the previous regulatory system was ill equipped to handle.

The second key point to note about the British reform program, which is too little understood elsewhere, is that it also involved an overhaul of the whole legislative underpinning of financial regulation. All the previous statutes—the Banking Acts, the Insurance Act, and so forth—were replaced by a single statute, the Financial Services and Markets Act. That statute gave FSA a single set of objectives and a single set of powers. Without one piece of legislation, it is extremely difficult to operate an integrated regulator effectively.

The third aspect is, of course, that 10 agencies were merged into one, with one or two more to come, in fact. That was quite a significant piece of institutional engineering.

The agencies concerned covered banking, insurance, and securities. But FSA also took on the listing function of the stock exchange and a number of other aspects of regulation, including building societies, small friendly societies (as they are oddly called in England), and other flora and fauna of the

financial sector. In total, it amounted to around 12,000 financial firms, with oversight of many other listed companies through the listing rules.

A further point to make is that FSA has broad responsibilities for regulation. It is both a regulator and a supervisor, for example. The act is a piece of framework legislation, with much authority delegated to FSA to make rules in line with its statutory objectives.

Also, FSA is fully responsible for authorizing all financial firms. In some countries, the authorization decision is made by the finance ministry on advice from the regulator. In the case of FSA, the decision rests with the regulator itself.

And FSA also prosecutes the offenses it identifies. It can bring action for regulatory breaches, or it can bring either civil or criminal prosecutions. This is an important feature of the regime, which allows rational decisions on how to prosecute offenses, without worrying about institutional boundaries and turf wars between agencies.

That was the substance of the reform. How successful has it been in operation?

How Successful Has FSA Been?

The first point to make, which is particularly relevant to practitioners of regulation, is that the new regime does, technically speaking, work. This could not be taken for granted at the outset. And the transition was achieved without any major upsets. We never stopped regulating while we built the new organization, and we managed to keep up a good level of service throughout. One important reason for this is that we were quite well funded. FSA is funded entirely by contributions from the market, and market participants are much

more sensible than governments about the need to pay properly for regulation and to allow a bit of financial flexibility in a period of transition.

The second point is that the issue of whether or not to have a single regulator is not remotely controversial in London and was not particularly controversial at the outset. The market, and almost all commentators, almost immediately accepted the logic of the change, the principle was supported by all political parties, and the prospect of reassessment is remote. The government undertook to carry out a two-year review of the legislation, which is happening now. The reviewers have consulted widely and received the almost unanimous response that no change should be made to the legislation or the institutional structure.

The third point is that relations with the Bank of England have been excellent throughout. The respective roles of the two institutions were well defined at the outset, which has helped a lot. I raise the issue of central bank as regulator again later on.

The fourth point is that successive surveys have shown that financial firms like integrated regulation. The most significant survey was carried out by an independent think tank, the Centre for the Study of Financial Innovation, in July 2003. A series of questions were put to 300 international firms located in Frankfurt, London, New York, and Paris. In the summary of their conclusions, the authors noted “the high regard in which the FSA is held” and said they were “impressed with the FSA’s standing in the eyes of practitioners” and that “the FSA’s clearly doing something right”; it also appears to be right in putting regulatory competence ahead of a light regulatory touch. “The London brand” has a lot to do with the perceived competence of U.K. regulators, they noted.

To give you the detail, they think there are six key competitive factors for a financial center, including a pool of skilled labor and a decent living and working environment, for example. Two of the six factors relate to regulation, where they identify two complementary dimensions, what they called a competent regulator, on the one hand, and a light regulatory touch, on the other. Their conclusion is that “London comes in a length ahead of New York on the confidence of its regulator, reflecting well on both the quality and the integrated structure of the FSA.” London is also the clear leader in terms of the lightness of its regulatory touch.

Furthermore, looking forward, firms were asked which financial center they thought would have the best regulatory environment in five years. Of those asked, 148 firms thought it would be London, compared to 97 for New York, 20 for Paris, and 17 for Frankfurt. The reason behind this strong vote of confidence in London is the presence of a single regulator. Those who believed that having a single regulator is a big advantage for London outweighed those who disagreed by 174 to 31. So if the goal is to create a competitive environment for financial firms, then integrated regulation is clearly the way to go.

But what about investor protection and the attitude of consumers of financial services? Here the answer is more shaded. A BBC survey produced a strong conclusion that people think a single regulator makes them feel more confident about their savings and investments. Yet some consumer groups do not like the fact that an integrated regulator internalizes decisions about the balance between consumer protection and financial stability. Overall, though, investors and their representatives have found an integrated regulator to be easier to deal with and more effective in the defense of their interests.

So the introduction of the FSA looks to have been outstandingly successful, which, of course, leads to the key question examined in this conference. Can this model be extended sensibly and safely elsewhere to general benefit?

It is fashionable in such gatherings to say that no one model of financial regulation is clearly preferable to all others, that all kinds of regulatory systems can be made to work well, and that individual countries need to take their own particular circumstances into account in deciding which way to go. When I was at FSA, I used to adopt this line in order to be polite to regulators in other countries with whom we did business. However, I do not believe it. And although some diversified regulatory systems work reasonably well, this is in spite of their organizational design rather than because of it. Overall, as long as some important preconditions are met, many other countries would benefit from a radical simplification of their structures.

The Case for Integrated Regulation

This section offers a quick rundown of the main reasons why it makes sense to merge regulators and then a brief review and rebuttal of some of the arguments against integration.

The four arguments for regulatory integration are relatively simple to set out. First, regulation should follow market changes, rather than the reverse, and market developments in most countries point strongly toward integration. Banks own insurance companies, insurance companies open banks, and both of them transact securities business either directly or through fund management subsidiaries. Furthermore, banks and insurance companies do considerable business with each other through the derivatives markets, and risk is transferred back and forth between one and the other.

In these circumstances, if a regulator wants to get a good understanding of the total risk profile of a multifunctional business, then it is much easier to do so within one institution. And it is very hard to understand what is going on in the credit markets unless you have oversight of banks, insurance, and the markets through which they transact business with each other.

So where financial institutions are allowed to cross sectoral boundaries, the case for integrated regulation is enormously strong. Where there are legal restrictions on such cross-sectoral activity, the argument is considerably weaker. A country that maintains separation between businesses along the lines of Glass-Steagall would not gain the same benefits from regulatory integration as one that, like the United Kingdom, allows cross-border activity.

The second, and related, argument is that there are significant synergies or economies of scope between different functional areas of regulation. As David Llewellyn argues in his paper, a single agency should, in principle, avoid problems of competitive inequality, should allow similar products to be regulated and supervised in a consistent manner, and should allow the same risks to be handled, for capital purposes, in a consistent way. These advantages do not arise automatically. They need to be worked for even within a single agency, but U.K. experience shows that they are certainly available.

And these economies of scope also apply to skills. High-quality regulatory skills are in short supply everywhere. A single regulator allows those skills to be deployed most effectively. There are considerable opportunities for individuals to work across sectors, and many of the skills needed for regulation are common.

The third advantage is that a single regulator offers economies of scale. The skill point is relevant here, too, but there are many other opportunities for the economic use of resources: one financial system, one human resources department, even one chairman! But also, more significantly, one authorization department, a single enforcement division handling cases of all kinds, and a single policy division, or whatever one calls that essential function.

Fourth, and last, a single regulator facilitates international cooperation, which is increasingly important in an interdependent financial world.

As a general point, we all know that achieving a good global understanding of financial problems, and a consistent approach to regulatory problems across the world, is the major challenge we all face. How much more difficult is that challenge when we need to involve a handful or more of regulators in each country? The problems of coordination and consistency are magnified many times.

The Case Against Integration and Why It Is Wrong

Those are the main positive points in favor. Now, what of the arguments advanced against? How powerful are they in practice?

When I was still chairman of FSA, I would not have entered this difficult territory. But, in inviting an academic—by definition someone without practical responsibilities—the World Bank took the risk of some provocation. And I would not wish to disappoint. Based on my practical experience, most of the arguments advanced against integrated regulation can be easily dismissed. You would not thank me for addressing every single point made, so let me deal with five

major concerns, which are covered, one way or another, in David Llewellyn's paper.

Overly Bureaucratic?

First, there is the argument that a mega regulator will become too bureaucratic. Of course, this is a risk. It is a risk with any public authority. But it is no more of a risk with an integrated regulator than with any other. It is, in any event, possible to exaggerate the size argument. FSA, which supervises the whole of the London financial system, employs around 2,200 people. The Bundesbank and the Banque de France employ around 15,000 each. The Securities and Exchange Commission, a functional regulator, employs around 4,000 people and rising.

There is no academic evidence to suggest a clear linear relationship between size and efficiency. There are some extremely efficient, very large companies and some extremely inefficient, very small ones. This argument, therefore, is a debating point, at best.

A second argument, which is run sometimes in parallel, is that a single regulator would be too powerful.

Overly Powerful?

Those who argue that central banks should be both wholly independent in monetary policy terms and also regulators of large parts of the financial system do not typically think the argument applies to them. But, for some reason, it is thought to apply to a financial regulator outside the central bank, even one operating within a well-defined statutory framework.

In fact, there is a risk in this area, but I regard it more as a problem of inflated expectations than of excessive concentration of power. It is true that a single regulator will become better known and will appear to be more powerful than the entities it replaces. That is an inevitable consequence of unification. But, of course, breadth does not necessarily mean an excessive concentration of power. Indeed, in some respects FSA is more constrained in the exercise of its disciplinary powers than its predecessors, but that is not the way it appears to the market. So, if you merge regulators, it is important to ensure that people have a good understanding of what a regulator can and cannot do. That is an issue in any regulatory system, however structured, and is not a point that applies only to integrated regulation.

Loss of Specialist Expertise?

A third argument, which David Llewellyn summarizes, is that an integrated regulator may lose some elements of specialist expertise and may become too remote from the particular circumstances of individual sectors.

It follows from the arguments advanced in favor of integrated regulation that one should attempt to achieve cross-fertilization and to ensure that scarce skills are applied in the areas of greatest need. In turn, it follows that one should work to reduce compartmentalization. There is a powerful logic for doing so given the way the market is changing. So some of the specializations will be challenged, and that is a good, rather than a bad, thing. But, of course, one needs to retain people with industry expertise, and you will find people with that expertise within the Financial Services Authority and within other integrated regulators, too. There is noth-

ing in the integrated regulation model that requires you to lose expertise; it is a matter of choice as to how you organize internally. So while this is a risk one has to take into account, I do not see it as a decisive argument.

Conflict between Prudential and Conduct-of-Business Regulation?

A third set of arguments is sometimes advanced—often, but not always, by central banks—to the effect that within a single regulator there is a necessary conflict between prudential and conduct-of-business regulation. Those who are strongly attached to consumer protection believe that this means that integration will diminish the importance given to consumer issues. Those who attach a higher weight to financial stability believe that there is a risk that consumer protection will come to dominate. In my view these arguments display seriously muddled thinking.

We might begin by asking what financial stability is for. In my view, it is not a platonic ideal, unrelated to the circumstances of individual savers and investors. The reason we want financial stability is so that individuals' money will hold its value and be reasonably secure and so that rational economic decisions can be made, which will promote investment and growth in the long run. Financial stability itself is a route to consumer protection. So the aims of prudential regulation and conduct-of-business regulation are one and the same. They are both different routes toward protecting the savings of individuals.

Sometimes these two routes may appear to diverge. The aggressive pursuit of consumer protection for a particular group of investors may result in serious financial problems

for a firm and could even bring it down. That is clearly much more of a risk in regimes where the consumer protection regulator is not obliged to take account of financial stability issues. In the case of a single regulator, and particularly one that is responsible for financial stability as well, it is possible to reach a balanced view when this conflict arises and to determine a rational way through.

The United Kingdom has faced this kind of choice in practice. For example, FSA inherited a historical problem of mis-selling personal pensions and, indeed, what are known as endowment mortgages, whereby a life insurance policy is taken out to repay a mortgage at the end of its term. Given the recent performance of the stock market, many of these policies will not pay out as hoped. And in many cases, it is clear that the individual investors did not understand the risks they were running. A consumer protection regulator that did not have an eye to the stability of the industry as a whole could have taken an unduly aggressive line in promoting compensation, which would have been hugely costly for the industry and almost certainly would have resulted in the failure of a number of firms, with adverse consequences for their policyholders and, indeed, for the insurance sector as a whole.

Reaching a balancing decision is rarely popular. Individual mis-sold investors want the maximum redress for themselves and cannot easily see the systemic consequences of pressing their case to the limit. A kind of “tragedy of the commons” argument is embedded here. But it is easier to reach a decision that is rational for society as a whole if the regulator is able to balance the twin objectives of financial stability and consumer protection than if those objectives are in the hands of different agencies.

So I would turn this argument on its head. It is one of the best supporting arguments for integrated regulation that there is.

The Central Bank Problem?

Last, and most controversial, is the central banking problem. It is quite clear that central banks around the world regard the move toward integrated regulation with the greatest of concern. A traditional central banking function is being taken away. Few countries that have moved toward integrated regulation have chosen to keep all the functions within the central bank, although there are one or two examples where central banks have gained new responsibilities as a result of regulatory consolidation: in the Netherlands, for example, and in a somewhat different way in Ireland. Those examples are, however, significantly outweighed by the number of countries in which central banks have lost banking supervision, as the Bank of England did in the United Kingdom.

I have been on both sides of this argument. When I was deputy governor of the Bank of England, I argued in favor of retaining banking supervision responsibilities and therefore can understand the motivations of central banks. Those motivations are particularly strong in the euro zone, where national central banks have lost their prime monetary policy function and are understandably nervous about losing the second major leg of their remit.

But having reflected long and hard on the issue, I find the arguments advanced by central banks to have little merit. First, there is the skills argument. As a practical matter, it had become extremely difficult within the Bank of England to move staff between the monetary policy and banking su-

pervision functions. The level of expertise required to be effective in the monetary analysis area of the bank has risen sharply over the last two decades. Similarly, the days of the amateur banking supervisor are over. It was almost impossible to move any but the most junior staff around the institution. Indeed, when we separated the functions, around 450 people moved from the bank to FSA. We offered those who felt they were on the wrong side of this divide and believed that their career lay either in monetary policy, if they were in the supervision bits of the bank, or vice versa, the opportunity to jump over the wall. In practice around 20 people did so, about the same number in either direction. The two sections of the bank had clearly grown apart. In contrast, within an integrated regulator, there has been a huge amount of movement between divisions. The needed mix of skills and the cultural attitudes are very similar in different parts of FSA. Supervisors have shown themselves to be enormously adaptable to work in different sectors.

But there are two other issues to deal with: the link with monetary policy and the lender-of-last-resort function. In the past, I would accept that the link between banking supervision and monetary policy was at times quite close. In the days when, in the United Kingdom, we attempted to control monetary growth through direct quantitative restrictions on the growth of bank lending, there was a strong argument for linking the two. But we do not operate monetary policy that way, and indeed few, if any, developed countries do so now. (There may well be developing countries that operate in this way, and for them the arguments may look different.)

In a system in which the prime tool of monetary policy is the interest rate, and when banking supervision is about the prudential soundness of some institutions and consum-

er protection, and not about the control of monetary aggregates, then the link between monetary policy and banking supervision is tenuous. Indeed, as a practical matter, the contacts between the Bank of England and FSA on this point have been very few and far between. I can scarcely remember a discussion on the subject in six and half years. Of course, the formulation of monetary policy does require an understanding of what is going on in the banking system and the financial system more generally. That can be achieved by looking at aggregate data. It does not require oversight of individual institutions.

I would add that integrated regulation has been an advantage to the Bank of England rather than the reverse. In the past, the bank had privileged access to banking supervisors, but no structural relationship with other financial regulators. And under the FSA regime, there are both a memorandum of understanding and an open gateway for information about all parts of the financial sector, something that the Bank of England has used effectively. So I would turn this argument on its head. Integrated regulation is an advantage for a central bank in its other functions, not the reverse.

It is important, in this context, to have a good understanding of the respective roles. We spent a lot of time arguing through our memorandum of understanding right at the start, and it has proved to be a robust basis for a constructive relationship. The Bank of England is responsible for the financial stability of the system as a whole, but that responsibility is paralleled by FSA's responsibility for market confidence; the potential tensions between financial stability and consumer activism are internalized within FSA, not across the frontier with the Bank of England. Many analysts of our system have entirely missed this important point.

But what of the lender-of-last-resort function? This issue is also explicitly addressed in our memorandum of understanding, which clearly sets out the respective roles of the central bank, the regulator, and the treasury (Ministry of Finance). It is very important to include that third leg, since, of course, solvency support for a failing institution ultimately can only come from the public purse. The central bank may be a channel for such support, but it is not the origin of it. Even central banks with large seigniorage income of their own are spending public money when they offer solvency support, since the seigniorage income they hand over to the government is thereby reduced.

The U.K. model allows the Bank of England to provide liquidity support on its own initiative, in consultation with FSA, if necessary. And, indeed, it could step in with solvency support, but only if it notifies the treasury of its intention to do so, which would give the treasury the opportunity to decline to support such a venture, if it wished.

This memorandum of understanding is underpinned by a tripartite committee. That committee technically includes the chancellor, the governor, and the chairman of FSA, and it did not meet during my term of office. At the deputy level, however, meetings were frequently held to monitor threats to financial stability from wherever they might come. In a highly international financial center like London, one is mainly looking at possible repercussions of events overseas. This tripartite arrangement provides for a most comprehensive and thorough assessment of risks to financial stability, bringing together the needed expertise of the Ministry of Finance, the central bank, and the regulator. Within such a framework, there is absolutely no advantage in keeping banking supervision in the central

bank, since one would also need to include regulators of other parts of the financial sector as well. The days when systemic risk could arise only in the banking system are long gone.

Indeed, embedded in these arrangements is a further argument for separating the lender-of-last-resort function from the day-to-day business of supervision. When it reformed the arrangements in the United Kingdom, the government took the view that there was a positive advantage in separation, since if the lender of last resort was also the supervisor, there might be a temptation to provide public sector support for a failing institution, in order to avoid embarrassing questions about why the supervisor did not act sooner to head off the failure. The government therefore saw a virtue in requiring the supervisor to assess the need for support and the Bank of England to confirm that, if it wished.

It is quite possible that a circumstance could arise in which the supervisor wanted to provide support, but the central bank declined on the grounds that the issue was not properly systemic. This imposes an important element of discipline on the supervisor and also makes it absolutely clear to the market that public support will not easily be forthcoming. All this is spelled out in the memorandum of understanding so that, in the event of support being forthcoming, Parliament could require both the governor and the chairman of FSA to explain the views they took on the need for it. The fact that this could happen is a further stimulus to close relationships between the two institutions. These are buttressed by cross-membership at the board level as well as many working links.

Once again, far from thinking that the separation of supervision from lender of last resort creates risk that needs to

be managed, I take the view that it improves the operation of the system and adds helpful disciplines within it.

The Preconditions for Success

So would I, therefore, advise all countries to move immediately to integrated regulation? Not quite. As I have mentioned on my way through this analysis, there are some preconditions, before it makes sense.

First, if there are other legal restrictions on cross-sectoral financial business—in other words, if banks are not allowed to transact securities business—then clearly the case for integrated regulation is somewhat reduced.

Second, and perhaps a more important point, it is absolutely crucial for a regulator to have an appropriate degree of political independence. This is a point that both the International Monetary Fund and the World Bank are making strongly in their assessments around the world. There are countries in which the political system makes it quite difficult to create new institutions with a high degree of independence from the government or the party in power. In those circumstances, the central bank may be the most appropriate agency to carry out these important functions, if it has a reasonable degree of independence itself, as is often, though not always, the case.

Lastly, I come back to where I started. Integrated regulation is not just about merging agencies and changing the letterhead and the business cards. An integrated regulator attempting to operate a series of sectorally based pieces of legislation will not be effective in delivering the full potential benefits from merger. So it is best not to embark on such an exercise unless you plan to do it properly and to realign the powers and legislative supports of the agency.

These preconditions will rule some countries out of this movement for a while, at least. But integrated regulation is a growing trend. The number of countries that make this move is growing every year, and the ranks of the conference of integrated regulators, which has met annually for the last six years, continue to grow. I expect more countries to join as time goes on. This is an idea whose moment has arrived.

Implementing an Integrated Supervisor in Estonia: Lessons Learned

Andres Trink

The topic of this conference—aligning supervisory structures with country needs—reflects an ongoing search in a number of countries for an optimum balance of supervision and regulation, a balance that can be established in various forms, that is often hard to find, but that is definitely worth pursuing.

The Financial Supervision Authority (FSA) in Estonia—an integrated mega supervisor—has been in business for almost two years now. It took us about three years from the initial idea to agree on the appropriate institutional framework and draft the respective legislation. Then we had about six months to carry out the practical steps for implementing the merger. And now, after the first two years of operations under the new structure, we are starting to move from the transitional post-merger phase to a more long-term, strategic, and capacity-building stage of development. But we are not there yet. It is fair to say that most supervisors who have experienced a similar institutional change have seen that it

takes years to get comfortable under the new model and fully understand its opportunities as well as handicaps, no matter which institutional model has been chosen. But this does not mean that those choices should not be made.

When I prepared these remarks, I revisited the statement that I made at the Conference on the Challenges for the Unified Financial Supervision in the New Millennium that was held in Estonia in July 2001. In that statement, six months before our FSA was launched, I highlighted four main expectations for our unified supervisor, reflecting the key objectives of our institutional reform:

- First, we expected the unified agency to be better able to supervise universal banking groups. That was and still is important to us since our financial sector is very much dominated by universal banks active in all main segments of financial services.
- Second, we wanted to be better placed to attract qualified staff and other resources to guarantee an equal level of supervision in banking, securities, and insurance sectors.
- Third, we expected the new FSA to have more authority and independence in order to be more effective in carrying out supervision.
- Fourth, we wanted FSA to be better placed to prevent regulatory arbitrage.
- And clearly, the merger in our case was driven by the fact that we are a very small country where economies of scale and scope are hard to find. We also looked at the global trend for integration.

So the question is, What kind of preliminary conclusions can we make about the decision to merge? Were we

right, or were we wrong? And admitting that we will never know what would have happened in case of an alternative decision, the main conclusion, at least for now, is that all main expectations for the merger have been met to a greater degree than many people initially thought possible. Whether this is a good enough benchmark is, of course, yet to be determined. It clearly is too early to make any more affirmative conclusions.

So let me speculate briefly about how the future would have looked if we had failed to make the transition to FSA.

Under the previous structure of separate agencies, we probably would have had more duplication of resources and less efficient coordination between agencies than we do now within a single FSA.

Managing the seemingly conflicting objectives of conduct-of-business and prudential supervision, at least in our case, probably would have been even more difficult among the various agencies than it is within FSA. So far, we have done a pretty good job of making sure that the interests of depositors, the insured, and investors are protected in a balanced way and that our actions are sufficiently explained to outside constituencies.

As our FSA is fully funded by supervised firms, we are more competitive in the skill market than we would have been under the previous model; such resource limitations might have compromised the quality of supervision. I also believe that it is not just the level of funding that matters; the funding model is also an important factor in making the cost of supervision more transparent and improving the accountability of the supervisor. Funding by the market also forces the supervisor to be competitive vis-à-vis other—namely foreign—supervisory agencies, as financial services firms in-

creasingly seem to be looking for the optimum regime of supervision in terms of effectiveness and efficiency. Therefore, one could even argue that, in this debate about the cost and price of regulation, in fact, a relative price tag for supervision does exist, at least in theory.

Interagency coordination with policymakers such as the central bank, finance ministry, and other authorities would have been much more complex. Under the multiple-agency structure it probably would have been more difficult for us to achieve the same quality and degree of convergence in our financial services legislation and supervisory practices across the various segments of the financial sector than is the case today in Estonia. This is also an important factor in the overall convergence of regulation and supervision that is taking place in Europe.

But, more fundamentally, if we had not implemented the merger two years ago, we would be having much greater difficulty in the run-up to European Union membership, and we would have had more difficulty participating effectively in the process of building the common market for financial services in Europe.

However, it does not necessarily take a major institutional reform to improve the effectiveness and efficiency of supervision and regulation, as has been underlined on several occasions during this conference.

And whether our new structure will prove sustainable, effective, and efficient over a longer term will need to be tested over a longer period and in an environment of adverse developments—in fact, in a crisis that inevitably will occur sooner or later. We were quite fortunate that such developments did not happen during the active phase of the merger.

I will not go into detail about all the lessons we learned and mistakes we made in the process of the merger. To be sure, the merger and the building up of the new agency have taken considerable effort and have not been without challenges. Nevertheless, I would like to make a few points based on our own experience.

When contemplating a supervisory reform, many countries spend years discussing and disagreeing on the roles of the finance ministry and the central bank, on the powers and objectives of supervisory agencies, on who is the acquirer and who is to be acquired. We were certainly not an exception in this regard, although we succeeded in moving from talking to doing. These long periods of uncertainty can be quite dangerous, because they are distracting, may lower motivation of supervisory staff, and impose an unnecessary burden on resources of the supervisor. So timing and quick implementation are crucial.

Reforming the supervisory structure can succeed only if there is consensus among all the parties involved about what is the right way to do it and what is the role of the supervisor vis-à-vis other authorities. Reaching consensus is difficult, especially in countries with a short history of modern financial regulation and less prominent financial markets. Also important in this context is the existence of a good management team that is able to build such consensus and effectively communicate the objectives and the necessary steps to all stakeholders, including politicians, central bankers, ministry officials, supervised firms, and supervisory staff.

A structural model of supervision should not be considered in isolation from the overall institutional framework for financial regulation. At least in continental Europe, normally the ministry has a role in financial regulation, while

the central bank has an important role in banking regulation. For example, in our case, FSA does not have the authority to issue binding secondary legislation; the finance ministry plays this role in the area of insurance and securities, and the central bank plays it in the area of banking regulations. And even though the distinction between regulation and supervision is becoming increasingly blurred, the effectiveness and efficiency of the supervisory structure depends on the overall institutional framework, not just the portfolio and structure of the supervisor itself. The supervisor has to take an active role in the regulatory process and strive for close cooperation and smooth exchange of information between the central bank, the ministry, and other authorities to build a culture of public sector cooperation. The memorandums of understanding that many countries, including Estonia, have put in place for such cooperation are helpful, but more important is the inherent willingness of people to work together and share information. As a single supervisor, we are better positioned to do this.

Finally, the issue of an optimal regulatory and supervisory structure will continue to evolve, not least in response to fast developments in the financial markets but also in the context of integrating Europe. As Europe becomes larger and more integrated, the issue of a pan-European supervisory structure is becoming increasingly important. It is probably going to be an important factor, among others, in determining whether a common market for financial services in Europe will or will not happen in the near future.

What we see today, particularly in the Nordic-Baltic region of Europe, is a deepening of branching of financial firms and an increase in cross-border financial services provision. In Estonia, for example, 95 percent of banking assets

are controlled by foreign banks; the same applies to insurance, investment services, and the stock exchange. The same is true in other Nordic and Baltic countries, where systemically important institutions are foreign owned and the focus of financial stability oversight is shifting across national borders. Systemic risks are increasingly moving across national boundaries, and this will inevitably have implications for the future institutional arrangements regarding supervision.

When looking at the level of integration of financial services groups in the Nordic-Baltic area, it is quite clear that the current mechanisms of cooperation and information sharing among supervisory agencies are rapidly becoming insufficient to deal with the spreading of risks from one country to another within large financial groups. As a point for discussion, there may even be a case for a regional—if not pan-European—supra national supervisor with at least a mandate for addressing cross-border issues of financial stability.

So the target for supervisors keeps moving, and it is moving fast. Let us therefore think out of the box and be ready to deal proactively with continuous change, to respond in a timely fashion to developments in the marketplace, so that we have the institutional mechanisms in place when needed.



Aligning Financial Supervisory Structures with Country Needs

Increasingly, governments have been asking themselves whether their current financial supervisory structure is appropriate for overseeing their quickly evolving financial sectors. Such financial sectors are often characterized by a brisk pace of innovation and by significant institutional changes, including the emergence of conglomerates offering a wide range of financial services. In response to these changes, governments are examining the options for aligning their supervisory agencies with the evolving financial sector.

This book adds value by synthesizing the range of views, setting out the frame of reference for assessing possible changes in supervisory structure, and offering a rich set of case studies elaborated by leading practitioners from around the world.



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