Regulatory and Supervisory Regimes for Financial Services

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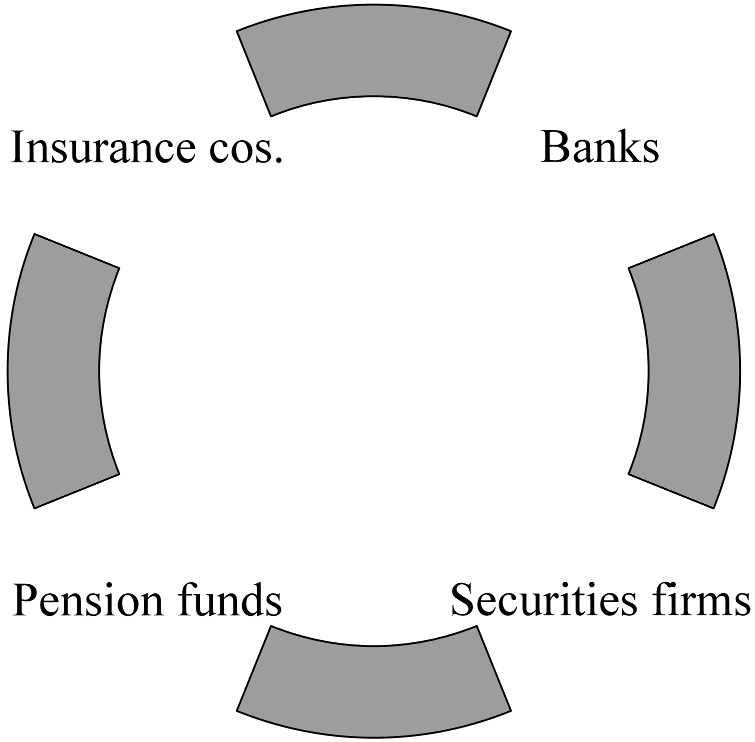
Design of regulatory and supervisory regimes for financial services

- Framework that ensures the safety of the financial system as a whole and allows other objectives of supervision to be attained efficiently and effectively
- Flexibility, adaptability both to changes in the business practices of regulated entities and in the structure of the financial system (including domestic and international components)
- Minimal competitive distortions

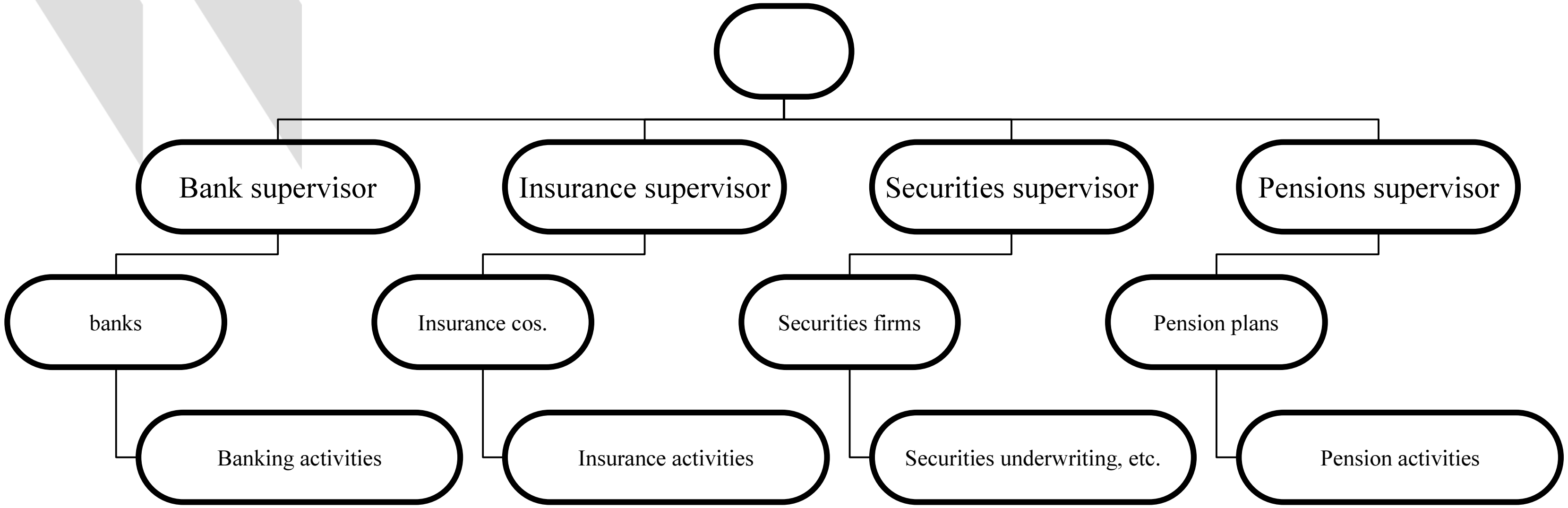
Design of regulatory and supervisory regimes (cont.)

- Is there an ideal regime?
- The range of supervisory regimes in practice would seem to suggest the answer is ‘no’
- Many alternative models exist and can be made to work effectively under normal circumstances
- Are all structures equally effective and efficient under all circumstances?
- Does the structure of a supervisory regime need to mirror the structure of the financial services industry it covers?

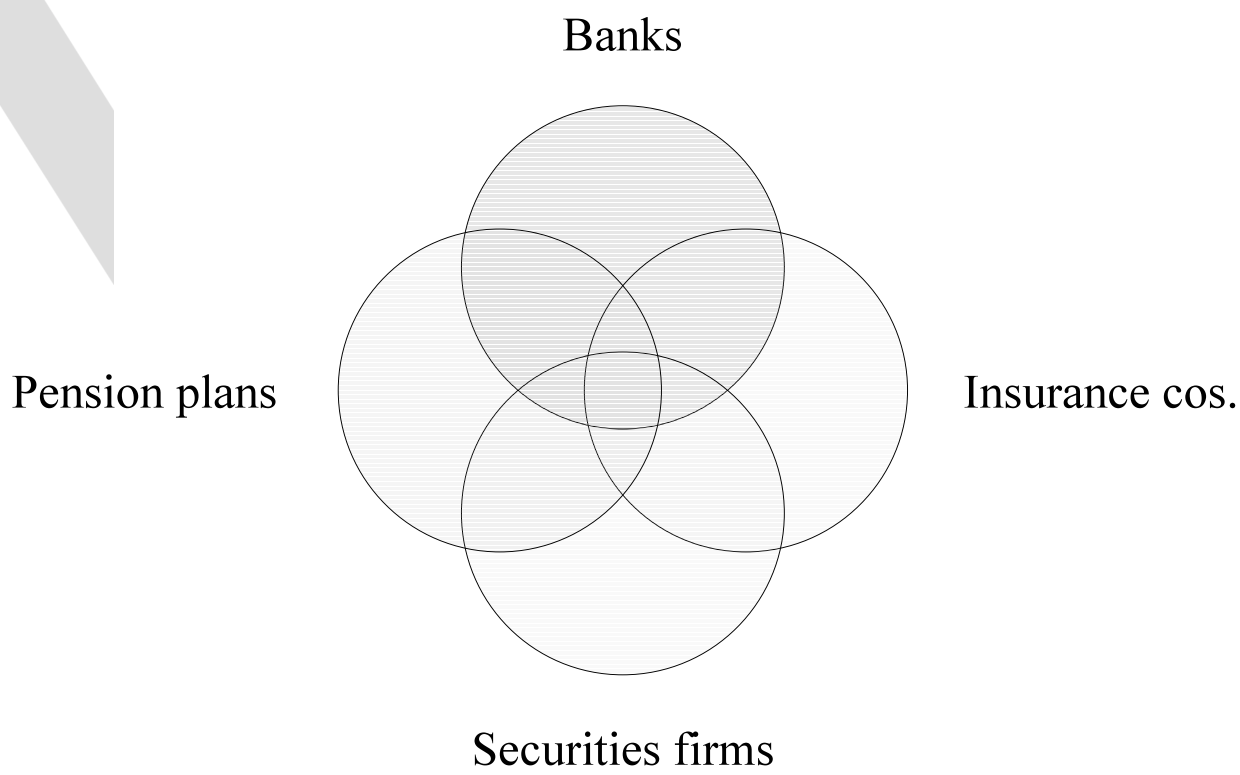
Hypothetical financial services sector with segregated service providers



Hypothetical model of financial supervision for segregated service providers



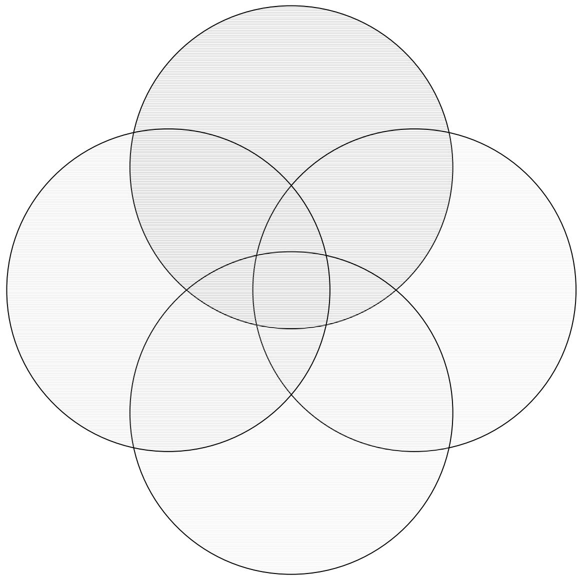
Hypothetical financial services sector with integrated service providers



Integrated financial services group

Banking activities

Pension plans



Insurance activities

Securities activities

Financial Convergence

Integrated (fully) financial services provider: pure financial conglomerate, combines the production <u>and</u> distribution of <u>all</u> financial products and services in a single corporate entity, with all activities supported by a single pool of capital

- Regulations governing the *production* of certain financial products and services often differ from those covering the *distribution* of products and services
- Cross-distribution is often allowed, as well as cross-investment (broadly speaking, including cross-creation of subsidiaries)
- But not cross-production (*e.g.* underwriting)

Financial Convergence

Types of convergence interfaces:

- cross-production
- cross-investment
- cross-distribution (e.g. *bancassurance* (*i.e*., bank cross-sells insurance products through its own distribution channels), *assurbanque* (insurer cross-sells banking products), *assurfinance* (insurer sells broader array of products), *allfinanz* (distribution across all major financial service sectors)
- tie-in sales
- provision of integrated services, e.g. “one-stop shopping”
- cross-sector risk transfers

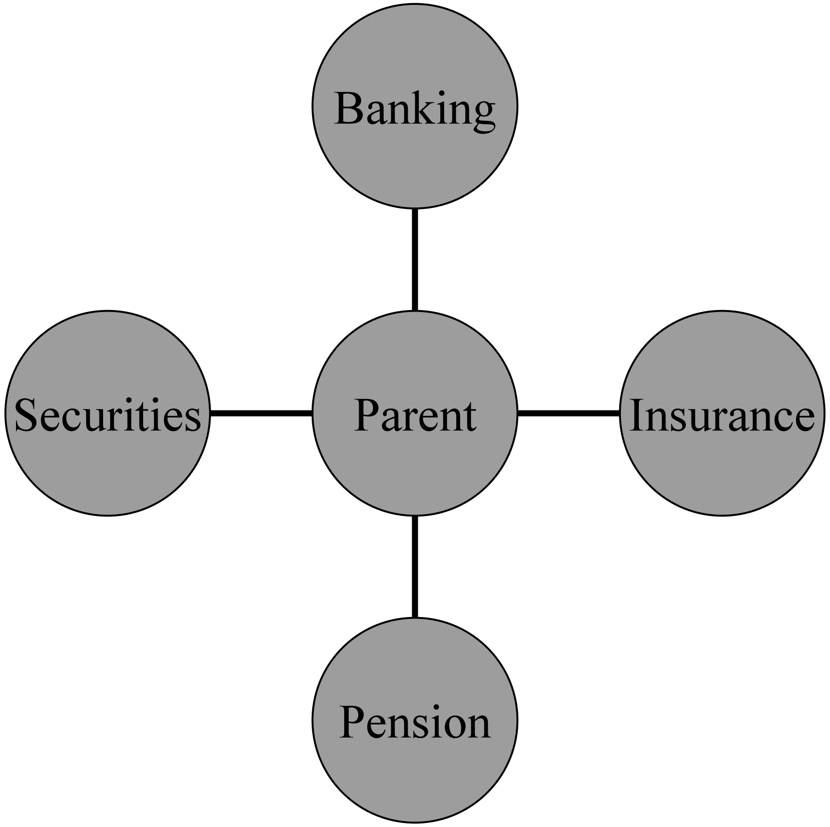
Formal structures for providing integrated financial services (cont.)

- Joint ventures
- Cross-shareholdings
- Distribution alliances

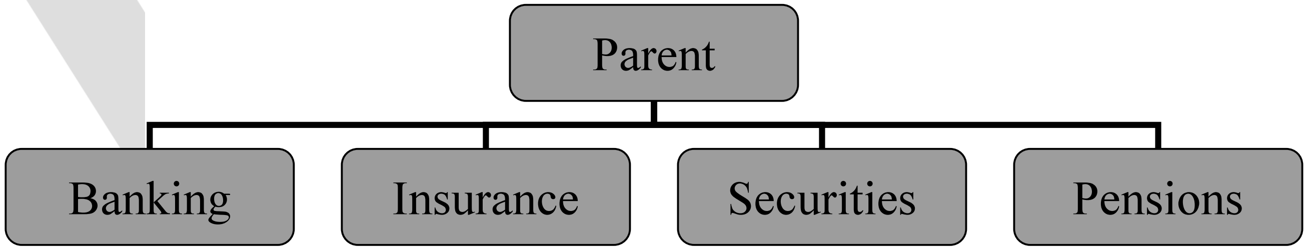
Formal structures for providing integrated financial services

- *Universal bank*: commercial banking and investment banking activities in one corporate entity, with other financial services, especially insurance, carried out in wholly owned but <u>separately capitalised</u> subsidiaries
- *Single bank* or *insurance parent*: conducts other financial service activities in separately capitalised subsidiaries
- *Financial holding company*: single holding company holds most or all of the shares of separately incorporated and capitalised subsidiaries

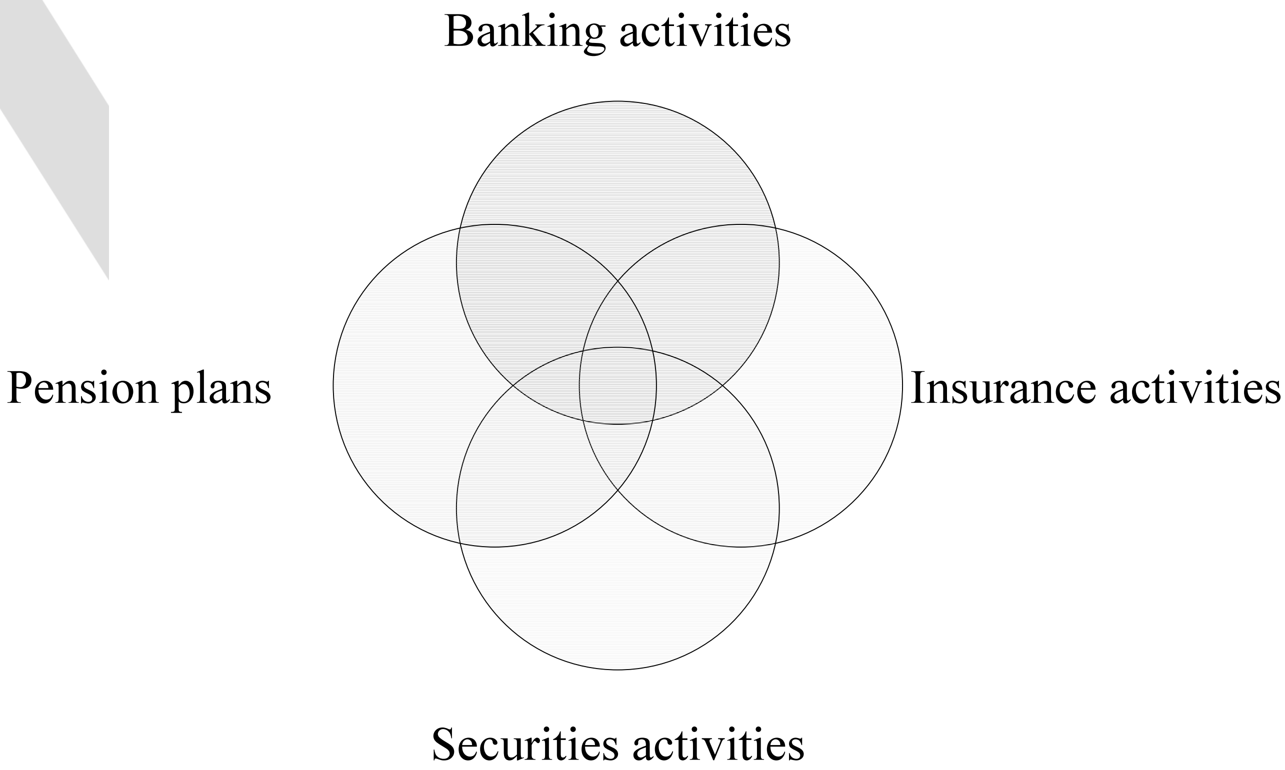
Model of an integrated financial services group with separate constituent entities



Integrated financial services group with separate constituent entities



Hypothetical fully integrated financial service provider



Potential risks associated with integrated financial services groups

As financial groups centralise their internal controls, risk assessment and management, it becomes more difficult to oversee them on a purely institutional/sectoral basis due to the increased complexity of the corporate structure and the inter-linkages therein. Monitoring of any firewalls becomes increasingly important, yet increasingly difficult.

- Lack of transparency stemming from complex intra-group exposures
- risk of contagion due to non-existent or ineffective firewalls
- risk of multiple gearing
- problems arising from unregulated group members
- potential for regulatory arbitrage

Implications of increased financial sector integration for supervision

The potential for intra-group exposures within integrated financial services groups complicates the task of supervision.

It increases the need for information sharing, co-ordination and co-operation among authorities (both domestic and international) with responsibility for different institutional components of a financial group to ensure that a group-wide risk assessment and oversight is achieved.

- risks can exist at the group level that do not appear at the level of individual entities
- individual entities can look risky while the entire organisation can be well-diversified or hedged.

Approaches to financial supervision

How do we supervise the group without losing sight of the differences among its constituent entities?

How do we take into account the particular characteristics of the members of the group while maintaining adequate oversight of the group in its entirety?

The rules that are applied to different types of financial service providers regarding their solvency, the types of assets they manage, and the management of their liabilities vary across countries

Supervision of financial services providers

Commercial banks:

- Basle Committee's core principles: "ensure that banks operate in a safe and sound manner and that they hold capital and reserves sufficient to support the risks that arise in their business".
- Bank supervision has sought to limit the chance that institutions become insolvent, but with a view toward ensuring the *stability of the system* as a whole rather than preserving individual banks. The focus is thus on the asset side of the balance sheet to ensure a proper valuation of those assets, based on " consolidated" reports of income and condition.

Supervision of financial services providers (cont.)

Life insurance companies:

- IAIS core principles: primary objective of insurance supervision is to “maintain efficient, fair, safe and stable insurance markets for the benefit and protection of policyholders”.
- Oversight has stressed the soundness of *individual* insurers to ensure the protection of policyholders and has focused on the liability side of insurers’ balance sheets

Supervision of financial services providers (cont.)

Securities firms:

- oversight has been oriented towards protection of customers and investors, via rules on disclosure, rules relating to capital and internal controls, rules concerning so-called “Chinese walls” and other conduct of business and trading considerations
- IOSCO’s core principles: 1) the protection of investors, 2) ensuring that markets are fair, efficient and transparent, and 3) the reduction of systemic risk.

Supervision of financial services providers (cont.)

Pension funds:

- structure of oversight regimes for pension schemes is quite complex, reflecting the variety of schemes in practise and the varied nature in which such schemes are financed and managed
- numerous distinctions must be drawn, *e.g.* between “private” versus “public” schemes
- 15 principles for the regulation of private occupational schemes have been endorsed by the INPRS and approved by the OECD

Methods of supervising financial groups

- “Solo” or “solo plus” approach--protect the customers and creditors of the regulated entity from monetary losses and delays were the institution to fail
- “Consolidated” approach--supervision is directed at the top tier of the group, covering all members that provide financial services

Consolidated regulation is generally accompanied by consolidated supervision, but sectoral regulation might or might not be accompanied by consolidated supervision.

What did that statement mean?

Definitions:

Regulation: establishment of specific rules of behaviour

Consolidated regulation: rules are the same across different categories of financial service providers (*e.g.*, level playing field)

Supervision: the more general oversight of institutions' activities

Consolidated supervision: oversight is directed at the parent or holding company covering all entities that provide financial services

Integrated: fully consolidated

Structure of financial supervisory agencies

What does the need for oversight of financial groups imply about the organisational structure of supervisory agencies?

Little: the existence of an ‘integrated’ supervisory authority is neither a necessary nor sufficient condition for consolidated supervision.

It is possible for independent, sector-based supervisory agencies to co-ordinate their activities to supervise institutions on a consolidated basis

It is possible for consolidated agencies to supervise institutions on a sector based or “ solo” basis

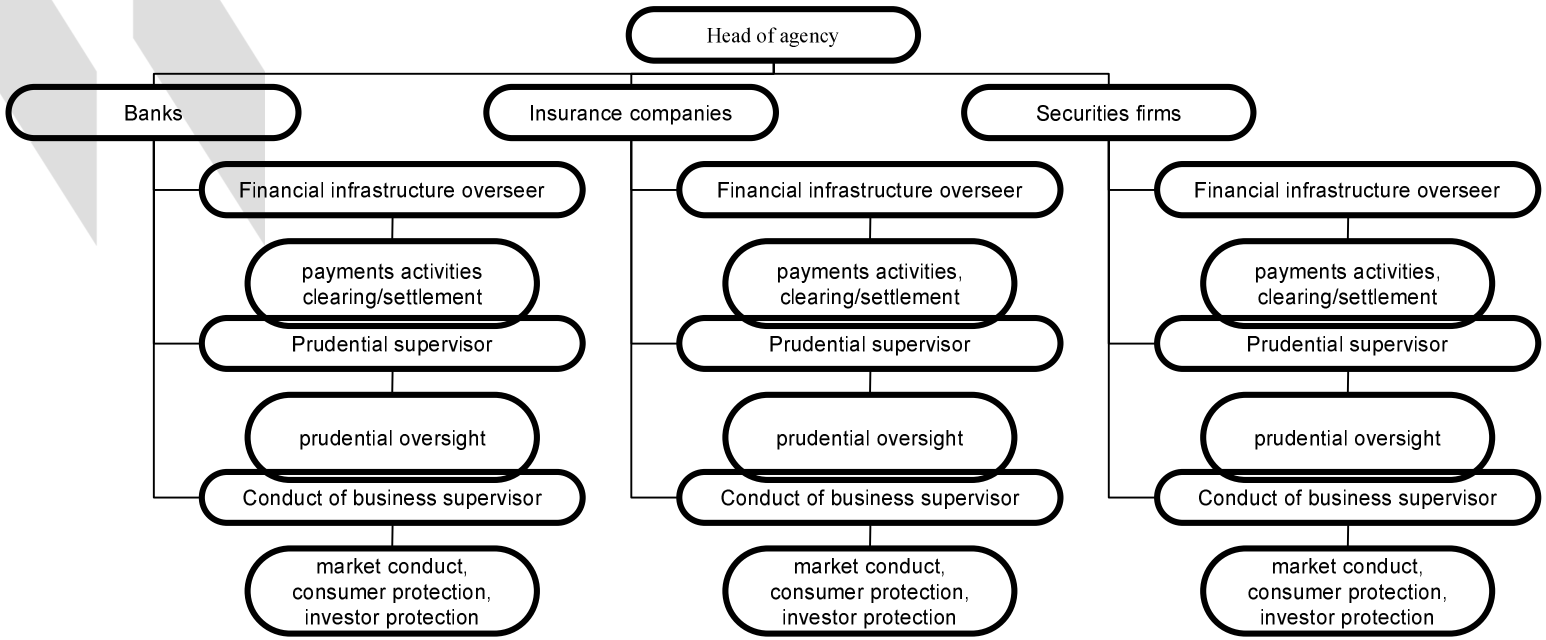
Structure of financial supervisory agencies (cont.)

The term “integrated” as applied to supervisory authorities in practice is not particularly well defined:

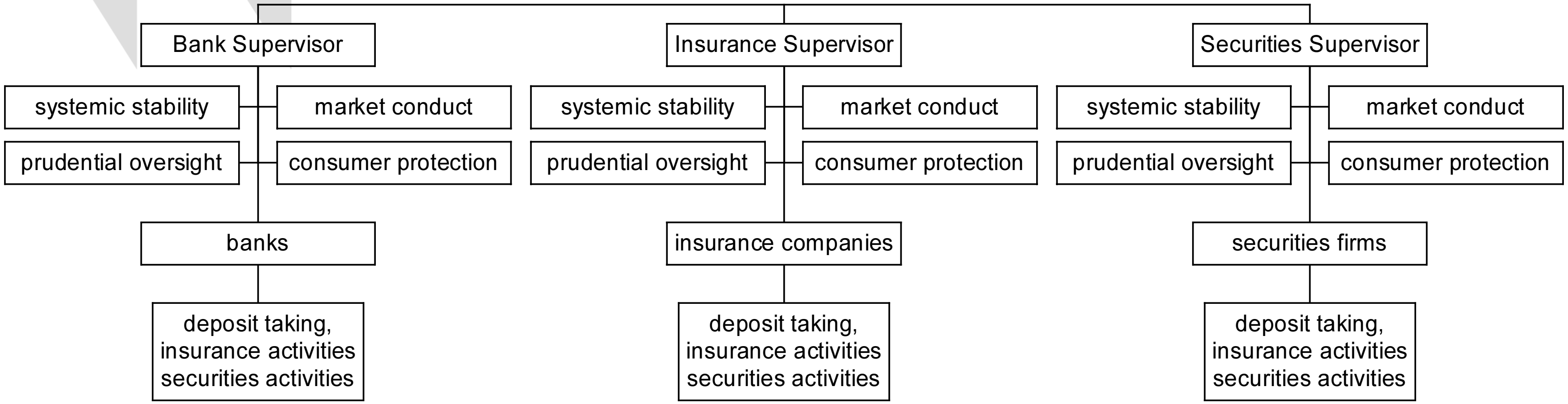
- Some jurisdictions have single supervisory authorities, but only for certain sectors (e.g. banking plus securities but not insurance, or insurance plus securities, but not banking)
- Some authorities are responsible <u>only</u> for *prudential oversight*, and then, not of all institutions.

A better label might be single-agency versus multiple agency regimes.

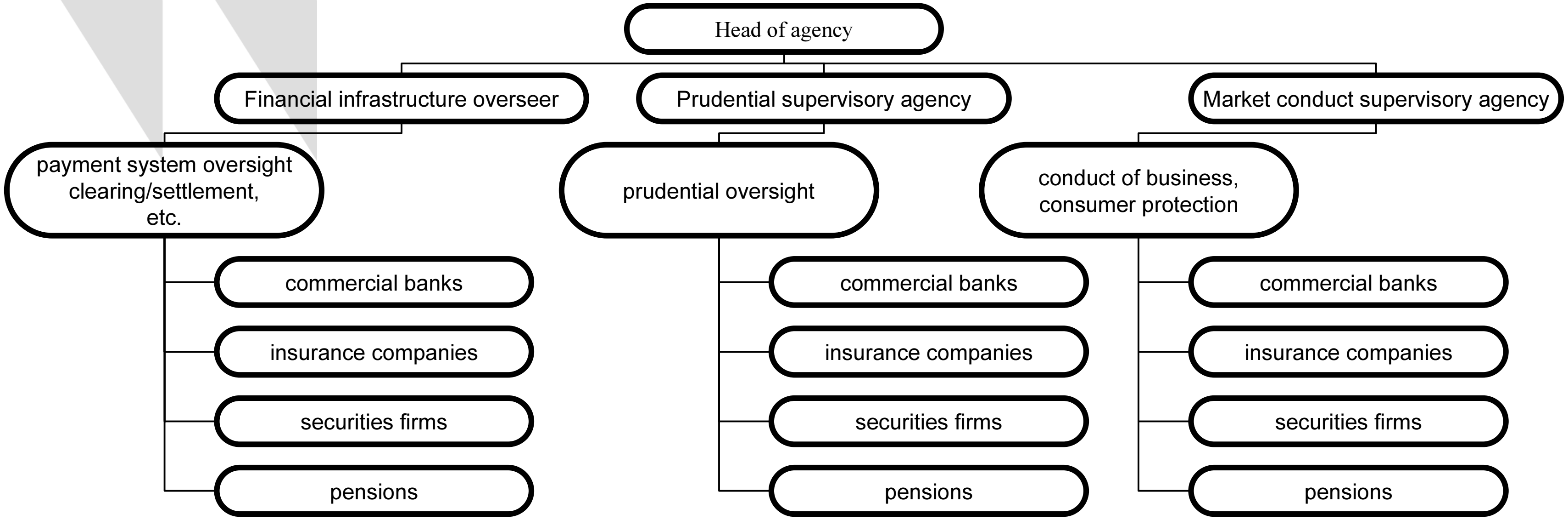
“Integrated” financial supervisory authority with sectoral oversight



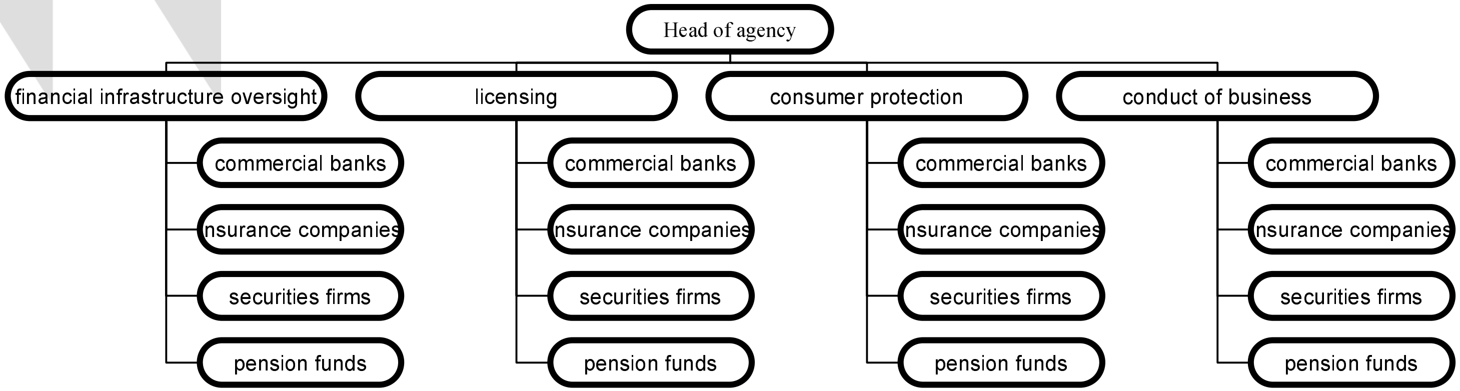
Financial supervisory authority with sectoral supervision



Model of financial supervisory agency with supervision by objectives



Model of financial supervisory agency with functional supervision



Which approach is best?

- The organisational structure of supervisory agencies and the conduct of supervision are separate concepts
- Which structure is chosen should depend on how best to achieve an efficient production of supervisory tasks, and also how to provide for the efficient production of financial services
- The increasing complexity of many modern financial products increases the need for specialist supervisors who understand the inherent risks. However, financial institutions have broadened their product ranges to include products that are functionally equivalent to those offered by other types of service providers, a development that calls for a more generalised knowledge base for supervisory personnel
- Structure must take into account country-specific characteristics such as the institutional set up and the degree of financial market integration
- Relevant criteria for assessing the efficiency of a supervisory regime include cost effectiveness, transparency, and accountability.