

**OECD/ADBI 7th Round Table on
Capital Market Reform in Asia**

**27-28 October 2005
ADB Institute, Tokyo, Japan**

SESSION 1: FINANCIAL POLICY LANDSCAPE

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Financial Sector Supervision: What We Have Learned So Far.

Paper prepared for the OECD Roundtable, Tokyo 27-8 October 2005

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This Round-table audience embodies more practical experience in the specific regulatory requirements of the securities sector than a former central banker can match. If I can make some contribution, it may be in two very disparate areas. The first one is quite micro – on the role of the “front-line” supervisor. The second is at a more macro level – to make the case that, for the emerging financial markets in East Asia, conventional (old-fashioned, if you like) industry-based supervision may be more appropriate than the current vogue for universal/unitary supervision of the financial sector as a whole.

The Role of the “Front-line” Regulator

Douglass North (2004) has observed: “Economists of the libertarian persuasion have for some time laboured under the delusion that there is something called laissez faire and that once there are in place “efficient” property rights and the rule of law, the economy will perform well without further adjustment”¹. Practitioners working in financial markets are aware of just how deeply embedded these markets are in rules, both formal and informal, of the type that North described as “institutions”: “humanely-devised constraints that structure human interaction”, and how vital it is to get the right rules (and avoid having too many rules). Practitioners are aware, too, that it makes good sense if these rules are seen as layers which are imposed and administered by a variety of authorities. Some rules need the force of law, and the black-and-white precision of language that is required if they are to be enforced effectively in a court of law. Others are informal “understandings” of the way things should be done, with little more to enforce than the opinion of colleagues in the financial markets; reputation matters and is the basis of many effective rules or procedures. Somewhere mid-way are the rules laid down by the “front-line” supervisors – the stock exchanges and derivative exchanges which have the task of working out the detail of how market

¹ Similar ideas are found in John Kay’s book “The Truth About Markets”, discussed by Sheng (2005)

trading will be made fair and efficient. Each of these three layers of rules – the formal rules administered by the authorities; the detailed market rules administered by the exchanges, and the informal rules-of-practice administered by the individual participants themselves – are important, and rules made in the wrong “jurisdiction” will be inefficient and probably ineffective. Attempts to write into the formal law subtle understandings on how market participants should behave will be unenforceable and disruptive. But where serious penalties are to be imposed, black-letter law will be needed. The point I want to emphasize is that not only is it hard to get the right set of rules (enough, but not too many), but they often require different forms of administration and methods of discipline.

Where does this leave the “front-line” regulator – the exchanges? Their position as rule-makers seems constantly under attack, often by individuals in the market who feel themselves to have been disadvantaged in a particular instance. Often the self-interest is hidden by claims that the exchange has some conflict of interest in the matter, and no doubt some elements of this might be found. But the overwhelming interest of the exchanges, especially as they are now public companies, is to maintain their “franchise”, at the heart of which is a well-functioning market which meets the needs of the players taken as a whole. If exchanges pursue this diligently and objectively, conflicts of interest will be second-order issues.

The current danger (which may be detectable in Australia) is that the exchanges will draw back from this “front-line” supervisory role, passing it back to the official supervisor. Faced by the loud complaints of the aggrieved party, the exchange may just wish to avoid the hassle of the regulatory role. The official regulator, for its part, may pick up this role readily enough: not to do so might imply incapacity. But it seems likely to be a step backwards. The rule-making done by the exchanges is, for the main part, technical and driven by the needs of a well functioning market, not lending itself readily to the legalistic approaches the authorities will inevitably take. These are generally market-oriented rules, best made and enforced by people close to the market rather than the bureaucrats in the regulatory body. If the market participants do not speak up loudly in support of this continuing function (which often means arguing with one of their own, who perceives some disadvantage out of the particular application of the rules), then they may find themselves with a less flexible and subtle set of North-type “institutions” governing their lives.

Overall Supervision of the Financial Sector: Is a Universal Supervisor the Best Way?

The past decade has seen a revolution in the way financial sectors are supervised and regulated. The initial heady euphoria of deregulation was driven by the belief (commonly held among economists) that free markets would sort out the various interests and provide an efficient solution, and that all that was needed was well functioning markets and clear property rights. The key to greater market efficiency was to be found in de-regulation. This suited the practitioners in the financial sector, with the less regulation the better. In this environment, regulators focussed attention on market imperfections – if these could be fixed or compensated for, then the rest would sort itself out. So we saw the attention on addressing the problems of²:

- Anti-competitive behaviour
- Market misconduct
- Asymmetric information
- Systemic instability (externalities from the failed promises of one financial institution)

This took the focus of regulation in the direction of identifying and responding to these sources of market failure (ensuring that markets were competitive and had integrity), and away from the earlier focus on the financial health of individual institutions. If the focus was taken away from the balance sheets of individual financial institutions, this addressed the growing problem of convergence – that the various financial institutions were trespassing into areas of business which had previously been outside their field of operations. Banks began to provide insurance, just as insurance companies were providing deposit-like facilities. The emphasis on “market efficiency” also suggested that it was wrong to have separate rules for different financial institutions. Innovation should be allowed to flower and “levelling the playing field” became part of the mantra. So the change of emphasis was neat and fortunate: just when it became very much more difficult to enforce different sets of rules on balance sheets which were increasingly conglomerated, we decided that it wasn’t necessary anyway, because what mattered was at a higher level – market integrity.

What about the special characteristics of banks – that their liabilities were fixed-nominal sums usually at call and their assets were idiosyncratic and therefore not readily marketable if liquidity was needed, leaving them

² See The Financial System Inquiry (Wallis Report) AGPS March 1997

susceptible to “runs”? Deposit insurance could look after the consumer protection aspects (caring for the deposits of “widows and orphans”). Of course in practice there were still very large non-guaranteed deposits (and other liabilities) in the banks, but the failure of deposit insurance to address the old problem of bank runs was either glossed over, or the view was taken that runs would either be small, or in any case if the runs were “systemic”, they would be too big for the central bank balance sheets or any of the traditional forms of industry support, so they would need *ad hoc* budgetary support³.

But running parallel to the line of thought that concentrated on the wider market as a whole, there was a recognition that a much more complex set of rules was required to ensure the stability of banks: hence the enormous complexity of the Basle II framework. This is combined with strenuous efforts to make sure that prudential supervision knows enough to get in early if an institutions gets into trouble – Prompt Corrective Action, so that it could be “resolved” while the firm still had positive shareholder capital.

In the developed financial markets (here I include, of course, Singapore and Hong Kong) the new supervisory fashion was very timely: just as old-style prescriptive supervision of an institution’s balance sheet became much more difficult because it now contained a melange of bank-style assets, insurance-style assets and a whole lot of difficult-to-evaluate risks, we decided that risk on the conglomerated balance sheet could be assessed and compensated by equity capital, the market would provide discipline and the regulator would become more diligent and probably more intrusive (the Basle “three pillars”), and that bank runs were going to be once-a-century events. Developed markets, faced by the reality that the balance sheets of the various financial types were already conglomerated and irrevocably intertwined, decided that this was all for the best, and put this diverse industry in the charge of some form of universal/unified regulator.

This may well be true. If enough resources are put into implementing Basle II and getting ready for Prompt Corrective Action where necessary, this may work well.

So much for the developed financial markets. What about emerging markets? This fashion in supervision seems to have spread, and the strong presumption now is that a universal supervisor is “best practice” (see Hall

³ As occurred shortly after the creation of APRA, with the HIH collapse.

(2005))⁴. The question is whether the same circumstances apply in emerging markets? Goodhart (2000), writing before this trend had become so strong, recognised the case for the unified supervisor in those cases where the financial system is complex through conglomeration and linked balance sheets (i.e. in mature economies), but in the case of emerging economies said: “a combination of anecdote and experience (admittedly mostly observed through a central banking prism) does

⁴ This is a vexed issue on which reasonable people might disagree, but some of the arguments in favour of the universal regulator seem misplaced. Perhaps the most naïve is the argument that it was *necessary* to separate monetary policy from prudential policy so that the central bank would not be distracted from carrying out optimal monetary policy by problems occurring in the financial sector. This seems another example where some analysts seem to see virtue in compartmentalisation of policy and lack of co-ordination. Should monetary policy take notice of a melt-down in the financial sector? Of course it should. Even in more mild circumstances, Greenspan’s Fed was given much ex-post credit for taking into account the “headwinds” in lending policy in the late 1980s/ early 1990s (see Greenspan (1997)). So there is no question that monetary policy should be insulated or isolated from financial sector problems – the only debate can be about whether it is better able to strike the right balance of objectives if the problems are internalised in one place or are spread between institutions. The central point is that these should be seen as co-ordinating problems, and the general rule is that better co-ordination comes from internalising the decision process, rather than leaving it to blame-shifting between rival fiercely-independent bureaucracies. It’s very hard to see much advantage in protecting the reputation of the central bank if the financial sector collapses around it.

One curious argument coming out of the debate is that it was actually *desirable* to have diversified financial institutions, using the same sort of logic applied to portfolios. No doubt there is virtue in a degree of lending diversification (so that all loans are not given to a narrow geographical area or concentrated by industry), but to generalise this using portfolio logic would have banks amalgamated with diverse industries such as entertainment and resource exploitation (the logic of the portfolio argument is to conglomerate with industries which have the least co-variance). Whether more modest diversification (e.g. bankassurance) makes sense seems more an issue of management efficiency, and the current experience would suggest that management has difficulty in successfully integrating the diverse mindsets and business practices of commercial banking, investment banking, funds management and insurance.

Perhaps the greatest misunderstanding is the idea that all financial institutions are affected by risk, and therefore their supervision should be the same. It is now clear (if it wasn’t ten years ago) that the balance sheet of an insurance company is totally different from that of a commercial bank, and needs to be managed differently. Managing a mutual fund, investment bank or fund manager is totally different again, and each type of institution tends to have a certain type of person working for it⁴. The case for having these different institutions over-seen by the same supervisor is no more logical than having the technical work of surgeons and lawyers over-seen by the same regulator.

suggest that banking supervision in developing countries has been rather better done if taken under the wing of a central bank.”

The case for differentiating between the mature financial markets and the emerging markets goes like this:

- The emerging economies still seem susceptible to regular (every decade or two) systemic crisis. Whether or not it is a good idea to bail out the banking system in a systemic crisis, the established practice is that it will be done, at huge cost to the taxpayer⁵.
- While prudential supervision has been improved in these countries since the Crisis, it is still not good enough to ensure Prompt Corrective Action (i.e. closure while the institution still has positive equity), and the prudential supervisor does not have a clear mandate to carry this out, in the face of strong vested interests.
- While deposit insurance has been or will be introduced in most of the East Asian emerging countries, it covers only around 30 percent of deposits (by balance sheet value), so will have little effect in discouraging banks “runs”.
- These countries are much more vulnerable to macro-economic shocks than mature economies, in particular because of the volatility of foreign capital flows. Shocks usually come as “twins” – simultaneous crises in the balance of payments and the financial sector (see Kaminsky and Reinhart (1999))
- These countries do not have the depth of administrative capacity to cover all the problems in the emerging financial sector, so priorities should be defined, including in prudential supervision and regulation.
- The Basle rules will rely heavily on risk assessments made by private-sector firms. The integrity of this system is in question for developed markets (see “The Mystery of the \$890 Billion Insurer” Fortune Magazine (Asian edition) May 30 2005). For emerging markets, the risk assessments are not available and the informational basis on which they could be made is shallow and fragile.

Most fundamentally, the driving force of the universal supervision – the fact that financial sector balance sheets were already so inter-twined that the conglomeration could not be unwound – does not apply in emerging countries, where the conglomeration is at an early stage, and in any case the non-bank elements of the financial sector are still small.

⁵ In Indonesia, for example, one measure of the bail-out cost puts it at more than half of a year’s GDP, and this is probably a serious understatement of the true cost

This debate might best be seen in terms of three issues:

- Which regulator will have the greatest ability to carry out its task with independence, impartiality and skill? Where are the institutional strengths? Can it be adequately funded?
- Which institutional arrangement achieves the best format to co-ordinate collection and analysis of information? What degree of inter-institutional co-ordination is needed? What is administratively feasible?
- Will the regulatory arrangements widen the taxpayer-funded safety net?

The first issue is not a serious one for mature countries with deep administrative resources, but may be the decisive one for emerging countries. It is hard to see how a newly-created institution with no tradition of independence could achieve the required degree of authority quickly – it is likely to take decades. The funding of the regulator presents special issues. The current “best practice” model for universal regulators has the funding coming from industry subventions (fees and charges on the industry). The brief experience with this approach has already shown that this model will not provide adequate funding: among the players in the industry, the benefits are diffuse and the costs immediate. There will be little interest in vigorous and effective supervision. The industry will always lobby for low fees, and unless a crisis leads to general budget support for the regulator, it will be underfunded. A central bank, with the ability to draw on seigniorage, has a better chance of adequate funding for prudential supervision.

The second issue – co-ordination of information and action - depends on the structure of the financial sector. If there are complex inter-connections between different types of financial institutions and the balance sheets cannot be separated (or the regulator will not be able to keep them effectively separated in the event of a problem), then only a universal regulator can effectively sit astride this complexity. But in countries where this conglomeration is not yet deeply embedded, where institutional separation still exists and can be maintained, the job of the supervisor will be much simpler (and therefore more effective) if regulation by institutional type is retained. More important still, co-ordination issues in the event of a banking crisis will also be simpler (and therefore more likely to work). The first signs of banking problems show up in the payments system and the short-term money market, where the central bank has a clear information advantage. The first stage – the use of the Lender of Last Resort (LoLR) - is clearly in the domain of the central bank – its has the LoLR cheque book and information advantage

on bank liquidity. If LoLR is insufficient to stem the problem, then actions outside the central bank will be needed – the deposit insurance agency has to pay out depositors and arrangements made for “resolution” or recapitalisation, which may well involve the Ministry of Finance. Co-ordination issues arise here, but the urgent issues in a crisis fall naturally to the central bank.

The third issue – whether a universal regulator widens the taxpayer-funded safety net – may again point to differences between mature economies and emerging economies. In mature countries, the view seems to be that a system-wide crisis is very unlikely, LoLR is extremely rare⁶ and deposit insurance will adequately cover the political demands for consumer protection. When a problem occurs in an institution which is “too big to fail”, it will be dealt with in an ad hoc way, and this ambiguity, plus the rarity of the event, minimises moral hazard.

But in emerging economies, where bank failure is relatively common and systemic crises are a fact of life, the public might well take the lesson of history that banks (or at least their depositors) will be protected. The safety net spreads in two ways. The presence of a universal regulator encourages the idea that all institutions under its wing are protected. Secondly, unless a very clear separation can be maintained between the balance sheets of banks and NBFIs, the LoLR facility runs a high risk of being indirectly used to cover risks across the entire spectrum of financial institutions: non-banks affiliated with banks will shift their losses to the group bank (perhaps through asset transfers at inflated prices), knowing that this has the ultimate protection of the LoLR. “As firms increasingly have cross-sectoral activities, the risk increases that safety nets will be inadvertently extended. Consolidation also implies that firms can become both too big to fail and too complex to fail.” (White (2004))

Beyond these institutional arguments, we need to acknowledge that differences in risk and management approach are *desirable characteristics* in a financial sector, and put in place a supervisory framework that sharply differentiates risk types, rather than homogenises them. We don’t want to force all financial institutions into the same mould, by imposing the same supervision framework. And we certainly don’t want the users of the institutions to see them as all equally protected by the regulatory process. A universal supervisor has an interest in

⁶ Experience would suggest that LoLR in mature economies is now confined to *operational* issues, such as the Bank of New York problem in 1985.

treating all financial institutions in a uniform way, which encourages the idea that they are all equally-well protected by implicit government guarantees. Once we recognise that banks *will* be protected and rescued in a systemic crisis, the desirability of keeping these balance sheets separated from other financial institutions is clear. So, rather than accept conglomeration as a fact-of-life and adapt prudential regulation (imperfectly) to this, the better path is to acknowledge the powerful (if old-fashioned) case for the authorities enforcing separation of different types of institutions. Just as the electrician and the surgeon are required to stick to their specialisation (and are regulated separately), so too for financial institutions.

Al Wodjnilower (1991) talks of the “financial zoo”, where the different types of financial institutions are kept in different cages, rather than being allowed out to compete with each other according to the “law of the jungle”. In the mature economies, the cages were opened long ago, in the name of competition and a “level playing field” (part of the general push to de-regulate). The result is a world-wide trend towards consolidation of the various types of financial institution – with banks merging with insurance, fund management and investment banking. Whether it is a good idea commercially (and the reversal of some of the bankassurance conglomerations would suggest its hasn’t worked all that well), it is too late to re-think this regulatory framework in the mature economies. Glass-Steagall kept some important divisions in place for a long time, but has crumbled. In a number of the emerging economies of the region, however, it may not be too late to at least explore whether this conglomeration should be resisted by the regulatory authorities, while the animals are still (largely) in their separate cages.

In making the case, here, that institutional separation is still the way to go for most emerging economies, two questions arise. First, does institutional separation impose serious efficiency costs on the developing financial sectors? This is hard to answer definitively, but it’s also hard to see that such costs are serious. Of course financial institutions always want to work with minimum constraints on their scope of operation, so they will criticise any limitations. But what evidence there is would suggest that these conglomerated structures have not succeeded commercially, and conglomerates are in practice usually managed as silos, which suggests few intrinsic efficiency gains. In mature economies where there are few restrictions limiting conglomeration, the extent has been much less than anticipated: a sample of banks received only 4 percent of their profits from insurance activities, and the insurance companies received only 9 percent of their profits from banking activity

(van der Zwet (2003))⁷. Why, then did this multi-function model become the norm in countries with mature financial markets? Some saw it as desirable on two grounds – both very much based on the “efficient markets” view of the world. The first was that competition would produce an optimal outcome: the second was that any difference in prudential or regulatory framework would fail to provide the much-vaunted “level playing field”, and would create opportunities for regulatory arbitrage. These latter arguments are much less persuasive now, with the experience of a variety of financial crises. The operational question is: “is it too late to keep the balance sheets separated?” For many emerging countries, the answer is, at least for the moment, “no”, as banking has not melded irretrievably with embryonic insurance and pension/fund-management services. Whatever the long-term trends, the opportunity exists to keep the institutions separated during the critical period in which a deeper legal and prudential framework is built up and a stronger credit culture established.

Where would this leave the securities segment of the overall financial sector? Of course the motivation of the separation suggested here is aimed at making the *banks* easier to supervise, making a clear separation about who will be helped in the event of a systemic crisis, and protecting the governments financial position in the event of a crisis. It is not designed to help the securities sector. It is worth noting, too, that some of the “universal regulators” do not embrace the securities industry (Australia is just one example). That said, it’s hard to see any substantial disadvantage to this sector through an enforced separation. When I look at the thirty IOSCO principles, all those designed to ensure arm’s length transaction, disclosure and self regulation seem easier to implement if the securities industry is not institutionally embedded in the infinitely more complex banking regulatory world coming out of Basle. The one element that gives me pause, among the IOSCO principles, is the requirement for dealing with failure of a market intermediary in order to minimize damage and loss to investors and to contain systemic risk. This, to my inexpert ear, sounds too much like the obligations on the *banking* supervisors. For me, the disclosure commitments should be the center of protection, both for users and for the system as a whole, with no ambiguity that the universal regulator (or anyone else) may have some duty to attempt to support institutions in the event of problems. This reinforces the case for clear separation of functions, which can best be done by having specialized institutions.

⁷ It may be that the main driver of conglomeration is the advantage of single *marketing*, but this could be achieved without conglomerating the balance sheets.

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