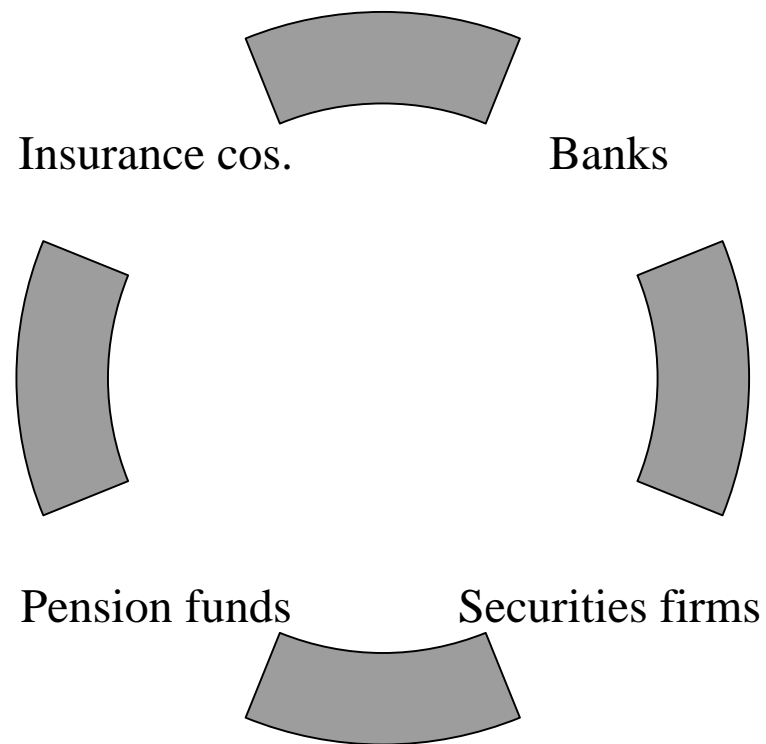




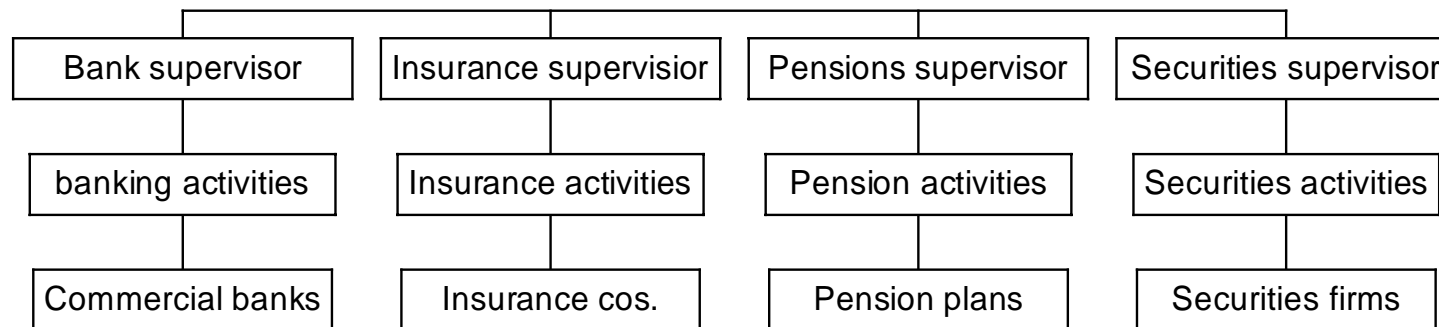
Alternative Approaches to Supervision of Financial Services

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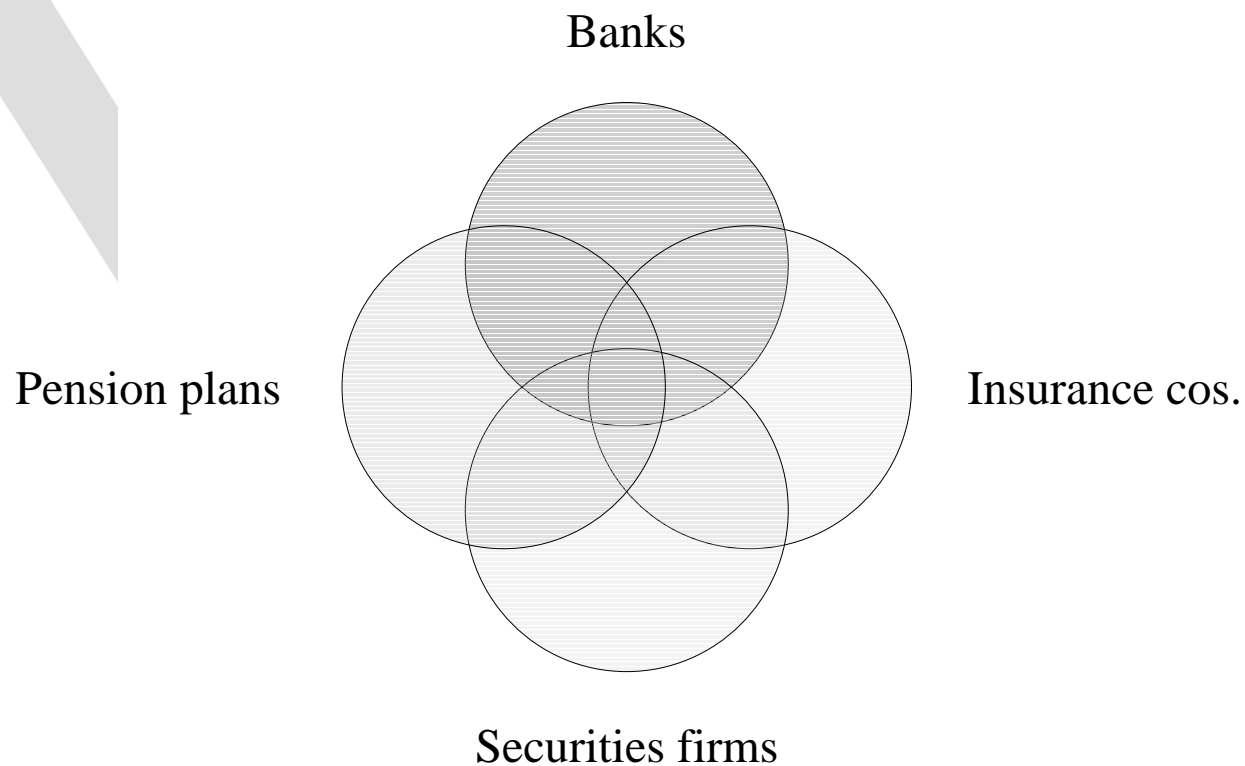
Hypothetical financial services sector with segregated service providers



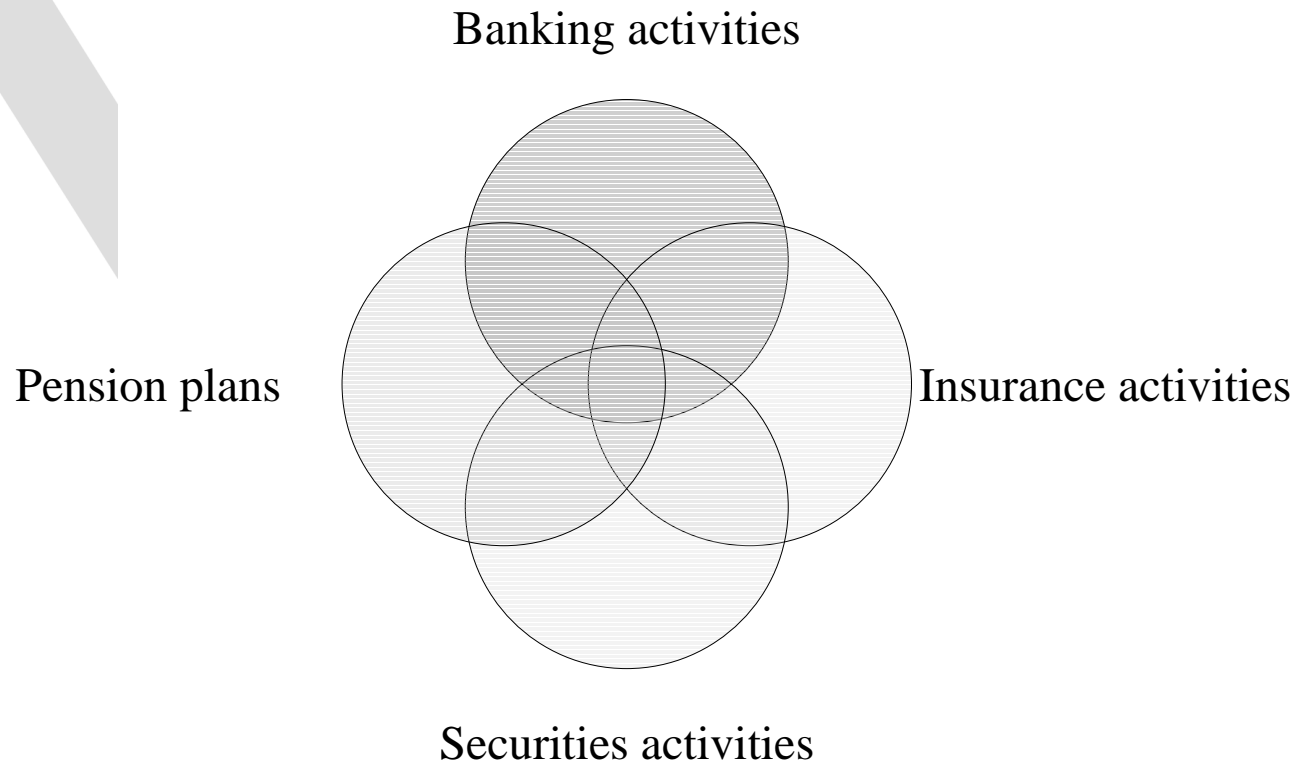
Model of financial supervision for segregated service providers



Hypothetical financial services sector with integrated service providers



Integrated financial services group



Forces underlying recent trends and developments in the financial services sector

- Technological advances in telecommunications and computing
- Development of options pricing models and related innovations in financial engineering
- Deregulation/financial sector reform
- Globalisation of financial and real markets
 - by-product of technology and deregulation
 - largely affects institutions providing wholesale services
- Demographics

Impact of major environmental forces

- Technology, deregulation and globalisation have eased or removed entry barriers
 - changes in distribution capacity
 - creation of new financial services and products
 - blurring of distinctions (competition on a product-by-product basis)
 - harnessing information
 - new entrants
- paving the way for increased competition.

Impact of major environmental forces (cont.)

- Competition has squeezed profit margins for many financial institutions
- shareholders, meanwhile, have become more active
- ⇒ managers have been forced to seek measures to improve performance
 - organic growth
 - de novo entry
 - distribution and other strategic alliances
 - consolidation

Financial sector consolidation

- Mergers and acquisitions (within service sectors)
- Convergence across service sectors
 - tie-in sales
 - cross-sector risk transfers
 - joint ventures
 - cross-shareholdings
 - cross-investment
 - cross-distribution (e.g. bancassurance ⇒ bank cross-sells insurance products through its own distribution channels, i.e. its branch network)

Integrated financial service providers

- Growing number of large, internationally active financial groups
- have unique organisational structures, with various combinations of regulated and non-regulated entities
 - insurance companies are dominant in some
 - some are dominated by banks
 - some are large players in all sectors
- structural forms vary and reflect historical context, supervision and regulation, and tax considerations
- issue is not formal ownership structure per se but implications for risk management and oversight

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.
 - 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

Implications of financial sector integration for supervision

- Potential for intra-group exposures within integrated financial services groups complicates the task of supervision
- 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

Design of regulatory and supervisory regimes for financial services

- Central goal: ensure the safety of the financial system as a whole and allow other objectives (e.g. consumer and investor protection, market conduct) to be attained efficiently and effectively
- How do we supervise a financial group without losing sight of the differences among its constituent entities?
- How do we take into account the particular characteristics of the members of a group while maintaining adequate oversight of the group in its entirety?

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 models 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?

Methods of supervising financial groups

- “Solo” or “solo plus” approach--focuses on individual entities and is designed to protect the customers and creditors of a regulated entity from monetary losses and delays were the institution to fail
 - this approach may also entail monitoring of the financial risks posed to the regulated entity by its material affiliates within a conglomerate structure
- “Consolidated” approach--supervision is directed at the top tier of the group, covering all members that provide financial services

Methods of supervision financial groups (cont.)

- 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
 - 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)

Supervision of financial services providers

Commercial banks: lending activities at the core of banking activities, so credit risk is dominant

- 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: long-term focus; technical risks (underwriting) dominant but also investment risk

- 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.)

Pension funds: very long-term focus; risk of fund insolvency; interest rate and inflation risk in funded schemes in general; investment portfolio risk for employer in DB plans and for employees in DC schemes

- structure of oversight regimes for pension schemes is quite complex, reflecting the variety of schemes in practice 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

Supervision of financial services providers (cont.)

Securities firms: short-term focus; operate on a mark-to-market basis & fund overnight or short-term; liquidity risk in particular and market risk in general dominate

- 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.

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 group-wide 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

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 effective and 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.