INSTITUTIONAL STRUCTURE OF FINANCIAL REGULATION: THE BASIC ISSUES

David T Llewellyn
Professor of Money & Banking,
Loughborough University

Paper Presented at World Bank seminar
Aligning Supervisory Structures with Country Needs
Washington DC, 5 June 2006
STRUCTURE OF PAPER

• Why institutional structure is important
• Range of Options: Regulation Matrix
• Advantages and Disadvantages
• Role of Central Bank
• International experience
• Governance issues
INITIAL PERSPECTIVES

• Regulation and the financial system
• Over-regulation
• Objectives of regulation & supervision
  – Systemic stability
  – Safety & soundness
  – Consumer protection
  – Consumer confidence
• No universal model
• No structure is perfect
• Two Questions and a dilemma
  – Should central bank supervise banks?
  – How many agencies?
• Governance
INTEGRATION

- Integrated agencies
- Unified agencies
TWO QUESTIONS

• Should the central bank be the supervisor of banks?

• Should there be a single agency?
Universal Functions

- Prudential regulation
- Prudential supervision
- Systemic stability
- Conduct of business: regulation
- Conduct of business: supervision
• Safety Net arrangements
• Liquidity assistance
• Insolvent institutions
• Crisis resolution
• Market integrity
ORIGIN OF THE DEBATE

- Financial structure
- Financial innovation and risks
- Financial conglomerates
- Piece-meal responses
- Objectives change
- Internationalisation
- Accountability
- Effectiveness & Efficiency
KEY ISSUES

• Number of agencies
  – Spectrum
• Prudential v Conduct of business
• Role of central bank
• Structure of agencies
• Governance
• Role of competition agency
• International
IMPORTANCE OF THE ISSUE

• Effectiveness
• Clarity of responsibility
• Conflict resolution
• Costs
• Duplication
• Regulatory arbitrage
• Public perceptions
CRITERIA

- Crisis v. stable environment
- Effectiveness and efficiency
- Costs: Economies of Scale and Scope
- Public credibility
- Competitive neutrality
- Not lose what good
- Clarity of responsibility
CRITERIA

- Retain staff
- Financial conglomerates
- Regulatory arbitrage
- Resolution of conflict
- Public perception
- Accountability
REGULATORY MATRIX

1. Prudential Regulation
   - Banks
   - Insurance
   - Securities
2. Systemic
3. Consumer Protection
4. Competition
A SPECTRUM

Fragmented

↓

Integrated

↓

Twin Peaks

↓

Unified
ALTERNATIVE CRITERIA

(1) Institutional

(2) Functional

(3) Objectives

(4) Market Failures
FUNCTIONAL CRITERIA

• Anti-competitive behaviour
• Market misconduct
• Information asymmetries
• Systemic stability
CASE FOR INTEGRATION

- Economies of scale
- Economies of scope: synergies
- Group-wide view of risks
- Coverage: gaps
- Financial conglomerates
- Regulatory arbitrage
- Accountability
CASE FOR INTEGRATION

• Consistency
• Blurred distinctions
• Staffing
• Use of resources
• Competitive neutrality
• Information flows
• Simplicity
• Costs on firms
• Trading of credit risks
INTEGRATED SUPERVISION

• Differences persist
• Moral hazard
• Single view of risk
• Power
• Competition
• Single approach
UNIFIED SUPERVISION

Advantages of Integrated Supervision

Plus

• Prudential and conduct of business merge
• Economies of scope
• Simplicity
• Careers of personnel
• Authority
• Accountability across-the-board
• Single approach
• Consistency
• Consumers
UNIFIED SUPERVISION NEGATIVES

- Power concentration
- Objectives clear?
- Dedicated objectives
- Balance of objectives
- Conflict of objectives
- *Christmas tree* effect
- Bureaucratic?
- Reputation risk
- Culture differences
TWIN PEAKS MODEL

(1) Single/Integrated Prudential Agency
(2) Single Conduct or Business Agency
(3) Competition Agency
(4) Systemic Stability Agency
CASE FOR TWIN PEAKS

• Effectiveness: clear mandates
• Accountability
• Conduct of business priority: signal through dedicated agency
• Unified agency gives priority to prudential
• Synergies(?)
CASE FOR TWIN PEAKS

• Different approaches needed: culture?
• Externalise conflicts
• Concentration of power
• Reputation risk is less
TWIN PEAKS

• Is the prudential regulator the central bank?
CENTRAL BANK AS PRUDENTIAL: POSITIVE

• Systemic stability without institutions?
• Concentrated banking system: system = institutions
• Duplication is inevitable
• Crisis management efficiency
• Synergies between systemic and prudential requirements greater than between prudential and conduct of business
CENTRAL BANK AS PRUDENTIAL: POSITIVE

- Systemic problems could emanate outside the banking system
- Independence and credibility well-established
- Risk analysis: advantages of integration without costs and risks of unification
- Information flows from market intervention
CENTRAL BANK AS PRUDENTIAL: POSITIVE

• Assess credit standing of parties in the payments system
• Macro intelligence via bank supervision
• LLR role needs information
• Existing expertise
• Recruitment
CENTRAL BANK AS PRUDENTIAL PEAK: NEGATIVE

• Conflict with monetary policy
• Power
• Public perception: moral hazard
• Reputation risk
SURVEYS

• Abrahams and Taylor (2000)
• Healey (2001)
• Llewellyn (1999)
• Luna Martinez and Rose (2003)
• Masciandaro (2003)
• Quintin and Taylor (2002)
• Taylor and Fleming (1999)
• Carmichael et al., (2004)
CAUTION IN INTERPRETATION

• Changing Landscape
• Complex and nuances
• Practice v Form
• Co-ordination
• Federal states
## SUPERVISORS OF BANKS

<table>
<thead>
<tr>
<th>Category</th>
<th>Central Bank</th>
<th>Other</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Banks alone</td>
<td>81</td>
<td>10</td>
<td>91</td>
</tr>
<tr>
<td>Banks &amp; Securities</td>
<td>3</td>
<td>5</td>
<td>8</td>
</tr>
<tr>
<td>Banks &amp; Insurance</td>
<td>14</td>
<td>8</td>
<td>22</td>
</tr>
<tr>
<td>Banks, Securities &amp; Insurance</td>
<td>9</td>
<td>32</td>
<td>39</td>
</tr>
<tr>
<td>TOTAL</td>
<td>104</td>
<td>56</td>
<td>160</td>
</tr>
</tbody>
</table>
## REGULATORY MATRIX

<table>
<thead>
<tr>
<th>Integration Type</th>
<th>Count</th>
</tr>
</thead>
<tbody>
<tr>
<td>Fully Integrated</td>
<td>39</td>
</tr>
<tr>
<td>Central Bank</td>
<td>9</td>
</tr>
<tr>
<td>Other</td>
<td>30</td>
</tr>
<tr>
<td>Partially Integrated</td>
<td>23</td>
</tr>
<tr>
<td>Banks and Insurance</td>
<td>9</td>
</tr>
<tr>
<td>Banks and Securities</td>
<td>5</td>
</tr>
<tr>
<td>Insurance and Securities</td>
<td>9</td>
</tr>
<tr>
<td>Separate</td>
<td>43</td>
</tr>
<tr>
<td><strong>TOTAL</strong></td>
<td><strong>105</strong></td>
</tr>
<tr>
<td>Year</td>
<td>No. of Countries</td>
</tr>
<tr>
<td>------</td>
<td>-----------------</td>
</tr>
<tr>
<td>1980</td>
<td>4</td>
</tr>
<tr>
<td>1990</td>
<td>10</td>
</tr>
<tr>
<td>1995</td>
<td>15</td>
</tr>
<tr>
<td>1996</td>
<td>15</td>
</tr>
<tr>
<td>1997</td>
<td>16</td>
</tr>
<tr>
<td>1998</td>
<td>19</td>
</tr>
<tr>
<td>1999</td>
<td>20</td>
</tr>
<tr>
<td>2000</td>
<td>22</td>
</tr>
<tr>
<td>2001</td>
<td>23</td>
</tr>
<tr>
<td>2002</td>
<td>30</td>
</tr>
<tr>
<td>2003</td>
<td>32</td>
</tr>
<tr>
<td>2004</td>
<td>35</td>
</tr>
<tr>
<td>2005</td>
<td>39</td>
</tr>
</tbody>
</table>

(1) but not necessarily unified
Banking + Insurance + Securities
GOVERNANCE AREAS

• Legal legitimacy and authority
• Clarity of mandate
• Transparency
• Accountability
• Independence
• Integrity
GOVERNANCE AREAS

• Intervention procedures
• Communication and consultation
• Legal immunity
• Appointments
GOVERNANCE IS IMPORTANT

- Power of the agency
- Discretion
- Over-regulation bias
- Efficiency and performance
- Role model
- Credibility and legitimacy
- Discipline on agency
GOVERNANCE IS IMPORTANT

- Intervention/disciplinary powers
- Potential for capture: government and industry
- Resources
- Predictability (time/firm consistency)
- International credibility
- Role model
ACCOUNTABILITY

- Consultation *ex ante*
- Explanatory
- Procedural
- Functional
- Personnel
- Financial
- Performance
- Intervention and sanctions
FINAL MESSAGE

- Institutional structure is important
- But how important?
- Not a panacea
- Do not exaggerate significance!
- What is important
- No single universal model
- Governance
- Strong case for integration
- Unified less so
- No perfect/costless system
“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, find past shortcomings is doomed to relive past crises”. (Jeff Carmichael, 2003)