Is there an optimal way to structure supervision?

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This article is based on a speech held in Dubai at the Islamic Financial Services Board. The focus of the presentation is on countries where banking still is the dominant part of the financial sector but where other services such as insurance and securities trading are expanding. That said, also countries with more diversified and integrated financial sectors have strong reasons to ensure that the structure of their supervision is updated to follow sector developments, not least the new and more sophisticated approaches to regulation and supervision. There are also countries with a substantive but not necessarily advanced banking sector which, for commercial or political reasons intend to implement sophisticated supervisory and regulatory frameworks such as the Basel II capital requirements. To succeed in this endeavour, the demands on the supervisory system will be high.

The article is about finding the best way of structuring the financial regulatory authorities in a country, given the development of the country's financial system and other criteria. This issue has been hotly debated for a long time because of the important and political issues involved and the discussion is still going on. We will discuss the matter based on experiences from countries around the world, including situations in which we have been personally involved such as when a country reconsiders its institutional set-up after a crisis. First we will describe the alternatives for supervision that countries have chosen. Then we will discuss how certain key aspects for supervision, such as independence, accountability, transparency and efficiency can be accommodated under various supervisory structures. Third, we will debate the arguments for and against having supervision inside a Ministry or in a national central bank, which we will call NCB for short. We will also evaluate the arguments for and against combining various supervisory authorities.

There are two basic issues in the discussion on the organisation of supervision:

- Should supervision be inside or outside the NCB and the Ministries?

- Should supervision of different sectors be unified in the same authority?

These questions will be discussed later in our presentation. Let us first describe some of the present practices in organising supervision.

Present practices

Currently there is a great diversity of supervisory structures but the majority comes under one of the two main streams:

The first is the traditional one with bank supervision in the NCB and securities supervision in an independent standalone authority. Insurance supervision is in many countries also located in a separate authority, but in other cases it is a department of the Ministry of Commerce or some other ministry.

The second main stream is full unification of the supervision of banks, securities companies and insurance companies, all in one institution.

The trend since some 15 years is that bank supervision in a number of countries has been moved outside the NCB and has been consolidated with the supervision over securities and insurance companies. However, the most common structure is still the traditional one described above[1]

But there are many variations. One is the combination of banking and securities supervision, which is logical due to the close relations between banking and securities activities. Another is the combination of securities and insurance supervision with the aim to create a stronger authority with more resources and expertise. This combination is also logical since insurance companies are major actors in the securities' markets.

There are also some broader alternatives. The FSA in the UK, among others such as the Swedish Finansinspektionen, performs supervision over a wide range of financial institutions, including brokers, pension funds and many more. Its objectives also includes consumer education issues and the competitive position of the UK in international financial business. All kinds of supervision and other activities related to the financial sector are placed under one roof.

The Netherlands, Australia and others have followed an approach based on the purpose of the supervision. In these countries prudential supervision of banks and securities firms is conducted in separate bodies from the oversight of the conduct of the financial markets. The underlying rationale is that these activities are different. Ensuring the safety and stability of banks and securities firms requires different regulations and skills from monitoring market conduct and taking enforcement actions.

1 Martin Čihák and Richard Podpiera: IMF Working Paper WP/06/57 from 2006.

The table below sets out in general terms the objectives of prudential supervision versus the oversight of market conduct, and financial stability versus consumer protection. Also in countries where there is no corresponding supervisory structure the existing supervisory authorities would need to keep these different objectives in mind when arranging their work.

	Protect the system	**Protect the consumer**
Prudential supervision	Financial and operational stability and adequate risk management in central financial institutions and functions	Well managed financial institutions and efficient and adequate regulatory frameworks which ensure that obligations to depositors, insured parties, holders of collective funds units, etcetera will be honoured
Market conduct oversight	Efficiency and confidence in the financial markets	Correct and relevant information to customers and investors, reasonable terms for and correct treatment of customers.

Source: Finansinspektionen, Sweden

Ireland, France, Finland and others have retained bank supervision in an organisation closely related to the central bank but not in the central bank itself. In this way they benefit from the resources of the NCB and can make some cost savings, but avoid some of the arguments against locating supervision in the NCB itself.

Other countries, among them Germany, have a stand-alone consolidated authority for financial regulation, BaFin, but the central bank maintains a role in the conduct of prudential supervision by performing most of the compilation of data from the banks. In this way the Bundesbank benefits from its vast network of regional branch offices and its knowledge of the local economy. The Bundesbank also administers audits of banks by hiring and overseeing the work of authorised audit firms, and evaluates banks' risk management models. Of course, such an approach of work-sharing presupposes close cooperation between the NCB and the supervisory agency and clear legal mandates for the duties of each authority.

Criteria for evaluating the organisation of supervision

The choice of structure for supervision is not an end in itself but a means to achieve certain objectives. We should therefore analyse the conditions that must be in place to ensure good supervision.

The first one is *operational independence*. There must be laws to prevent policy makers or financial market participants from trying to influence the operational decisions of the supervisor. Independence also implies sufficient and stable resources to attract skilled staff, to build good IT-systems, and to inspect supervised entities. The head of supervision should be independently appointed and should not be dismissed for other reasons than those provided in the law. The head and the staff should be protected against frivolous law suits, as long as they conduct supervision in good faith.

Traditionally, independence has been best protected when supervision is conducted in an NCB since the NCB itself is independent due to its role in monetary policy. The NCB in most cases also has its own revenues and may set its own budget. Outside the NCB, independence must be ensured through explicit legislation and through clear rules for obtaining the necessary resources, e.g. by levying fees on the supervised entities. Contrary to supervision located in the central banks, or in other independent bodies, the supervisory sections which are entities within Ministries are by definition not operationally independent and their resources are dependent on budget appropriations. However, independence may be ensured in stand-alone authorities reporting to but operationally and financially independent from the ministries.

The second condition for good supervision is *accountability*. The authority must regularly provide information about its performance in various forms, such as Parliamentary hearings, speeches by the management, written reports and websites. On these occasions the authority describes and explains its actions and stands ready to receive criticism.

There is no specific structure of supervisory authorities that automatically leads to better accountability so clear rules must be set regardless of how the authority is structured. The rules and policies setting out NCBs' accountability for their monetary policies may act as examples for supervisory accountability, also when performed outside the NCB.

The third condition is *transparency*. The general public and in particular the supervised entities need to have full information about the regulatory framework and the general conduct of supervision. This does not include information about sensitive ongoing operational issues. In such cases the authority must carefully weigh the public's need for information against the risk that this might negatively affect the prevailing situation. The authority must consult with interested parties to ensure that efficient laws and regulations are drafted and after implementation they should cooperate with the market participants and others to ensure that the rules are well understood and implemented. Transparency is traditionally not a focus of supervisors and may sometimes conflict with other supervisory objectives, so it needs to be explicitly enacted, independently of how supervision is organised.

The fourth condition is the *efficiency and efficacy* of supervision. Does the authority perform its services at a reasonable cost? To a large extent this depends on the organisation of the work itself and not the overall supervisory structure. There is also an argument of economies of scale and scope, implying that some costs could be reduced if you combine the supervisory authorities. Generally, the same criteria should be applied on the organisation of supervision as in the process of creating new regulation, namely a cost-benefit analysis. Do the total costs of supervision, including costs borne by the supervised entities, provide commensurate benefits?

A more important aspect of efficacy is whether the authority lives up to its stated objectives, for instance to ensure a safe and sound financial system. This has not so much to do with the organisation of the authority but more with its legal powers and independence. An even broader issue concerns the appropriate range of objectives for a supervisory authority, for instance if consumer protection, competition policy or promotion of the financial sector should be included together with the basic objective of financial stability and smooth operations in the financial sector and its institutions. Our experience from many countries is that it is usually more efficient to separate these objectives between different authorities. For instance, handling consumer issues is resource intensive and may negatively affect confidence in the supervisory authority. That said, a supervisory authority does have knowledge about the financial institutions and instruments which makes it well placed to handle difficult consumer issues. It is important also from a supervisory perspective that customers of financial institutions are treated in a way that the public's overall confidence in the financial sector is maintained. Hence, responsibility for some consumer issues might be retained in the supervisory authority, including the oversight self-regulatory bodies. Having too many objectives might also lead to conflicting goals for the authority. As an example, it might in certain situations prove more difficult to propose needed regulatory measures while simultaneously having the objective of promoting the growth of the financial market.

To sum up: A country should be able to manage independence, accountability, transparency and efficiency satisfactorily in any kind of supervisory structure. For independence there might be some advantage with central bank supervision. But for cooperation leading to better efficiency there might be a slight advantage with a unified authority.

Arguments for and against various supervisory structures

After having discussed the conditions for good supervision let us now review some of the arguments for and against the various actual supervisory structures. We will first address the issues of having supervision inside or outside the ministries and the central banks. We will then turn to the arguments for and against unified authorities.

Supervision inside ministries may provide some benefits in the form of insight and staff expertise since the staff deals with similar issues in their other work, e.g., on regulation, maybe also access to resources. But there is a strong disadvantage in the lack of independence plus the risk to the public's confidence in the government if failures should occur in the supervised sector. There is also a serious governance issue in those countries where the government is the owner of financial institutions and also supervises them.

The above refers to the conduct of supervision within the ministries themselves. Many countries have formed supervisory authorities as separate bodies but, as with other public bodies, organisationally accountable to a ministry. Such a structure may work well, provided that operational independence and integrity for the authority in relation to the ministry is ensured. For instance, Sweden has a constitutional rule against ministerial involvement in operational issues in the authorities reporting to the ministries.

ARGUMENTS FOR RETAINING SUPERVISION IN THE NCB

What about supervision inside the NCB? First, banks have a special importance in the financial system. Their activities are often complex. Therefore, they need high quality, resource-intensive supervision. The NCB in most cases has a legally ensured basis for its independence and raising of revenues. NCBs can often recruit and retain good staff by offering attractive salaries and other advantages.

Second, Federal Reserve Board Chairman Bernanke[2] and others argue that information gathered in the conduct of supervision provides important input for the monetary policy. Having updated knowledge about the financial system is also important if the central bank is requested to provide liquidity support in a crisis situation. Although such information can be summoned from a supervisory authority outside the NCB, the NCB will be in a better position if it is already familiar with the situation through its in-house supervision. A similar argument is that the central

[2] Held at the Allied Social Science Association Annual Meeting, 9 January 2007. Link to the speech: http://www.federalreserve.gov/BoardDocs/speeches/2007/20070105/default.htm

bank is often operating or overseeing the country's main large value payments system. Thus the central bank will be able to spot potential liquidity problems at an early stage and can take timely remedial action if it has the supervisory powers to do so.

ARGUMENTS AGAINST RETAINING BANK SUPERVISION IN THE NCB

But there are also counterarguments to conducting supervision in the NCB. Some would reverse Bernanke's argument and say that just because the NCB is responsible for monetary policy, payments system oversight and, in many cases, liquidity support in a crisis, it should not be responsible for daily supervision. An NCB with such responsibilities might run into a conflict between the objectives of monetary policy and of supervision. Simply put, the NCB might be tempted to keep interest rates excessively low in order to prevent that some weak banks run into acute problems. In fact, some research results[3] based on OECD countries have indicated that the inflation rate is higher and more volatile in countries where the central bank has the sole responsibility for banking supervision. A failure in a supervised entity might affect the reputation of the NCB to the extent that its capability to perform effective monetary policy is hampered. In a crisis, there is a management problem in that the solution of a crisis in the supervised entities will preoccupy the minds of the NCB management so that it will not have the time to focus on other important issues. The "Finnish approach", mentioned above is an attempt to solve this dilemma by creating an independent body with a separate board for the supervisory decisions but still being a part of the central bank for its funding and sharing of administrative resources.

An overarching argument is that the Parliament should not delegate too much power to a non publicly elected body such as the central bank. But we do not see this as a major problem. The Parliament should set the parameters and limits for the powers of the NCB and the NCB will have to account for its conduct on a regular basis. If supervision is located in another authority, there will be similar issues of delegation and accountability.

We noted earlier that the current trend is to move supervision out of the NCBs. However, some countries have gone the opposite way by moving securities and insurance supervision under the umbrella of the NCB where only the supervision of banks earlier took place. They have benefited from the independence and resources of the NCB. However,

[3] Haubrich (1996) and Di Noia and Di Giorgi (2000). These and other issues related to the role, responsibilities and governance of central banks are discussed in the paper Governing the Governors: A clinical study of central banks, drafted by Lars Frisell, Kasper Roszbach and Giancarlo Spagnolo. A yet unpublished draft manuscript was issued in August 2006.

these sectors require partly different staff skills and methods and they include issues which are normally outside the mandate of a central bank such as investigations of market conduct and law enforcement actions against individual firms or persons. Failures in securities and insurance companies may affect overall confidence in the NCB, although these institutions are in most cases of limited interest to the NCB from the point of view of financial system stability. The risk of such failures occurring might even lead to what Professor Goodhart calls "a creep of the Central Bank safety net"[4] implying that exceptional liquidity assistance might be used for non-systematically important institutions. Our conclusion is therefore that you should only bring securities and insurance supervisors into the NCB if this is needed because they can not adequately fulfil their tasks outside the NCB for some reason such as lack of independence or resources. As a possible alternative you can bring them close to the NCB by using a "Finnish structure" with an independent supervisory body, only organisationally attached to the NCB.

After having discussed whether supervision should be inside or outside the Ministries and the NCB, we now turn to the issue of unified supervision. These are some often-heard arguments for the consolidation of supervisory authorities:

CONSOLIDATING PRUDENTIAL SUPERVISION IN ONE AUTHORITY

"Information sharing and coordination will be facilitated if the different sector supervisors are located in the same authority". In our experience this argument is mostly correct, both for practical and legal reasons. But this requires that the unified supervisor is really integrated and not just a combination of separate branches. We have seen bad examples of unified supervisors where the staff are not allowed to discuss mutual issues since there are still legal barriers between the departments within the authority! We have also seen bad examples of turf battles within a unified authority, which has certainly not facilitated information sharing.

"A unified authority will imply some cost savings because of economies of scale." However, this argument should not be exaggerated. Some administrative overhead costs may be reduced but other costs will remain. Most of the costs emanate from the supervisory operations and there is little scope for savings in this area. More substantial cost savings and more efficiency in supervision may be achieved through better streamlined cooperation between different sector supervisors but this can be achieved both when they are located separately and when they are within the same authority.

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[4] Charles Goodhart: The Organisational Structure of Supervision; FSI Occasional Papers No 1, Nov. 2000.

The authority conducting banking supervision is in most countries more advanced and has more resources than the other supervisory authorities. By combining bank supervisors with other supervisors it is hoped that the former can share resources and knowledge with the weaker sectors. This argument if often heard, but in practice it does not always work as planned. The risk is rather that banking supervision is weakened when resources are transferred and when skilled banking supervisors leave the authority.

Another argument is that a unified supervisory authority could become stronger and thus more independent than the individual authorities. We would argue, though, that the issue of independence is not *per se* related to the unification of supervision. Independence could equally be given to a small standalone supervisory authority as to a unified large one.

IS THERE AN URGENT NEED TO CHANGE YOUR COUNTRY'S SUPERVISORY STRUCTURE?

Let us turn to another aspect which is relevant especially for countries with a dominating banking sector but where securities trading and insurance activities as well as other financial services are gaining market shares. Is there any urgency to change to unified supervision or could you wait? The main argument for changing is when the non-bank financial sector is expanding rapidly and is taking a significant market share. Consolidated supervision is then needed to ensure that all risks to the financial groups and markets are taken into account. We see some development in this direction in almost all countries. The financial sector is expanding and introducing new instruments and activities. The boundaries between banking, securities operations, and insurance business are becoming blurred. In many countries this is a slow process, but in others it moves faster. Financial conglomerates, bank-led or otherwise, encompass different financial services within the same organisation.

There are arguments against changing the supervisory structures in the near term. The first one is the flip-side of the argument above. Also the banks are getting larger and more complex. In many countries they still dominate the financial sector and the payments system. Hence, society has a clear interest in strong banking supervision to avoid costly bank failures. We should take into account that banking supervision in many countries functions quite well, while supervision of the other financial sectors is much weaker. Major structural changes involving bank supervision will therefore hamper the conduct of such supervision for a long time due to the focus on the transition rather than on the operations. There is also an obvious risk that qualified staff will leave bank supervision due to the less attractive work prospects outside the NCB. For instance, government salaries and other benefits are usually not as good and in most countries it is less prestigious to work outside the NCB. The result would be weaker bank supervision without compensating improvements in other sectors.

There are other ways of meeting the challenge. Many countries have instituted arrangements for closer cooperation between the supervisors. Memorandas of Understanding have been drafted so that information may be shared without legal or other impediments. Joint forums have been established where representatives from the different supervisory authorities meet regularly. Cross directorships imply that high level supervisors sit on each others' Boards and can inform themselves of developments.

Legislation might also be necessary in order to ensure that the NCB can always obtain the information it needs to fulfil its responsibilities on financial stability, extraordinary liquidity assistance in a crisis, and monetary policy. In Sweden, the central bank concluded a non-legally binding MoU with our bank supervisors but we also have the legal power to ask the banks directly for information.

It is difficult to sum up all the arguments for and against. If you are contemplating change in your country, We would say that a broad and objective assessment of the present strengths and weaknesses of your supervisory arrangements will provide good guidance as to which way to go. The optimal solution for the near term may not be the same as for the long term.

The aspects of cross-border supervision

Financial institutions increasingly operate across national borders. They establish branches and subsidiaries in other countries and they have different forms of business linkages with institutions in other countries. Is there any structure of the domestic regulatory authorities that is particularly suited to the efficient supervision of international financial operations? We do not think so. What matters is that there are arrangements between home and host supervisors which ensure information-sharing and close cooperation in particular in crisis situations. Such arrangements can be agreed on whether bank supervision is in a central bank or combined with securities and insurance supervision in a separate authority. That said, Roger Ferguson, a former Member of the Fed Board and Chairman of the FSF, argues that the well established global network among central banks, such as through the BIS, gives central banks a comparative advantage in informal information sharing and cooperation[5].

[5] Ferguson, R (2000) Alternative Approaches to Financial Supervision and Regulation, Journal of Financial Services Research, 17(1), 297-303

Which role remains for the central bank?

Ensuring jobs for the central bank staff is not a valid reason for retaining bank supervision in the NCB. Hence, the question is: Which would be the primary tasks of the NCB if supervision is moved out?

Of course, the task of conducting monetary policy would remain with the NCB. The NCB will also run the large-value payments system, or at least exercise oversight over it. In addition, the NCB should always have the responsibility for the oversight of overall stability in the financial system. Financial stability is a necessary condition for efficient monetary policy operations and is in itself an important component in a country's sustained macro economic growth. In those countries where the NCB will still be the lender-of-last-resort the knowledge gained from its financial stability analysis will be crucial in a crisis situation. But the NCB cannot perform an efficient financial stability analysis, nor act as lender-of-last-resort without close cooperation with the supervisory authorities. The other authorities will also benefit from the stability work by the NCB.

Challenges for effective supervision

Important developments in the financial sector and in financial activities pose challenges for effective supervision however it is presently organised. Some examples might be highlighted:

PRESSURE FOR INCREASED CO-OPERATION

The ongoing cross-border integration of ever larger financial groups puts new demands on supervisors. It adds to the pressures for increased co-operation between the authorities in different countries both in daily supervision and in crisis management. In order to achieve a higher degree of harmonisation, domestic legislation and regulation of the financial sector must increasingly be aligned with international standards, e.g. those set out by the international standard-setting bodies. Supervisory cooperation and harmonisation can to a large extent be achieved within existing laws and arrangements, including MoUs, but given the transnational character of many large financial groups the authors of this article believe that ultimately some supranational body will have to be established to ensure effective supervision and crisis management of these groups.

The blurring of the boundaries between the different subparts of the financial sector and the increasing role of other financial institutions than banks is not a new feature but the continuation of a long-term development. It fortifies the arguments for strengthened cooperation, starting at the national level, between the supervisory authorities. This is needed in order to ensure that similar financial instruments and activities are regulated and supervised similarly, irrespective of where they have originated.

BROADER PERSPECTIVE IN ANALYSIS OF RISKS

Another development affecting financial prudential supervision and stability analysis is the altered dispersion of risks. A wide range of derivatives and other instruments are being used to shift risks between the financial institutions but also to and from non-financial companies and households. Asset securitisation is already a major financial activity in some countries and is spreading rapidly. Banks are increasingly adopting an approach of "originate to distibute", implying that they do not intend to hold most of their exposures until maturity. This altered risk profile among the financial and non-financial actors must be carefully monitored by central banks and supervisory agencies, irrespective of the institutional structure. At least the central banks must in addition assume a broader perspective in their analysis than merely the financial sector; the wider risk dispersion may result in outcomes which have a substantial macro economic impact, e.g. on consumption patterns and on future pensions.

STRENGTHENS DEMANDS ON SKILLS

The trend in financial activities has since long been one of gradually rising complexity. Both the instruments and the management of risks have become more sophisticated, inter alia based on ever more advanced applied financial theories. Albeit with some lag, the laws and regulations have followed suit. For instance, the regulatory framework for the Basel II capital requirements acknowledges that banks may use advanced mathematical models to measure various risks provided that certain conditions are fulfilled. Hence, supervisors have to acquire the skills needed to fully understand these models as well as the inherent risks and weaknesses in them. At the same time, financial regulation is generally moving in the direction of becoming more principles-based as opposed to rules-based. This strengthens the demands on supervisory skills since supervisors in addition to understanding different model approaches must be prepared to accept different approaches as long as they fall within the accepted principles.

There is a double-edged risk if the laws or regulations or the supervisory skills and resources are not adequate in relation to the challenges mentioned. In their approach to the supervised institutions the supervisors may then tend to err too far on the conservative side, unnecessarily stifling innovation in the financial sector. But in other cases the supervisors might be convinced by the institutions' own specialists and may accept models and instruments without fully understanding their potential implications.

As shown above, recent developments in financial instruments, activities and structures imply a shift in the focus of supervisory authorities. This increases the incentives for structural changes, such as integrated domestic supervisory agencies and arrangements for cooperation or even closer integration of supervisory activities across country borders. But, as has been noted earlier in this article, structural changes in themselves are meaningless unless they increase the effectiveness of the actual supervisory processes. Unless supervisors have the independence, integrity and adequate resources to fulfil their tasks they cannot function satisfactorily in any kind of structure.

Conclusions

To sum up: Our first conclusion is encompassed by the American expression "If it ain't broke don't fix it". If bank supervision works well in your country, let it be as is and strengthen the other sector supervisors instead. Operational independence must be implemented and at the same time rules for accountability and transparency. This is more important for good supervision than the structure of the supervisory authorities.

If you see good reasons in your country for changing the supervisory structure, you should follow a transparent process and be clear of the consequences. For obvious reasons, you must avoid making organisational changes when the financial sector is weak. Nor should you change during major developments in the financial sector, such as the introduction of the bank capital framework Basel II and the new accounting standard IAS 39. (However, introducing new and complex regulatory frameworks put higher demands on the supervisory system and may call for a strengthening also of its structure. If so, any major structural changes should be effected before the transition to the new framework).The changes must be accompanied by measures to strengthen the capacity of the new authority. Otherwise the change is merely cosmetic.

In many countries there is a political pressure to change the supervisory structure to show expediency, in particular when there has been a recent financial crisis and irrespective of the supervisory agencies' roles and behaviour before and during the crisis. As a result banking supervision may in such cases be moved out of the central bank or conversely, at other times, into it. Also the unification of the supervisory authorities is sometimes seen primarily as an issue of the delegation and distribution of powers within a country. In our experience, there is not much to gain from such a view. On the contrary, the politicians might be blamed for future failures of supervision if this, at least partly, can be blamed on a less efficient organisational structure.

Finally, the time has come to answer the question in the title of this presentation “Is there an optimal way to structure supervision”. Our answer is “No”. The different supervisory structures reflect the specific situation of their countries, which changes over time, and there is no globally agreed best practice. As former Chinese Chairman Deng Xaioping once said: “The colour of the cat does not matter as long as it catches mice”.