

The Role of the Council of Financial Supervisors

Talk by Deputy Governor, Mr G. J. Thompson to AFMA National Convention, Sydney, 14-15 September 1995.

Council of Financial Supervisors

Introduction

I appreciate the opportunity to talk about the Council of Financial Supervisors in this session on 'Financial Markets Self-Rule'. It seems a little odd in a discussion of self-regulation to be talking about a group which brings together the main financial regulators – to plot and scheme, and generally get in the way of financial markets! But the Council and its members do have a close interest in self-regulatory initiatives, and we are keen to explore with the industry how they can usefully complement official regulation. As a banking supervisor and a member of the Council, I certainly welcome all the help which industry participants can offer in ensuring that financial markets operate with the high standards of efficiency, security, stability and fairness which the community expects.

My comments are under two main heads:

- the role of the Council; and
- general remarks about self-regulation, or self-rule.

Council's background and objectives

The Council of Financial Supervisors was established by the Commonwealth Government in 1992, following a recommendation of the inquiry into banking and deregulation by the House of Representatives Standing Committee on Finance and Public Administration – better known as the Martin Committee after its then-chairman. Its basic rationale was – and remains – to improve communication and co-ordination among the main agencies responsible for regulation and prudential supervision in the financial system. These are, in no particular order, the Reserve Bank, the Insurance and Superannuation Commission, the Australian Financial Institutions Commission and the Australian Securities Commission.

Looking back to the original recommendation for a Council, it seems that the Martin Committee's main concern was more effective supervision of *financial conglomerates* – groups of financial institutions which are linked by ownership or, occasionally, less formal ties. The Committee observed that financial conglomerates were becoming more common in the Australian

financial system and that they posed particular supervisory challenges. In particular, since the various component institutions of a conglomerate are usually supervised by different agencies and the health of one constituent entity cannot realistically be considered independently of the others, it is important that there be effective communication between the agencies. There need also to be safeguards against double-counting of capital between members of the group, precautions against complex structures which could disguise true financial positions, and so on.

A second reason to get supervisors talking to each other in a Council is the trend for traditional *boundaries* between financial products, and the services offered by different groups of financial institutions, to be less clear than they used to be. This trend raises questions about whether current regulatory requirements, for institutional groups and/or product types, need to be harmonised in the interests of equitable treatment for providers and simplicity for consumers of financial services.

I think the Martin Committee also had in mind that a Council would be helpful in responding to *financial crises*. As our financial markets and institutions are becoming more intertwined – even leaving aside the spread of conglomerates – the potential has grown for a disturbance in one segment to be felt widely elsewhere in the system. To respond to crises and anticipate their secondary effects we need ways of ensuring regulatory co-operation and, at times, co-ordinated action.

Over the past three years the Council has become a flexible, low-cost, effective vehicle for identifying and addressing these sorts of issues. More mundanely, it is helping to promote the member agencies' understanding of trends and problems across the financial system as a whole. It meets three or four times a year, reports to the Treasurer (through the Parliamentary Secretary to the Treasurer) and publishes an Annual Report.

I don't want to give the impression that the regulatory agencies never spoke to each other before the Council arrived. They did. What

the Council has added is a regular forum for *multilateral* discussion of systemic issues, and other matters which run beyond the interests of one or two agencies. As a byproduct, bilateral contacts have also been strengthened.

Having outlined what it *is*, I should also make clear what the Council is *not*. It is not a statutory body, and it has no formal supervisory or other powers in its own right. It is not, in any sense, a mega-regulator or 'super-supervisor' and its formation has not altered the existing legal powers and responsibilities of its members.

Council's activities

Discussions at Council over the past three years have ranged widely, including the lessons from Barings, the best way of organising supervision of friendly societies, the pros and cons of more integrated ombudsman arrangements in the financial system, and arrangements for disclosure of counterparties in transactions arranged by funds managers. Its most substantive work has been in the following four areas.

Sharing information

A prerequisite for effective co-operation is that the various regulators be able to exchange information which is, for the most part, provided to them confidentially by market participants. Council has identified a number of legislative impediments to such information-sharing and is now seeking to have these removed. Pending the necessary amendments to legislation, it has agreed on interim working guidelines for the exchange of information.

Financial conglomerates

Council has also agreed on broad guidelines for cooperation among the supervisors of institutions which are linked in a financial conglomerate. These refer, *inter alia*, to the sharing of information and to handling financial difficulties within the group. In case of serious problems the supervisor of the parent (or largest) entity would co-ordinate a response – that is, take on in these circumstances something of a 'lead regulator' role.

Another important issue currently occupying the Council is the merits (and otherwise) of special purpose holding companies at the head of conglomerates, and the supervisory arrangements which should apply to such companies.

The Council is not yet convinced of the need for formal 'lead regulator' arrangements which have been adopted for conglomerates in some other countries. On this and other issues, such as ways of assessing capital adequacy at group level, Council has been keeping in close touch with the work of the Tripartite Group – an international committee of banking, securities and insurance regulators which is attempting to codify best practice in supervision of financial conglomerates.

Overlaps

On occasions, the regulations of two agencies will both impact on a financial institution, or on a particular segment of its activity. This can occur with conglomerates. It also arises where one agency (usually the ASC) regulates conduct in a particular *market*, while another supervises *institutions* which operate in that market.

An example is the Reserve Bank's disclosure requirements for bank-owned funds managers, which aim to protect the parent from 'moral risks', and the ASC's rules to ensure proper disclosure of risks to investors with the subsidiary. The Council can help to avoid inconsistencies in these requirements.

Another example of overlap arises when the ASC requires participants in a market to meet certain prudential operating standards. Where some players in that market are already supervised on an institutional basis by the Reserve Bank, the ISC or AFIC, it seems both unnecessary and undesirable for a duplicate set of controls to be imposed. This principle is recognised in CASAC's proposals for regulation of players in OTC derivatives, at least in respect of capital requirements. No doubt there will be further consideration of this issue in the Council.

Level playing fields

The phrase 'level playing fields' typically means different things to different players.

What I have in mind here is the question of how far functionally similar products and services should be subject to the same (or similar) regulation. For instance, public unit trusts, investment-linked insurance policies and public offer accumulated contribution superannuation funds are all, with minor variations, long-term savings vehicles. Under present arrangements, however, they are covered by different 'product rules' on information disclosure, and there are different requirements of the agents, brokers and advisers who market them. Are the differences justified by the fact that products are offered by institutions falling under different regimes of prudential supervision? If the differences are a problem, how would they best be resolved? Is harmonisation preferable to a monolithic regulatory system? How important is preserving the spectrum of risk for investors in all this?

These questions are currently the subject of a study by the Council.

What of the Council's future?

The Council was set up in response to emerging trends in the structure of Australia's financial system. No doubt, as this system evolves further, the shape of our supervisory/regulatory arrangements – of which the Council is now an important part – will also change. Its relatively informal and flexible structure means that it is well-placed to adapt as necessary. The Council does not see itself becoming some kind of mega-regulator but I suspect that, over time, it could well acquire more formal status and authority than it has now. This could happen in a modest way if, for example, legislation were to recognise Council membership for certain purposes of information-sharing among agencies.

Self-Regulation

The Council has not developed a formal policy on 'self-regulation'. Nor, of course, has it had the opportunity to consider AFMA's

proposals which are being unveiled at this Convention. So the following general remarks have a Reserve Bank perspective, but I believe there would be pretty broad agreement with them.

It is important to recognise that 'self-regulation' is a fundamental feature of financial markets in the sense that, whatever official supervision might exist, the *ultimate responsibility* for the prudent and 'ethical' operation of financial institutions always rests firmly with the boards (or their equivalents) and senior managers of those institutions. This principle certainly underlies the Reserve Bank's approach to supervising banks; it is illustrated by the greater attention we are giving to the quality of risk management systems in banks and to the need for boards and senior managers to take a close interest in these. The ISC's recent proposals for guidelines on use of derivatives also rest on this principle.

Equally, there are no pure self-regulatory systems. All participants in all markets are subject to (at least) the constraints of basic corporations legislation and the common law.

What we see in practice is a spectrum of arrangements, with different mixes of official regulation and self-regulation. The challenge is to find the best balance in each case.

Clearly, the general community will always tend to favour official regulation. This stems from innate scepticism that the regulated can effectively 'do the job' on themselves, even with the best of intentions. It means that proponents of self-regulatory schemes will always need to work pretty hard to convince others of their credibility and effectiveness.

Notwithstanding the scepticism, there are clearly areas where self-regulation – or at least a good dash of it – can make an important contribution. One example is in promoting ethical standards of behaviour in markets; such standards are difficult to codify in regulation and can be difficult to enforce in the absence of widespread acceptance by market participants themselves. Guidelines may be more meaningful and more willingly observed if they are put together and 'owned' by the industry.

Another difficult area for official regulators is relatively new markets where rapid change is the order of the day. Hasty attempts to regulate these could be particularly harmful in stifling innovation or creating incentives for avoidance. The more exotic derivatives markets can be seen in this light, and supervisors have consequently tended to focus on encouraging disclosure of more information to markets, and urging participants to develop strong internal systems for risk management.

In today's complex markets any official regulations are likely to be more soundly based if they are developed in consultation with industry, drawing on the technical knowledge and the closer understanding of trends which market participants can bring. Prior consultation does not, of course, guarantee that industry will always agree with regulations. Nor is it intended to; but at least industry views will have been taken into account, and regulation should be more soundly constructed as a result.

The credibility and effectiveness of any type of regulation depends heavily on the mechanisms for monitoring compliance, and exercising discipline when there are breaches.

Self-regulatory arrangements are best suited to *professional markets*, where the players are sophisticated and knowledgeable, and relatively few. Breaches of behaviour codes – or of standards for prudent conduct – should be quickly recognised, and information about them disseminated speedily to others. Business will tend to move away from the unprincipled and unsound. In other words, the market itself acts as a disciplinary force. Fraud and misrepresentation can be dealt with through legal channels because aggrieved parties are likely to be of sufficient substance to access these.

Those sceptics I referred to earlier will usually question the effectiveness of relying solely on market discipline, even with sophisticated players. They will prefer to see this supplemented by some industry-sponsored monitoring system, and industry-based mediation to reduce resort to the courts.

Even with well-constructed self-regulation

there usually remains an important place for official involvement in professional markets, because of the risks which major malfunctions in such markets can pose to the wider financial system. It is not so easy for self-regulation to deal with these concerns. Once again, the OTC derivatives field comes to mind.

Official regulation must play the major role in *retail markets*. The customers are less knowledgeable and less able to interpret complex information; and they have less capacity, as individuals, to sanction or seek redress against institutions which fail to meet proper standards. In these circumstances the market is a less efficient disciplinarian. (Even then, self-regulation can still play a part. The

banking industry's code of practice for retail transactions illustrates this – but it would not be credible without the formal mechanisms for monitoring compliance and resolving disputes provided by the Australian Payments System Council and the banking ombudsman, respectively.)

Finally, I note that an increasingly significant influence on standards in regulation and self-regulation is 'the rest of the world'. With finance, particularly at the wholesale end, becoming more international, Australia's arrangements have to be compatible with best practice if our institutions and markets are to participate fully in the global scene.