Achieving Effective Supervision

Talk by the Chief Manager, Bank Supervision Department, Mr B.L. Gray, to the 10th Annual Australasian Finance and Banking Conference, Sydney, 5 December 1997.

Introduction

By the middle of 1998, legislation permitting, a new regulatory agency will come into existence. It will reflect the Wallis Committee's call for a more integrated and consistent approach to prudential supervision and regulation, geared towards a rapid pace of change in the financial system and an increasing prevalence of financial conglomerates. APRA, the Australian Prudential Regulation Authority, will combine the banking supervision functions of the Reserve Bank with the activities currently carried out by the Insurance and Superannuation Commission. On present plans, the new agency will be supplemented in the middle of 1999 by inclusion of the supervisory functions of AFIC (the supervisor of building societies and credit unions). With the Wallis Committee's recommendation on this accepted by the Government, the key challenge now is to put in place the new arrangements to achieve a flexible regulatory system focusing on both the prudential soundness of the financial system and, importantly, financial system efficiency.

Issues

As a preliminary, I should make the obvious point that the new arrangements are not starting from scratch (or worse, starting with a financial system which is in trouble, or a regulatory system which is deficient). The new arrangements build on a well-functioning system, but seek to adapt it to expected future developments. The task is to take over the best features of the current approach, to continue the kind of adaptive evolution which has occurred, and to tailor the existing institutions more precisely to achieve a snug fit with the demands of a fast-changing financial sector. It is never possible to achieve perfect congruence between institutional arrangements and multi-dimensional needs, but there is now a new opportunity to re-align institutions and methods. The various objectives will not flow *automatically* or easily, however, from creating a single prudential regulator. So there is some point in offering some thoughts, as the Bank passes on the baton to the next runner, urging them to run the good race. In that spirit, let me offer the following comments.

First, I will touch on the issue of flexibility. There can be a tendency for regulators covering a wide institutional field to become more highly bureaucratic than those with a narrow focus. A legalistic, accounting-based approach to regulatory matters can emerge over time. Why is that the case? The answer is relatively simple. Big institutions by their nature tend also to be complex institutions. The simplicity, flexibility and innovation that is often the hallmark of a smaller entity can fade with size. This view should not be especially controversial for it applies to most organisations and institutions – it is why the small to medium business sector is often viewed as the engine for growth and employment in the economy. It is why mergers of smaller businesses into large corporates often fail to deliver the expected benefits.

Sometimes large regulators also have large rule books which are often written into legislation. The rationale is usually that this approach is more consistent with the notion of the level playing field, with everybody in the market knowing the rules of the game. There is often, also, a strong sense that supervisors should not be permitted to make arbitrary judgments on policies or supervisory approaches. Policy is policy and should be applied to the letter of the law until it is changed. It is an approach that is administratively tidy. Yet, there is also a big cost, for as soon as you proceed down that legalistic path, flexibility can disappear.

Regulatory rule books can, of course, always be rewritten and legislation changed where circumstances warrant but the time scales involved in achieving change through that channel can be measured not in days or weeks but sometimes in terms of years. The history of the Capital Adequacy Directives in the European Union is compulsory and sobering reading for anyone who might question this view.

In developing APRA, therefore, it will be important to keep those dynamics firmly in mind. The financial system of the future will require an increasingly flexible and quick-footed approach to prudential supervision and one of the key challenges will be to ensure that the regulatory system meets that need. Financial institutions should be able to get a quick answer when they come to the regulator with a proposal. They should also feel that they do not have to be accompanied by their lawyer.

There is every reason to believe that this objective can be achieved if it is kept in mind. A noteworthy feature over the past five or so years has, in fact, been the increasing trend internationally towards 'market friendly' approaches to supervision. One example of this trend in Australia is the development of the on-site visit programs to banks, covering first credit risk and, more recently, market risk. Such developments can be described as market friendly not because they have led to any easing of prudential standards, but because they reflect an approach to supervision that aligns itself more to the way that banks themselves think about and address risk. Rather than requiring banks to provide reams of standardised statistical data on, say, the health of their credit portfolios, the approach has been to reach in to the information and data that the individual banks have developed for their own credit risk management purposes, and to examine the systems and controls in place to measure and manage the risk. The same approach applies in relation to the supervision of traded market risk in banks and, in theory, could apply to all other forms of risk facing financial institutions.

By taking that path, the supervisory burden on institutions is reduced, supervisors get better information than could otherwise be obtained and, through closer interaction between the bank and the supervisor, the result is a much improved understanding between the two parties. It should be recognised, however, that it is also a more difficult approach to adopt and can make consistency of treatment across institutions harder to achieve. It is not as tidy as the traditional approach. It requires supervisors to know more about the businesses they supervise. It is also an approach that, possibly, may be at odds with the natural inclination of some supervisors or regulators to stay quite removed from the activities and institutions they monitor. The outcome of the preferred approach, however, is a much better balance between prudential objectives and market efficiency.

As we look to the future of the financial system, and to the development of prudential standards over time, there is no doubt that this approach of utilising institutions' own risk measurement and management systems, and of requiring the management and Boards of institutions to vouch for the adequacy of those systems, must be the way forward.

As mentioned earlier, the Wallis proposals for a single prudential supervisor also turned very much on the idea that the process of financial intermediation, and financial services more generally, was blurring and becoming less distinct. The implication is that the supervision of different types of financial entities should be more consistent and integrated within a single agency. There are a couple of dimensions to this. At the simplest level, while the broad policies applying to what we currently define as banks and building societies can be reasonably aligned, the supervisory approach adopted and the techniques applied to an intermediary with a balance sheet of $150 billion will be quite different from the situation where a balance sheet of $50 or $100 million or less is involved. I think that point is well understood.

Integrating supervisory approaches applied variously to deposit-takers or intermediaries, traditional forms of insurance and superannuation will be very complex. There is a real opportunity, however, for APRA to smooth out some of the regulatory inconsistencies which currently exist between banks and insurance companies especially. Not all of these inconsistencies will be capable of being ironed out, simply because of the nature of the different sorts of businesses conducted by banks and insurance companies. The practical task will be to look for the areas of commonality between deposit-takers and insurance businesses especially, and develop consistent policy where it is possible. That should be an early priority for the new regulatory agency.

The new framework should handle conglomerates more neatly than at present, but bringing different institutions under one regulatory roof should not be allowed to disguise differences in underlying characteristics of the various institutions or the products they offer. APRA should work hard to spell out the boundaries between financial instruments offering capital guarantees and the market-linked returns found more frequently in the superannuation area. Those distinctions are likely to remain over the long term. It will be important to ensure that any confusion in the mind of the investing public between these product boundaries is not accentuated by the presence of a single prudential authority covering banking and superannuation.

I want to say something about supervisory philosophy because, ultimately, I think it is the key to achieving effective supervision. Whether it is in relation to the style of supervision, or the policies applied, or the approach to integrating supervisory arrangements across different types of institution, the model has to be forward looking and innovative. I would summarise all this by saying that APRA should be very much a policy-driven, not process-oriented, agency. Analytical effort is central to the task, which will require it to invest in a significant financial research capability. That last point will come as a surprise to some who would not normally associate supervision and regulation with a strong research focus. Research, policy and good supervision are inextricably linked. I would go as far as to say that in a dynamic financial system, supervision is likely to be ineffective and generate significant financial inefficiencies unless it is backed up by high-level research and analytical effort focusing on broad developments in the structure of the financial system, trends within financial institutions, financial markets and the interconnections between them. The characteristics of emerging financial products and instruments need to be understood and leading edge work must be done in the area of risk measurement and management and in the modern finance theories which increasingly underlie developments in this field.

Only by carrying out work of this nature can supervisors be attuned to emerging developments in the system and be capable of responding accordingly. Only through an emphasis on research, and the spreading of the resulting work into the closely related policy area, and then into the operational sides of the institution as a whole, that you can guarantee that supervisors will be credible in the eyes of the people they deal with day-to-day – the supervised institutions. There is a good deal of evidence to back this view. Come the end of this year, the Reserve Bank will be one of the few banking supervisors internationally to implement the internal models approach to traded market risk. The reason I believe we will be in a position to do so links back to the research work carried out on market risk, financial instruments, evolving risk methodologies, and so forth, over the past four or five years. Some overseas supervisory agencies that have not devoted resources to market related analytical and research activities are lagging the field. The problem, of course, is that the institutions they supervise are not lagging, the effect being that regulatory arrangements are holding back the market and creating inefficiencies.

As I mentioned a little earlier, these approaches we have applied to traded market risk, involving the use of sophisticated models and reliance on more rigorous risk management frameworks, will come to be applied to other forms of risk (credit risk, operational risk, etc.) and to institutions other than the banks. APRA should have the capability to deal with those eventualities.

Conclusion

I will conclude with the thought that there is now a very strong commitment within the Australian regulatory community to APRA and to ensuring that it becomes a first-rate prudential supervisor capable of handling the issues likely to be confronted within the financial system over the next decade. Success as a prudential supervisory agency will not flow solely, however, from the reorganisation of functions between the current set of prudential regulators. Rather, it will be a product of the development of an appropriately flexible market-oriented philosophy within the new authority. A dynamic, policy-driven institution, feeding off strong research capabilities which, in turn, feed into equally robust operational areas, will achieve the objectives set for it by the Wallis Committee and the Government.