

Prudential Supervision and the Changing Financial System

Talk by Deputy Governor, Mr G. J. Thompson, to Monash University Law School Foundation, Melbourne, 28 March 1996.

I propose to talk about some current financial system trends, which will no doubt receive attention in an inquiry, and their implications for regulation.

Introduction

With the new Government foreshadowing an inquiry, regulation of the financial system promises to be more than usually topical over the next year or so. Such an inquiry – some fifteen years on from Campbell – will be timely in view of the important changes occurring in the shape and features of Australia's financial system. It should help to clarify the way forward on a number of issues. It should also provide the opportunity for various hobby horses and special pleadings to be thoroughly scrutinised.

It is pleasing that the inquiry will take place in an environment which should be conducive to a considered assessment of regulatory questions – and not against a backdrop of financial instability. Following the problems of the early 1990s, the Australian financial system has recovered rapidly and is currently in sound shape. The banks, in particular, are well-capitalised and enjoying strong profits.

Types of Regulation

There are two broad categories of financial regulation or supervision.¹ These should be clearly differentiated because failure to do so often confuses debate about the need for reform.

(i) Prudential supervision

The first category is prudential supervision, which has the primary objective of promoting the *stability* of financial institutions and/or of the financial system more broadly.

Prudential supervision focuses on *institutions*, with the aim of protecting their solvency or viability. As the term suggests, prudential supervisors are concerned with ensuring – or, more realistically, encouraging and promoting – prudent behaviour by managers of financial institutions. So this sort of supervision

1. A third category of regulation relates to competition, but the main law on this – the *Trade Practices Act* – does not have special provisions for the finance industry.

involves capital adequacy ratios, liquidity ratios, systems for managing various risks, limits on large credit exposures and so on. Prudential supervision is importantly also concerned with preventing a problem in one institution from spreading more widely in the financial system. This objective of *system stability* is the main reason that, historically, banks have been supervised especially closely.² Particular characteristics of banking – such as the importance of depositor confidence in institutions which borrow short and lend long, combined with the difficulties in objectively valuing many bank assets, and the interconnection of banks through the payments system – mean that one bank's problems can spread quickly to others. Widespread banking problems can cause broad damage to the economy, not only by threatening access to the community's financial wealth but by interfering with the payments system and jeopardising credit flows, especially to individuals and small businesses.

The Reserve Bank, as you know, has supervisory responsibility for Australian banks. Its relevant powers and objectives are set out in the *Banking Act* which, in the very terms I used a little earlier, charges the Bank with 'the encouragement and promotion of the carrying out by banks of sound practices in relation to prudential matters'. The Act defines prudential matters (in part) as relating to the conduct of a bank so as to 'keep itself in a sound financial position' and 'not to cause or promote instability in the Australian

financial system'.

Another section of the Act imposes a specific responsibility on the RBA to protect the interests of depositors with banks. That provision, originally in the 1945 Act, emerged from the Government's consideration of the 1937 Report of the Royal Commission on Monetary and Banking Systems. At that time, with banks by far the largest group of financial institutions and controlling the bulk of community savings, protecting depositors amounted to the same thing as promoting system stability and preserving the flow of credit to business.

We supervise individual banks with a view to reducing the likelihood of their failure. To limit the risk of wider damage to the financial system due to serious problems of one bank (which no supervisor should or can absolutely guarantee against), we also take a very close interest in procedures for dealing with an institution's inability to meet its obligations in financial markets and in the management of interbank settlement risk in the payments system. To this end we are sponsoring reforms which will eventually see high-value payments among Australian banks settled on a real-time gross basis, rather than the present deferred net basis.³

There are only two other important agencies⁴ in the prudential supervision field – the Insurance and Superannuation Commission (ISC) for insurance companies and superannuation funds and the Australian Financial Institutions Commission (AFIC), established in 1992

2. It is also why central banks – which have broad responsibility for financial system stability – are commonly the supervisors of banks, but much less so of other financial institutions.
3. The RBA's broad interest in financial system stability is reflected also in its chairmanship of the Council of Financial Supervisors, the Australian Payments Clearing Association and the Australian Payments System Council, and its regular liaison with groups such as the Sydney Futures Exchange and the Australian Financial Markets Association.
4. The Australian Securities Commission (ASC) is not, strictly speaking, a prudential supervisor – being primarily concerned with promoting efficiency and confidence in securities markets through enforcement of the disclosure and conduct provisions of the Corporations Law. In this, it works with industry-based organisations such as the stock and futures exchanges. If draft recommendations of the Companies and Securities Advisory Committee are adopted, the ASC would acquire some prudential-type responsibilities in relation to certain institutions in over-the-counter derivatives markets.

to oversee building societies and credit unions.⁵

The responsibilities of each prudential supervisor are clearly specified in law. And no individual financial institution is subject to supervision by more than one of them.

(ii) Product regulation

The second major type of financial regulation deals with fair treatment of investors and borrowers. A short-hand (not totally satisfactory) label is 'product regulation'.

Its underlying purposes are:

- to protect customers' interests in their dealings with financial institutions, with particular concern for the less sophisticated – requirements for disclosure and complaint-resolution are usually more stringent in retail markets than at the professional or wholesale markets end; and
- to promote competition and efficiency by improving the quality of information for market participants.

Product regulation deals with standards, guidelines and rules for the provision to customers of comprehensive, accurate information about the terms and conditions attaching to financial services, and of objective advice about alternative (often complex) investment products. It also takes an interest in procedures for lodging complaints and in arrangements for resolving disputes between financial institutions and their customers. It can extend as far as prescribing the supply of certain products, in particular forms and at certain prices.

In the banking field, this sort of regulation (broadly defined) is embodied in laws such as the uniform State credit legislation and the *Trade Practices Act*, in the industry-based Code of Banking Practice, in the monitoring activities of the former Prices Surveillance Authority (now part of the Australian Competition and Consumer Commission) and in the terms of reference

and operating procedures of the Australian Banking Industry Ombudsman. There are separate regulations and codes with similar intent in the insurance, superannuation and investment fields, generally the responsibility of either the ISC or ASC. Consumer protection provisions of the *Trade Practices Act* apply across the board.

The public interest concerns behind prudential supervision and product regulation are not totally distinct. (Both are, for instance, prompted to some extent by the difficulty for individuals of gathering relevant information and by particular concern for the interests of the financially unsophisticated.) But, in their objectives and their methodology, they are very different.

To put it rather baldly, prudential supervision is about techniques of risk management, while the other is about standards of customer service. It follows that the skills and knowledge required for the two tasks are also rather different, and are likely to reside in different agencies.

The other important difference is that, while prudential supervision has an *institutional* focus (it is impossible to oversee solvency without taking account of the full range of an institution's activities), product regulation need not. In fact, effective competition requires similar basic rules of disclosure etc to apply as widely as possible to *similar products*, regardless of who offers them. This principle is embodied in the State credit laws which apply to any credit provider; it was also accepted in the adoption of very similar codes of practice by banks, building societies and credit unions, all three being monitored by the Australian Payments System Council.

While my main interest is in prudential supervision, I suspect there is room for some rationalisation in arrangements for product regulation. A large number of laws and agencies impinge on financial institutions in this area, as I indicated in relation to banking, and an inquiry will almost certainly be able to identify avoidable costs and inefficiencies.

5. AFIC establishes common prudential standards which are, in practice, implemented by an agency in each State.

Changes in the Financial System

I noted at the outset that an inquiry will be able to review the need for change to regulatory arrangements occasioned by changes in the shape of the financial system. These changes are undoubtedly significant (although habitually exaggerated by those feeling threatened). They are driven by the powerful forces of globalisation, technological change and deregulation, while government policies to promote retirement saving are also important.

The broadest manifestation of all these changes is *increased competition*. We are seeing:

- the entry of additional 'traditional' players (eg more foreign banks, some as branches);
- emergence of new suppliers of traditional products (eg mortgage originators in housing loans);
- the development of new products, offered by both established and new players (eg complex derivatives);
- new delivery systems (eg phone banking, EFTPOS and stored value cards) with a bigger role for non-financial entities, such as Australia Post and telecommunications companies; and
- the growth of funds management relative to intermediation; funds managers now control 39 per cent of financial system assets, compared with 26 per cent in 1980.⁶

While creating both opportunities and challenges for established suppliers of financial services, these changes have generally been beneficial for the community: they are increasing the range and sophistication of

products, allowing services to be tailored more closely to the needs of customers and promoting competition in pricing.

As well as impacting on both suppliers and consumers, financial system change requires adaptation in supervision and regulation. It is not surprising that we have seen major developments in prudential supervision in recent years. These include the formation of the Council of Financial Supervisors, the establishment of AFIC and, specifically in the banking area, prudential guidelines covering banks' involvement in funds management and securitisation, guidelines for derivatives business and the development of an RBA capacity to conduct on-site reviews of banks' risk management systems.

No doubt there are further changes ahead, although I doubt that these need to be as radical as some commentators suggest. I would like to consider three topical examples of change and their implications (if any) for prudential supervision: securitisation and, in particular, the associated activities of mortgage originators; so-called 'blurring of distinctions' between traditional categories of financial institutions; and growth in financial conglomerates.

Securitisation/mortgage originators

Securitisation – the bundling of loans into packages financed by the sale of marketable securities – has not been common in Australia until quite recently. It is now an important force in the market for residential mortgages and, while not yet prominent elsewhere⁷, is likely to spread. Contributing to this will be the growth in superannuation and other funds managers with an appetite for securities as an investment, the desire of banks to manage their capital and liquidity more efficiently and relaxation of supervisory limitations on bank support for securitisation vehicles. Housing

6. Even so, the banking sector remains the largest and most diverse in the financial system. Banks currently control 47 per cent of financial system assets, compared with 42 per cent in 1980. Their significance is greater when account is taken of their dominance in the payments system and in trading of financial instruments. Consolidated with their subsidiaries, banks (excluding State Bank of NSW in 1995) control 56 per cent of financial system assets, compared with 53 per cent in 1980.

7. It is something of an urban myth that there has been substantial disintermediation of other forms of debt finance in Australia in recent years. In fact, the proportion of corporate debt sourced from banks and other intermediaries in 1995 (about 54 per cent) was a little higher than five years earlier.

loans were an early candidate for securitisation because they are relatively homogeneous, and low-cost originators could undercut the banks on a line of business where their interest margins were wide (in part to support the cross-subsidisation of transaction and other services supplied below full cost).

Banks have securitised some mortgages which were previously on their balance sheets, but the main activity has been in new loans written by non-bank originators. In the past year, these have accounted for almost 10 per cent of housing finance approvals to individuals, compared with a negligible figure only a few years ago. Around half of this has been funded through securitisation vehicles (many bank-related), the rest by financial intermediaries on-balance sheet.

What supervisory implications are there in this?

I argued earlier that similar *product* regulation should apply to a housing loan from whatever source. By and large, this is the case – the activities of originators will be covered by the forthcoming Consumer Credit Code in relation to standards of disclosure and explanation, and are already subject to the consumer protection provisions of the *Trade Practices Act*. Meanwhile, wholesale offerings of the securities backed by mortgages are subject to the Corporations Law.

There have been suggestions that mortgage originators or the associated securitisation vehicles should be subject to *prudential* capital requirements similar to those for banks. But, as outlined earlier, these requirements are to protect banks from insolvency and their depositors from loss – objectives which are simply not relevant for the originators or their securitisation vehicles, neither of which has deposit-type liabilities. The funding comes via marketable securities issued in professional money markets (or from banks), while

mortgage originators are agents with no significant balance sheets of their own.

This is not to say that the RBA as prudential supervisor has taken no interest in the originators, or in securitisation generally. Quite the contrary. But our primary interest is in the connections between these activities and risks carried by banks. For instance, capital requirements apply in the usual way when a bank finances originated loans and keeps them on its balance sheet. Capital must also be held against bank-provided credit enhancement and liquidity facilities for mortgage-backed securities. Banks have also to ensure, through appropriate disclosure, that investors in securitised mortgages issued by a bank-associated vehicle cannot confuse such investments with deposits. Where banks directly fund loans organised by an originator they are expected to satisfy themselves about the credit-worthiness of the borrowers as they would if writing the loans themselves. And because of their potential liabilities under credit legislation, banks (or associated trustee companies) should also ensure that the originators with whom they deal are observing required standards of behaviour toward borrowers.

It is hard, however, to see why there should be prudential supervision *directly* of the mortgage originators. The failure of an originator (or several of them) would have no significant ramifications for investors or borrowers, or for the broader financial system.⁸ There would, at most, be some inconvenience until a new servicing agent was appointed for existing loans.

Although there is no rationale for prudential supervision of these new channels of finance, their emergence does draw attention to the (unintended but real) competitive impacts of prudential requirements. Compliance costs are by no means the only costs which can

8. Investments in a securitisation program might, of course, perform poorly, causing unexpected losses for professional investors. These investors are, however, well-placed to assess the risks they take on. Moreover, such losses do not have the same potential impacts on credit flows or the payments system as may flow from losses in a bank.

In the longer term, there may be issues for macroeconomic policy to resolve as an increasing proportion of household savings is held directly or indirectly in securities whose values are subject to market fluctuation. To date, however, this has not caused significant problems in the United States where securitisation is much more advanced than here.

disadvantage banks and other established intermediaries relative to the new players, but they are one component. Recognising this, governments and supervisors should from time to time review whether the appropriate balance is being struck between the *benefits* of prudential requirements, in terms of safety, stability and public confidence, and the direct and indirect compliance *costs* for supervised industries.

Unfortunately, precise assessments are impossible here and the 'right' trade-off depends ultimately on the community's willingness to accept risk in the financial system. Judgments therefore inevitably involve social and political elements. An inquiry may be able to offer some general views.

'Blurring' of traditional distinctions

The term blurring is commonly used, but less often defined. Here, I take it to mean that life insurance companies and funds managers are offering some products which have been largely the preserve of banks, building societies and other intermediaries, and some products which replicate these. Examples in the first category would be housing loans and, in the second, certain capital-guaranteed, relatively liquid investment products.

Banking groups have also, of course, become increasingly active in insurance and funds management but (mainly) through subsidiaries which are covered by the same regulations as stand-alone insurance companies and funds managers. This trend is properly considered under 'conglomerates', to which I will come in a moment.

Blurring has been attracting a good deal of attention from those feeling the effects of extra competition for the marginal customer. It is, however, hardly new – for instance, life insurance companies were much bigger housing lenders in the 1960s than they are now. And its extent is often overstated.

Even so, it is a reason sometimes advanced for combining prudential supervisory regimes for banks, insurance companies and so on. The argument seems to be that these institutional groups have become so similar (or will soon become so) that it makes no sense to have

them supervised by different agencies. Combination would not only ensure the convergence of currently different regulations, but would reap some resource economies as well.

There are two problems with this reasoning. First, a position of essential similarity between the main groups of financial institutions has *not* been reached in Australia (or anywhere else, even where regulatory agencies are combined). So far, the 'intrusion' by the one group into another's traditional patch is very small in relation to their aggregate business. Furthermore, there remain fundamental differences in the overall nature of banking, insurance and funds management business, the structures of balance sheets and the risks involved. These call for different supervisory approaches, and mean that there would be few economies of scale in combining agencies.

Most financial products can be typified as either capital-guaranteed (eg deposits, annuities, defined benefits superannuation, and much insurance) or market-linked (unit trusts, investment-linked insurance products and accumulation superannuation). The former are supported both by assets and supplementary capital/reserves/guarantees, with the various risks carried in the first instance by the product provider. The latter are usually supported solely by assets, with risks carried by the investor. Within capital-guaranteed products, there are important distinctions between the types of risk to be managed and supervised – for example, the credit and market risks associated with a typical bank balance sheet are very different from the insurance risks related to death and other distant events.

Moreover, while overlaps might well increase in future, it is unlikely that there would ever be a full merging of the different sorts of balance sheets in the one financial institution or legal entity. There could be formidable legal obstacles – stemming from the different claims available to classes of stakeholders such as depositors, policyholders and investors – to the co-mingling of different product classes in one entity. Notional segmentation in a single balance sheet could

address some such issues, but might not avoid all legal questions about the separation of assets, and the ranking of access to reserves, in the event of liquidation or merger.

I note that, in the few countries which have a single regulatory agency, the supervision of banking and insurance remain essentially separate in practice.⁹

Financial conglomerates

An important development over the past decade has been the increasing role of financial conglomerates, groupings of financial institutions under common ownership. About 70 per cent of Australia's financial system assets are managed by the 25 largest conglomerates.

Conglomerates are becoming more significant as specialised financial institutions seek to offer within their group a comprehensive range of products and to economise on distribution infrastructure. The interest of banks to share in the expansion of funds management (including superannuation) has been probably the main factor, but insurance companies have also been keen to offer loans, deposits and payment services through subsidiary banks and building societies. Some insurance companies have also been attracted by the distribution possibilities of banks' branch networks, although this attraction will diminish as electronic distribution channels become more widely accepted by consumers.

This availability of a range of financial services from different legal entities under the one umbrella is another sort of 'blurring'. It increases the need for clear disclosure of the details of each product on offer, eg investors in equity trust units sold in a bank branch should be under no misapprehension that they are buying a bank deposit.

Financial conglomeration also complicates the task of prudential supervisors who, in addition to their normal concerns, must take into account:

- the risk that weakness in one part of a

group might spread to other parts, known as contagion risk; this is especially difficult to deal with if important components of a conglomerate are unsupervised;

- lack of transparency in intra-group linkages, which can complicate assessment of the soundness of the group or of individual components; this can be a particular problem with international conglomerates;
- the potential for double-counting of capital; and
- the operational risks from management's being stretched over a diverse range of activities.

These potential problems are generally less of a worry when a conglomerate is dominated by one of its constituent entities and, until quite recently, this has been a characteristic of the Australian scene. Conglomerates-of-equals will probably become more common, Colonial's purchase of the State Bank of New South Wales producing one example.

The growing importance of conglomerates is a world-wide phenomenon and prudential supervisors are responding in several ways: liaison and cooperation among agencies is being enhanced; techniques such as consolidation and deduction are being adopted to help in assessing capital adequacy across groups and to avoid double-counting; and closer attention is being paid to intra-group linkages and to the transparency of ownership structures.

An international group (called the Joint Forum on Financial Conglomerates) comprising representatives of banking, insurance and securities regulators has recently been established to progress thinking in this area, foster cross-border cooperation and see how far techniques for supervising conglomerates can be standardised across countries.

It is sometimes suggested that the issues raised by conglomerates could be handled best

9. Among the 25 OECD countries, only Canada, Sweden, Denmark and Norway have banking and insurance supervision under the one roof.

by a single regulator, combining the agencies with present responsibilities for component entities. It would not, however, be possible to create a single regulator simply to deal with conglomerates. Such an agency would have to extend across the whole financial system because it would, for instance, be absurd to have different regulators for stand-alone banks and for banks in conglomerates.

A more realistic response is a convenor or lead regulator model. In this, each supervisor retains its individual responsibilities but one agency also oversees the health of the conglomerate as a whole and coordinates remedial action if a serious problem threatens. This approach has been implemented in some countries and is being studied by the Joint Forum.

In Australia, the creation in 1992 of the Council of Financial Supervisors was mainly in response to the perceived need for more formal coordination in supervision of conglomerates.¹⁰

The Council – whose members are the RBA, the ISC, AFIC and the ASC – has greatly improved communication and understanding among the main regulators. It has agreed on guidelines for the supervision of conglomerates and is seeking legislative changes to facilitate information-sharing among its members.

While the need to consider a formal lead regulator model has been made less pressing

by the fact that one supervised entity (either a bank or insurance company) has typically dominated Australian conglomerates, Council has recently agreed on a framework for supervising conglomerates headed by special purpose holding companies, which, subject to necessary legislative changes, would have one agency acting as ‘convenor’. It is likely that, over time, this arrangement could usefully be extended to other conglomerates.

While yet to be tested under stress, the Council’s current approach, and its scope for further adaptation, looks to be an effective response to the supervision problems posed by conglomerates.

End Piece

We have seen considerable change in the financial system since deregulation in the 1980s. This will no doubt continue as the winds of globalisation and technological change remain strong.

Australia’s prudential supervision arrangements have already shown the capacity to adapt to meet the resulting challenges. Without wanting to underestimate the extent of further change ahead, I am confident that we can proceed from a base which is both robust and appropriately flexible.

10. Important work on harmonising ISC and ASC product regulation is also being conducted under the Council’s auspices.