Regulatory reform after the financial crisis

– Twin Peaks Revisited

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Outline

- Why the structure of regulatory agencies matters
- The case for "Twin Peaks":
  - Functional despecialisation and financial conglomerates
  - Efficient use of resources
- Six lessons of the crisis

Does regulatory structure matter?

- Sometimes dismissed as "rearranging the deckchairs on the Titanic" (Martin Wolf).
- Temptation for politicians to change regulatory structures after a crisis to be seen "to do something".
- Other factors influencing effective supervision:
  - Clear objectives
  - Independence and accountability
  - Adequacy of resources
  - Effective enforcement powers
  - Comprehensiveness of regulation (Abrams/Taylor 2000)

But structure not irrelevant

- Comprehensiveness
  - Ensuring no significant market or intermediary escapes effective supervision
- Cost efficiency
  - Avoid duplication of resources/activities
- Coordination
  - Ensure that all aspects of a firm's operations are adequately supervised
  - Especially important in crisis management

The Case for Twin Peaks

Institutionally-based structures are outmoded

- Changes in industry structure
- Changes in nature of products
- Neither institutional nor functional approaches were adequate
- Problem of scarce specialist skills

Changing industry structure

- Financial conglomerates
- Abolition of formal (Glass-Steagall) and informal (U.K.) restrictions on investment/commercial banking combinations
- Bank-insurance linkages becoming commonplace
- How to obtain a "group-wide" perspective to monitor their prudential soundness? (Tripartite Group, Supervision of Financial Conglomerates, 1995)

Changing nature of products

- New financial products that overlapped conventional deposit/insurance/securities boundaries
- E.g. Credit Default Swaps – credit or insurance?
- Especially problematic for consumer protection – who regulates which product?
- But also a systemic dimension – OTC (over-the-counter) derivatives markets increased the interconnectedness of institutions, banks and non-banks

Efficiency in supervisory resources

- TP allows more flexibility in allocation of supervisory resources than institutionally-based structures.
- In theory, should be possible to allocate resources according to risk assessment (e.g. vulnerabilities assessment) irrespective of legal form.
- Also allows more efficient use of support services (e.g. IT) and the effective deployment of scarce specialist skills

Lessons of the crisis

Lesson 1: Twin Peaks Analysis was correct

- The crisis has shown that:
  - Industry concentration – in the form of financial conglomerates or "Large Complex Financial Institutions" – now an established part of the financial landscape
  - A wide range of firms (not just banks) are potentially systemically important institutions (Lehman, AIG)
  - To this extent Twin Peaks analysis has been justified: the chain of collapse ran through non-banks, "too interconnected to fail"

Lessons 2: Twin Peaks is superior to a single regulator

- Twin Peaks superior to a single regulator because it permits each agency to focus on a single objective:
  - Political priority likely to be given to consumer protection versus prudential regulation (House of Lords, 2009)
  - Different skills required by consumer protection and prudential regulation
  - Giving "equal billing" to central bank and regulatory agency did not work in practice. Recipe for delayed decisions and lack of coordination (cf. Northern Rock).

Lesson 3: Synergies matter – if they are the right ones

- Twin Peaks rejected in UK because prudential and consumer protection regulation had strong synergies – involved many of the same issues (e.g. management, systems and controls) (Briault, 1998).
- GFC shows that synergies between the central bank's financial stability mandate and prudential regulation more important than synergies between consumer protection and prudential regulation.

Lesson 4: Internal structures also matter

- Even where TP or single regulator has been adopted, there is a tendency for regulation to remain in separate, institutionally-based silos.
- For TP structure to work, needs to be more integration and an agency-wide resource planning process based on an assessment of systemic vulnerabilities.
- This process needs to recognise that supervisory resources not perfect substitutes – e.g. bank supervisors cannot overnight become insurance supervisors (HIH example).

Lesson 5: Structures do not prevent financial crises

- Countries have been affected by financial crisis irrespective of their institutional structure
- Other factors arguably more important:
  - Mandate, powers, resources, independence
- However, bad structures can make crisis management more difficult (as in the UK)
- TP in future will:
  - Improve crisis management.
  - Improve ability to detect risks irrespective of where in the system they arise.

Lesson 6: No one (structure) is perfect

- There is no one right model of regulatory structure
- Regulatory structures need to mirror the structure of the industry
- Institutional structures may remain appropriate where financial conglomerates/despecialization are not major issues

Twin Peaks: The Future

- More emphasis on interaction between micro- and macro-prudential supervision.
- Focus on risks to the system irrespective of legal form.
- Ensure that crisis management arrangements are robust.
- Regulators must take a “system-wide” perspective.

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Thank You

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