Overseas Regulatory Frameworks

Licensing of Financial Institutions

Requirement for Licences

D.1 Nearly all countries with sophisticated financial systems have in common that only authorised or licensed entities are permitted to conduct core financial services (banking, insurance and securities dealing), and that licensing is based on requirements which relate essentially to operational and prudential standards. Beyond this broad similarity, regulatory frameworks diverge greatly, reflecting differences in both cultural and institutional heritage. For example, most countries have special financial entities such as credit co-operatives, agricultural financiers and clearing houses which are objects of special categorisation or exemption in licensing laws.

Separation of Banking, Insurance and Securities Business

D.2 In most countries, the laws and procedures for licensing financial institutions distinguish among banking, insurance and securities business. There are very few, if any, countries in which a licence to conduct one of these types of business represents a licence to conduct the other types of business as well.

D.3 The strongest distinction is between banking and insurance. While it is common for banks to sell insurance products as agents, the separation laws typically require banking and insurance business to be held on separate balance sheets.

D.4 The separation of banking and securities business is less rigid. In a number of countries, most notably Germany and Switzerland, the licensing laws reflect the concept of 'universal banking', which allows banks to deal in securities. However, even in Germany, banks are required to conduct insurance business through subsidiary entities with separate licences.

D.5 Separate licensing means that, where a financial business combines insurance with either banking or securities dealing, it is required to do so through at least two separate entities in the corporate group. In recent years, as the trend towards conglomerate structures, combining banking, insurance and securities trading, has become more pronounced, regulatory frameworks have been adapted in several respects.

- The United States (since the 1930s) and Japan (since 1945) have embodied in their financial licensing laws the principle that banking and securities trading should not be combined at all. However, in the past two decades or so, under the pressure of international practice, their laws have been modified so as to permit some combining of banking and securities business through separate entities within conglomerates.
- The traditional approach to business alliances among financial institutions has been characterised by the requirement that banks head all conglomerate structures. In recent years, a growing number of regulators have relaxed this requirement by allowing financial conglomerates to be headed by insurance companies, or by non-operating holding companies.

Foreign Participation

D.6 In many countries, the regulatory framework for the financial system includes restrictions on foreign ownership or participation in at least the core banking, insurance and securities businesses. These restrictions are not always explicit in laws or stated policies. During the 1990s, a major (though far from complete) liberalisation has been taking place. This has resulted from negotiations within the Uruguay Round on trade in financial services, and from a commitment to a common internal market in financial services within the European Union (EU).

Prudential Regulation of Financial Institutions

Objectives

D.7 The safety and stability of the financial system are — not surprisingly — virtually universal objectives in regulatory frameworks throughout the world. There are many other objectives, however, which also figure, although not always transparently. Examples include support for the government's monetary, debt management or fiscal objectives, community service obligations, continuing domestic ownership, and international competitiveness of the financial sector.

Separate versus Integrated Regulatory Bodies

D.8 The basic pattern of prudential regulation of financial institutions has been to have separate regulatory bodies supervising banking, insurance and securities businesses, reflecting the separate character of these businesses in the financial licensing laws. Separate regulators for banking, insurance and securities remain, for example, in France, Hong Kong, the Netherlands, Spain, the United Kingdom and the United States.

D.9 Notwithstanding this basic pattern, a number of countries have combined regulation of banking, insurance and securities dealing, at least to some extent. Some of these combined arrangements are of long standing. For example, in Japan the comprehensive regulatory responsibilities of the Ministry of Finance date from the early years after 1945. In Germany, Switzerland and the United Kingdom, the prudential regulation of banking has, for most of the same period, included the extensive securities businesses which banks in those countries are licensed to conduct. In Singapore, the regulatory functions of several agencies were combined in the Monetary Authority of Singapore in 1971.

D.10 In the past decade, there has been a modest trend towards amalgamation of financial regulators. While these amalgamations have mostly been in response to concerns raised by failures of financial institutions, some have reflected perceptions that the convergence of banking, insurance and securities businesses requires their supervision to be better integrated.

- In Canada, prudential regulation of banking, insurance and pension funds at the federal level has been combined since 1988. Securities businesses and exchanges are regulated separately, by agencies of the provincial governments.
- In Denmark, the prudential regulation of banking, insurance, securities and pension funds has been combined since 1990. In Norway, the prudential regulation of banking, insurance and securities has been combined since 1986, and in Sweden, since 1991. In Finland, the prudential regulation of banking and securities has been combined since 1993, with separate agencies regulating insurance and pension funds.
- In Malaysia, the central bank has had responsibility for prudential regulation of banking, insurance and some other financial institutions since 1988. A separate agency regulates securities businesses and exchanges.
- In the Netherlands, regulation of collective investments was added to the responsibilities of the central bank in the early 1990s.
- In South Africa, a Financial Services Board was established in 1993 to achieve a more unified approach to the regulation of all financial institutions and businesses other than banks, which continue to be regulated by the central bank.

D.11 The close linkages between securities and banking, both within and across jurisdictions, were emphasised by the collapse two years ago of the Barings group. This event prompted a wide-ranging review of the operation and regulation of financial conglomerates. In some countries, there has been pressure from the banking industry to remedy a perceived competitive advantage for securities firms over banks in respect of their capital requirements and other prudential standards. To date, most responses have taken the form of requests for greater co-operation among financial regulators — in particular, more complete sharing of information and harmonisation of some standards.

Prudential Regulation of Banks — by Central Bank versus Separate Body

D.12 Around the world, there are roughly equal numbers of cases in which the prudential regulation of banks is a function of the central bank and cases in which it is the function of a separate body.

- In Hong Kong, the Netherlands, New Zealand, South Africa, Spain and the United Kingdom, the prudential regulation of banks is a function of the central bank. In some of these countries, the central bank is also responsible for prudential regulation of non-bank deposit-taking institutions. In Finland, the prudential regulation body is a unit within the central bank but operates autonomously. In France, the bodies which regulate banks and other deposit-taking institutions are separate from, but under the direction of, the central bank. In the United States, the central bank system (the Federal Reserve Board) is one of four separate prudential regulators of banks.
- In Canada, Denmark, Germany, Japan, Norway, Sweden and Switzerland, bodies separate from the central bank are responsible for the prudential regulation of banks. In all of these countries, the central bank and the prudential regulation body co-operate closely in the monitoring of the banking system, and whenever necessary in considering how to handle banks in difficulties. Often they co-operate in the collection of data from individual banks. In the United States, the Federal Reserve Board and the other prudential regulators of banks have an extensive range of formal and informal means of co-operation. These co-ordination arrangements are mentioned again below.

D.13 The particular arrangements in each country reflect a range of factors, some historical and some structural. Among the latter, two themes are common:

- where prudential regulation has been extended beyond banking, to include either insurance or securities business, there has been a clear preference to remove regulation from the central bank, usually on the grounds that these other regulatory functions lie beyond the core competence of central bankers; and

- where great emphasis has been placed on independence in the operation of monetary policy, again there has been a tendency to separate even banking regulation from the central bank, in order to minimise conflict among the objectives of the central bank.

D.14 It seems that in most countries, the authorities and the managers of financial institutions are broadly comfortable with whichever of these two arrangements their history has given them.

Contributions to Prudential Oversight from Deposit Insurers and Other Bodies

D.15 Deposit insurance is common to most countries, including all members of the EU (a directive of the EU has recently made deposit insurance schemes mandatory for credit institutions in member countries) as well as Canada, the United States and most other countries with sophisticated financial systems. Deposit insurance plays a dual role in consumer protection and prudential supervision. In the latter role, the body responsible for providing insurance sometimes provides a supporting regulatory function to the prudential regulator. A similar supporting role is sometimes played by self-regulatory or industry bodies for small, local financial institutions.

- The Canada Deposit Insurance Corporation requires its member financial institutions to report on their compliance with its practice standards, analyses data from individual members using an asset valuation model, conducts inspections of members which are in some difficulty and has considerable weight in decision-making about them. These functions overlap considerably with those of the Office of the Superintendent of Financial Institutions.
- In France, national bodies of the local mutual banks and agricultural credit co-operatives provide their members with administrative, technical and financial assistance and, in so doing, play a supervisory role. In the Netherlands, Rabobank performs this function for the country’s co-operative banks.
- In Germany, a Liquidity Consortium Bank, set up on the initiative of the central bank and incorporating all categories of banks, can

provide temporary assistance in the form of short-term bridging loans to banks which it considers basically sound but which are experiencing liquidity difficulties. There are also deposit insurance schemes operated by three major banking industry associations. Those for savings banks and credit cooperatives are aimed at protecting the solvency of the institutions, thus indirectly guaranteeing deposits, while the commercial bank deposit insurance scheme directly protects deposits. By virtue of these schemes the banking associations, in combination with the Federal Banking Supervisory Office, play an active role in prudential regulation.

- In the United States, the Federal Deposit Insurance Corporation is the primary regulator of some banks (state-chartered banks which are not members of the Federal Reserve System) and a complementary regulator (in combination with the Office of the Comptroller of the Currency and the Federal Reserve Board) of other banks which are its members.

Management of Weak Financial Institutions

D.16 It is almost universal for regulators to have the power to intervene immediately when an institution fails to meet a solvency standard. Initial intervention is usually limited to orders of remedial action. Regulators usually also have powers to intervene more comprehensively in the event of outright insolvency, by assuming administrative responsibility and ordering sale or wind-up. These intervention powers are common to most prudential regulators of banking and insurance businesses, although not generally in regard to securities businesses, for which the normal processes of bankruptcy and liquidation apply.

D.17 International practice varies in relation to whether prudential regulators have a formal policy of early intervention, that is, in circumstances well short of those which necessitate the sale or liquidation of the weak institution. In its strongest form, this policy involves mandatory intervention on the basis of objective indicators of weakness. Most countries have, at least, an informal policy of early intervention.

- One approach to early intervention is to require disclosure of solvency indicators. For example, the Danish Financial Supervisory

Authority (DFSA) recently instituted a self-assessment system whereby each bank uses twenty-eight key variables to compare its performance with the average for the sector, and is encouraged to publish the results. Disclosure requirements are the centrepiece of a more market-based approach to prudential regulation which was recently adopted by New Zealand's Reserve Bank.

- Another form of early intervention is to impose differentials in deposit insurance premiums according to indicators of capital adequacy. This is the practice of the deposit insurance funds operated by the German banking associations and, in recent times, in the United States.
- Stronger forms of intervention are usually triggered by the breaching of particular prudential standards. The DFSA, for example, is committed to intervening in the running of any deposit-taking institutions whose capital ratio falls below the required level — a condition well short of insolvency. This early intervention policy has been credited with keeping the capital standards of Danish banks relatively high, and thereby having helped to avert the difficulties which were widespread among banks in the other Scandinavian countries in the early 1990s.[1]
- Through legislation which came into force in mid-1996, Canada's Office of the Superintendent of Financial Institutions has been committed to an early intervention policy, and given strengthened powers for the purpose.

Financial Markets Regulation

D.18 Generalisation about this area of financial regulation is difficult. In countries with sophisticated financial systems, there are diverse combinations of statute law, rule-making by government bodies which monitor securities firms and their trading, and rule-making by securities firms themselves as members of stock (and other) exchanges.

1 Pozdena, Randall J. 1991.

D.19 In the countries of the EU, regulation of financial markets is being extensively reviewed as EU Directives are implemented.

D.20 Changes are also being made as a result of recommendations of international bodies of regulators, notably the Joint Forum of banking, insurance and securities regulators, and as a result of projects jointly undertaken by the Committee on Payment and Settlement Systems of the Bank for International Settlements and the International Organisation of Securities Commissions.

Consumer Protection

D.21 Consumer protection in the financial system includes a wide range of structures and practices. Prudential regulation of financial institutions plays an important role in protecting consumers, not only by prescribing rules of prudent behaviour but also by monitoring that behaviour. Consumers are also protected by a range of laws focused on fair trading, disclosure of information and competition. In many countries, consumers are given further support by insurance schemes and guarantee funds, established to protect their interests in the event of failure.

D.22 In most countries, competition in the financial system is regulated by the same laws and administered by the same agencies as apply to the rest of the national economy. These laws are directed at both anti-competitive structures (and hence at proscribing mergers which are considered anti-competitive) and anti-competitive practices such as price collusion. In the appraisal of merger proposals in the financial sector, most competition regulators consult closely with prudential regulators.

D.23 Fair trading laws, aimed at preventing fraud and misrepresentation, are also usually applied on an economy-wide basis. In a number of countries, however, tribunals and other similar structures have been established to provide recourse at a less formal level to aggrieved consumers.

D.24 As noted above, explicit deposit insurance for banks is now widespread throughout the developed world. In some countries, insurance also extends to non-bank deposit-taking institutions. Where deposit insurance is not explicit, a number of countries, including Hong Kong and

Singapore, have legislated first priority to the claims of depositors in the event of wind-up.

D.25 Following problems faced by some deposit insurance schemes, a number of countries have reviewed the basis of their schemes. The United States, where insurance losses have taken on enormous proportions, has consolidated its insurance into two schemes. All insured deposit-takers are now regulated; premiums are scaled according to prudential criteria; and the cost of the schemes is being directed much more at the industry than was the case in the past. In Europe, schemes are being harmonised, with restrictions on co-insurance and the amounts of protected deposits.

D.26 Some countries also have schemes directed at protecting consumers from failure in the insurance industry or from the inability of securities dealers to complete transactions. In some cases, these fidelity funds reimburse investors in the event of fraud or malpractice. In general, the cost of these schemes is borne by industry participants.

D.27 It is difficult to generalise in respect of other specific mechanisms to protect consumers' interests in the financial system. Some mechanisms derive from arrangements confined to the financial system, and others from economy-wide laws and administering agencies. The mixture varies from country to country.

- First, in most countries there are detailed laws or self-regulatory codes which prescribe the terms of consumer credit and related business practices. These may be developed and administered by economy-wide bodies (such as the Office of Fair Trading in the United Kingdom), or by bodies with prudential regulation functions (such as the Federal Reserve Board in the United States, which prepares the regulations in this area while enforcement rests with the Federal Trade Commission).
- Secondly, in some countries there are ombudsman schemes which mediate between customers and businesses of all kinds, including financial institutions. In other countries there are codes of practice, specific to banks or other financial institutions, which cover much the same matters of dispute resolution.
- Thirdly, it seems that in some countries where there have been shifts from public to private provision of health and retirement needs,

there is a corresponding shift in consumers' concerns and regulators' attention towards insurance, investment and pension products — particularly the new, complex or high-value products — and towards the provision of investment advice. Consequently, laws and codes about disclosure and other elements of advising and selling practice are developing rapidly.

Co-ordination among Financial Regulators

D.28 Co-ordination among financial regulators is an important common feature of most countries' regulatory frameworks, despite the wide differences in the extent and nature of their formal co-ordinating arrangements. In some countries there is a standing co-ordination apparatus, for example:

- in Canada, the Financial Institutions Supervisory Commission;
- in Finland, the Financial Supervisory Authority Board;
- in France, the Capital Markets Liaison Committee;
- in Hong Kong, a set of advisory committees convened quarterly by the Financial Services Branch;
- in the Netherlands, a Memorandum of Understanding between the central bank and the insurance supervisor;
- in South Africa, the Policy Board for Financial Services and Regulation;
- in the United Kingdom, cross-membership of the boards of the Bank of England and the Securities and Investments Board and Memoranda of Understanding among some of the main regulatory bodies; and
- in the United States, the Federal Financial Institutions Examination Council.

D.29 As noted above, where a body other than the central bank is the prudential regulator of banks, there is generally a system of close co-ordination between the two, whether formal or informal. It is common for regulatory bodies to answer to advisory boards which represent other interested government agencies and the financial services industry.

D.30 In addition, in most countries the finance minister and ministry have a policy responsibility which includes ensuring adequate co-ordination within the financial regulatory system, either by way of communication among the regulatory bodies or through the finance ministry itself. This responsibility is complicated where more than one minister has responsibility for components of the financial system — for example, in Denmark, Finland, Japan, South Africa and the United Kingdom — or where there is a federal system of government.

Recovery of Costs of Financial Regulation

D.31 It is common for financial regulators' own costs to be recovered through charges on regulated financial institutions. This may mean that they are ultimately borne by consumers. The bases for setting charges vary but seem generally to be objective — for example, flat fees by institutional category, or fees related to the size of each regulated financial institution, or fees related to the hours spent within the regulatory body on each institution.