Legal Aspects of Financial Services Regulation and the Concept of a Unified Regulator

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“The views expressed herein are solely those of the author”
What do we mean when we say ‘regulation’?

- The term regulation refers to a set of binding rules issued by a private or public body.
- Generally, regulatory rules are rules that are applied by regulators in the fulfilment of their functions.
- Such rules include prudential rules, corporate governance and internal control systems, conduct of business rules, and methods of supervision.
- The body issuing these rules must have the necessary authority to issue the rules.
Conceptual problems in the definition of ‘regulatory rules’

• Although some scholars and commentators, including the International Compliance Association, argue that the body issuing regulatory rules should also have both
  
  (a) the necessary authority to supervise compliance with the rules and,

  (b) the power to issue sanctions against breach of the rules,

experience has shown that this is not always the case.

• There are situations where power to issue regulations is reposed in a different body from the body handling sanctions for breach of regulations.
• Also, the role of a regulator should not be confused with the role of a supervisor.
• A regulator is concerned mainly with the task of preparing and issuing regulations, and promoting a culture of compliance with these regulations.
• A supervisor, by contrast, undertakes mainly on-site and/or off-site supervision of financial services businesses.
• In some jurisdictions, the regulatory framework reposes in the same body both powers to regulate and supervise the activities of financial services businesses.
Developing a regulatory framework for financial services supervision

• A number of areas should be considered when designing a regulatory framework.
• First, the size and structure of a particular industry is important.
• Secondly, the role of a regulator in that country should be taken into account.
• In most jurisdictions, enormous power is bestowed upon regulators to authorise the commencement and cessation of business.
• Regulators have the power also to make judgements about the conduct of individuals which can have a profound impact on their ability to work in the regulated sector.

• Invariably, the structure and objectives underpinning the regulatory framework in different countries differ from one jurisdiction to another.
• In the US, for example, there are a multitude of agencies, at the state and federal levels, which have separate but sometimes duplicative regulatory authority over the financial services industry.

• The US has a high level of duplicated regulation caused by a combination of functional and institutional regulation.

• Even in jurisdictions such as the UK, or certain common law ‘offshore’ jurisdictions, where there is no hierarchy of different regulatory authorities as such, the regulatory environment is complex.
• In simple terms, regulators fulfil the following functions:

(a) laying down rules or principles that determine who can conduct financial services business;
(b) authorising financial services businesses;
(c) laying down rules by which regulated financial services business must conduct their business (both prudential and conduct of business rules);
(d) supervising compliance with the rules, either through desk-based supervision or on-site inspections or a mixture of the two;

(e) conducting investigations into suspected breaches of the rules, sometimes in conjunction with other law enforcement bodies;

(f) enforcing the rules; and,

(g) co-operating and exchanging information with other regulators
Designing a regulatory framework for financial services supervision

- An efficient and effective regulatory framework is often constituted by a combination of two or more of the following:
  (a) primary and enabling legislation;
  (b) secondary legislation issued pursuant to provisions of the enabling statute;
  (c) principles, rules and codes issued by regulators; and,
  (d) guidance or policy directives issued by the regulatory authority
• In some jurisdictions, primary legislation provides that ‘guidelines’ are also law.

• And in civil law countries, unlike common law jurisdictions, recourse should also be made to the Civil Code.

• The Civil Code which is the blood-line of private property rights in most civil law jurisdictions, can be equated to a Constitution for the protection of private commercial and contractual rights of citizens.
• The Civil Code is found only in civil law systems.
• Common law jurisdictions do not have the equivalent of a Civil Code.
• By contrast, almost all Common law jurisdictions import and apply principles of the common law and doctrines of equity.
• The design of a regulatory framework for financial services can be motivated by the need to introduce either principles or rules-based regulation.
• The difference between principles and rules-based regulation can be summarised as follows:
“...A principles-based system which is common to most offshore financial centres is one in which regulators simply issue a set of principles with which regulated businesses must comply. They are generally supplemented by broad codes...

...In a rules-based system (for example the UK), regulatory bodies also impose principles of regulation and supplement them with detailed ‘rules’ with which regulated businesses must abide in the fulfilment of those principles.”
• A common criticism made by international evaluators is that regulators lack sufficient resources to fulfil their functions.

• Also, the issue of how independent a regulator should be has generated considerable debate.
Models of financial services regulatory bodies

• There are several models of financial services regulation in different parts of the world.
• For example, in Hong Kong, while the Hong Kong Monetary Authority is in charge of the currency board and is responsible for banking supervision, the Insurance Commissioner supervises insurance businesses.
• The Securities and Futures Commission (SFC) supervises the securities and futures markets.
• And there is a Mandatory Provident Fund Authority that oversees mandatory retirement funds.
• By contrast, in most EU countries, central banks are responsible for banking supervision, although in Austria, Germany, Luxembourg, Finland and partially France, this task is assigned to a separate agency.

• Other common models of financial services regulation include: (a) regulation by objectives; (b) functional regulation; (c) institutional regulation or regulation by silos; and, (d) a single regulator.

• In a system that subscribes to ‘regulation by objectives’, the regulatory model ‘seeks to achieve certain explicit objectives by giving responsibility for one or more of them (i.e. the objectives) to specific regulatory bodies that exist solely for that purpose.’
• Examples of regulation by objectives include:

(a) a central authority that is empowered to conduct prudential regulation;

(b) a central authority that is responsible for supervising and passing regulations for the conduct of business; and,

(c) a central bank that is responsible for monetary policy, and a central authority that is responsible for regulating competition.
• A major difference between the functional regulatory model and the institutional regulatory model is that –

“...the former emphasizes the setting up of departments in a supervisory agency that deal with such non-sectoral based functions as licensing, legal, accounting, enforcement and information technology, irrespective of the type of business activity being regulated or supervised.”
• By contrast, a silos or institutional regulatory model encourages the setting up of organizational departments that deal separately with different types of business activities being supervised.

“…For example, the silos model could address the banking sector, the insurance sector, the pension funds sector and the securities market separately, while the functional model would concern itself mainly with finding out whether the issue at hand is one of licensing or any other regulatory norm, irrespective of the type of business activity being supervised.”
A unified theory of financial services regulation?

• There is no unified theory of financial services regulation.
• However, the following comprise some of the broad objectives of regulation:
  (a) protection of investors/consumers to help build investor confidence in the market;
  (b) ensuring market fairness, market efficient and market transparent;
  (c) reduction of systemic risk;
  (d) protection of financial services businesses from malpractices of some consumers (e.g. perpetrators of money-laundering activities); and,
  (e) maintenance of consumer confidence in the financial system.
• The development of financial services regulation in each industry has followed a historic pattern.
• This historic pattern arises due to various factors that include:
  (a) public policy;
  (b) structure of the existing legal framework (including the national Constitution, as in the case of Canada);
  (c) impact of international best practices;
  (d) government efforts to move towards regional integration;
  (e) government’s response to financial scandals (such as the collapse of Barings and BCCI in the UK, and the collapse of Enron in the US);
  (f) pressure from the international community; and,
  (g) market pressure.
A key objective of financial services regulation

• One key objective of regulation is to redress the information imbalance that sometimes exists between consumers and financial services businesses in favour of consumers.
• This is usually done by imposing minimum standards of business conduct upon financial services businesses.
• Also, the fairness of the financial market depends, in part, on the degree of consumer protection.
• Overall, regulation attempts to strike a balance between protecting the marketplace from itself without stifling legitimate risk taking.
• In the final analysis, the objective is to prevent failures by imposing capital and internal control requirements.
• These requirements ensure that business entities have sufficient liquidity to meet their obligations.
• The availability of sufficient liquidity makes financial institutions (including banks) less vulnerable to hasty withdrawals by depositors and investors.
• Also, the availability of liquidity makes financial institutions (including banks) less vulnerable to other market shocks.
International experience with financial services regulation

• A number of countries have focussed on the regulation of banking business (or more specifically deposit-taking activity) and investment business (securities).
• But more recently regulation has been introduced to control the conduct of trust and company services providers, and to curb financial crimes such as money-laundering.
International experience with unified supervision

An international trend towards unifications?

– The experience of Nordic countries
  (a) Extensive parliamentary and public debate before unification in 1986.
  (b) Norway was first and arguments for economies of scale were prominent.
  (c) Norway merged banking and insurance inspectorates.
  (d) Norway’s securities market not included in the unification model
  (e) Then Denmark merged banking and insurance supervision in 1988.
Differences and similarities

a) Danish model largely under an administrative arrangement with no major legislative changes.
b) Sweden’s unification prompted by banking crisis of 1990-91.
c) Also, in Sweden, strong nexus between banking and insurance.
d) Finland model started by mirroring Norway and others, but has remained largely partially integrated.
e) Developments in the city (UK) on integrated supervision, plus the Scandinavian experience, offered lessons to other countries.
Which countries are unifying?

- **AFRICA**: Mainly partial unification - Mauritius, South Africa, Nigeria, Zambia
- **PACIFIC**: Australia (‘twin peaks’ model)
- **CENTRAL ASIA AND FAR EAST**: Japan, Korea, Malaysia, Pakistan, Singapore.
- **SOUTH AMERICA**: Guatemala, Venezuela, Ecuador, El Salvador, Peru
• CARIBBEAN: Jamaica, Trinidad and Tobago
• WESTERN EUROPE: UK, Ireland, Iceland, Malta, Germany
• EASTERN EUROPE: Hungary, Bulgaria, Latvia and Estonia now (and some others are debating)
• NORTH AMERCA: Canada.
Arguments in favor of unification

The reasons countries are unifying world-wide

– Economies of scale
– Enhanced over-sight
– Emergence of universal banking practices (dealing with innovation and associated risks, plus emergence of new products)
– Separation of monetary policy from banking supervision
– Emergence of complex financial conglomerates
- The internationalization of banking practices
- Increased efficiency in allocation of regulatory resources to supervisors
- Efficient resolution of conflict of interests between supervisors
- Avoidance of competitive inequalities between regulatory agencies
- Increased coordination and better information flow
One case does not fit all

- Some countries have gone for partial unification e.g. Nigeria, Zambia, and South Africa.
- Nigeria – partial unification, involving pension funds
- Zambia - twin system: insurance and pensions, on one hand, and banking and NBFI, except securities, on the other.
- South Africa - securities and insurance
- Mauritius now has a unified regulatory agency (initial proposal to have banking supervision out)
- Others have full unification e.g. the UK, Hungary, Malta, and Iceland.
- Methods and structuring of unification have differed significantly
Different matrixes adopted by unified regulatory agencies world-wide

- Combined securities and insurance regulators
- Combined banking and securities regulators
- Combined banking and insurance regulators
- Unified supervision (in central bank)
- Unified supervision (outside central bank)
Arguments against unification

Why some African countries should not unify

- Limited financial resources to support unification
- Inadequate human capital to manage change
- Other pressing problems in the economy that demand greater attention first
- Limited inter-connectedness of segments of the financial sector
- The presence of an already efficient system of supervision, needing no structural improvement
How to make unification work

*Pre-conditions for success*

- Availability of financial resources
- Qualified human resources
- Government support and commitment of regulatory agencies
- Commitment of staff to institutional and cultural change
- Contingency approach to systemic restructuring, allowing for improved information flow
Issues in implementation

– Does a particular country really need to unify?
– How should unification be structured and undertaken?
– Should unification precede a banking crisis or be part of that crisis’ resolution?
– Should unification start with banking and insurance sectors?
– Are there international best practices on unification?
– What about effective change management; culture, power-politics, processes, organization design and information flow?
– And what about transfer of divisional powers and individual responsibilities?
Concluding remarks

Some issues for African countries to consider

- Unification not always a must! Case-by-case approach.
- There could be other pressing problems in the financial sector.
- Structure and methods vary from context to context
  - E.g., Canada has two layers of regulation; provincial for securities, and federal for insurance and banks
  - UK has fully unified model
  - Iceland and Hungary have fully unified models, supported by special agreements between unified agencies and the central banks
  - African countries have, so far, gone for partial unification.
– Consider (a) the level of inter-connectedness of financial sector segments, and (b) the dangers posed by systemic risk.

ii. Skills mix required for a mega regulator:
– The skills mix in unified agencies vary from country to country.
– Unification should be handled by experts and specialists, both from within and outside the country.

iii. Information flow must be addressed too

iv. Cultural change is another issue

v. Power-politics during and after transition

vi. Organizational design of the new agency

vii. Organizational processes in the new agency

viii. Avoid creating a Christmas tree