The Institutional Models for Financial Supervision: An Analysis

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INTRODUCTION

The governance of supervision varies across jurisdictions (G30,2008). In certain instances, the institutional model for supervision has gradually evolved in reaction to changes in the dynamics of financial services and the integration of financial institutions. Changes to the financial architecture were also effected as a consequence of the occurrence of debacles, such as the global financial crisis.

The evolution of financial supervision is an ongoing process. As this paper is being written, the Council and the European Parliament are discussing the Commission's proposal for a supranational model for the supervision of banks under the ECB.

The paper considers the different institutional models for supervision at national level. It examines the existing models, being the three pillar sectoral model, the twin peaks model and the single financial supervisor model. The paper delves into the rationale for the selection of a particular model and how these have been changed.

The central argument of the paper is that while the institutional model is likely to have an effect on the quality of supervision, in itself it does not guarantee it. Noticeably, effective supervision is a function of the internal governance arrangements for this purpose.

For narrative ease, the paper is organised into three additional sections. The next section explores briefly the meaning of 'governance'. This is followed by an examination of the institutional models. Some concluding remarks are made at the end of the paper.

THE MEANING OF 'GOVERNANCE'

Research on governance presents a vast amount of literature. However, there is no coherent body of governance theory (Kjaer,2004). As a matter of fact, the concept of governance is considered as being particularly unstable and liable to change, with social scientists often applying it without a commonly agreed definition (Pierre and Peters,2000).

Governance may be defined as the aggregate of processes, systems, relationships and arrangements, by which the interaction between members of society is regulated and the decisionmaking process is organised (Myers,1988). It is the ability to steer using a mixture of tools and mechanisms. Governance is therefore about steering to solve society's problems through inter alia the adoption of regulation, the supervision of compliance and enforcement where necessary (Kjaer,2004).

Members of society, when confronted with the limitations of rational behaviour, adopt regulation that has the purpose of instituting order by creating incentives or by imposing constraints that transcend those limitations (Chhotray and Stoker,2009). Regulation reduces uncertainty in human exchange, by governing the interaction between members of society. Regulation can extend from the informal to the formal. The latter requires the establishment of institutional arrangements that promote the wellbeing of society by regulating and supervising the interaction between its members.

Institutions are human artefacts that are generally bound in cultural and temporal terms. These may be effective to resolve a specific problem in some places at a point in time, but may not be the solution to resolve similar difficulties across the globe. Once established, an institution can be strengthened, weakened and abolished if this is no longer necessary (Prakash and Hart,1999). Albeit, experience suggests that once established, institutions for economic regulation, such as central banks, remain relatively permanent over the mediumtolong term.

In the context of institutions, governance is the study of the processes, which give rise to their establishment and the arrangements for the steering of institutions (Pierre and Peters,2000). It examines the events that trigger a decision to establish an institution and the relevance of the resulting arrangements in shaping the direction taken by policymakers (Chhotray and Stoker,2009). Indeed, decisionmaking is not only influenced by the framing features of the human mind but also by the organisational context within which it operates (Chhotray and Stoker,2009).

The creation and development of institutional models for supervision is a function of societal and economic forces and events, which trigger public needs that justify intervention. In this regard, governance is concerned with institutional building for the carrying out of supervisory activity; the factors that influence decisionmaking; and the legitimacy and accountability of the decisionmakers.

Political will and consent are fundamental drivers that make the creation and reform of governance mechanisms possible. A governance mechanism is effective to the extent allowed by political authority. Electoral considerations may determine the creation or breakup of an institution (Chhotray and Stoker,2009). In this sense, the study of governance becomes concerned with the exercise of political power.

Governance of financial supervision may therefore be defined as the study of the institutional models for supervision and the governance arrangements that contribute to a timely and fair decisionmaking process, which aims at achieving financial stability and investor protection.

INSTITUTIONAL MODELS FOR SUPERVISION

Financial supervision may be divided into two units of activity, macro and micro supervision. Macroprudential supervision is generally undertaken by central banks, which seek to ensure financial stability and focus on the interconnectedness in the financial system (Taylor,2009). Microprudential supervision is carried out by supervisors that follow different institutional models and focuses on the stability of individual financial institutions.

From a European perspective, the existing institutional models for microprudential supervision may be categorised under one of three headings, the three pillar sectoral model (banking, securities and insurance), the functional approach model ('twin peaks'), and

the single financial supervisor model (Wymeersch, 2008). The following tables analyse the institutional models adopted by the EU Member States and the EEA States. This is followed by an analysis of the models.

Table 1a – Models for Supervision at the end of 2012

EU State	Model	Three Pillar Model	Twin Peaks	Single Financial Supervisor
Austria				☑
Belgium			☑	
Bulgaria			☑	
Cyprus		☑		
Czech Republic				☑
Denmark				☑
Estonia				☑
Finland				☑
France			☑	
Germany				☑
Greece			☑	
Hungary				☑
Ireland				☑
Italy		☑		
Latvia				☑
Lithuania				☑
Luxembourg				☑
Malta				☑
Netherlands			☑	
Poland				☑
Portugal		☑		
Romania		☑		
Slovakia				☑
Slovenia		☑		
Spain		☑		
Sweden				☑
United Kingdom				☑

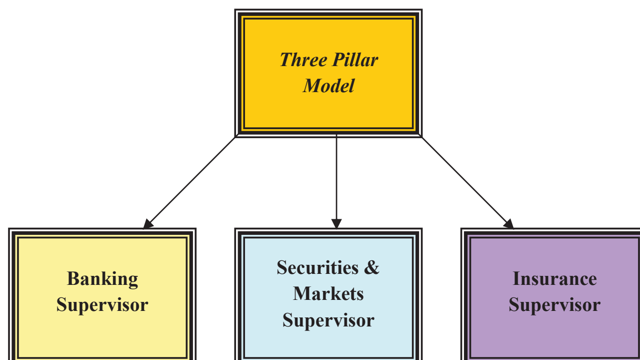
Table 1b – Models for Supervision at the end of 2012

EEA State	Model	Three Pillar Model	Twin Peaks	Single Financial Supervisor
Iceland				☑
Liechtenstein				☑
Norway				☑

THE THREE PILLAR MODEL

The three pillar institutional model is built upon the premise that the main line of business of the financial institution should determine the supervisor responsible for its supervision (Wymeersch,2008). Figure 1 outlines the structure of a three pillar sectoral model.

Figure 1 Structure of a *three pillar* sectoral model



Before the process of deregulation of financial services, which took place during the last quarter of the twentieth century, financial institutions were largely prohibited from undertaking more than one line of activity. It was therefore appropriate for financial supervision to be structured and operated along identical segregated lines, that is, each area of financial services having its own supervisor with each having its own policies and practices.

As a consequence of deregulation and the movement towards liberalisation of the financial sector, the situation was reversed and financial institutions were allowed to provide different types of services (Kaufman,1984). As a consequence, whereas it was once possible to have a clearcut distinction between banks, securities business, and insurance companies, or between a depositbased product and a securities or an insurance product, financial innovation and the formation of conglomerates meant that market fragmentation became largely extinct (Gart,1994).

Financial supervision should inter alia be based on the type of entities that are being supervised (Briault,1999). Therefore, a model based on distinctions between banking, securities, and insurance is not an effective mechanism to supervise a financial system in which these distinctions are increasingly irrelevant (Taylor,1995). The evident difficulty being that the position of the financial conglomerate may become concealed, in particular with respect to operational and solvency risks, since no sector specific supervisor would be unambiguously responsible for the supervision of the conglomerate as a whole (Goodhart and Others,1998).

In certain instances, an attempt to achieve consolidated supervision was made through the appointment of a lead financial supervisor, selected from amongst the three sector specific supervisors. The lead financial supervisor would be assigned the responsibility for consolidated supervision and the coordination of supervision with the other sector specific supervisors. However, experience suggests that poor communication and difficulties with cooperation resulted in turf wars between financial supervisors and ineffective consolidated supervision.

The difficulties that emerge from consolidated supervision have led to the application of two alternative institutional models for microprudential supervision, these being the twin peaks model and the single financial supervisor model.

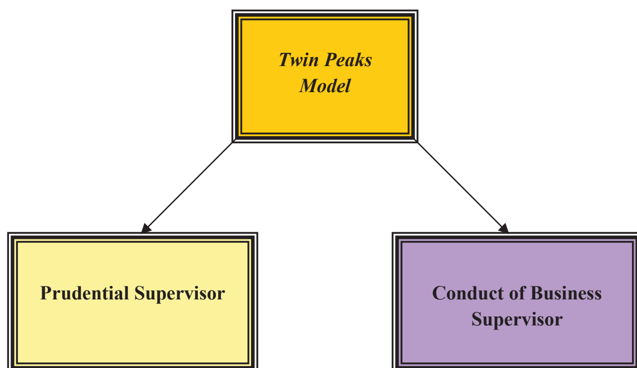
THE TWIN PEAKS MODEL

The twin peaks model organises supervision along the lines of the objectives of regulation. This model consolidates the three sector specific supervisors into two functional supervisors, which are vested with clear objectives for which they may be held accountable. A prudential supervisor, which is made responsible for monitoring ►

the financial soundness of the individual institutions, and a conduct of business supervisor, responsible for monitoring compliance with investor protection regulation (Taylor,1997).

Figure 2 outlines the structure of a twin peaks model.

Figure 2 Structure of a *twin peaks* model



A case for a twin peaks model for microprudential supervision is made on the basis that this should do away with duplication and overlap and would produce supervisors that have a specific and unambiguous remit (Taylor,1997).

It also institutes a system for supervision, which should address existing conflicts between the objectives of regulation. Indeed, experience in supervision suggests that the objective of prudential supervision may conflict with the investor protection objective. Moreover, supervision that seeks to achieve these distinct objectives requires a particular mindset, specialised technical skills, and specific supervisory tools. It is therefore efficient to concentrate in one institution the expertise in each field.

A framework for supervision based on the twin peaks model may in theory be a suitable alternative to achieve consolidated supervision. However, in practice, the division between prudential and conduct of business supervision is not as straightforward as the model might imply. Countries applying this model have encountered a number of practical difficulties.

As in the case of the three pillar sectoral model, the application of twin peaks is in practice also characterised by communication difficulties and overlapping supervision. It is argued that these difficulties could have a serious impact on the coordination of supervision of financial institutions that fall within the competence of both supervisors and could lead to the duplication of work and inconsistencies in decisionmaking (Knott,2004).

Furthermore, given their different and sometimes conflicting supervisory practices, especially in the field of enforcement, tensions between the two supervisors generally occur (Kremers and Schoenmaker,2010). In certain instances, these difficulties were overcome through the application of a single supervisor institutional model for supervision.

SINGLE SUPERVISOR MODEL

During the end of the last century, many jurisdictions reviewed their institutional model for supervision. A number of these selected the single financial supervisor approach (Fabri,2006). As indicated in tables 1a & 1b, at the end of 2012 sixteen EU States and all the EEA States had a single financial supervisor. This is more than 60% of the entire EU supervisory network.

A single financial supervisor is responsible for monitoring compliance with both prudential and conduct of business regulation of the entire industry. Therefore, this may be a suitable option for doing away with turf wars that distort the effectiveness of supervision. However, the single financial supervisor has both advantages and disadvantages.

A single financial supervisor benefits from economies of scale and scope and lessens compliance related costs for the industry, given that regulated entities are subject to one authorisation procedure, one rule book and one disciplinary process (Lomnicka, 1999). It also makes possible the bringing together and the development of scarce regulatory expertise and is associated with increased supervisory consistency and quality of supervision (Cihak and Podpiera,2006).

Moreover, empirical research on the models for supervision in the context of the political environment of different jurisdictions, suggests that the choice of a single financial supervisor is generally associated with a political environment characterised by lower levels of corruption, better institutional governance, and more efficient judicial systems (Dalla Pellegrina and Masciandro,2008). This notwithstanding, certain drawbacks of the model have been identified.

In the absence of a proper accountability mechanism, a single financial supervisor is likely to become an overmighty bully and a bureaucratic monster, which is disconnected from the industry (Briault,1999). Furthermore, the lack of regulatory competition could curb improvement in supervisory systems, procedures and methods. Albeit, it is conceded that in a global financial market, competition could possibly come from other jurisdictions (Lomnicka,1999).

It has been argued that careful consideration and design is needed to ensure the effective functioning of an integrated supervisor, as the plurality of tasks allocated to the institution, may give rise to multitasking related challenges, such as the inherent conflicts between the different objectives of regulation (Holopainen,2007). On this count it is reasonable to suggest that the three pillar sectoral model and the twin peaks model may achieve more focus on critical issues and be able to mobilise more resources effectively than a single financial supervisor that may be distracted by urgent issues in other sectors under its brief.

WHICH MODEL FOR EFFECTIVE SUPERVISION?

The financial crisis has challenged each of the three models for supervision. It demonstrated that irrespective of the selected option, supervisory failures may still occur and that these create a pretext or a suitable occasion for reform (Maschiandaro and Quin,2009).

Taking as an example the single financial supervisor model, Belgium and the UK are jurisdictions where following the financial crisis this specific model was criticised as having been an ineffective mechanism and has now been replaced with a twin peaks model.

On the other hand, in the Netherlands, where the twin peaks model has been in place since 2002, some high profile failures during the financial crisis seriously tested the robustness of the model. However, this did not result in policy change. Moreover, twin peaks is also the model of preference for countries where reform is being considered, such as Spain and Italy, and which currently have a three pillar model.

The trend post the financial crisis suggests an emerging preference for the twin peaks model. Nonetheless, from a theoretical standpoint, ▶

there are no categorically strong arguments in favour of any one of the models, there are only pros and cons of the different models, the importance of which largely depends on the conditions of the financial system in the particular jurisdiction. In practice each model suffers from its particular strengths and weaknesses.

Therefore, while the selected institutional model may have an effect on the quality of supervision, in itself it does not and cannot guarantee it.

CONCLUSION

The paper has considered briefly the meaning of the term 'governance'. It established that governance of supervision is the study of the different models for financial supervision and the governance arrangements that contribute to a timely and fair supervisory and decisionmaking process, which seeks to ensure financial stability and investor protection.

It examined the different institutional models for supervision being the three pillar sectoral model, the twin peaks model and the single financial supervisor model. The institutional model for financial supervision should be based in part on the type of entities that are being regulated and the objectives of regulation. In this regard, given the integrated structure of the main players in today's financial system, the paper supports the view that the traditional three pillar sectoral model is not the most effective way to supervise a financial system.

The financial crisis demonstrated that adopting any one of the other two institutional models for supervision is still not an automatic recipe for success. Indeed, unless a supervisor operates within a framework built on highlevel standards of internal governance, such as independent decisionmaking, accountability, fairness, and transparency and has competent human resources to fulfil the required duties, it is doubtful whether effective supervision may be achieved in practice.

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