Reform of Financial Supervision in Austria

Final Report

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I. Overview

This report analyzes the possibilities for reform in financial supervision in Austria in the light of (i) the short-comings of the current arrangements for supervision, (ii) international developments in financial regulation, and (iii) changes in financial markets that affect the scope for different supervisory approaches.

The structure of the report is as follows. Section II describes in general terms the objectives that any well-designed supervisory system should aim to achieve. Section III considers the weaknesses of the current approach to banking supervision in Austria. Trends that will contribute to pressure for change in the future are also discussed.

Section IV places the discussion of financial supervision reform in Austria in a broader international context by (i) describing the approaches to financial regulation and supervision currently taken by other industrial countries, (ii) by setting out the reasons why some of these countries have changed their supervisory arrangements in the recent past and (iii) by summarizing the analyses of financial supervision reforms in IMF publications. The issues of whether supervision should be organized on a sector-basis or functionally and to what extent the central bank should be relied on to play supervisory roles receive particular focus.

Section V provides a summary and analysis of the principles and recommendations for financial regulation and supervision provided by several international bodies, namely the Basel Committee on Banking Supervision, the International Organization of Securities Commissions (IOSCO), the International Association of Insurance Supervisors (IAIS), and the International Monetary Fund (IMF).

Based on the earlier sections, Section VI establishes a set of criteria for judging the effectiveness of different arrangements for financial regulation and supervision. Ultimately, the goal should be to organize supervision and regulation so that the broad objectives set

out in Section II of this report, namely stability, market confidence and efficiency, are achieved. However, it is useful to establish a set of detailed criteria which supervisory/regulatory organizations should satisfy.

Section VII describes in concrete terms four possible approaches to organizing financial supervision that seem to be the practical alternatives which might be adopted by the Austrian authorities. The alternatives involve greater or lesser reliance on the central bank as a supervisory body and are more or less ambitious in shifting from the current sector-based approach to supervision to a more functionally oriented alternative.

Section VIII discusses the practical scope for adopting different processes and techniques of banking supervision within the models set out in the previous section and in the light of what is done in other countries.

Alternative methods for allocating the costs of financial supervision are explained and summarized in Section IX.

Section X sets out recommendations and conclusions.

II. Objectives of financial supervision

Sector-based versus functional approaches to supervision

Until recently, financial supervision has been based on the notion that different sectors of the financial system provide unique and distinct services and functions for investors and consumers. As a consequence, most countries have established separate specialized supervisory institutions for each sector: banking supervision, insurance supervision, securities markets supervision, pension fund supervision etc. Today the functions and services of the financial system can no longer be clearly attributed to particular sectors. For example, mutual or money market funds currently offer intermediation services in which banks have traditionally specialized. Similarly, life insurance contracts frequently resemble investment or savings instruments rather than traditional insurance agreements.

A modern approach to financial system supervision therefore focuses on the core functions[1] performed by the financial system rather than on institutions or sectors. It has been well recognized in the economics literature that these functions cannot be fulfilled efficiently by an unregulated and unsupervised financial system because of two major sources of market failure:[2]

[1] According to Nobel Laureate Robert Merton (see "A functional perspective of financial intermediation", Financial Management, Summer 1995, pp 23-41) the financial system performs six core functions,
Function 1: A financial system provides a payments system for the exchange of goods and services
Function 2: A financial system provides a mechanism for the pooling of funds to undertake large-scale indivisible enterprise.
Function 3: A financial system provides a way to transfer economic resources through time and across geographic regions and industries.
Function 4: A financial system provides a way to manage uncertainty and control risk.
Function 5: A financial system provides price information that helps coordinate decentralized decision-making in various sectors of the economy.
Function 6: A financial system provides a way to deal with the asymmetric-information and incentive problems when one party to a financial transaction has information that the other party does not.

[2] See Commonwealth of Australia (1997), Financial System Inquiry Report, page 190 ff.

1. The risk of third party losses due to systemic instability.
2. The informational asymmetries faced by most consumers/investors, which mean that they cannot reliably assess risk, particularly the creditworthiness of their counter-parties.

The objective of financial system supervision should be to mitigate or eliminate these sources of market failure. This may be achieved by enhancing and promoting

a) stability and
b) market confidence.

In pursuing the objectives of stability and market confidence, financial system supervision can impose significant costs on the system. These include direct costs of supervision and the indirect costs that arise when supervision hampers competition, stifles product innovation or simply imposes large compliance costs on the financial sector. It is therefore important to add a third objective of financial system supervision, namely

c) efficiency.

We will now comment on each of these three objectives.

Enhancing and promoting the stability of the financial system

Stability is fundamental to any successful financial system. Stability of the financial system can be threatened by systemic risks in the financial system since there is great potential that the collapse of one institution is transferred to others. This "contagion" may result since the failure of one institution to settle its obligations may directly cause other fundamentally sound institutions to fail. The main transmission mechanism for systemic instability is the payment system.

It should be stressed that maintaining stability of the financial system does not imply zero failure of regulated firms or markets. Here, one should aim for as low an incidence of failure as is consistent with the maintenance of competition. If the supervisor pursues a zero failure rate, then this will lead to an excessively burdensome regime for the regulated

firms. Also, the cost of implementing a level of supervision that ensures a zero failure probability would be excessively high. The supervisor therefore should explain to the public that occasional failures are unavoidable so that there will be limited damage to market confidence when a failure actually occurs.

Market confidence

Market confidence rests on two pillars. First, the financial system cannot function well unless participants are confident that financial promises by banks or other financial institutions will be kept. It would be extremely costly for consumers to assess individually the creditworthiness of their counter-parties in the financial system. Thus, a major responsibility of financial system supervision must be the enhancement and assessment of the creditworthiness of financial institutions providing financial services.

The second pillar of market confidence is the integrity of market participants and adequate information disclosure to facilitate informed judgments. Thus, the intention of financial system supervision should be to ensure that markets are sound, orderly and transparent; users are treated fairly; the price formation process is reliable; and markets are free from misleading, manipulative or abusive conduct. Confidence in the financial system is also undermined if it is abused for criminal purposes. Financial supervision should therefore also aim to prevent that supervised entities get involved in financial crime. Furthermore, financial system supervision should aim to ensure that retail customers have adequate information, are treated fairly and have adequate avenues for redress. This should include explicit disclosure obligations and the supervision of the conduct of distribution and advice.

It should be recognized, however, that even in a situation where market confidence prevails, market participants should still have incentives to acquire information about the financial soundness of financial institutions with which they interact. This will allow the

market to aggregate information of many individual investors/consumers and will lead to market discipline, which cannot be replaced entirely by the supervisor.

Efficiency

Regulation and supervision can impose costs both on the financial system directly and on the wider economy. This fact highlights the need to balance the objectives of stability and market confidence with efficiency considerations.[3] Supervision of the financial system should, therefore, aim

a) to minimize the adverse effects on competition that may arise from its general functions and
b) to achieve competitive neutrality such that the regulatory burden applying to a particular financial service should also apply to similar services and
c) to maintain minimal barriers to entry and exit from markets and products.

Although financial services are increasingly complex, the key issues relevant to competition in the financial sector are similar to those which affect other sectors. Thus, the same guidelines should apply to the financial sector as to all sectors in the economy. The case for specific arrangements for the financial sector is relatively weak.

In fact it may even be counterproductive to define a statutory competition objective for financial system supervisors. This could create a conflict with the other objectives, making it more difficult to hold the supervisor accountable. Nonetheless, the supervisory agency should be required to consider explicitly the economic costs of its rules and to report regularly on the effects of supervision on competition.

[3] For a discussion of this issue, see, for example, Commonwealth of Australia (1997), Financial System Inquiry Report, page 189.

III. The need for reforming financial supervision in Austria

1. Weaknesses of current arrangements

The current Austrian system of financial supervision suffers from several weaknesses. The most obvious of these may be summarized as follows.

Lack of clear objectives

Currently, there is a lack of clear objectives for financial supervision in Austria. Rather than defining specific objectives, the BWG merely specifies the supervision of compliance with the relevant law as the primary goal. In addition, the BWG states that the supervisor should take into account the general economic interest in a functioning banking industry. Furthermore, there are currently no mission statements for the banking or the insurance supervisors which specify the objectives to guide their supervisory policy.

Lack of clear division of responsibilities between supervisory agencies

It is questionable whether Austrian financial supervisors have clearly defined responsibilities. For example, banking supervision is split between the Ministry of Finance and the OeNB. While the Ministry of Finance has the legal responsibility for banking supervision, the OeNB performs bank examinations that form the basis of supervisory judgments. This separation of legal responsibility and function does not provide the incentives necessary for good financial supervision and does not conform to the best practice that one may observe in other countries.

Lack of independence

There is a lack of operational independence of financial system supervisors. The arguments for independence are, first, that an independent agency is likely to take full responsibility for supervision rather than passing responsibility to others, and second, that such an

agency, if its statutory objectives are clearly spelled out, will be less driven by short-term considerations and political pressure when it comes to managing problems in the financial sector. A recommendation to improve independence of financial supervision was recently made by the IMF in its August 2000 report on Austria.

Lack of arrangements for information sharing and cooperation between supervisory agencies

There is a lack of arrangements for sharing information and cooperation between supervisors. As a consequence, it is questionable whether financial supervisors are currently capable of supervising financial conglomerates that offer, for example, banking and insurance services.

2. Trends that increase the need for reform of financial supervision

Regulatory trends and the scope of financial supervision

Adding to the need for reform, there is international pressure to expand the scope of financial supervision in certain areas. As an illustration, the recent Basel review of bank capital regulation will generate significant additional work for bank supervisors, requiring a greater expenditure of resources and increased technical expertise on the part of bank examiners and policy-makers. Banks will supply more information about their books under likely new capital regulations and there will be additional work for supervisors interpreting that information and authorizing internal ratings systems and risk management models of different types. Given the current budgetary constraints and the above-stated lack of clarity in the organizational setup of banking supervision, it seems unlikely that these additional tasks can be mastered adequately.

Industry developments

Any reform of Austrian financial supervision must also address industry developments that confront supervisors with new tasks. Most important, consider the increasing problem of

supervising financial conglomerates. For some time, Austrian banks have been heavily involved in securities trading in addition to their core activities of deposit taking and extending credit. An increasingly noticeable feature of financial markets in Europe, which is only now beginning to affect Austria, is the inter-penetration of banking, securities and insurance markets. This trend takes the forms of (i) inter-sector mergers, i.e. mergers between banks and insurance companies and (ii) a blurring of boundaries between the services offered by banks and insurance companies. The structure of financial supervision should take such industry developments into account.

3. Possible directions of reform

While there are many conceivable ways to respond to the problems stated in the last two subsections, any reform proposal for Austrian financial supervision must address two basic questions.

- First, it is essential to specify the role of the central bank in any proposed supervisory framework. As supervisory agency responsible for payment systems and - to a certain extent - banks, the central bank disposes of essential expertise. How should this expertise be deployed after the reform of Austrian financial supervision?
- Second, any reform proposal must specify the extent to which supervisors should specialize. Currently, the institutional framework of financial supervision is characterized by complete specialization: separate supervisory agencies are responsible for banks, insurance companies, securities markets and payment systems. Is this system of specialized supervision sustainable? If not, how should financial supervision be consolidated?

In the next section of this report, we discuss how other countries have responded to the above-stated questions in their arrangements for financial supervision.

IV. Reforms in supervisory arrangements

1. International evidence

Table 1 summarizes the structure of financial supervision in the 15 EU countries and the U.S. and Japan. Of the seventeen countries listed, nine have separate regulators for securities markets and thirteen regulate insurance through separate regulatory agencies. In seven of the seventeen countries banking supervision is performed solely by the central bank while in another three the central bank either also participates in banking supervision or is closely associated with the bank supervisor for example through staff-sharing arrangements.

It is interesting to note, however, that of the seven countries listed in Table 1 which have recently adopted substantial changes in their systems of financial supervision (these are Denmark, Finland, France, Italy, Sweden, the UK and Japan), four (namely Denmark, Sweden, the UK and Japan) have introduced unitary regulators covering banking, securities and insurance combined[4], while one (namely Finland) has combined bank and securities supervision in one supervisory agency leaving insurance to be regulated separately.[5] Again, a large fraction of the countries listed in Table 1 that have recently adopted major changes in supervisory arrangements, have located the supervisory function outside the central bank.

[4] In the case of Japan, the central bank retains a special role in supervising some large banks that act as its counter-parties in monetary policy operations.

[5] In Finland, the bank and securities regulator shares staff with the central bank although it has a separate board. It is currently discussed to also include insurance supervision into a single regulatory agency.

	Banking	Securities	Insurance
European Countries:			
Austria	M	S	M
Belgium	BS	BS	I
Germany	B/CB	S	I
Denmark	U	U	U
Spain	CB	S	I
Finnland	BS	BS	I
France	B/CB	S	I
Greece	CB	S	I
Ireland	CB	CB	M
Italy	CB	S	I
Luxembourg	BS	BS	I
Netherlands	CB	S	I
Portugal	CB	S	I
Sweden	U	U	U
UK	U	U	U
Other countries:			
US	CB	S	I
Japan	U/CB	U	U

Table 1: Regulatory arrangements across countries

U = Universal Regulator (as the FSA in the UK or Japan)
CB = Central Bank
B, S, I are specialized regulatory agencies for the banking, securities and insurance industries respectively
BS = Regulator in charge of both banking and securities industries
M = Government Ministry
Source: Adapted from Lannoo (1999)

In countries that have recently implemented major reforms of financial system supervision, local factors have played an important role in precipitating change and influencing the direction of reform. For example, Japan and Sweden both adopted changes after the major solvency crises in their banking sectors; while the UK altered its arrangements partly because of high-profile problems in the supervision of retail financial services (especially pensions) and partly because it was viewed as inappropriate to give the newly independent Bank of England control over both monetary policy and banking supervision.

Nevertheless, the number of countries that have changed their arrangements clearly indicates that general, non-country-specific factors have played an important role. We will now summarize the major considerations on which the recent reforms have been based.[6]

2. Considerations that have influenced reforms in different countries

Non-sectoral supervisory arrangements

What are the considerations that have influenced different countries' decisions of how to structure financial supervisory agencies? In Sweden, Denmark, the UK, Japan, and in Australia, the supervisory agencies are no longer separated by sectoral boundaries. As mentioned above, Sweden and the UK have adopted single supervisory agencies and Australia has created two supervisory agencies, which are separated functionally rather than by sector. The major considerations that have lead to these non-sector solutions were:

- Concerns over a lack of supervisory neutrality with respect to the competition between different types of financial institutions offering similar financial services. For example, the Australian Financial System Inquiry (Wallis report) makes a strong case for intense prudential supervision not only of deposit taking institutions but also of

[6] Appendix A gives a detailed analysis of financial supervision in the UK, the Netherlands, Switzerland, and Finland.

life insurers offering capital backed investment products or risk products.[7] The same concern was mentioned as a major consideration for setting up the unified financial supervisory agency in Sweden, according to director general, Claes Norgren. Furthermore, similar considerations have motivated Switzerland and Finland to explore the possibilities of a move towards integrated financial system supervision.[8]

- Concerns that supervisors may become too identified with the interests of the industry under supervision and hence may lack detachment in making supervisory judgments.
- Concerns about unused economies of scale if different supervisory agencies, such as bank- and insurance supervisors, require similar human capital to perform their tasks. Concerns of this kind are expressed by the Wallis report and by various position papers in the UK.[9] The efficiency gains from concentrating supervision in a single body appear to be confirmed by UK experience in that the costs of the FSA budgeted for 1999/2000 are lower than those of its component organizations in either of the previous two years.[10] Furthermore, the UK industry's reaction to the proposed unification of supervisors was welcomed by industry: "There was almost unanimous support from the consultees for the proposals to have a single statutory regulator, in order to tackle overlaps, gaps and inconsistencies in supervision and to improve accountability and clarity of purpose." (HM Treasury (1999), page 7.)
- Concerns that specialized supervisors may be unable to consolidate their information about prudential risks taken by different institutions within a financial conglomerate.
- Concerns over incompatibility of the supervisory system with the trend that financial conglomerates have centralized internal audit departments.

[7] In the case of the capital backed products, the institution implicitly absorbs the credit risk of the investments involved. The fact that these assets are typically long-term increases the exposure of retail investors and reduces their capacity to make valid judgements about the creditworthiness of the promissor, see chapter 8, page 304 of the Wallis report.

[8] Switzerland has set up several expert groups, such as the "Expertengruppe Finanzmarktaufsicht des Eidg. Finanzdepartement, eingesetzt von BR K. Villiger, unter der Leitung Prof. Dr. J.-B. Zufferey". The same is true for Finland.

[9] See, for example Briault (1999).

[10] See Briault (1999).

Reliance on the central bank as a supervisory body

A second important difference between different countries' approach to financial supervision is the degree to which the central bank is relied upon to perform banking supervision functions. Tables 2a-2c summarize[11] in broad qualitative terms the current involvement in financial supervision of central banks in a range of different countries. The summaries shown in the tables suggest a mixed picture. In most Nordic countries, central banks have never been involved in banking supervision. In all the Commonwealth countries described except Canada, the central bank in the past acted as the supervisor of commercial banks; but where reforms have occurred (as in Australia or the UK, for example) supervision has been moved to other institutions (see Tables 2a and 2b).

The policies followed by central and eastern European countries including Poland, Hungary, the Czech Republic, Latvia and Estonia show a wide range of different approaches (see Table 2c) but in several cases the central bank plays an important role.

Tables 2a-2c provide a broad summary of how much central banks in different countries are involved in banking supervision but, of course, supervision and regulation involves many different rather specific functions and broad qualitative assessments do not convey whether central banks perform particular functions or not. Tables 3a and 3b show a breakdown of different supervisory/regulatory functions and whether or not central banks in different countries perform these individual functions.

The information in Tables 3a and 3b suggest that countries fall into three basic categories. The "narrow" central bank model focuses on the overall stability of the financial system such as payment system oversight, some payments processing and occasional emergency liquidity assistance. Countries such as Australia, Canada, the Scandinavian countries and

[11] See Financial Stability and the Central Bank: International Evidence, by Juliette Healey, Bank of England, in Financial Stability and Central Banks, Center for Central Banking Studies Bank of England.

the UK belong to this group. In these countries the remaining financial stability functions are carried out by other government entities or sometimes even by private entities.

Countries in a second group have chosen an intermediate model in which the central bank performs the core functions and also play some role in crisis resolution but does not directly supervise or regulate individual financial institutions. This model has been chosen by a number of industrial countries including South Korea.

Finally, there is a third model, which can be referred to as the broad model, in which central banks also play a role or are solely responsible for the regulation and supervision of banks and some non-bank financial institutions. Besides Singapore, the Netherlands and Hong Kong have chosen the broad model.

While Tables 2a to 2c show that the role of central banks in supervision of the financial system varies significantly across countries, we also note that in this sample only Singapore has transferred supervision of banks and most non-bank institutions to the central bank. We also observe that a number of countries, especially in Central and Eastern Europe, have agreed to transfer banking supervision out of the national bank.

Of the countries such as the UK, Sweden, Australia etc which have substantially reformed their financial supervisory system in recent years and in this process established supervisory authorities *outside* their central banks, the major considerations seem to have been the following.

- The central banks' approach to supervision may be influenced by the fact that it is itself a bank. If prudential supervision were assigned to the central bank, it may approach supervision from a limited banking perspective, thereby failing to provide the broader perspective that is central to the proposed functional specialization of supervision.
- A separate supervisory agency assists the task of clarifying the nature of the assurance provided by prudential supervision to consumers. Correspondingly, the

Wallis report states that "while the central bank may provide support to financial institutions to maintain financial stability, separation makes clear that the balance sheet of the central bank does not provide an implied or automatic guarantee of deposits or other investments, in the event of insolvency of a regulated institution."[12]

- In the UK, a reform that involved concentrating prudential supervision in the Bank of England was considered politically infeasible given that the Bank was simultaneously acquiring control over monetary policy. Furthermore, the Bank had attracted criticism for its handling of the failures of BCCI and Barings Bank.
- Finally, separating the roles of prudential supervisor and lender of last resort removes a potential conflict of interest. The key question facing the lender of last resort is whether or not the recipient institution is illiquid or insolvent. To the extent that the reputation of the supervisory agency may be adversely affected by institutional failure, there is an incentive for liquidity to be provided more readily than may be the case where there is a separation of functions.

[12] See chapter 8, page 314 of the Wallis report.

Country	Central Bank as supervisors
Australia	In 1998 supervisory responsibilities were consolidated within two new separate supervisory agencies. The Corporations and Financial Services Commission was created to cover the conduct of business supervision. Separately, the Australian Prudential Regulation Authority (APRA) was established through the amalgamation of the insurance supervisor and the banking supervision responsibilities previously carried out by the Reserve Bank of Australia. In 1999 the remaining deposit-taking institutions in Australia were also amalgamated into APRA.
Canada	Regulation and supervision of financial institutions has never been within the central bank. Supervision is carried out at the federal and provincial levels. The Department of Finance has broad responsibility for policy and the Office of the Superintendent of Financial Institutions is the primary supervisor of banks and other federally incorporated financial institutions (established in 1987 through the amalgamation of the banking and insurance supervisors).
Denmark	Regulation and supervision of financial institutions has never been within the central bank. A consolidated supervisory agency which covers the whole of Denmark´s financial sector was established in 1988 through the amalgamation of the banking and insurance supervisory agencies.
Finland	Regulation and supervision of financial institutions has never been within the central bank. The Financial Supervision Authority (FSA) was established in 1993 when the former Banking Supervision Office was abolished and its activities were linked with the Bank of Finland. The FSA is connected administratively with the Bank of Finland, but is independent in its decision-making. In addition, a separate body, the Insurance Supervision Authority, is responsible for the supervision of insurance companies. It was established in 1999 and functions under the Ministry of Social Affairs and Health.
Hong Kong	Regulation and supervision of deposit taking institutions within the Hong Kong Monetary Authority. There are separate supervisory agencies for the insurance and securities sectors.

Table 2a: Central Banks as Supervisor

Country	Central Banks as supervisor
New Zealand	Regulation and supervision of banks within the Reserve Bank of New Zealand (RBNZ) but since 1996 the RBNZ has operated a supervisory system which emphasizes the responsibility of the individual Directors of institutions to comply with regulations (and to disclose compliance) and reduces direct prudential supervision by the RBNZ.
Norway	Regulation and supervision have never been within the Norges Bank (except for the foreign exchange market under the Norwegian Currency Control Act.). In 1986, a consolidated separate supervisory agency, the Kredittilsynet, was established by amalgamating the Banking and Insurance Inspectorates. Previously responsibilities for banking supervision had been gradually consolidated in the Banking Inspectorate including some of the functions of the securities bureau of the Ministry of Finance in 1983. The only part of the Norwegian financial sector that is not currently covered by the Kredittilsynet is the responsibility for supervising the Oslo Stock Exchange, but this function will soon be transferred to it from the Ministry of Finance.
Singapore	Regulation and supervision of all financial institutions within the Monetary Authority of Singapore (MAS). Prior to the establishment of the MAS the regulation and supervision of depositories was distributed among several government agencies. Responsibility for depositories was given to MAS from the outset and in 1984 MAS gained responsibility for insurance and securities from the relevant government agencies.
Sweden	Regulation and supervision of financial institutions has never been within the Riksbank. A consolidated separate Financial Supervisory Authority was established in 1991. Previously banks were covered by a government controlled Bank Inspection Board and there were separate agencies supervising the insurance and securities sectors.
UK	In 1998, a consolidated supervisory agency, the Financial Services Authority, was created by amalgamating the supervisory bodies for all financial services sectors and the banking supervision function, previously carried out by the Bank of England.

Table 2b: Central Banks as Supervisors

Country	Central Bank as supervisors
Czech Republic	Regulation and supervision of banks within the Czech National Bank. There is a separate securities supervisory agencies.
Estonia	Regulation and supervision of banks currently within Eesti Pank but there is agreement to form a consolidated supervisory agency outside of the central bank in the next few years. Currently there are also agencies for each of the insurance and securities sectors.
Hungary	Regulation and supervision within the National Bank of Hungary (NBH) is limited to legal regulations specified in the central bank Act and NBH decrees on money circulation, foreign exchange, data supply and minimum reserves. Capital and other prudential regulation and supervision has always been carried out by a separate supervisory agency, although the NBH is involved in the issuance and withdrawal of licenses (from April 2000 the Hungarian Banking and Capital Market Supervision agency merged with the insurance supervisory agency and the State Private Fund Supervision to create the Hungarian Financial Supervisory Authority).
Latvia	Regulation and supervision of banks currently within Bank of Latvia but the government hopes to form a consolidated supervisory agency outside of the central bank by mid-2001. There are also currently separate agencies for each of the insurance and securities sectors.
Poland	Regulation and supervision of banks is situated in the NBP, carried out by the General Inspectorate of Banking. Since 1998 these functions have been under the direction of an independent Commission for Banking Supervision. There are separate supervisory agencies for the insurance and securities sectors. A draft law has been prepared which will transfer the licensing power of the Ministry of Finance to the insurance supervisory body and this body will be governed by representatives of the other financial regulatory and supervisory bodies (including the NBP).

Table 2c: Central Banks as Supervisors

Financial Stability Function	Description	Singapore	Neth	Ireland	Hong Kong	New Zealand
Payment systems services	Some or all of: Currency distribution and provision of settlement balances, electronic payments, check clearing and general oversight of payments system.	✓	✓	✓	✓	✓
Safety net provision/crises resolution						
Emergency Liquidity Assistance to the Market	Provision of liquidity to the money markets during a crisis.	✓	✓[1]	✓[1]	✓[1]	✓
Emergency Liquidity Assistance to Depositories	Direct lending to individual illiquid depositories.	✓[2]	✓	✓	✓	✓
Emergency Solvency Assistance to Depositories	Direct lending to individual insolvent depositories.	x	x	x	x	X
Emergency Liquidity Assistance to Non-Depositories	Direct lending to individual illiquid non-depository institutions.	x	x	x	x	✓
Emergency Solvency Assistance to Non-Depositories	Direct lending to individual insolvent non-depository institutions.	x	x	x	x	x
Honest Brokering	Facilitating or organizing private sector solutions to problem situations.	✓	✓	✓	✓	✓
Resolution	Conducts, authorizes or supervises sales of assets and other transactions in resolving failed institutions.	✓	✓	x	x	✓
Legal	Resolves conflicting legal claims among creditors to failed institutions.	x	x	x	x	X
Deposit Insurance	Insures deposits or other household financial assets.	x	✓[3]	x	x	X
Regulation and supervision						
Bank Regulation	Writes capital and other general prudential regulations that banks (and other deposit taking institutions) must adhere to.	✓	✓	✓	✓	✓
Banking supervision	Examines banks to ensure compliance with regulation.	✓	✓	✓	✓	x[6]
Bank Business Code of Conduct	Writes or monitors banks´ compliance with business codes of conduct.	✓	✓	✓	✓	x
Non-bank Financial Regulation	Writes capital and other general prudential regulations that non-banks must adhere to.	✓	✓[4]	✓[5]	x	x
Non-bank Financial Supervision	Examines non-banks (although not necessarily all) to ensure compliance with regulation.	✓	✓[4]	✓[5]	x	x
Non-bank Business Code of Conduct	Writes, or monitors non-banks´ compliance with, business codes of conduct.	✓	✓[4]	✓[5]	x	x
Chartering and Closure	Provides authority by which a banking entity is created and closed.	✓	✓	✓	✓	✓
Accounting Standards	Establishes/participates in establishing uniform accounting conventions.	✓	✓	x	x	✓

Table 3a: Degree of Central Bank Involvement in Financial Stability "Functions"

1 For Euro-Zone countries, in the context of Euro-system co-ordination.

2 The MAS will assess the situation should it arise. Systematic risk is not an unconditional call on emergency liquidity assistance.

3 The deposit insurance scheme has been set up by the banking sector. The central bank is responsible for implementation.

4 De Nederlandsche Bank is also responsible for investment institutions and exchange offices, but not insurance or securities sector.

5 Excluding the insurance sector.

6 The Reserve Bank is the banking supervisory agency but in 1996 moved to a system whereby the Reserve Bank does not conduct on site inspections as a matter of course but has the power to require independent reports on a bank. Directors of institutions are primarily responsible for ensuring compliance with regulation and are required to provide regular attestations on compliance.

7 Most likely to be carried out by the supervisory authority or the deposit insurance agency but the central bank might assist, particulary in systemic circumstances.

8 The Bank of Korea may require the supervisory agency to examine banking institutions and to accept the participation of central bank staff on joint bank examinations.

9 In principle, emergency liquidity support is available to any institution supervised by the Finanzinspektionen or APRA, respectively, provided the institution is solvent and failure to make its payments poses a threat to the stability of the financial system, and there is a need to act expeditiously.

Financial Stabilitiy Function	Description	Fin	Den	Swe	Canada	South Korea	Austral.	Norway	UK
Payments system services	Some or all of: currency distribution and provision of settlement balances, electronic payments, check-clearing and general oversight of payments system.	✓	✓	✓	✓	✓	✓	✓	✓
Safety net provision/crises resolution									
Emergency Liquidity Assistance to the Market	Provision of liquidity to the money markets during a crisis.	✓	✓	✓	✓	✓	✓	✓	✓
Emergency Liquidity Assistance to Depositories	Direct lending to individual illiquid depositories.	✓	✓	✓	✓	✓	✓	✓	✓
Emergency Solvency Assistance to Depositories	Direct lending to individual insolvent depositories.	x	x	x	x	x	x	x	x
Emergency Liquidity Assistance to Non-Depositories	Direct lending to individual illiquid non-depository institutions.	x	✓	✓[9]	x	✓	✓	✓[9]	x
Emergency Solvency Assistance to Non-Depositories	Direct lending to individual insolvent non-depository institutions.	x	x	x	x	x	x	X	x
Honest Brokering	Facilitating or organizing private sector solutions to problem situations.	✓[7]	✓	✓[7]	✓[7]	✓	✓[7]	✓[7]	X[7]
Resolution	Conducts, authorizes or supervises sales of assets and other transactions in resolving failed institutions.	x	✓	x	x	x	x	x	?
Legal	Resolves conflicting legal claims among creditors to failed institutions.	x	x	x	x	x	x	x	x
Deposit Insurance	Insures deposits or other household financial assets.	x	x	x	x	x	x	x	x
Regulation and supervision									
Bank Regulation	Writes capital and other general prudential regulations that banks (and other deposit taking institutions) must adhere to.	x	x	x	x	x	x	x	x
Banking supervision	Examines banks to ensure compliance with regulation.	x	x	x	x	x[8]	x	x	x
Bank Business Code of Conduct	Writes or monitors banks´ compliance with business codes of conduct.	x	x	x	x	x	x	x	x
Non-bank Financial Regulation	Writes capital and other general prudential regulations that non-banks must adhere to.	x	x	x	x	x	x	x	x
Non-bank Financial Supervision	Examines non-banks (although not necessarily all) to ensure compliance with regulation.	x	x	x	x	x	x	x	x
Non-bank Business Code of Conduct	Writes, or monitors non-banks´ compliance with, business codes of conduct.	x	x	x	x	x	x	x	x
Chatering and Closure	Provides authority by which a banking entity is created and closed.	x	x	x	x	x	x	x	x
Accounting Standards	Establishes/participates in establishing uniform accounting conventions.	x	x	x	x	x	x	x	x

Table 3b: Degree of Central Bank Involvement in Financial Stability "Functions"

3. Considerations discussed in IMF publications

There also exist several papers on the reform of financial supervision which are published in journals or working paper series issued by the IMF. While these papers do not necessarily reflect the official IMF view, they are still relevant for this study. The following subsection contains a short summary of the major arguments in Abrams and Taylor (2000)

and in Taylor and Fleming (1999). We first summarize the main arguments and results of these papers and then derive implications for the reform of financial market supervision in Austria.

3.1. Summary

Abrams and Taylor (2000) first emphasize that various basic principles must be satisfied before it makes sense to evaluate the advantages and disadvantages of different models of financial supervision. These principles are listed and discussed in Section V of this report below.

A basic recommendation in Abrams and Taylor (2000) is that the structure of the financial supervision should reflect the structure of a country's financial market. For example, the authors conclude that in a country with universal banking it would seem advantageous to merge banking supervision with securities market supervision.

The main part of the paper by Abrams and Taylor (2000) lists and discusses advantages and disadvantages of a unified financial market supervision. According to the authors, the main advantages of a unified financial market supervision are

1) Efficiency gains due to economies of scale and economies of scope.
2) Improved recruiting possibilities through better career opportunities in a larger organization.
3) Clear responsibilities, i.e. no regulatory overlaps or regulatory gaps.
4) Easier information sharing between supervision of different financial sectors within the same supervisory institution.
5) Regulatory neutrality, i.e. it is more likely that similar products or services will be treated in a similar way within a single supervisory agency.
6) No need to coordinate between different agencies when supervising financial conglomerates. No need to define a "lead regulator".

7) Easier cooperation internationally: it is clear whom foreign supervisory agencies need to contact.
8) Easier to respond to financial innovations – clear responsibilities.

The paper also lists some possible disadvantages associated with a single supervisory agency.

1) Unclear objectives since a single supervisory agency may have a variety of responsibilities. For example, a single supervisory agency may have as objectives both the stability of the financial system as well as the protection of consumers.
2) Diseconomies of scale since a single agency may be so large that it leads to excessive bureaucracy. This however is not likely to be of significance in countries with small financial markets.
3) Moral Hazard: Possible misconceptions about the responsibilities of a single supervisory agency. For example, investors may expect the same consumer protection in the insurance and in the banking sector if both sectors are supervised by the same authority. However, the authors point out that this is clearly an informational problem, which can be solved by adequately informing the public about the actual responsibilities of the supervisor.

Abrams and Taylor (2000) also discuss the role of central banks in bank supervision. Again they list and discuss advantages and disadvantages of having bank supervision performed by the central bank. They emphasize the following advantages:

1) The stability of the banking sector is prerequisite for an effective monetary policy. Therefore, information which is relevant for bank supervision is also relevant for the implementation of monetary policy.
2) Information about the solvency and liquidity of banks is also relevant for the central bank as the lender of last resort.

3) Economies of scale can be generated by merging bank supervision into the central bank.

On the other hand there are also several potential disadvantages when bank supervision is the responsibility of the central bank.

1) Loss of credibility to implement a tight monetary policy. E.g. if the central bank is also bank supervisor, then it may take into account the effect of, say, higher interest rates on the solvency and liquidity of individual bank institutions. This may harm its credibility with regard to expected monetary policy.
2) Moral hazard (see discussion above).
3) Excessive concentration of power.
4) Loss of reputation in the case of a bank insolvency. Since the central bank would be responsible for bank supervision, an insolvency may adversely influence its reputation in general.

Abrams and Taylor (2000) also discuss alternatives to a "stand alone" Financial Supervision Agency (FSA). In particular the following alternatives are put forth.

1) A unified oversight board. According to this alternative, an oversight board would ensure information sharing and coordination between the separate supervisory agencies. The authors emphasize that this alternative is only justified if the country's financial market is sufficiently large.
2) Sharing of IT-structures, building and other infrastructure by otherwise separate agencies.
3) Sharing of IT-structures and other infrastructure between an integrated financial supervisory agency and the central bank.

The paper also emphasizes the potential risks associated with the process of reform itself. In particular the following dangers are identified once it has been decided to reform financial supervision:

1) Time pressure during the reform process.
2) Risks in the legislative implementation.
3) Loss of key personnel due to uncertainties during the reform.
4) Heavy demand on management resources during the reform.

Finally Taylor and Fleming (1999) analyze the performance of integrated financial market supervision in Scandinavian countries in an IMF working paper series. The authors conclude that the performance of the financial market supervision in the Scandinavian countries has been quite positive. In particular they state that "the economies-of-scale argument for establishing an integrated agency in […} any country with a small financial sector is a strong one." And "In a financial sector that is dominated by banks and allows little scope for capital markets or a highly integrated financial sector, there is also a strong case for adopting an integrated approach, because a small non-bank financial sector is unlikely to be able to sustain separate and effective regulatory agencies."

3.2 Implications for reform in Austria

The analyses have several direct implications for the reform in Austria. According to the IMF publications summarized above, the organizational structure of financial supervision should reflect the structure of the country's financial market. Austria's financial market has three important characteristics: First, Austria has a universal banking system with banks, which are active both as commercial banks and as investment banks. According to Abrams and Taylor (2000), this provides a strong argument for combining bank supervision with securities market supervision. Second, Austria's financial market is small and, third, within this small financial market, the securities market sector and the insurance sector are small relative to the universal banking sector. According to Taylor and Fleming (1999) this

makes a strong case for adopting an integrated approach because "a small non-bank financial sector is unlikely to be able to sustain separate and effective regulatory agencies."[13] It also implies that the potential for economies of scale and scope is important, that the danger that an integrated financial market supervision would require an excessively large and bureaucratic institution is small and that the advantages in terms of better hiring and career opportunities for personnel achieved by adopting a unified financial market supervision can be significant.

[13] See Taylor and Fleming (1999).

V. International best practices and principles of financial supervision

Before we evaluate alternative models for financial supervision in Austria we will review the principles suggested by international bodies concerned with financial regulation. In this section, we discuss relevant recommendations of the Basel Committee on Banking Supervision of the Bank for International Settlements (BIS), the International Organization of Securities Commissions (IOSCO), the International Association of Insurance Supervisors (IAIS), and the International Monetary Fund (IMF).

These international organizations have issued various documents stating principles for effective bank, insurance, and securities market supervision as well as principles for enhanced transparency and accountability of supervisory agencies. The most important documents are:

1. "Core Principles for Effective Banking Supervision" published by the BIS in September 1997.[14]
2. "Objectives and Principles of Securities Regulation" published by IOSCO in September 1998.[15]
3. "Insurance Supervisory Principles," published by IAIS in September 1997.[16]
4. "Code of Good Practices on Transparency in Monetary and Financial Policies: Declaration of Principles," published by the IMF.[17]

Appendix B sets out the principles identified by these reports but the guidance they provide may be summarized in broad terms as follows.

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[14] See http://www.bis.org/publ/index.htm.
[15] See http://www.iosco.org/
[16] See http://www.iaisweb.org/framesets/pas.html. These are currently under review.
[17] See http://www.imf.org/external/np/mae/mft/code/index.html.

The BIS principles

The BIS states as its first core principle that the agencies involved in banking supervision have clear responsibilities and objectives,[18] operational independence and adequate resources. A suitable legal framework, which gives supervisors appropriate powers to enforce compliance with laws and to address concerns about safety and soundness, is also viewed as a prerequisite to effective banking supervision. Supervisors must be able to limit participation in banking through control of the granting of banking licenses and must have the ability to limit major investments or acquisitions by banks and to review transfers of ownership.

The BIS principles place heavy emphasis on the regulatory bodies' ability to impose and monitor levels of capital in supervised banking institutions. In addition, supervisors must determine that banks' internal controls are adequate given the nature of their businesses.

For internationally-active banking organizations, the BIS principles state that supervisors should "practice global consolidated supervision [...] adequately monitoring and applying appropriate prudential norms to all aspects of the business conducted by these banking organizations worldwide, primarily at their foreign branches, joint ventures and subsidiaries."

This emphasis on global consolidated supervision reflects the BIS's general concern with systemic instability and international spill-overs of banking problems. To achieve consolidated supervision requires close coordination with other supervisors, primarily those in host countries.

[18] As mentioned above, the current Austrian system does not obviously conform to this standard and clarifying the role and responsibilities of supervisory agencies would be an important objective of reform.

The IOSCO principles

The IOSCO principles also begin by advising that the regulator have clearly expressed responsibilities, operational independence, adequate powers and resources. Reflecting the highly technical nature of the securities market, the IOSCO principles stress that Self-Regulatory Organizations should be appropriately employed. Furthermore, proper standards of disclosure should be maintained for securities issuers and reasonable legal forms and structures should be required for collective investment schemes.
Conduct of business and prudential supervision are more explicitly dealt with by the IOSCO principles than they are by the BIS principles, the latter focusing primarily on the maintenance of systemic stability. The IOSCO principles also say that the regulatory body should be “accountable in the exercise of its powers.”

The IAIS principles

Even more than the IOSCO principles, the IAIS principles focus on investor protection. The first IAIS principle is thus: “An insurance supervisor is expected primarily to protect policyholders by ensuring that companies comply with legislation and regulations governing the business of insurance.”

To a greater extent than the banking and securities market principles just discussed, the IAIS principles directly prescribe appropriate activities and powers for insurance supervisors. In particular, they state that insurance supervisors should review internal controls, establish appropriate prudential standards to limit the risks insurance companies face, establish standards for assets and liabilities, devise appropriate capital requirements, and monitor regulated insurance providers through on-site inspections and analysis of information they supply and reports by external audit.

The IMF principles

The IMF "Code of Good Practice" is primarily concerned with clarity of mission and transparency. Again, it states that the objectives of supervision and the relationship between different regulatory bodies should be clearly and publicly stated. It also suggests that supervisory agencies should publish regular reports on the sectors they supervise and on how overall policy aims are being pursued. It recommends that the texts of regulations, directives and guidelines should be publicly available, that agencies should publish audited accounts, and that standards for staff of supervisory agencies should be disclosed.

Implications of the above principles for supervision of conglomerates

It is particularly difficult to identify appropriate principles for the supervision of financial conglomerates. The BIS advocates consolidated supervision and argues that: "An essential element of banking supervision is the ability of the supervisors to supervise banking groups on a consolidated basis."
In cases in which two types of financial intermediary owned by the bank assume similar risks the BIS suggests that supervisors exercise their discretion to "decide which prudential requirements will be applied on a bank-only (solo) basis, which ones will be applied on a consolidated basis, and which ones will be applied on both bases."[19]

In contrast, the IOSCO and the IAIS focus mainly on arrangements to share information between supervisors. For example, the IAIS states "In developing or implementing a regulatory framework, consideration should be given to whether the insurance supervisor is able to enter into an agreement or understanding with any other supervisor both in other jurisdictions and in other sectors of the industry (i.e. insurance, banking, or securities) to share information or otherwise work together."

[19] See page 34 of the "Core Principles for Effective Banking Supervision" of the Basel Committee on Banking Supervision.

VI. Criteria for evaluating alternative organizational models

Drawing on the principles of financial supervision just described and the more general analysis of financial supervision given in Section IV, we develop here a set of criteria for assessing different organizational models of banking supervision and of financial supervision more broadly.

Independence

The first criterion is independence of the supervisory authority. The need to maintain independence from direct government influence is mentioned in several of the principles discussed above. Independence is desirable, first, so that regulators take direct responsibility for the sector they oversee and, second, so that political interference in supervisory judgments is kept to a minimum. Consequently, the first BIS principle mandates independence of supervisors as one pre-condition for effective supervision: "An effective system of banking supervision will have clear responsibilities and objectives for each agency involved in the supervision of banks. Each such agency should possess operational independence and adequate resources…"

In order to provide guidelines for reforms of financial supervision, the BIS has also issued criteria by which it can be judged whether supervisory arrangements live up to the requirement of operational independence. The following criteria are regarded as essential:

"1. There is, in practice, no significant evidence of government or industry interference in the operational independence of each agency, and in each agency's ability to obtain and deploy resources needed to carry out its mandate.
2. [...]

3. Each agency is financed in a manner that does not undermine its autonomy or independence and permits it to conduct effective supervision and oversight. This includes, inter alia:

- salary scales that allow it to attract and retain qualified staff;
- the ability to hire outside experts to deal with special situations;
- a training budget and program that provides regular training opportunities for staff;
- a budget for computers and other equipment sufficient to equip its staff with tools needed to review the banking industry; and
- a travel budget that allows appropriate on-site work."

Besides these "essential" criteria, the BIS has also issued supplementary criteria, stated below:
" 1. The head of each agency is appointed for a minimum term and can be removed from office during such term only for reasons specified in law.
2. Where the head of an agency is removed from office, the reasons must be publicly disclosed."

In view of these guidelines, we can identify two broad criteria for independent financial supervision that can guide the choice between alternative organizational setups for the supervisory bodies. Instead of formal independence, both of the BIS criteria focus on operational independence by suggesting as requirements for independent financial supervision that (i) there is, in practice, no significant government or industry interference in financial supervision and that (ii) supervisors have access to those resources that enable independent supervision. Based on these broad criteria, we can identify several desirable characteristics of supervisory setups:

1. Restrictions concerning political- and industry interference in financial supervision:
    a. If the government has a right to give directives to the supervisory agency, it should not lead to “significant government interference”. Thus, directives

should not be issued regarding the daily operations of the supervisor and should not concern decisions about specific supervised entities.

b. To ensure that there will not be any significant government interference, there should be special provisions regarding the transparency of directives given to supervisory bodies. Also, it should be possible to hold accountable any outside parties for directives to financial supervisors. To achieve these goals, there should be special formal requirements for directives, such as the requirement of issuing a directive in writing, accompanied by some discussion of the reasons for the directive, and/or the obligation to give the supervisory bodies opportunity to respond, and/or the obligation to publish any directive received by financial supervisors as part of the annual report of the respective supervisory body.

2. Board structure of supervisory agencies: On the governance structure, it seems advisable that supervisory agencies should have an executive and a supervisory and possibly an advisory board. The executive board should comprise at least two members. These executives should be directly responsible for the operational and administrative policies of the supervisory body, the fulfillment of its legislative mandates, and its performance. It should be obligatory for the executive board to consult the supervisory board in case of important policy decisions. The procedure for appointing the executive board and the members of the supervisory board should be designed to avoid significant conflicts of interest.
3. Access to resources: Access to adequate resources is an essential requirement if the supervisory agency is to be independent. This will be discussed below but it seems that the only way to ensure access to resources is to allow the agency to recover a significant fraction of the costs of supervision directly from supervised institutions. Initial start-up costs could be met by means of a one-time endowment that the supervisory agency would receive upon inception. Thereafter, the agency would operate largely off-budget.
4. Authority: Operational independence of the supervisory agency can only be effective if the activities of the agency comprise all of the relevant tasks of

> surveillance, inspection, and enforcement. This suggests that the agency should have sufficient authority to act without any outside support, although in some cases this may be impossible on constitutional grounds. The IOSCO principles clearly recognizes this problem: "In some jurisdictions, particular matters or regulatory policy require consultation with, or even approval by, a government, minister or other authority. The circumstances in which such consultation or approval is required or permitted should be clear and the process sufficiently transparent or subject to review to safeguard its integrity."

Even if the agency has sufficient authority, its activities may conflict with the interests of other authorities. For example the Basel Committee recognizes that "the way in which [bank] failures are handled, and their costs borne, is in large part a political matter involving decisions on whether, and the extent to which, public funds should be committed to supporting the banking system. Such matters cannot therefore always be entirely the responsibility of banking supervisors; however, supervisors should have in place adequate arrangements for resolving problem bank situations." In practice, this means that supervisors should specify a "default" procedure to deal independently with any problems uncovered by supervision. While political intervention can never be ruled out, it should take the form of an exception - with all the resulting publicity.

Internal cost efficiency (including setup costs)

The second major criterion, which in our view should influence the design of supervision, is the internal cost efficiency of supervision. In particular, it is essential that economies of scale and scope be exhausted. This raises two important questions. First, which tasks should be handled by the same supervisory agency? Second, what should the internal organization of the agency be (i.e., along institutional and/or functional lines)?

On the issue of how different tasks should be parceled up in the same regulatory body, our discussion so far underlines the fact that various functions and financial services can no longer be uniquely attributed to single sectors of the financial system. In order to achieve internal cost efficiency of supervision, these trends may imply that the division of labor between supervisors should be restructured to permit economies of scale within the regulatory body.

Most of these economies of scale result from fixed set-up costs and the investment in human capital that is necessary to perform the more technical tasks of supervision. For fixed set-up costs, consider the example of reporting systems. In this area, economies of scale can be realized if different regulated entities, such as banks and insurance companies file reports with the supervisory agency using the same infrastructure (for example, IT-resources). Examples of economies of scale in the utilization of supervisory human capital include prudential supervision and supervision of firms' conduct of E-business. In prudential supervision, expertise on assessing capital adequacy is likely to increase as the boundaries between banks and insurance companies diminish. In the supervision of firms' conduct of E-business, similar security concerns exist for the different IT solutions used by banks, on-line brokers, and many other financial intermediaries.

Consider next the question how the internal organization should be designed to maximize economies of scale and scope in the activities of the regulatory body. While an organization along functional lines is best suited to exhaust economies of scale, the trend towards financial conglomeration implies potential economies of scope to be realized by consolidated supervision of conglomerates if specialized supervisory staff work together in one organizational unit. Most obvious, such an organization along functional lines enhances the transfer of information in the supervision of one conglomerate since no special arrangements must be set up to exchange information and to ensure that data remains confidential.

External cost efficiency

The third criterion for the design of supervisory bodies is the extent of the costs that supervision places on the regulated firms. These “compliance costs” equal the value of the extra resources (including time) that firms and individuals must expend to comply with regulations. To assess their importance for the organizational design of supervision, note that compliance costs can affect the costs of supplying products or services and so reduce the volume of sales. In the extreme, it may even be unprofitable to offer certain products or services.

Consider the following example for compliance costs. To file reports with a supervisory agency, regulated entities incur the cost of lost time, especially that of senior management. The organization of reporting determines the magnitude of these costs. For example, centralized reporting and adopting a single point of contact between firms and regulators can reduce the costs of supervision to firms.

Two implications of compliance costs for organizational design are: (i) fragmentation of supervision should be avoided. Ideally, similar information should only be provided once and to a single supervisor by a supervised entity. (ii) Supervisory agencies should regularly analyze compliance costs and should consult with regulated firms about the cost of compliance.[20]

Domestic compatibility

A fourth criterion for design of supervisory bodies is domestic compatibility, by which we mean: how well can the different domestic supervisory agencies cooperate and how well

[20] The IOSCO has issued a similar recommendation, “The regulator should have a process for consultation with those who may be affected by the policy.”

can new industry developments such as financial conglomerates and new regulatory developments be dealt with?

According to the Basel Committee, a precondition for effective banking supervision is “a system of interagency cooperation and sharing of relevant information across various official agencies, both domestic and foreign, responsible for the safety and soundness of the financial system.” If supervision is fragmented, this requires coordination of supervisors covering quite different parts of the financial system, for example, banking, insurance, securities markets, investment funds and even the payment systems.

Depending on the transfer of information that is required for cooperation, there are different ways to institutionalize the link between supervisory agencies. Cross-representation of supervisory agencies on the boards of other agencies allows for bilateral high-level cooperation in general policy questions. To achieve cooperation between more than two supervisory agencies, a special committee should be set up. As an example, in Australia, the Council of Financial Regulators facilitates cooperation between its three members, the Reserve Bank of Australia, the Corporations and Financial Services Commission, and the Australian Prudential Regulation Commission. Similarly, in the Netherlands, a council coordinates the major specialized supervisory units in the supervision of financial conglomerates.

For more intensive and for day-to-day operational cooperation between supervisory agencies, the structure of these agencies must be compatible. As an example, consider the supervision of a financial conglomerate by several specialized supervisory agencies. If the specialization is along functional lines, then supervision is easily consolidated: for example, one agency could assess the compliance with capital adequacy of each sub-unit of the conglomerate, as well as on a consolidated basis.

However, if the specialization of supervisory agencies is along institutional lines, cooperation between them is more difficult to achieve. For example, an insurance supervisor would assess the capital adequacy of the insurance business of the conglomerate while the bank supervisor would focus on the banking division. For consolidation, these supervisory agencies would have to exchange information. To institutionalize this information transfer, a special committee should be set up. For example, in the Netherlands, the Council of Financial Supervisors performs this function.

More generally, domestic compatibility requires to quickly adapt to regulatory and industry developments. This necessitates a considerable amount of flexibility of the supervisory agency. New skills are required from financial supervision to ensure compliance with new regulation in the area of risk management and especially regulation concerning capital requirements, which are based on solvability risks and market risks. To accomplish such adaptive capacity an organizational structure should be chosen for financial supervision which supports a shift away from predominant emphasis on the stability of the traditional payment system towards a focus on liquidity risks, market risks, and credit risks.

International compatibility

A fifth criterion for effective supervision is international compatibility. The BIS argues that "close cooperation with other supervisors is essential, particularly where the operations of banking organizations cross national boundaries" is a precondition for effective banking supervision. Other institutions such as the IOSCO agree. As in the case of domestic cooperation, international compatibility of organizational structures of supervision is a precondition for international cooperation between supervisory agencies.

While some of the arguments about domestic compatibility also apply to international cooperation EU regulation adds a further dimension. In the case of foreign financial

intermediaries that offer services domestically, domestic supervisory agencies just provide support for the home country supervisors and do not supervise directly. In the case of internationally active, domestic financial intermediaries, domestic supervisory agencies must rely on the support of foreign supervisors for consolidated supervision. In this respect a consolidated financial supervisory agency may offer an advantage since it implies clear responsibilities, i.e. there is no ambiguity for the foreign supervisor who to contact in any particular matter.

In organizational terms, a special unit may be required for a supervisory agency to perform the consolidated supervision of internationally active domestic financial intermediaries. As its main task, this unit would gather information from foreign supervisors and transfer it to the domestic supervisors.

Availability of resources

A sixth criterion is that of availability of resources. As discussed in the context of the independence criterion, supervisory agencies must be able to determine their own staffing and remuneration. Autonomy of this kind can be used to match more closely the skill mix and remuneration of private entities in the financial industry and to develop an appropriate balance of expertise in areas such as law, enforcement, economics, finance and information technology. To guarantee autonomy, supervisory agencies should be off budget, drawing either on endowments or fees levied from regulated firms to cover costs. In this section, we discuss more specific provisions for the funding of a supervisory agency through fees.

Arrangements to levy fees from entities under the supervision of an agency should involve a mix of direct service fees and annual levies. Where possible, a distinction should be drawn between services provided at the instigation of individual entities, such as authorizations or registrations, for which per item cost recovery fees are appropriate,

supervisory activities undertaken at the discretion of the agency to the general benefit of customers of the financial industry, such as inspections, enforcement, and policy development, for which annual industry wide levies are most appropriate.

Where possible, levies should be related to costs to avoid cross-subsidies of activities with high supervisory costs by activities that can be supervised at low cost. Overall, over-recovery of the costs of supervision is as questionable as under-recovery.

Accountability and transparency

A seventh criterion is the accountability of supervision. The importance of accountability is identified by international organizations such as the IOSCO, "Accountability implies a regulator that operates independently of sectoral interests, a system of public accountability of the regulator, a system permitting judicial review of decisions of the regulator."

Consider first public accountability. To enhance public accountability, supervisory agencies should make regular, detailed, public annual reports on their operations, and on their sources and uses of funds, identifying: (i) the costs of each supervisory activity at a level of detail necessary to document cost recovery without cross-subsidization from fees charged to the entities under supervision; (ii) the costs for entities under supervision, including an assessment of compliance costs; and (iii) measures of the agency's efficiency and effectiveness in performing its functions.

In these reports, an agency should also compare itself to foreign supervisory agencies with similar responsibilities and evaluate itself in the light of best practices issues by the Basel Committee on Banking Supervision, the IOSCO, the IAIS, the IMF, and other relevant international organizations.

The reports of supervisory agencies should be subject to external review by the Rechnungshof, the MoF, the OeNB (if appropriate), as well as, from time to time, by independent analysts commissioned by the financial industry. The outcome of external reviews of the activities of supervisory agencies should be made public.

For greater transparency of supervision, supervisory agencies should publish any rules governing their activities. Prior to publication or any amendment of rules, the agencies should conduct a cost-benefit analysis of these rules and publish the results. Moreover, the financial industry and any interested parties should be given the opportunity to voice criticism and to make proposals of their own in a formal public "consultation process".

Absence of conflicts of interest

An eighth criterion is the avoidance of conflicts of interest. There are several potential layers of conflicts of interest that should be avoided when an organizational structure for financial system supervision is chosen. First, the core principles for effective banking supervision require that there be no significant conflict of interest for members of the board of directors. Second, the supervisory agency itself should not be in a conflict of interest in terms of its different responsibilities and objectives. For example, when the FSA was established in the UK, a major argument was that the Bank of England's new responsibilities in terms of monetary policy would be incompatible with the simultaneous responsibility as a banking supervisor. Similarly, it has been pointed out that a central bank's role as lender of last resort may create a conflicting situation with its role as bank supervisor.

At the same time one should recognize that the objectives of financial supervision are sometimes conflicting. For example, the objectives of stability and of efficiency will generally create conflicts. These cannot be avoided by the organizational setup.

Reputational weight

The ninth and last criterion we regard as important for the design of supervisory bodies is reputational weight. It is more likely that objectives such as stability and market confidence will be achieved if the financial supervisor has a solid reputation for integrity, consistency and predictability in the processes it follows and the techniques it uses. If financial supervision is transferred to a new institution it will, therefore, be important that a close cooperation and support by other institutions that have already built up reputation is ensured. Specifically, support by and cooperation with institutions such as the central bank will be crucial.

The supervisor's reputation will also be crucial in attracting and retaining high quality employees. Only if the supervisory institution enjoys high esteem and good reputation will it be possible to attract employees with the education and skills necessary to keep pace with the rapid industry and regulatory changes. The supervisor's reputation will also be enhanced if it has broad powers when it comes to licensing or decisions about penalties.

VII. Alternative organizational models for Austria

Before we lay out four specific models to organize financial supervision it is useful to define the role of the central bank in achieving the objective of financial stability, independently of which of the four models of financial supervision is actually chosen. Central banks are generally considered to have two main tasks: maintaining price stability and promoting the stability of the financial system. Recently, the terms "oversight", "macroprudential supervision" or "supervision of systemic risks" have been used to describe the latter task of central banks.[21] A narrow interpretation is that this means oversight of the payment systems, i.e. to ensure their stability, reliability and efficiency.

The authority of the ECB as regards oversight of payment systems is defined in the Treaty establishing the European Community and the Statute of the European System of Central Banks. According to Article 105 of the Treaty, one of the ECB's basic tasks is "to promote the smooth operation of payment systems". Smooth operation in this context is equated with stable and efficient operation.

Article 22 of the Statute states that the "ECB and national central banks may provide facilities, and the ECB may make regulations, to ensure efficient and sound clearing and payment systems within the Community and with other countries".

As one of few countries in Europe Austria has not yet defined the role of its central bank as a supervisor of the payment system in the law. When reforming financial supervision, it appears advisable to explicitly define these general tasks of the OeNB.[22]

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[21] See, for example, Koskenkylä and Virolainen, 1999, Macroprudential supervision of financial markets, Bank of Finland paper.

[22] An example for a country which has recently explicitly defined responsibilities of the central bank in the supervision of systemic financial risks is Australia.

Thus, when interpreting the following models of financial supervision, it should always be kept in mind that the supervision of systemic risks, in particular the supervision of the payment system would be the responsibility of the OeNB under all four alternatives.

1. Model A: Responsibility for banking supervision is transferred to the OeNB

If this approach were followed, banking supervision would become the responsibility of the OeNB. The OeNB would also take over the supervision of mutual funds and all other responsibilities that the Ministry of Finance currently subsumes under banking supervision. The OeNB's current role in banking supervision would be complemented by magisterial tasks (behördliche Tätigkeiten), including licensing, sanctioning non-compliance, cooperation with foreign supervisory agencies, and supporting the MoF in the formulation of new legislation for bank regulation. With regard to securities market supervision, insurance supervision and pension funds supervision, the status quo would be maintained.

In assessing this approach, we shall organize our discussion using the criteria identified in the last section. The first of these was *independence*. In its current operations the OeNB is independent from political institutions such as ministries or the government as a whole. However, if bank supervision is transferred to the OeNB, then the Ministry of Finance (MoF) may still have the right to issue directives to the OeNB with regard to its function as bank supervisor. However, since the OeNB is a member of the ECB, any possible influence from the MoF on the OeNB would have to conform with the statutes of the ECB.

Such limitations of the MoF's right to issue decrees ("Weisungsrecht") would require a careful evaluation of whether or not they require a change in the Austrian constitutional law.

Independence would be strengthened by the budgetary freedom of the OeNB. In other words, this approach would make it less likely that any influence could be exerted through the budget for financial supervision. Thus, given that the legal questions discussed above are solved, this approach would score well on the criterion of independence.

Again, on the second criterion of *availability of resources* this approach scores well. Currently most of the personnel for banking supervision are already employed by the OeNB. If this model were chosen, these employees would continue to be available for supervision. In addition the OeNB currently covers the cost of its activities in banking supervision out of its own budget. Under this organizational model the OeNB would presumably continue to contribute to the budget of banking supervision.

On *internal cost efficiency (including setup costs),* this approach appears less attractive. In the short run there would be some cost advantages due to savings in setup costs. All the existing structures of the OeNB, such as IT-structures, libraries, etc. could be utilized. In terms of expected operating costs, one needs to keep in mind that four separate supervisors (for banking, insurance, securities industries and pension funds) would remain, necessarily leading to some duplication and to foregone economies of scope and scale.

On *external cost efficiency,* again this model appears somewhat unattractive since regulated firms would continue to deal with four separate supervisors. The information that firms would provide to supervisors would in some cases overlap and coordination of banking supervision with the securities and insurance supervisors would introduce additional costs. A positive feature of this approach would be that communication of bank supervisors with the supervisor of the payment system would be easier since the latter would also be located in the OeNB.

In our view, this approach would also score poorly on the criterion of *domestic compatibility*.[23] The communication between banking supervisors and the securities and insurance and pension fund supervisors would be restricted. It is very difficult to see how this approach might be the basis in the future for introducing a single supervisor (Allfinanzaufsicht) since there is no European or North American country in which the central bank is responsible for banking, securities, insurance and pension fund supervision. If conglomeration increases and the boundaries between Austrian banks and insurance companies become further blurred, this approach would therefore be relatively inflexible.

There are several potential *conflicts of interest* if banking supervision is transferred to the OeNB. First, the OeNB still has some input on monetary policy through the ECB. This could conflict with its role as bank supervisor. Second, the OeNB is also lender of last resort. As discussed in the Wallis report, this can on occasion create a conflict of interest since if the central bank's reputation as a bank supervisor would be adversely affected by a bank failure, it may have an incentive to provide liquidity as lender of last resort even when this is not justified by the economic fundamentals of the institution in distress.

Third, there exists a potential conflict of interest between the shareholders of the OeNB (also banks) and its role as bank supervisor. It would be important to design the governance structure to mitigate such problems. In particular, the structure would have to ensure that the representatives of financial institutions in the "Generalrat" and in the "Generalversammlung" would have no influence over supervisory decisions or the budget of the departments of the OeNB which are performing banking supervision, and no access to sensitive information regarding their own institution or their competitors.

On *international compatibility,* majority of countries still have banking supervision located in the central banks. Hence, the international compatibility of model A is in principle given. However, most of the countries that have recently reformed their banking supervision

[23] I.e., How well could the different domestic supervisory agencies cooperate and how effectively would financial conglomerates and other industry developments be dealt with?

have not chosen to follow this approach. Indeed, there has been a noticeable trend to transfer banking supervision out of central banks and into non-sectoral supervisory bodies. International cooperation in the area of banking supervision would also be in principle the responsibility of the OeNB. An exception would be those international organizations which prepare legislative changes in the area of banking supervision. In this area the MoF would continue to be represented.

In principle, this approach could be structured so that *accountability and transparency* are ensured. However, it may not be as easy as in some of the approaches described below. First, if banking supervision is one of several departments of the OeNB there will always be some ambiguity about cost allocation such as overheads etc. within the OeNB. Also, under this model, the OeNB would presumably finance banking supervision itself to a significant extent. Since there would be less outside pressure to control costs, transparency and accountability would probably be more easily achieved through an alternative approach.

This model, however, scores well on the criterion of *reputational weight*. The OeNB is an institution with a long history. Locating banking supervision within the OeNB would also automatically ensure that the supervisor is "close to the market", since the OeNB has been in close contact with the banking community for a long time.

2. Model B: The OeNB becomes responsible for both banking supervision and securities markets supervision

According to this model the OeNB would take responsibility for both banking supervision and securities market supervision. As mentioned in the discussion of model A, this would include supervision of mutual funds and all other responsibilities that the Ministry of Finance currently subsumes under banking supervision as well as the supervision of

conduct of business, insider trading etc. currently undertaken by the Bundeswertpapieraufsicht (BWA).

Evaluating this model according to the criteria developed above, many of the arguments put forth above also apply to Model B. Below, we therefore only focus on the differences between models A and B.

On *independence*, see the discussion of Model A.

On *internal cost efficiency (including setup costs)*, the fact that Model B combines two otherwise specialized supervisors should lead to an increase in cost efficiency relative to Model A. For example, both the banking supervision and the securities market supervision may need to assess the quality of a mutual fund corporation's or a bank's systems, its controls for managing risks and the calibre of its senior management.

Indeed, the importance of systems and controls and of senior management for the standards of compliance achieved by a firm against both the prudential and the conduct of business standards and requirements set by financial services regulators means that it is not possible to draw a clear dividing line between prudential and conduct of business supervision, since, in this respect, both types of supervision have an interest in the same aspects of a firm's business.[24]

In addition economies of scale and scope should arise because a single supervisor for banks and securities markets can take advantage of a single set of central support services (human resources, information services, financial control, premises etc.). Furthermore, unnecessary duplication or overlap across bank and securities market supervision can be avoided. Bank and securities market supervision may introduce a consolidated set of rules and guidance and they may tackle problems of coordination, cooperation and

[24] See Clive Briault, The Rationale for a single national financial services regulator.

communication more effectively within a single entity and under a unified management structure.

Having both banking supervision and securities market supervision in one organizational structure one can offer a single point of contact to both regulated firms and to consumers. For example, the FSA in the UK has already established single supervision, investigation and discipline, training and competence, consumer relations and central services functions. These economies of scale have been reflected in the costs of the FSA that were lower in 1999/2000 than the sum of its component parts in either the previous two years.[25]

In addition to the arguments of economies of scale and scope, a combined supervisory authority which is responsible for banking supervision and securities supervision should be more efficient in allocating resources across types of regulated activities. Such a supervisory authority can develop a single system of risk-based supervision under which regulatory resources are devoted to those firms and areas of business which pose the greatest risk when judged against the objectives of financial system supervision.

Finally, a single supervisor may be better able to retain highly skilled personnel especially when such expertise is in short supply, as it is almost surely the case in a small country like Austria.

Thus, in contrast to model A, this setup would create potential for utilizing economies of scope and scale. The potential advantage in setup costs mentioned in the context of model A would be diminished since new arrangements would have to be developed to integrate the securities supervision.

On the criterion of *external cost efficiency,* Model B would score better than Model A.
The consolidation of rules and guidance, the unification of reporting requirements and the removal of duplication and overlap across specialist regulators should reduce the costs

[25] See Financial Services Authority, 1999.

imposed on the regulated firms. This may be of significant importance since studies have found that these indirect additional compliance costs of supervision are a multiple of the direct cost of paying for the regulator itself.

As in Model A, the communication with the supervisor of the payment system would be very efficient since it is also located within the OeNB.

On *domestic compatibility*[26] Model B scores somewhat better than Model A. The communication to the securities supervisor would be much easier. An important drawback in this respect is, however, that Model B (like Model A) would not serve as a good basis for a future development towards a single supervisor (Allfinanzaufsicht). Also, no country in Europe or North America has transferred banking supervision, securities supervision and insurance supervision to its central bank.

On the criteria *absence of conflicts of interest, international compatibility*, *availability of resources*, and *accountability and transparency*, see the discussion of Model A.

3. Model C: Banking supervision and securities markets supervision is transferred to a new institution (juristische Person öffentlichen Rechts)

In Model C, a new institution would be created (Juristische Person öffentlichen Rechts) which would take responsibility for both banking supervision and securities market supervision. Again, this would include supervision of mutual funds and all other responsibilities that the Ministry of Finance currently subsumes under banking supervision as well as the supervision of conduct of business, insider trading etc. currently undertaken by the Bundeswertpapieraufsicht (BWA).

[26] How well can the different domestic supervisory agencies cooperate? How can financial conglomerates and industry developments be dealt with?

For this model to be successful, it will be necessary to move those employees of the OeNB and the MoF currently engaged in banking supervision into the new supervisory institution. One way to facilitate this would be to link the new institution organizationally to the OeNB and the MoF. One example of such a cooperation is the approach taken by Finland. According to this approach, both the OeNB and the MoF would be represented in the governance of financial supervision. The Finnish model is explained in detail in the Appendix.

Again, one may evaluate this model using the criteria developed above. We first consider the *independence.* To be consistent with the best practices of financial supervision, operational independence would have to be achieved. Thus, if the MoF retains the right to issue directives to the financial supervisor, then it will be necessary that those directives are transparent (e.g. written only), and that the circumstances in which directives are permissible are clearly defined (e.g. only after the advisory board or supervisory board of the supervisory institution has been heard).

On the *availability of resources,* if this model were chosen, OeNB employees would have to be transferred into the new supervisory agency. This would be easier the closer the organizational link is between the new supervisor and the OeNB. There could be some concern that some employees might consider the career opportunities in the supervisory institution to be less attractive than those directly in the OeNB. This potential problem must be addressed by making the employment contracts in the new supervisory agency sufficiently flexible and attractive.

The employees of the MoF who are currently responsible for banking supervision should also be transferred into the new supervisory agency. Alternatively they could be given the option to remain employees of the MoF, but to be“ leased” to the supervisory institution.

If this model is chosen, and the OeNB is represented in the corporate governance of the supervisory agency, the OeNB would presumably continue to contribute to the costs of financial supervision out of its own budget.

On *internal cost efficiency (including setup costs)*, as in Model B, Model C also combines two specialized supervisors and should therefore create some potential for increasing cost efficiency. Therefore, all the potential benefits resulting from economies of scale and scope, discussed in Model B apply. Obviously Model C requires somewhat higher setup costs than the previous models since it is based on a new legal entity.

On the criterion of *external cost efficiency*, Model C would have a score similar to that of Model B. The only slight disadvantage would be a somewhat greater distance to the supervisor of the stability of the payment system, i.e. the OeNB. However, since the setup could be chosen to ensure close cooperation and data sharing, this factor should be negligible.

On *domestic compatibility*[27] Model C scores better than either Model A or Model B. The major advantage of model C over the previous models is the flexibility towards conversion into a single financial supervisory agency. As we discussed above, there are several arguments against a central bank which also acts as a single financial supervisor. By contrast to Models A and B, Model C would be open towards a future integration with insurance and pension fund supervision. Thus, the cooperation and possible future integration with the insurance and pension fund supervisors is more feasible under this organizational setup.

On the criterion of *absence of conflicts of interest*, here too Model C scores better than Models A and B. The potential conflicts of interest mentioned above are no longer present. The bank and securities markets supervisor would no longer be the lender of last resort at the

[27] How well can the different domestic supervisory agencies cooperate? How can financial conglomerates be dealt with?

same time. Also the potential conflict of interest between supervisory responsibilities and the shareholders of the OeNB (i.e. banks etc.) would no longer exist.

On *international compatibility*, the majority of countries that have recently reformed their supervisory structures have moved their banking supervision out of their central banks. Thus, Model C is compatible with international developments. International cooperation would be joint by the new supervisor, the OeNB and – in legistic matters -- by the MoF.

Model C also scores better on the criterion of *accountability and transparency* than Models A and B. If a new, separate institution were founded for financial supervision, the cost structure would be more transparent than if the supervisory agency were located directly in the OeNB. Also, this institution would presumably be financed to a significant part by the supervised entities, further adding to the pressure for accountability and transparency.

Like Models A and B, Model C can score well on the criterion of *reputational weight*. Since the OeNB would be represented on the governance structure of the new supervisor, its reputational weight and its "closeness to the market" would be utilized. For the reputational weight of a new supervisory agency to develop, it will be most important to be able to attract and retain high-quality employees. Since the skills required by financial supervision are similar to those in demand in the financial industry, it will be most crucial that the supervisory agency can pay competitive salaries. Finally, the powers that the new supervisory agency will get in terms of licensing and in the setting of penalties will be important factors that determine the reputational weight that financial supervision will carry.

4. Model D: Banking supervision, securities markets supervision, insurance supervision and supervision of pension funds is transferred to a new institution (juristische Person öffentlichen Rechts)

Under Model D, a new institution would be created (Juristische Person öffentlichen Rechts) which would be responsible for banking supervision, securities market supervision, and insurance supervision and pension fund supervision. Again, we evaluate this model using the criteria derived above.

On *independence* and on *availability of resources,* see the discussion of Model C.

On *internal cost efficiency (including setup costs)*, as we outlined in Section II, the traditional approach to supervision according to sectors (banks, insurance companies, mutual funds, pension funds, securities markets etc.) is increasingly being replaced with a modern approach which is activity- or process-oriented (see Robert C. Merton[28]). Of course, the distinction between these two approaches is not always clear-cut.

The main idea is that similar services offered by financial intermediaries should face a similar regulatory framework, independent of the type of institution that offers the service. This implies that a single supervisory agency could realize significant cost savings, both through economies of scale when processing information and when developing expertise.

One way to realize these benefits is to define major risk types and supervise all activities that create similar risks in a similar way. This approach is consistent with the view that risk management should be process oriented and, thus, synergies will increasingly be realized by combining bank, securities market and insurance supervision, as it would be implied by Model D.

[28] See, for example: "Financial innovation and the management and regulation of financial institutions", Journal of Banking and Finance 19, 1995, pp. 461 – 481, or: „A functional perspective of financial intermediation", Financial Management 24, 1995, pp. 21 – 41.

Initial setup costs would presumably be relatively high since the insurance supervision and the pension fund supervision would need to be integrated.

Of all the models, this organizational model has clearly the greatest potential to maximize *external cost efficiency*. Each supervised entity would only need one single communication channel to the supervisor. The structure of the data to be provided could be unified.

This model would also score highly on the criterion of *domestic compatibility*.[29] Since there would only be one supervisor, communication between various departments could be organized efficiently within the single institution. The only "external" channel would be to the OeNB, which would still be in charge of supervising systemic risks. However, since we are proposing a close organizational link, this would not be a problem either.

Financial conglomerates could be dealt with most efficiently within the setup of Model D. As discussed above, to assess for example the total market risk that a conglomerate is exposed to, it is necessary to apply a unified view and aggregate the risks in the banking operations with those in the insurance operations. This could be done efficiently within a single supervisory unit.

Also, this model would most effectively limit regulatory arbitrage since it would be more likely that similar or identical standards would be used for similar risks in the banking and in the insurance operations.

Of course, in the beginning, an overlap between functional organization and sectoral organization within the supervisory agency would be likely.

On *absence of conflicts of interest*, see the discussion of Model C.

Model D also ensures *international compatibility*. As we discussed above, several countries have moved to a single financial supervisory agency. We expect that this trend will continue in the future. Thus, Austria would have a modern supervisory structure, compatible with several countries with sophisticated financial markets.

On *accountability and transparency* and *reputational weight*, see discussion of Model C.

5. Recommendations

We now turn to a comparison of the alternative models. The analysis in the previous subsection shows that no candidate model dominates the others on all criteria. Thus, the overall ranking will depend on an aggregate score which considers all the relevant criteria.

According to our discussion above, Models A and B perform relatively poorly on the criteria domestic compatibility, operating cost efficiency and external cost efficiency. Ultimately the boundaries between commercial banking, investment banking, insurance and even the securities markets will be blurred in terms of the products and services offered as well as in terms of the required risk management skills and techniques. Thus, eventually a functional and not a sectoral approach of supervising the financial system will prevail in order to assure supervisory neutrality across sectors. As a result, a single supervisory agency would score better in terms of potential economies of scale and scope.

Simultaneously transferring the supervision of systemic risks, banking supervision, insurance supervision, securities market supervision, and pension fund supervision directly to the OeNB does not seem to be a preferable solution either. Such an organization would concentrate enormous responsibilities in one institution. Also, the traditional focus of the OeNB on banking may not be the optimal corporate culture for a single supervisor also in charge of insurance and securities markets. We have also found potential for conflicts of

[29] How well can the different domestic supervisory agencies cooperate? How can financial conglomerates and new industry trends be dealt with?

interests between financial supervision and some of the OeNB's other responsibilities. Finally, this solution would not be compatible with recent international trends.

As a result Models A and B are dominated by Models C and D in terms of operating cost efficiency, external cost efficiency, domestic and international compatibility and absence of conflicts of interest. These advantages seem to outweigh potential disadvantages in terms of availability of resources and reputational weight that Models C and D may exhibit when compared to Models A and B.

Comparing Model C with Model D we first observe that the functional approach to supervision would clearly favor Model D over Model C. As discussed above, this would ensure that functions which create similar risks would face similar supervision. Also, Model D has the bigger potential for cost savings due to economies of scale and scope. Furthermore, since we expect an increasingly blurred boundary between the banking, insurance and pension funds sector so that eventually, supervisory structures will need to converge as well. These are important arguments why Model D exhibits higher scores on the dimensions of operating cost efficiency, external cost efficiency and domestic compatibility than model C.

Table 4 summarizes major arguments when evaluating each model along the criteria defined above to facilitate a direct comparison.

Criterion	Model A	Model B	Model C	Model D
Independence	Independence can be achieved through legal restrictions of the MoF's right to issue directives; OeNB could possibly accept liability for supervisory decisions.	See Model A	Independence can be achieved through legal restrictions of the MoF's right to issue directives;	See Model C
Internal efficiency: setup costs	Existing structures in OeNB can be used directly.	See Model A, however there are additional setup costs for securities supervision.	Organizational synergies with OeNB can be realized.	Organizational synergies with OeNB can be realized.
Internal efficiency: operating costs	Duplication of operating costs, no economies of scale.	Some economies of scale possible. For certain aspects similar high-tech skills are required by banking supervision and by securities market supervision.	Some economies of scale are possible. For certain aspects similar high-tech skills are required by banking supervision and by securities market supervision.	Even more economies of scale. Similar skills are also needed to supervise insurance companies and pension funds. Furthermore supervision, investigation and discipline, training and competence, consumer relations and central services functions could – for example - be centralized.
External cost efficiency	Regulated entities must deal with several supervisors, must provide similar information to more than one supervisor, must deal with different data interfaces etc.	Some economies of scale possible. Certain risk factors only need to be checked once.	See Model B	Maximizes possible economies of scale.
Domestic compatibility/ability to cope with new industry and regulatory trends	Information sharing between supervisors not guaranteed; this would require cross-representation of agencies on boards of other agencies and/or the creation of an oversight committee; supervisory neutrality is hard to ensure; existing structures may reduce flexibility to cope with new industry trends (i.e. focus in research departments on stability, payment system etc.)	Cooperation between banking supervision and securities market supervision is easier to achieve; OeNB may have a "banking focus"; existing structures may reduce flexibility to cope with new industry trends (i.e. focus of research departments on stability, payment system etc.)	See Model B; however this model allows for future integration of insurance supervision and pension funds ("future proof"); new structures may increase ability to cope with new industry trends, i.e. focus on research on market, credit and operational risk management, capital allocation etc.	Can deal easily with conglomeration; allows for a functional organization and, makes regulatory neutrality more likely; new structures may increase ability to cope with new industry trends (see Model C).
International compatibility	Majority of countries with recent major reforms have moved financial supervision out of central banks.	Majority of countries which recent major reforms have moved financial supervision out of central banks.	Conforms with recent trends to move financial supervision out of central banks and to combine supervisory agencies.	Conforms with recent trends to move financial supervision out of central banks and to combine supervisory agencies. A single supervisory agency can also simplify international cooperation between supervisory agencies.
Availability of Resources	Existing resources at the OeNB can be utilized; budgetary freedom possibly easier to achieve than for other models.	See Model A.	Funding to be provided off budget by supervised institutions.	Funding to be provided off budget by supervised institution.
Accountability and transparency	Cost structure relatively opaque, external audits and international comparisons may be difficult.	Cost structure relatively opaque, external audits and international comparisons may be difficult.	More transparent cost structure, cost-benefit analyses, external audits, intern. comparisons easier.	More transparent cost structure, cost-benefit analyses, external audits, intern. comparisons easier.
Absence of conflicts of interest	Conflicts of interest possible due to responsibilities of the OeNB in determining monetary policy, and due to being lender of last resort.	Conflicts of interest possible due to responsibilities of the OeNB in determining monetary policy, and for being lender of last resort.	Conflicts of interest can be avoided	No conflicts of interest.
Reputational weight	Can build on existing reputation of the OeNB; can be built up through consistent supervisory policies; also depends on the powers of the supervisory agency: licencing, deciding on fines etc.	See Model A	Can be built up through consistent supervisory policies; also depends on the powers of the supervisory agency: licencing, deciding on fines etc.	Can be built up through consistent supervisory policies; also depends on the powers of the supervisory agency: licencing, deciding on fines etc.

Table 4: Model Evaluation

It should be pointed out though, that not all criteria considered are of equal relevance. The focus should be on those criteria which are (i) important determinants in achieving the objectives of stability, market confidence and efficiency in the medium and long term and

(ii) for which the "score" cannot be improved by auxiliary measures, which can be taken independently of the organizational structure chosen.

For example, independence can be achieved by appropriate governance and legal changes for all of the models considered. Thus, when choosing between alternative models this criterion should get less weight. Similarly, setup costs will be less important in the medium and long run. Also, international compatibility is achievable by each of the models considered and thus should get less weight. We therefore assign a low weight to these criteria. By contrast, the criteria internal efficiency, operating costs, external cost efficiency, domestic compatibility and availability of resources will be decisive in achieving the objectives of financial supervision. The scores on these latter criteria vary substantially across the organizational models of financial supervision. We therefore assign a large weight to these criteria. The remaining criteria, i.e. accountability, absence of conflicts of interest and reputational weight can be classified into a group of intermediate importance.

Inspection of Table 4 reveals that Model D scores particularly well on those criteria, which were argued above to be the most relevant ones. Thus, the ranking based on the weighted scores would reinforce the non-weighted ranking: Model D is considered to be the best model followed by Model C. Models B and A are ranked third and fourth. This indicates that the ranking of the models seems to be robust in terms of the weights applied to various criteria.

VIII. Processes and techniques of financial supervision

The last section focused on the degree to which different institutional arrangements would fulfill the criteria for effective financial supervision set out in Section V. Focusing initially on institutional arrangements is appropriate since the first step in implementing substantial changes in financial supervision in Austria would necessarily be a review of how responsibilities and activities are allocated across different agencies.

Nevertheless, there remain several aspects of financial supervision deserving attention that are not directly affected by whether supervision is performed by the central bank or by some other authority. The issues are:

- the degree to which supervision can be contracted out to private sector agencies,
- the penalty structures and powers available to supervisory bodies to enforce their policies on regulated institutions
- the appropriate internal organization of supervisory bodies,
- measures that should be taken within supervisory bodies to limit the costs that supervision imposes on regulated institutions,
- arrangements to enhance information-sharing between domestic and foreign supervisory institutions.

Out-sourcing supervisory functions

Different countries vary considerably in the extent to which they rely on private sector bodies to carry out bank supervisory functions. The system operated in Switzerland is an extreme example of contracting out supervision. As we describe in the Appendix, the Swiss Federal Banking Commission (SFBC), in monitoring regulated institutions, relies almost entirely on information provided to it by audit firms it authorizes to inspect banks. Only rarely does the SFBC perform direct verification of the information it receives although

audit reports may result in critical inquiries being addressed either to the auditors or to the licensed institution. The alternative extreme is exemplified by the UK approach in which bank examinations are conducted entirely by specialized staff of the FSA.

Some of the arguments that affect whether the out-sourcing of financial supervision is desirable are the same as those that apply to the decision to out-source any public sector activity. In principle, private sector contractors are more likely to be efficient in performing the activity but this gain in efficiency will not yield cost savings to the government unless there is a reasonable degree of competition between different contractors. Such competition may only be possible if multiple contractors are operating and in this case it may not be possible to exploit fully whatever economies of scale exist.

Arguments that are more specific to the case of out-sourcing financial supervision are:

(i) Delegating supervisory functions to bodies outside the main supervisory authority may exacerbate the problems of controlling the quality and effectiveness of supervision. This is particularly true because assessing the quality of supervision is difficult.

(ii) Out-sourcing may be useful if it is difficult to recruit and maintain skilled teams of bank examiners within supervisory bodies. Private sector auditors may have more flexibility in paying high salaries to skilled individuals than is possible in a civil service setting.

(iii) Delegation may be inadvisable if the technical expertise required in making supervisory judgments continues to increase. The reason is that supervisors are only likely to grasp complex banking problems if they are themselves directly involved in day-to-day supervision. Consider, as an example, the possible use by banks of credit risk models following the current Basel review. The supervisory body will only develop expertise in interpreting the output of these models if its staff are directly involved in the processes of model authorization.

While these considerations constitute only a first step towards a full analysis of the degree to which financial supervision can be contracted out, it is particularly essential to analyze the relationship between financial supervisors and external auditors of supervised entities. Thereby, it must be recognized that the role of external auditors differs from that of supervisors but that there are also some areas where the work of supervisors and auditors can be useful for each other. For example, the International Standard on Auditing 260, "Communications of Audit Matters with those charged with Governance", identifies several audit matters that are not only of interest for persons charged with the governance of an audited entity but also for bank supervisors such as the following:

(i) "The general approach and overall scope of the audit, including any expected limitations thereon, or any additional requirements",

(ii) "The selection of, or changes in, significant accounting policies and practices that have, or could have, a material effect on the entity's financial statements",

(iii) "The potential effect on the financial statements of any significant risks and exposures, such as pending litigation, that are required to be disclosed in the financial statements",

(iv) "Audit adjustments, whether or not recorded by the entity, that have or could have a significant effect on the entity's financial statements",

(v) "Material uncertainties related to events and conditions that may case significant doubt on the entity's ability to continue as a going concern",

(vi) "Disagreement with management about matters that, individually or in aggregate, could be significant to the entity's financial statements or the auditor's report. This communication includes consideration of whether the matter has, or hast not, been resolved, and the significance of the matter",

(vii) "Expected modifications to the auditor's report",

(viii) "Other matters, such as material weaknesses in internal control, questions regarding management integrity, and fraud involving management".

At the same time, conclusions drawn from supervisory inspections may be of assistance to auditors in performing analytical reviews. For example, supervisory assessment of banks' loan loss allowances provide an independent opinion on the adequacy of these allowances.

Given the many ways that financial supervisors and auditors may benefit from each other, the BIS has recently issued two consultative papers titled "The relationship between banking supervisors and banks' external auditors" and "Internal audit in banking organizations and the relationship of the supervisory authorities with internal and external auditors" that should receive consideration in regulatory provisions concerning the relationship between financial supervisors and auditors. Further, international practice, may constitute a starting point for any review of current regulation. There, the survey of Swiss financial supervision (in the Appendix) is especially useful.

Powers available to supervisory bodies to enforce regulations

It is extremely important that the supervisory authority have sanctions available that permit it to enforce regulations effectively. Penalties and sanctions can take various forms. The ultimate sanction for a bank supervisor is to remove a bank's license to operate. Clearly, this sanction can only be used in extreme situations and is, to this extent, of limited use. In many countries, supervisors have, in addition, powers to require banks to take such steps as to rebuild capital or to limit dividend payouts in case of financial weakness.

Table 5 summarizes the practice in several countries on fining banks and individual bank managers. Supervisors in some countries have powers to levy fines but rarely use them in practice. In others, such as the US, the powers are relatively little used but are still regarded as an important part of the supervisors' armory of penalties and sanctions. The ability to impose penalties on individuals may be especially useful. Penalizing a bank may amount to penalizing shareholders who may be only indirectly responsible for whatever problem has arisen; furthermore, it may not be possible to impose large penalties on a bank since this might undermine its solvency.

Recently, regulatory authorities in several countries have reviewed the degree to which they can hold senior managers of banks responsible for lapses in control or inaccurate reporting to supervisors or to auditors. Part of the inspiration for these developments comes from New Zealand where in 1996 the authorities introduced greater responsibilities for senior management allied to greater public disclosure. Directors of banks are required to sign disclosure statements to certify that "the information contained in the statements is not false or misleading", and to attest to their bank's financial soundness and to the adequacy of its risk management systems. Where the disclosure statement is found to be false or misleading, banks and their directors face potentially severe penalties, both criminal and civil.

A review of appropriate powers for financial supervision would probably be advisable if the Austrian authorities do decide to make significant changes in supervisory arrangements. Considerable legal input would be needed in assessing what powers could be accorded to the supervisory body within the Austrian system. But providing adequate powers would certainly be necessary if financial supervision in Austria is to be fully effective.

Country	Power to Exercise	Frequency	Amount
Germany	Yes	Usually 10 to 20 cases of enforcement fines and about 4 to 10 cases of administrative fines per annum.	Enforcement fines DM 10,000 (£3,500) up to DM 50,000 (£17,500). Administrative fines not exceeding DM 100,000 (£35,000) and should reflect benefit gained from infringements. In practice usually between DM 200 (£70) and DM 25,000 (£8,750).
Norway	Yes	Authority not used so far.	No maximum. The amount would depend on the size of the institutions and the severity of the issue.
Greece	Yes	N/A	N/A
Iceland	Yes	Seldom used.	N/A
Luxembourg	Yes	Not frequently used.	LUX5,000 (£85) to LUX5,000,000 (£85,000) and/or 3-8 days imprisonment depending on the nature of the infringement.
Liechtenstein	No. Power rests with the Government and the district court.	Only used so far for five banks and three other financial institutions.	Depending on the specific case up to 50,000 Liechtenstein Francs (£21,000) or 100,000 Liechtenstein Francs (£42,000).
Belgium		Not used so far	Fines under administrative law are BEF 10,000 (£170) to BEF 1 mn (£17,000) per calendar day upper limit BEF 50 mn (£850,000).
France	Yes	Rare - only 5 times since 1984. In most cases fines are imposed as a sanction for late transmission of financial information to supervisors or failure to comply with money laundering regulations	Fines may not exceed the minimum amount of capital required for the institutions. Fines imposed have ranged between FRF 10,000 (£1,000) & FRF 300,000 (£30,000).
Ireland	No		
Italy	Yes		Breaches of prudential rules, integrity requirements etc. ITL 1 mn (£350) to ITL 50 mn (£17,500). Corporate officers who breach the rules regarding disclosure to customers of terms and conditions of contracts ITL 2 mn (£700) - ITL 25 mn (£9,000).
UK	No		
Spain	Yes	Authority used frequently but usually for not meeting complex reserve requirements.	Maximum amount for very serious infringements, 1 per cent of own funds or ESP 5 mn (£21,000), for serious infringements 0.5 per cent of own funds of ESP 2.5 mn (£10,500). Maximum fine for a manager ESP 10 mn (£42,000).
USA	Office of Comptroller of Currency- Yes Federal Reserve – Yes	This type of action is usually reserved for individuals except where a bank has filed a false or misleading report: 614 fines have been assessed in the last 6 years. Powers to fine firms for law violations e.g. misreporting 5-10 cases a year all foreign banks. Individuals can be fined for their actions - perhaps 2 cases a year.	The amount depends on the seriousness of the case but most fines for individuals are $10,000 (£6,300) to $25,000 (£15,700). Maximum $1 mn per day or 1 per cent of assets per day for a firm. Largest fine for a firm BCCI $200 mn (£126 mn). Fines for individuals usually $10,000 to $100,000 (£6,300 to £63,000).
Japan	Ministry of Finance - Yes Bank of Japan – No	Only one case of a bank being fined in the past. Other penalties are used as well such as restrictions on business activities.	Maximum of Yen500,000 (£2,600), likely to be revised upwards.

Table 5: Bank supervisors' powers to impose fines

Source of European Data: De Nederlandsche Bank survey for the Groupe de Contact

The appropriate internal organization of supervisory bodies

The internal organization of supervisory agencies is characterized by (i) the representation of the stakeholders of financial supervision in the design of supervisory policy, (ii) the governance structure, and (iii) the departmental structure of these agencies.

1. On stakeholders' representation in supervisory policy, it is instructive to consider the UK's FSA. There, the interests of supervised entities are represented by the so-called "practitioner forum", a body that reviews the effectiveness of the FSA and issues statements on questions concerning supervisory policy. At the same time, there is an institutionalized representation of consumers' interests via a consumer panel. It is important though to point out that the representatives of, say, the practitioner forum, are not chosen by industry organizations but by the FSA. Both panels have an effect on the FSA's policy mainly due to the publicity associated with their statements.

While the UK's system of stakeholders' representation in supervisory policy is certainly transparent, it offers no institutionalized way to effect a trade-off between the interests of supervised entities and consumers. It may therefore be advisable to represent stakeholders' interests via a single advisory board that also includes "neutral" experts such as representatives from universities. While the composition of this board is certainly a matter of negotiation, it should be charged with duties such as the following:

(i) to advise financial supervisors on new developments in the area of financial intermediation,

(ii) to propose issues that should receive supervisors' special attention,

(iii) to respond to documents issued by financial supervisors to seek advice on policy questions in the course of consultation procedures.

2. The governance structure of supervisory agencies should ensure the operational independence of supervision while allowing it to hold financial supervision accountable

with respect to its goals. To achieve this, a dual board structure seems advisable with a supervisory board charged with duties such as the following:

(i) to confirm the annual budget of the supervisory agency,

(ii) to confirm supervisory guidelines concerning matters that are significant or important in principle or have far-reaching consequences from the point of view of supervision,

(iii) to consider the rules of procedure of the supervisory agency,

(iv) to confirm the annual report of the supervisory agency,

(v) to conclude employment contracts with the executives of the supervisory agency.

3. Concerning the departmental structure of financial supervision, other sections of this report have stressed the functional versus sector-based approaches to financial regulation and argued that the functional approach accords more clearly with modern views on the appropriate design of financial supervision. A point not so far emphasized is that consolidating supervision in relatively few or even perhaps in a single supervisory body is a necessary but not sufficient step in achieving a functional approach to supervision.

The recent history of the UK's FSA is instructive in this regard. While initially it operated in an uncoordinated way, roughly organized along sectoral lines following the supervisory arrangements put in place by the several supervisory bodies it succeeded, it has increasingly attempted to move towards a functional approach. Ultimately, this will mean that teams of supervisors from different FSA departments and possessing different experience and skills will ultimately conduct joint assessments of complex financial groups. The benefits of this are that uniform regulatory frameworks will be imposed on similar financial products whether they are offered by banks or insurance companies.

At the same time, a functional organization must reflect the differences between risks in various sectors. For example, there are still significant differences between the nature of the risks faced by insurance companies and those faced by banks. Classical insurance risks are diversifiable and can be calculated using actuarial methods whereas many bank risks have systematic, i.e. non-diversifiable components. If banks decide to hedge these

systematic risks, they will generally be exposed to liquidity risk, i.e. the risk that they cannot engage in the transactions needed to continuously hedge certain risks. Also, bank failures generally carry a larger systemic risk and impose larger externalities on the economy as a whole than bankruptcy of an insurance company.

Clearly it is important that the internal organizational structure reflect these differences. Thus, at least at the outset of the new supervisory agency, a divisional structure along the lines of the sectors, i.e. banking, insurance, securities markets and pension funds will be useful. Synergies may still be realized in such an organizational structure, for example, through centralization of policy analysis functions, investigation and discipline, training and competence, consumer relations and central service functions. However, in the longer run it should be reconsidered if an organizational structure along functional lines is preferable.

Limiting the costs of supervision

As stressed in earlier sections, an important objective for regulators is to limit the direct costs on the public budget and the indirect costs on regulated institutions while still maintaining supervision at reasonable levels. The measures that supervisory authorities should take to limit costs may be divided into two categories: (i) cost benefit analyses of new regulations and (ii) regular assessments of the overall costs of existing regulation.

On the first of these categories, cost benefit analysis (CBA) is employed by leading supervisory bodies such as the British Financial Services Authority (FSA) to "provide guidance to policy-makers in the evaluation of actual policies in real markets using available data and reasonable techniques." CBA has been used as an appraisal tool for public expenditure by government departments in the UK and some other countries since the early 1960s.

Recently, CBA techniques have also been developed for use in financial supervision. One of the predecessor organizations of the UK's FSA, the Securities and Investment Board

(SIB) established a CBA department in late 1994 to advise on the costs and benefits of regulatory initiatives. CBA contributes to the assessment of any policy and its value-added but the SIB has suggested that it may have other uses in that it offers a non-partisan way to discuss policy issues with firms and enhances the accountability of supervisory and regulatory bodies.

As the successor of the SIB, the FSA continues to be a frontrunner in the development and application of CBA tools in the field of financial supervision, it is useful to look in detail at current UK practice.[30] The Financial Services and Markets Bill (FSMB), the legislation under which the FSA operates, obliges the FSA to publish a CBA as an intrinsic part of its mandatory process of "consultation" of supervised entities prior to any reform of its general policy. The scope of this requirement includes any reforms that are likely to trigger a "more than minimal increase in the costs of those affected."

The CBA procedure followed by the FSA involves assessing costs under six headings, evaluating alternatives to the proposed policy and comparing the costs and benefits over all. Table 6 provides details of the formal procedures the FSA follows.

[30] For an extensive survey, see the one by Alfon and Andrews (1999).

Cost Benefit Analysis at the UK's FSA
Each assessment of a policy change involves an examination of the following six aspects of the change: - Direct costs: "the value of the extra resources that would be absorbed by regulatory and supervisory bodies in respect of a policy proposal." - Compliance costs: "the value of the extra resources (including time) that would be used by firms and/or individuals to comply with a regulatory proposal." - Quantity of goods/services purchased: "As regulation can affect the costs of bringing a product to market, it can raise or lower prices and so increase or decrease the volume of sales." - Quality of goods/services offered: "A great deal of regulation, especially on the retail side, is designed to improve the quality of products in a market by, for example, mandating minimum standards or impeding the sale of inferior products." - Variety of goods/services offered: "By influencing the cost of specific products within a general class, regulation plays a role in determining the variety of the products available in that class." - Efficiency of competition: "Regulation plays an important role in determining how firms compete (for example, by affecting the level of entry barriers), and so influences whether competition creates value or wastes resources." To analyze these issues, the CBA department of the FSA employs a framework based on "option comparison": First, there is an assessment of the incremental impact of the policy options. Here, the focus is on the six types of "impacts" stated above. The analysis also includes the "do-nothing" option that corresponds to the status quo. For any option, the incremental impact is characterized by the difference between the situation if the option were adopted and that if it were not adopted. Second, the CBA department tries to identify and assess the economic benefits and costs that result from each option. Here, the analysis is mostly qualitative and the focus is on the key impact of policy options. The purpose is to distinguish between those options that seem likely to be cost-effective and those that do not. This analysis may reveal that a certain option is clearly dominated by others. If so, the former option is discarded at this stage of the analysis. Third, it remains to determine for the options still under consideration whether the economic benefits exceed the expected costs. To do this, the CBA department first analyzes whether any options can be discarded since even a rough quantitative analysis reveals high costs or low benefits. The remaining options are then ranked according to their cost. For the options considered most cost-effective, the CBA department devotes additional resources to analyze and, if possible, quantify costs and benefits. Thereby, quantification is not necessarily in monetary terms. Instead, the output of CBA should illustrate the relative advantages, disadvantages and net benefits of the options under consideration for use in the broad policy making process and in the process of consultation on policy proposals that is statutory under the FSMB.

Table 6: Cost-benefit analysis at the FSA

While there is a department in charge of CBA at the FSA, this task could also be out-sourced. However, in this case it is essential that the analysis remains independent of either sectoral interests or the interests of other institutions that are part of the supervisory regime such as external auditors.

IX. Allocating the Cost of Financial Supervision

This section features a survey of international practices in charging supervised entities with the cost of financial supervision. The survey draws on evidence from three countries, the UK, Germany, and Finland.

1. The Cost-Allocation Method in the UK

One overarching goal of the UK's system to allocate the cost of financial supervision is to avoid cross-subsidization between different groups of supervised entities. For this purpose, the cost-allocation is based on so-called fee-blocks, i.e. groups of supervised entities that are charged collectively for the cost of supervising. Within such a fee block a homogenous cost allocation key is used. To define such fee blocks, the British FSA implemented the following procedure:

1. First, the FSA split the supervised entities into groups that require the same type of financial supervision in order to achieve the FSA's goals. These groups are generally defined by the legal relationship of the entities in a group to the FSA. As a consequence, most groups are determined by the type of license that is required by the entities under supervision in order to do business.
2. Second, the FSA reviewed its own cost-accounting system to determine which types of costs it incurs to supervise different groups of entities. Then, the FSA decided which of these costs should be raised through fees charged for specific supervisory activities, such as granting a license, etc. The remaining costs must be allocated to the supervised entities according to some cost allocation "key", such as, for example, revenue. Given this cost allocation key, charges to supervised entities are determined to meet that part of the cost incurred by the FSA that is not covered by specific fees.

Several aspects deserve special attention:

1. Concerning the fee blocks, it is important to note that one supervised entity can be part of several fee blocks, e.g. if it requires different types of licenses to do business.

2. Concerning the total costs to be met by each fee block, the FSA aims at building up a reserve of a certain percentage of this cost in order to meet unexpected shortfalls in the contributions it receives from the supervised entities (e.g. due to bankruptcy of supervised entities). To build up this reserve, the FSA charges fees that slightly exceed the cost of supervision over a number of years.

3. There are several questions that need to be answered when allocating the costs of financial market supervision.

- Should there be a certain minimum fee? If so, this fee should reflect the marginal cost incurred by the FSA to supervise the smallest entities that contribute to a certain fee block.
- How should the fee depend on the cost allocation key? It is important to avoid a step-wise relation since that would imply that supervised entities try to "shed" their fee.
- Should there be a maximum fee?

Upon implementing the above-stated procedure, the FSA issued a consultation paper that contained several proposals for cost allocation methods. While the proposed fee structure is certainly a very complex one, its main characteristics can be summarized as follows:

- Supervised entities that take deposits: costs allocated to supervised entities in proportion to either total assets, total deposits, risk-weighted assets or "eligible liabilities", i.e. the sum of certain balance sheet positions corresponding to liabilities with a maturity of less than five years,
- Supervised entities that provide asset management services: funds under management,
- Supervised entities that trade financial securities on their own account: "gross assets related to their specific activity" or capital requirements for the trading book,
- Supervised entities that provide broker services: commission income, number of employees,
- Supervised entities in insurance markets: premia income.

2. The Cost-Allocation Method in Germany

In Germany, the "fee blocks" reflect the institutional specialization of financial supervision. The fees charged to supervised entities in securities markets are determined in § 11 of the "Wertpapierhandelsgesetz" and further implemented according to the "Umlage-Verordnung-Wertpapierhandel”.

According to these provisions, the BAWe (supervisory agency in charge of securities markets) uses the following method to determine the fees charged to supervised entities in securities markets:
- Commercial banks contribute 68% of the costs of BAWe in proportion to the number of their securities transactions.
- Stock exchange members contribute 4% of the costs of BAWe in proportion to the number of securities transactions.
- Financial Services Firms (Finanzdienstleistungsinstitute) contribute 9% of the costs of BAWe in proportion to either gross proceeds from securities transactions or their overall gross operating profit.
- Issuers of securities listed on a German stock exchange contribute 9% of the costs of BAWe in proportion to the trading volume of the respective securities.

The fees charged to supervised entities in credit markets are defined in § 52 of the "Kreditwesengesetz" and further implemented according to the "Umlage-Verordnung-Kredit- und Finanzdienstleistungswesen".

To summarize these provisions, the costs of BAKred are borne according to the following system:
- The fees charged to deposit-taking institutions increase in proportion to total assets.
- The fees charged to "Finanzdienstleistungsinstitute" increase in proportion to commission income.

2. The Cost-Allocation Method in Finland

In order to raise the cost of financial supervision, the Finish system distinguishes between two "fee blocks", namely supervised entities that provide services in securities markets or credit markets. While the overhead cost of financial supervision is met through fixed "basic fees", there is also a relatively simple system of variable fees:

- Deposit-taking institutions are charged fees in proportion to total assets.
- Brokers are charged fees in proportion to their market share.
- Fund management firms are charged fees in proportion to funds under management.
- Regulated securities exchanges are charged fees that equal the actual cost of supervision.

X. Conclusions

The current approach to financial supervision in Austria has several weaknesses which suggest the need for change. This report assesses the current state of Austrian banking supervision and proposes a new approach. The focus is on the economic rationale for different types of supervisory organization rather than on legal considerations. This approach reflects the authors' background as finance academics but also seems justified since the logically correct sequence of questions is (i) what would be a desirable way to organize financial supervision, and (ii) what legal steps are necessary to create such an organization.

The methodology employed in the report consists of:

1) a discussion of the broad goals of financial supervision
2) a description of the practice in other countries
3) a description of principles of financial supervision established by international bodies
4) the identification of specific criteria for effective supervision
5) a description of four alternative organizational models of bank/financial supervision that the Austrian authorities might adopt
6) an evaluation of the models according to the criteria established above and a recommendation based on that evaluation
7) and an analysis of processes and techniques of financial supervision.

The crucial questions that arise from the discussion are, first, to what degree should the bodies currently engaged in financial supervision be consolidated, and, second, to what extent should the central bank be involved in banking supervision or in financial supervision more generally?

On the first of these questions, we conclude that there is a strong case for consolidation, i.e. for bank, securities, insurance, and pension fund supervision. The case for

consolidation rests on, amongst other factors, (i) the economies of scale which would result both within the supervisory bodies themselves and within regulated firms which would have to deal with fewer supervisors, (ii) the scope that consolidation would offer for regulators to develop a more functional approach to supervision, whereby financial institutions in different sectors but offering similar services would face similar supervision.

On the second question, concerning the central bank's involvement in bank or financial supervision, the main considerations are the absence of conflicts of interest, the concentration of power, absence of duplication and appropriate reflection of the interests of banking, insurance, securities markets and pension fund supervision. We propose the establishment of a separate financial supervisory body which would have close structural links with the central bank but would possess a separate organizational and budgetary structure.

Many practical questions regarding the details of the organizational structure and the processes and techniques that should be implemented remain unanswered in our report. Instead this report has sought to set out a framework within which it is possible to evaluate different, feasible alternatives. As we emphasized in the introduction, the most important considerations for this choice of a broad direction of organizational reform are the need to maintain stability, market confidence and efficiency.

XI. Appendix A: The structure of financial supervision in selected countries

1. The structure of financial supervision in the UK

I Objectives of supervision

The Financial Services and Markets Act states four statutory objectives for the Financial Services Authority (FSA), the body responsible for financial supervision in the UK. These are:

- Maintaining market confidence
- Promoting public awareness
- Protecting consumers
- Reducing financial crime

The FSA's activities, including authorization, rule making, monitoring of financial institutions, etc., are intended to further these general objectives.

The stress placed on consumer protection is a striking feature of these objectives. This reflects the background of the creation of the FSA, which included dissatisfaction with the handling by UK regulators of several high profile cases of market abuse by retail financial service providers such as the miss-selling of pensions and the Barlow-Clowes affair. The objective of promoting public awareness is also linked to consumer protection since it was felt that a factor behind the problems mentioned above was the poor understanding of financial products among retail financial customers.

The objective of maintaining market confidence provides justification for a range of policies designed to limit the probability of failure by financial service providers, for example, bank capital standards and the supervision and monitoring of commercial banks. Financial crime is perceived to be an important objective of supervision and so is mentioned as a separate objective even though it might be regarded as included in the

market confidence and investor protection objectives. The perception of supervisors is that many prudential problems in financial institutions have in the past been the consequence of criminal activity. The position of London as a large financial center also makes it potentially vulnerable to money laundering, insider trading etc which the authorities are keen to keep in check.

II Supervisory institutions

Institutions engaged in banking supervision: Banking supervision in the UK is performed by the FSA. The FSA is also responsible for the supervision of securities markets, insurance companies and a wide range of other financial market participants (even including, for example, accountants, financial advisors and friendly societies).

Other regulators/financial policy institutions: Responsibility for monitoring the stability of the financial system as a whole falls to the Bank of England. A memorandum of understanding between the Bank and the FSA gives the Bank access to information about individual banks when this is necessary for the fulfillment of its monitoring of financial stability.

The Bank of England plays an active role in the development of bank supervisory policy since much of this policy is determined at an international level through the Basel Committee to which both the Bank and the FSA supply representatives. The Bank's analysis of policy proposals usefully supplements the work the FSA does on evaluating and developing policy.

The Bank of England retains the role as lender of last resort. Subject to Treasury approval, it is empowered to offer support to individual institutions experiencing liquidity problems. In addition, the FSA, again with Treasury agreement, may initiate market-based support operations which do not involve official finance.

Legal and governance structure of the supervisory institution: The FSA's legal status is that of an independent, non-government body exercising statutory powers under the Financial Services and Markets Act 2000. More precisely, the FSA is a company limited by guarantee, the board of which is appointed by the Chancellor of the Exchequer. Board members include the Executive Chairman, two managing directors and eleven non-executive directors, of whom one is the Deputy Governor of the Bank of England. The Board is accountable to Treasury and through them to Parliament.

III Critical evaluation of the organizational model of financial supervision

Conflicts of interest: A significant motivation for establishing the FSA was the perception that the previous arrangements based on the SIB and SROs had led to friction, which hampered supervision. Under the new arrangements, the Bank of England and the FSA cooperate, with the FSA having the lead role and the Bank contributing views on system-wide financial stability. Coordination is improved by regular monthly meetings of a Standing Committee, made up of senior representatives of the FSA, Treasury and Bank of England. In the event of a crisis, this committee would hold special meetings. In addition, Bank and FSA staff maintain contacts at all levels on a wide variety of topics. The fact that several hundred Bank staff joined the FSA when it was formed helped to establish very good cooperation between the two organizations.

Independence: The legal status of the FSA helps to ensure its independence. Also significant is its ability to fund its activities independently of the government. Once the Financial Services and Markets Act comes into force, the FSA will be entirely funded through fees and service charges paid by firms and organizations that it regulates. In the interim period, it will also derive income from the regulatory bodies (PIA, SFA, etc), which it was set up to replace.

External cost efficiency: The FSA is required to conduct cost benefit analyses of the rules it promulgates.

International compatibility: The unitary supervisor model followed by the UK has been adopted by a variety of other countries in recent years (Sweden, Switzerland, and (with some minor differences) Japan). Within this model, both the supervisory agency and the central bank participate in the Basel process of international negotiation of financial regulations. The involvement of both organizations has advantages in that the Bank with its broader financial stability responsibilities and greater resources tends to take a longer term and more analytic view of policy development while the supervisory authority with its closer contacts with firms contributes a more practical short-term input.

Availability of resources: When the FSA was formed, many Bank employees were needed to staff the new organization. Hence, it was necessary for remuneration packages to be competitive. In general, the FSA pays higher salaries than the Bank of England but the level of benefits offered by the Bank to its staff is greater.

Accountability and transparency: Concerns were voiced, when the FSA was set up, that, as a statutory supervisor, it would prove less responsive to practitioner views than the Self Regulatory Organizations (SRO's), which it replaced. To allay such worries, the FSA has established an independent Practitioner Forum, which is free to publish its views on the FSA's work and whether it is satisfying its statutory aims, including the needs referred to in the Financial Services and Markets Act for cost-effective supervision, for facilitating innovation and competition, and for maintaining the competitive position internationally. In addition, the FSA has created a Consumer Panel which like the Practitioner Forum, may publish independent views on the performance of the FSA and the degree to which it is meeting its statutory duties.

Ability to handle crises: It is still too early to say whether the new arrangements based on a single unitary supervisor represent a complete success. So far, there have been no major financial crises to test the new FSA. The change of supervisory emphasis evident in the

stress the FSA now places on consumer protection and conduct of business supervision might have been difficult to achieve under the prior arrangements.

2. The structure of financial supervision in the Netherlands

I Objectives of supervision

Banking supervision in the Netherlands is performed by the DNB (the central bank). Three types of supervision, each associated with particular objectives, are allowed for in the relevant enabling legislation, Wet Toezicht Kredietwezen (WTK), 1992:

- Supervision aimed at maintaining stability of the financial system.
- Supervision aimed at maintaining the financial well being of individual institutions. The objective of this is to protect creditors, including consumers, from the insolvency of their financial institutions.
- "Structuur" supervision. This specific type of supervision concerns advice which the DNB is required to provide to the Ministry of Finance as to whether particular banks should be permitted by the Ministry to acquire equity in another bank or company. The criteria that the DNB must employ in reaching a judgment are specified by the WTK law and primarily require that the investment involves (i) no threat to the 'health' of the bank that is involved, and (ii) no risk of excessive 'concentration of power' in the credit market.

The first two objectives, which relate to systemic risk and prudential supervision, could be seen as the prime-objectives. In its (more recent) policy-statements, the DNB complements these prime objectives with objectives addressing the integrity of banks and the quality of payments systems and products.

The third objective might be viewed as linked to the systemic risk objective, to the extent that shareholdings by one bank in another might lead to 'domino-effects' in the event of a crisis.

II Supervisory institutions

Institutions engaged in banking supervision: As mentioned above, the DNB is responsible for banking supervision. In addition, the DNB is responsible for any systemic risks (i.e., problems which might affect the financial system as a whole). It is important to note that historically the DNB had sole responsibility for three tasks: (i) monetary policy, (ii) supervision, and (iii) enforcing competitive behavior in a broad sense in the banking sector. Of these, only the second task is left since EMU has removed the first task, and the third task was transferred to an independent national anti-trust authority earlier this year.[31]

Other regulators/financial policy institutions: More broadly, the institutions involved in financial supervision in the Netherlands are:

- The central bank (DNB), which supervises banks, investment companies and money exchange offices.
- The insurance supervisor (VK), which supervises life insurers, non-life insurers and pension funds.
- The financial market supervisor (STE), which monitors exchanges and brokers ("effecten instellingen").[32]

Brokerage activity (in the sense of "effecten instellingen") is regulated on a functional basis in that institutions that engage in this activity, including banks, are regulated in this aspect of their operations by the STE. Typically, banks therefore have the DNB as their primary supervisor and the STE as a secondary supervisor for financial market activities.

The Ministry of Finance is responsible for developing the legal structure of financial regulation. The Ministry is also engaged in coordinating the three financial sector

[31] Substantial powers in this field are also exercised at an EU level.

[32] The Dutch term "effecten instellingen" is actually broader than the English term 'brokers' and means all parties that belong to the infrastructure of the financial markets.

supervisors (see the discussion below) and recently created a council (RFT) to facilitate such coordination.

The increasing level of inter-sectoral activity (e.g. banking and insurance) has raised concerns that the sectorally-specialized supervisory institutions in the Netherlands may not be able to supervise financial conglomerates in a fully satisfactory way. In response to this concern, a fourth coordinating institution has been recently been created, the Council of Financial Supervisors (RFT). This body brings together representatives of the three main supervisory bodies, so as to coordinate supervision of financial conglomerates active in different sectors.

Independence: All three supervisory organizations are formally independent. In practice, the Ministry of Finance plays an important role in selecting the management of these institutions, which might affect their independence from the government.

Legal and governance structure of the supervisory institution: All three of the financial supervisors described above are independent legal bodies. The DNB is incorporated as a particular type of company ("structuurvennootschap") with the government as its shareholder and its management accountable to an independent supervisory board.

Internal organization of the supervisory institution: The DNB consists of several "directoraten" (divisions). Banking supervision is one of the divisions. This division is organized along institutional lines. In Figure 1 we have drawn the current organizational tree. However, the DNB is in the process of creating a new department that focuses on what is called "integrity supervision".

In practice, "integrity supervision" means that the DNB will evaluate at regular intervals the integrity of each bank's management and general business practices, presenting the results in the form of conduct of business audit reports. The integrity of business practices

will be interpreted broadly. It may for example include remuneration practices, internal harassment policies, etc. This new form of supervision by the DNB has the objective of preserving the integrity of the financial system and, within individual banks, of monitoring corporate responsibility.

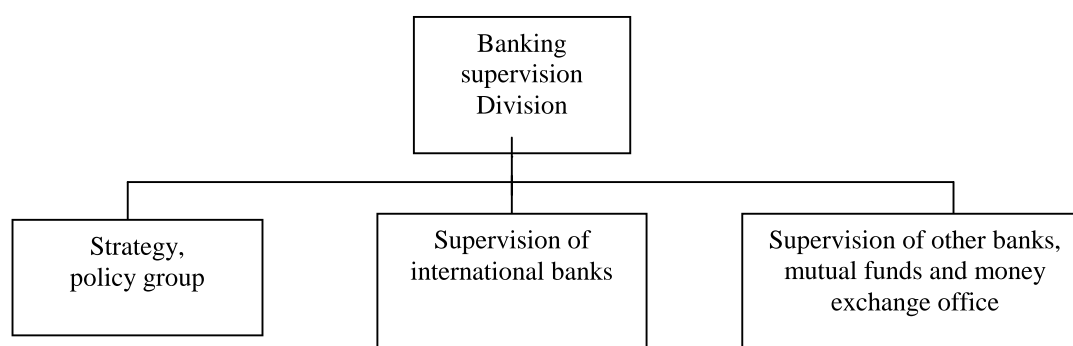

Figure 1 Internal organization of the banking supervision division at DNB.

The Dutch system in general (three sector-focused supervisory bodies) is debated, but no major organizational changes are expected. Various discussions center around cross-border supervision. But this problem obviously has to be addressed internationally.

Conflicts of interest: With the anti-trust responsibility and monetary policy passed to other institutions, the central bank is left with banking supervision as its primary responsibility. This has reduced the scope for conflicts of interest within the DNB, although some limited potential remains since (i) the DNB president is part of the ECB Council, and thus still involved in monetary policy; (ii) monetary policy is also still the dominant subject of study in the DNB's research departments, (iii) the background of most DNB executives is in monetary policy. There are no obvious conflicts of interest which might affect the insurance supervisor (VK) or the securities supervisor (STE), individually, and no obvious conflicts that would arise between the three supervisory organizations.

3. The structure of financial supervision in Switzerland

I Objectives of supervision

The Swiss Federal Banking Commission (SFBC) is the primary supervisory authority for Swiss banks. It is also the supervisory authority for a broad area of non-bank financial sectors including investment funds, mortgage bond businesses, stock exchanges and securities dealerships and it is responsible for regulating the disclosure of shareholdings and public takeover bids.

The objectives of the SFBC, which resemble those of other European supervisory institutions, are:

- The protection of creditors.
- The protection of investors.
- Guaranteeing the functionality of securities' markets.
- Maintaining the functioning of the financial system.

The protection of creditors includes: the prevention and minimization of losses for public depositors, the protection of customers, the prevention of unlicensed acceptance of deposits from the public, the efficient corporate reorganization or liquidation, and the indirect protection of owners, including taxpayers in the case of public corporations.

The protection of investors includes: protection of confidence for individual and collective investments, transparency of investment and conduct, security of customer assets, equality of treatment, avoidance or disclosure of conflicts of interest, protection from unauthorized bidders.

Guaranteeing the functionality of securities' markets includes: transparency of securities markets, equality of treatment of market participants, protection of minority shareholders, protection from unlawful takeover bids.

Maintaining the functioning of the financial system includes system stability, maintenance of confidence, maintenance of reputation and support in fight against crime, and international competitiveness.

The above objectives are not always explicitly mentioned in the SFBC's enabling legislation but are implicit in different articles in the Federal Law on Banks and Savings Banks 1934 (last amended 1999), the Federal Law on Stock Exchanges and Trading in Securities (Stock Exchange Law) 1995 (last amended 1999), and the Federal Law on Investment Funds (Investment Fund Law) 1994.

II Supervisory institutions

Institutions engaged in banking supervision: Banks in Switzerland are regulated by the SFBC located in Bern. The SFBC is also required to supervise the application of the Investment Fund Law and the Law on Stock Exchanges and Trading in Securities. It is, therefore, responsible for supervision of the banking system, security dealers and investment fund business. The Commission has the power to grant and withdraw licences, to announce decisions necessary to enforce the laws and to prescribe the content and format of financial statements and audit reports which it receives. The Commission is very active in issuing instructions by way of circular letters ("Circulars") to all market participants in connection with the application of specific legal regulations or reporting requirements.

Other regulators/financial policy institutions: Other institutions that play important roles in financial supervision in Switzerland, include:

- The Swiss Bankers' Association (SBA). The SBA issues guidelines to its members in certain areas of banking activity, which the SFBC regards as having general applicability, for example, practices concerning the identification of beneficial owners of accounts and rules of conduct in securities trading or guidelines for portfolio management.
- The Swiss National Bank (SNB) is the agent responsible for the implementation of those parts of the governments' monetary policy that relate to banks. It issues directives concerning, amongst other things, the maintenance of reserve requirements, expansion of credit facilities, acceptance of foreign source deposits, export of capital and foreign exchange transactions. The SNB has no direct supervisory tasks on the level of single banks, but the SFBC and the SNB exchange information. The SNB collects substantial information on the liquidity and interest-exposures of the Swiss banks. The main purpose of collecting this information is to allow the SNB to fulfil its role of preserving the stability of the financial system. The relationship between the banks and the SNB is the subject of legislation (Art. 7f. Federal law on Banks and Saving Banks).
- The Federal Bureau of Insurance Supervision (BPV) is the supervisory institution for insurance, pension business and insurance linked investments.
- The Federal Social Insurance Office regulates pension plans offered by banks directly (rather than as part of their insurance businesses).

Legal and governance structure of the supervisory institution: The SFBC is an administrative authority of the Confederation, which is independent of the individual directives of the Federal Council and is not part of central government administration. Administratively, however, it is simply integrated within the Federal Department of Finance. The supervision of those parts of the financial sector over which it has authority is assumed by the SFBC on an independent basis. The SFBC is a public authority of the administration law. Its activities are regulated by special laws.

The SFBC comprises 7 to 11 members who are elected by the Swiss Federal Council. The Federal Council, which also nominates the president and the vice-president, elects the 7 to 11 members of the SFBC (Art.23 Bank Law), and the director and vice director of the SFBC. Members of the SFBC must be experts (so generally economists or lawyers with a practical background) and are restricted in their participation in firms engaged in the financial services sector. The term of office is usually four years and it is possible to be re-elected twice.

Internal organization of the supervisory institution: The secretariat of the SFBC deals with day-to-day administration and includes legal and supervisory departments. However, it does not customarily perform its own examinations of banks, relying instead on authorized audit firms, which operate in an official capacity as "Banking Law Auditors" or in a similar capacity under the Investment Fund and Stock Exchange Laws. The Secretariat is divided into the following seven departments:

a. Licensing / investment funds (BAF)
b. Banks / securities dealers (BEF)
c. Large banking groups (GB)
d. Stock exchanges / markets (BM)
e. Legal department (RD)
f. Controlling / logistics (CL)

Within the departments the internal organization is primarily along institutional lines. In particular, the BEF department is divided into groups, each focussing on a certain kind of bank. (For example, one group is responsible for the regional and cantonal banks, while another group supervises foreign banks.) The groups are also organized with respect to the working language of the supervised institutions.

In addition, a team of specialists validates and monitors the risk-measurement models, which are employed by banks and securities dealers to compute the capital requirements to

provide for market risks. The team of specialists also conducts field tests in co-operation with the Banking-Law auditors at the banks and securities dealers. Furthermore, the team deals with issues arising from the area of risk management and risk control.

Another department, Banking Groups, handles the supervision of financial conglomerates and monitors the risks associated with links between banks and other institutions outside the banking sector, mainly insurance companies.

Conflicts of interest: The main potential conflicts of interest that arise in the current supervisory structure stem from the heavy reliance on delegating inspection function to private sector audit firms. On the one hand, audit firms have supervisory duties, while, on the other hand, they hold a mandate and act on behalf of the supervised company. This implies potential conflicts of interest if, for example, irregularities are discovered and the audit firm must either notify the SFBC or set an additional respite period for the supervised company to comply with the law. The division of labour between the SFBC and private audit firms has important advantages in reducing costs but supervision is likely to be effective only if the SFBC and the audit firms co-operate closely.

Independence: To finance its activities, the SFBC levies an annual supervisory fee on entities it supervises. The supervisory fee is based on the costs that the SFBC incurred in the prior year. The activity of the supervisory authority is thus financed independently of the federal government. Nevertheless, the SFBC is administratively integrated into the Department of Finance and the overlap of staff is likely to yield a high degree of interdependence.

Most board members of the SFBC work for the Commission on a part-time basis. This again may create conflicts of interest as members typically[33] hold other posts in the financial services industry. Presidents of bank boards and bank employees are excluded

[33] Board member means "Mitglied des Verwaltungsrates" which are typically part time positions. However, according to the Swiss Company Law, the "Verwaltungsrat" represents the "top management" (oberste Geschäfsleitung) of a firm. Members of the board are however not allowed to take part in the operations of the company.

from membership of the Commission but many other roles in the financial industry may be combined with being a member of the Commission.

Internal cost efficiency: The widespread use of internal and external auditors to carry out on-site supervision offers significant cost savings. Competition between rival external audit firms is likely to assist in reducing costs. Equally, the external audit firms possess wide banking experience and are familiar with up-to-date risk management systems. Typically, external auditors will cooperate closely with the internal audit in performing on-site inspections. Top management, and, to a more limited extent, the board of directors, are held responsible for the implementation of the inspection, internal controls and risk management. Another relatively efficient aspect of the Swiss approach to supervision is the fact that banks report information to the SNB, which then makes it available to the SFBC. This implies cost savings for the SNB and SFBC collectively.

External cost efficiency: The costs imposed on supervised firms comprise fees paid to the SFBC and the costs of external and internal audits. The supervisory fee an institution pays is directly related to the costs the SFBC incurred in the previous year. This approach avoids cross-subsidisation and provides each institution with an incentive to adhere to the reporting standards, to avoid a costly investigation by the SFBC.

Other costs incurred by supervised institutions include the costs of external and internal audit. There is a trade-off between these two costs since the more the internal audit is able to check on compliance aspects, the lower is the cost of the external audit. However, the external audit must take it's responsibilities and has to make sure, that everything is in compliance with the law and other rules imposed to banks.

The direct costs of external auditing (for the Bankengesetzlicher Revisionsbericht) are perceived by bankers to be very high and increasing. A rough estimate is that they represent annually between 0.5% and 1% of a bank's capital. This does not include internal auditing (which is required by the Banking Law) and compliance. It may be interesting to

notice that banks tend to delegate their internal auditing to outside auditors (which is allowed with certain restrictions).

Domestic compatibility: Effective supervision of financial firms engaged in different sectors, such as banking and insurance, requires co-ordination between the relevant supervisory authorities. In the case of conglomerates primarily engaged in banking, the banking supervisers take the lead and are responsible for providing information to the insurance supervisers. When a conglomerate is primarily an insurance company, the roles of the supervisors are reversed. Despite the ad hoc co-ordination that has grown up between banking and insurance supervisors, there are concerns that supervision of financial conglomerates is not wholly adequate, as no explicit procedures have been established for their supervision (for example, regarding the exchange of information) and no reporting standards have yet been defined.

Availability of resources: Wage levels of SFBC employees are based on civil service pay rates. This has constrained the recruitment of highly qualified personal and hampered the SFBC in recruiting adequate staff. The increasing complexity of supervisory tasks implies that this problem may become worse and the authorities, therefore, plan in future to link pay levels more closely to market rates.

The SFBC faces challenges, which will be hard to be met with the current staff. The assessment of banks' internal risk management models, the growing complexity of the business-models, information systems and products banks offer all imply greater need for expert supervisory staff. To keep up with the growing complexity, in 1999 the SFBC established a new department, which deals with the supervision of large bank groups and assumes the responsibilities already discussed above.

Out-sourcing the inspection function: The Swiss system of supervision is based in principle of the division of tasks between the SFBC, as the state supervisory authority, on the one hand, and private audit firms authorised by the SFBC to conduct audits, on the other. The audit costs are fully passed on to the institutions subject to audit.

The relationships between the individuals and audit firms authorized by the SFBC and the institutions being audited are governed by civil law. The contents of their auditing activity, on the other hand, is laid down by public law as to its principal object. The auditors exercise direct supervision through regular audit procedures at the institutions being audited as the extended arm of the SFBC. They fulfil a public task but possess no sovereign authority. They must, however, report to or notify the SFBC of the results of their audit procedures.

The SFBC, as the Federal administrative authority, has all necessary sovereign powers, but in the monitoring of the institutions subject to its supervision, to a large degree, is dependent upon the information provided by the auditors. Only in rare cases will the SFBC perform direct verifications in the institutions. In principle, it exercises only a function of superintendence.

Having regard to their important position in the system of supervision, the auditors have to satisfy strict conditions for authorisation. The auditing duties of the Banking- and Stock-Exchange-Act auditors go further than those imposed on auditors appointed for statutory reporting purposes under the Swiss Federal Code of Obligations. In addition to examining the annual financial statements according to form and content with independent valuation of assets and liabilities, the auditors have also to examine whether the bank or securities dealer has complied with its by-laws and business rules as well as the provisions of banking legislation, the instructions of the SFBC and professional rules of relevance from the supervisory point of view.

A detailed audit report has to be drawn up annually to set out the audit findings. The audit report, as an important means of information for supervisory purposes, is systematically analyzed by the SFBC. It can rise to critical inquiries with the licensed institution and the auditors. In addition to the audit report, the auditors have to notify the SFBC immediately if serious shortcomings are found.

Furthermore, the Swiss system of supervision foresees a delegation of certain duties to self-regulating organizations in various fields. In particular, in the area of the supervision of stock exchanges, licensed stock exchanges assume far-reaching admission and monitoring functions. Should violations of the Law or other irregularities be suspected, the SFBC is to be notified and the latter orders the investigations and measures required.

The responsibilities of internal auditors: In addition to the requirement of an external audit, banks need an internal audit, which has mainly the same tasks as the external, independent audit firms. The internal audit has to co-operate closely with the colleagues of the external audit. The internal audit is responsible to the governing board. In recent years the board became - because of tighter regulations in the private law sector - more liable for actions within the bank not corresponding to the state of the art e.g. of the risk management and reporting standards.

Functional versus institutional supervision: Traditionally, most functions in the Swiss capital market were performed by banks. This includes: Trading and brokerage of securities and foreign exchange, investment banking, fund management and advisory, etc. More and more, as in the anglo-american system, these functions are separated and performed by independent agencies: independent brokers, asset managers, investment consultants, etc. This challenges a system where the banking supervision is responsible for most of these tasks.

The first case where this problem became explicit was the creation of SOFFEX (the Swiss Options and Financial Futures Exchange) which performed functions that were not consistent with most of the existing regulation. Particularly, the operation of exchanges was regulated by cantons (states) which made no sense for a fully electronic exchange. Moreover, strictly speaking, the cantonal laws only applied to stocks or securities which did not make sense for abstract contracts. Moreover, the range of market participants was anticipated to be by far larger than the banks regulated by the existing regulations. In light of the substantial stockholder losses after the 1987 crash, a few smaller after-crashes and major criticisms about the structure of the Swiss stock market, the Swiss parliament issued a new Stock Exchange Law[34] which now also covers the supervision of independent brokers (Wertpapierhändler), and includes takeover and shareholder protection issues. A truly innovative part is the definition of an exchange as a "system" which releases information about the pricing of securities (quotes, volumes) and enables transactions. There is no institutional stock exchange definition any more. However, no separate exchange supervisory body was created, the task was delegated to the banking commission (which was to become the Bank- und Börsenaufsicht) which was somehow inconsistent. The law stipulates self-regulation which means that the exchang(es) have to install their own supervisory framework. An exchange has to obtain from the SFBC an appropriation (Bewilligungsvoraussetzung) to operate, and must have its rules and regulations approved by the SFBC. This approval also includes the clearing and settlement (c&s) procedures adapted by SOFFEX, because the clearing house is, naturally, an integrated part of the exchange. But, interestingly, c&s institutions such as SEGA (Schweiz. Effektengiro AG) or Intersettle were never regulated before. Also, other institutions which represent big operational risks (such as Reuters or Telekurs) were never regulated.

The implication from all this is that a functional approach must be prefered to an institutional approach. Except for the case just described (stock exchange), it might however be difficult to design a supervisory system which is entirely based on this

[34] While this is the widespread translation, it is not complete. The exact title is "Bundesgesetz über Börsen und Effektenhändler", 1995.

approach – particularly, to transform the current institutional based system without substantial costs and risks. A more practicable way to implement the basic idea of a functional approach is to regulate specific *business processes* with respect to their (specific) risks. This would enable a supervisory approach which is capable to treat different risks by their most appropriate supervisory measures – not just capital. Take a clearing house – capital is definitively not a sufficient instrument to prevent systemic risk from a collapse, rather a number of key processes must be certified, controlled, audited etc. Similarly, processes can be defined across the entire financial system: loans, underwriting, asset management, investment banking, trading, brokerage, IT outsourcing, etc.

To summarize, an institutional based approach supplemented by a risk-based activity approach could well provide a more adequate supervisory approach than an undifferentiated application of value-at-risk models and derived capital charges within risk categories where the application of these models is not justified or possible.

Treatment of large groups: A problem of the Swiss banking sector is that the structure of the banks is extremely heterogeneous. On the one hand, there are two major, global universal banks (UBS, CS), while there are more than 500 Raiffeisen banks and regional banks with minimal balance sheets. There are state owned banks (Kantonalbanken), banks dominated by foreign holding companies, and private asset management banks managing approx. half a trillion CHF. The number of independent asset managers is increasing drastically. It is extremely difficult to find supervisory rules applicable to all banks in the same way: This is true for capital standards, risk management principles, auditing principles, etc. Therefore the question is raised whether special supervisory entities should be designed to supervise "large" institutions. Obviously, the two major banks would be natural candidates for such an entity. But the question is whether institutions representing major systemic risks should also be subject to special supervision. This could, for example, apply to clearing institutions or other systems exhibiting operational risk. Currently, the "SFBC-Sekretariat" contains a special Department designated to "large banking groups", which also includes the Raiffeisen group as a whole.

Credit Suisse (CS) has acquired Winterthur Insurance several years ago which became part of CS Holding, and Zurich Financial Services Group (a former insurance company) has created an own bank within its holding structure[35]. These cases challenged Swiss supervisors because bank and insurance supervision (Bundesamt für Privatversicherungswesen, BPV) were two strictly separated areas within their supervisory structure: The bank supervisors (SFBC) are not even in the same department (ministry) as the private insurance supervisors: while the first are in the Min. of Finance, the latter is part of the Min. of Justice. Ironically, the supervision over the private pension system (the so called second pillar in their social security system) is again in a different department, in the Min. of Internal Affairs. The current legislation is, in the case of Credit Suisse, that the holding company is *not* subject to the Bankengesetz. However, the SFBC has issued an injunction (Verfügung) for that specific case, according to which the group will be supervised on a consolidated basis with respect to (a) capital and risk management, and (b) accounting principles, consolidation and auditing. Winterthur itself remains supervised by the BPV[36].

The case of Zurich Financial Services is more complex. The SFBC traditionally shared the view of most international insurance supervisors that there is no case for a consolidated supervision over insurers, but the SFBC took the case of Zurichs appropriation for getting a banking licence to discuss the need for a possible action in detail. The legal framework to do so can be derived from the Bankengesetz which stipulates[37] that the holding company is under consolidated supervision. But the issue is not settled in detail.

Current policy debates: A functional or activity-based supervisory regime (see Section IV) has strong implications for the organizational design of supervisory authorities. At least, since the establishment of the FSA in the UK, the issue of consolidating supervisory authorities

[35] While writing this, UBS Group is launching its own life insurance company.
[36] See Verfügung der SFBC am 26.3.1998 in SFBC-Bulletin Heft 36 1998 und SFBC Jahresbericht 1998 p. 27.

is one of the most controversial issues which is currently discussed in Switzerland. Within this context, the discussion is also about (a) which agencies should be consolidated (insurance companies, banks/exchanges, funds, pensions, social security, ...), (b) the degree of consolidation (information transfer, basic rules, adaption of one consistent approach, ...), and (c) the independence of the new agency and its relation to the central government and to the central bank.

4. The structure of financial supervision in Finland

I. Objectives of supervision

Section 1 of the Finnish "Act on the Financial Supervision Authority" states,
"The Financial Supervision Authority, which operates in connection with the Bank of Finland, shall supervise the financial markets and the entities operating therein as prescribed in this Act and as provided by other legislation concerning the financial markets and by international obligations binding on Finland". However, as its "mission statement", Finnish financial supervision aims to foster "the stability and efficiency of financial markets as well as public confidence in the activities of supervised entities and operation of markets." Besides monitoring supervised entities' compliance with legal provisions, financial supervision therefore tries to enhance

- market orientation and markets' access to information,
- the efficient and reliable functioning of markets and
- cooperation with stakeholders at home and abroad.

As an organization, the FSA seeks to be independent, reliable, transparent and a respected member of the supervisor network.

II. Supervisory institutions

[37] See BankG Art 3bis Abs. I. Strictly speaking this only applies to foreign holding companies.

Institutions engaged in banking supervision

The Finnish Financial Supervisory Authority (FSA) is the main supervisory body charged with banking supervision. As stated by the Act on the Financial Supervisory Authority, this institution is charged with the supervision of

1) credit institutions as referred to in the Credit Institutions Act (1607/93);

2) guarantee funds of deposit banks and deposit guarantee funds as referred to in chapter 6a of the Credit Institutions Act (19.12.1997/1349);

3) branches and representative offices of foreign credit institutions;

4) management companies and custodians;

5) investment firms and investor compensation funds as referred to in the Investment Firms Act (579/96), (10.7.1998/521);

6) branches and representative offices of foreign investment firms;

7) stock exchanges, corporations of securities intermediaries as referred to in section 13 of chapter 3 of the Securities Markets Act (495/89), options corporations, market makers as referred to in chapter 1, section 4 of the Act on Trading in Standardized Options and Futures, clearing corporations and clearing parties, central securities depositories, funds and clearing funds of central securities depositories;

8) authorized book-entry registrars;

9) pawnshops;

10) foundations as referred to in Section 6 of the Act on Conversion of Savings Banks into Limited Liability Banks (972/92);

11) cooperative societies as referred to in paragraph 1 of section 41a of the Cooperative Bank Act (1126/93);

12) amalgamations and central bodies of the cooperative banks as referred to in section 7a of the Cooperative Banks Act.

13) holding corporations of credit institutions and investment firms,

14) corporations holding a controlling interest in a stock exchange, options corporation, clearing corporation or a central securities depository as referred to in chapter 1, section 5, of the Securities Markets Act.

In total, the FSA is in charge of the supervision of about 500 entities. In discharge of its responsibilities, the FSA has to

1) ensure that the supervised entities operate in accordance with acts and decrees, the regulations and guidelines issued by authorities and their own Articles of Association, bylaws or regulations;

2) issue regulations to the supervised entities concerning the observance of the applicable regulations, and to issue guidelines that are necessary for purposes of supervision to the supervised entities, to their associations and to other entities operating in the financial markets;

3) inspect supervised entities as often and as thoroughly as is required for purposes of supervision;

4) direct and supervise the activities of the savings bank inspectorate;

5) monitor conditions in the financial markets and propose measures as such conditions may require; and

6) cooperate with the Insurance Supervision Authority and with other authorities involved in the supervision of the financial markets.

Other regulators/financial policy institutions

While the Ministry of Finance is responsible for legislation and authorization of any rules issued by self-regulatory bodies, the FSA is the main supervisory agency. Besides the FSA, the Insurance Supervisory Authority and the Bank of Finland are engaged in the supervision of Finland's financial system. As discussed below, both of these institutions have representatives on the board of the FSA in order to enhance the cooperation between financial supervisors.

Governance structure of the FSA

There are two bodies responsible for the governance of the FSA,

- a parliamentary supervisory council
- the board of the FSA.

In addition, the director general is responsible for the day-to-day operation of the FSA and the Bank of Finland has control over the budget of the FSA.

The parliamentary supervisory council: The duties of the parliamentary supervisory council are
1) to appoint three members of the board and their personal deputies for three years at a time on the basis of proposals by the Bank of Finland, the Ministry of Finance and the ministry responsible for the insurance business;
2) to appoint, on the basis of a proposal by the competent ministry, an auxiliary member of the board and his personal deputy to handle, on the board, the cooperation between the FSA and the Ministry of Finance in supervising groups that comprise at least a credit institution and an insurance company;
3) to appoint the chairman and the deputy chairman of the board, and, on the basis of a proposal by the board, a deputy to the director general;
4) to decide upon the basis for determination of the director general's salary, leave of absence and annual leave;
5) to decide upon reprimanding the director general and on other matters related to his employment relationship; and
6) to confirm the rules of procedure of the Financial Supervisory Authority on the basis of a proposal by the board.

The board of the FSA: The board of the FSA consists of the director general and two other members appointed by the Parliamentary Supervisory Council. The duties of the board of the FSA are
1) to confirm supervisory guidelines for the FSA concerning matters that are significant or important in principle or far-reaching from the point of view of supervision or which otherwise are of general significance. When confirming the guidelines, the board shall take into consideration the general guidelines issued by the board of the Bank of Finland to the financial markets for the maintenance of their stability;
2) to confirm those regulations and guidelines to be issued to the supervised entities which the board has not submitted to the director general for confirmation;

3) to decide upon the supervision fees;
4) to attend to the development of the cooperation between the different authorities involved in the supervision of the financial markets and confirm the principles of cooperation with the Insurance Supervision Authority;
5) to present the rules of procedure of the FSA to the parliamentary supervisory council for confirmation;
6) to consider the annual budget of the FSA;
7) to appoint and dismiss the highest ranking employees of the FSA, with the exception of the director general;
8) to decide upon suspension from duties or issuing of a caution with regard to employees appointed by it;
9) to decide upon matters concerning the internal administration of the FSA;
10) to order the payment of a conditional fine imposed by the FSA; and
11) to decide upon those far-reaching and important matters of principle which the director general submits to it for consideration.

The director general: The director general of the FSA is appointed by the president of the Republic of Finland at the suggestion of the parliamentary supervisory council of the FSA. In addition, the parliamentary supervisory council appoints an employee of the FSA to act as deputy of the director general.

The duties of the director general include all matters not assigned to the board of the FSA. In particular, the director general appoints and dismisses employees of the FSA and also suggests to the board candidates for high-ranking positions such as the heads of the operational units of the FSA. These high-ranking employees of the FSA assist the director general as "advisory management group" in decisions concerning
1) general guidelines for activities of the FSA;
2) issues that are important in principle or have far-reaching significance;
3) the operations plan, the annual budget and the annual report of the FSA as well as the supervision fees charged by the FSA;

4) general principles governing regulations and guidelines issued to supervised entities;
5) special audits of the activities of a supervised entities;
6) the appointment of an agent to supervise the activities of a supervised entity;
7) the amendment or rescindment of an authorization granted to a supervised entity;
8) the imposition of a conditional fine.

The Bank of Finland: Besides appointing a member of the board of the FSA, the role of the Bank of Finland in the governance of the FSA is limited to control over the budget of the FSA. To obtain funds, the FSA has to propose a budget and an annual operations plan to the Bank of Finland, including an account of the planned activities of the FSA and the related costs as well as any fees to be charged to supervised entities.

Internal organization of the FSA

The FSA is divided into the Credit Institutions Department, the Capital Markets Department and the Support Services Department. The FSA employs about 120 persons.

Credit institutions department: The Credit Institutions Department oversees credit institutions and their consolidation groups, ensuring timely and critical evaluation of supervised entities' financial standing. The department also prepares regulations and guidelines falling within its competence and participates in legislative work, other related preparation and self-regulation.

The department is divided into the Sectoral Analysis Division, the Institutional Supervision Division and the Legal Services Division.

Capital markets department: The Capital Markets Department supervises the capital markets and market participants and continually monitors supervised entities' financial standing and ability to operate. The department also prepares regulations and guidelines falling within its competence and participates in legislative work, other drafting of regulations and self-regulation.

The department is divided into the Market Supervision Division, the Supervision Division and the Regulations Division.

Support services department: The Support Services Department is responsible for preparation and interpretation of regulations and guidelines concerning supervised entities' solvency and annual accounts. It also handles FSA communication and coordination of international issues. The department's tasks include coordination and cooperation with other authorities in detecting and preventing money laundering. Further, the department develops and maintains the FSA's information management and information systems. Finally, the department is responsible for calculation of supervision fees and implementation of FSA operations planning and budgeting.

III. Critical evaluation of the organizational model of financial supervision

Cost efficiency: As supervisory body in charge of both the supervision of banks and securities markets, the FSA can realize economies of scale and scope. In addition, the FSA was set up very cost-efficiently since it leases employees of the Bank of Finland.

Domestic compatibility: To enhance the cooperation between the FSA and the Insurance Supervisory Authority, the parliamentary supervisory council can appoint, on the basis of a proposal by the Ministry of Finance, an auxiliary member of the board of the FSA to handle the cooperation between supervisory bodies in supervising groups that comprise a credit institution and an insurance company.

International compatibility: Chapter 3a of the act on the FSA contains provisions for the cooperation of the FSA with a supervisory authority of a member state of the EEA.

Accountability and transparency: The FSA has to

- propose an annual operations plan consisting of a plan for its day-to-day activities, a budget and a staff plan,
- submit an annual report on its activities to the parliamentary supervisory council,
- propose procedural rules for its day-to-day operations to the parliamentary supervisory council.

In addition, the FSA has to obey certain disclosure obligations. Most important, section 19a of the act on the FSA specifies that the FSA has to "collect and keep available for public inspection information on such credit losses as have given rise to the need for bank support, broken down by lines of business and regions, and by banks or banking groups, in as detailed a manner as possible, however so that a customer's bank secrecy will not be violated or his business activities hampered, or detriment caused to the protection of a private person. This information cannot be regarded as a business secret of a bank."

While these provisions enhance the accountability of the FSA in its day-to-day operation, the act on the FSA also specifies how to appeal against specific decisions of the FSA. According to section 24, "a decision made by the Financial Supervision Authority may be appealed to the Supreme Administrative Court in the manner provided for the appellation of decisions of the Council of State or a ministry in the Administrative Appeals Act (154/50)." However, the section also states that "a decision made by the Financial Supervision Authority that has been appealed shall, notwithstanding the appeal, continue in force until further notice, unless otherwise prescribed by the appeal authority or unless provided otherwise elsewhere in the law."

Finally, the act on the FSA also contains provisions to enhance the accountability of employees of the FSA.

- Section 17 states that employees shall not have a vested interest in a supervised entity. In addition, this section specifies certain disclosure requirements concerning financial transactions between employees of the FSA and supervised entities.

- Section 22 states that “charges of misconduct against the director general of the Financial Supervision Authority or any other member of the board shall be dealt with by the Helsinki Court of Appeals as the first instance.” Further, “if a member of the board other than the director general of the Financial Supervision Authority is prosecuted for an offence or investigated for an offence, the members of the parliamentary supervisory council may order that he be suspended from performing his duties for the duration of the prosecution or investigation and that he lose his wages in part of in whole.”

XII. Appendix B: Principles of financial supervision

1. "Core Principles for Effective Banking Supervision" of the Basel Committee on Banking Supervision

Preconditions for effective banking supervision

1. An effective system of banking supervision will have clear responsibilities and objectives for each agency involved in the supervision of banking organizations. Each such agency should possess operational independence and adequate resources. A suitable legal framework for banking supervision is also necessary, including provisions relating to authorization of banking organizations and their ongoing supervision; powers to address compliance with laws as well as safety and soundness concerns; and legal protection for supervisors. Arrangements for sharing information between supervisors and protecting the confidentiality of such information should be in place.

Licensing and structure

2. The permissible activities of institutions that are licensed and subject to supervision as banks must be clearly defined, and the use of the word "bank" in names should be controlled as far as possible.

3. The licensing authority must have the right to set criteria and reject applications for establishments that do not meet the standards set. The licensing process, at a minimum, should consist of an assessment of the banking organization's ownership structure, directors and senior management, its operating plan and internal controls, and its projected financial condition, including its capital base; where the proposed owner or parent organization is a foreign bank, the prior consent of its home country supervisor should be obtained.

4. Banking supervisors must have the authority to review and reject any proposals to transfer significant ownership or controlling interests in existing banks to other parties.

5. Banking supervisors must have the authority to establish criteria for reviewing major acquisitions or investments by a bank and ensuring that corporate affiliations or structures do not expose the bank to undue risks or hinder effective supervision.

Prudential regulations and requirements

6. Banking supervisors must set prudent and appropriate minimum capital adequacy requirements for all banks. Such requirements should reflect the risks that the banks undertake, and must define the components of capital, bearing in mind their ability to absorb losses. At least for internationally active banks, these requirements must not be less than those established in the Basel Capital Accord and its amendments.

7. An essential part of any supervisory system is the evaluation of a bank's policies, practices and procedures related to the granting of loans and making of investments and the ongoing management of the loan and investment portfolios.

8. Banking supervisors must be satisfied that banks establish and adhere to adequate policies, practices and procedures for evaluating the quality of assets and the adequacy of loan loss provisions and loan loss reserves.

9. Banking supervisors must be satisfied that banks have management information systems that enable management to identify concentrations within the portfolio and supervisors must set prudential limits to restrict bank exposures to single borrowers or groups of related borrowers.

10. In order to prevent abuses arising from connected lending, banking supervisors must have in place requirements that banks lend to related companies and individuals on an

arm's-length basis, that such extensions of credit are effectively monitored, and that other appropriate steps are taken to control or mitigate the risks.

11. Banking supervisors must be satisfied that banks have adequate policies and procedures for identifying, monitoring and controlling country risk and transfer risk in their international lending and investment activities, and for maintaining appropriate reserves against such risks.

12. Banking supervisors must be satisfied that banks have in place systems that accurately measure, monitor and adequately control market risks; supervisors should have powers to impose specific limits and/or a specific capital charge on market risk exposures, if warranted.

13. Banking supervisors must be satisfied that banks have in place a comprehensive risk management process (including appropriate board and senior management oversight) to identify, measure, monitor and control all other material risks and, where appropriate, to hold capital against these risks.

14. Banking supervisors must determine that banks have in place internal controls that are adequate for the nature and scale of their business. These should include clear arrangements for delegating authority and responsibility; separation of the functions that involve committing the bank, paying away its funds, and accounting for its assets and liabilities; reconciliation of these processes; safeguarding its assets; and appropriate independent internal or external audit and compliance functions to test adherence to these controls as well as applicable laws and regulations.

15. Banking supervisors must determine that banks have adequate policies, practices and procedures in place, including strict "know-your-customer" rules, that promote high ethical and professional standards in the financial sector and prevent the bank being used, intentionally or unintentionally, by criminal elements.

Methods of ongoing banking supervision

16. An effective banking supervisory system should consist of some form of both on-site and off-site supervision.

17. Banking supervisors must have regular contact with bank management and thorough understanding of the institution's operations.

18. Banking supervisors must have a means of collecting, reviewing and analyzing prudential reports and statistical returns from banks on a solo and consolidated basis.

19. Banking supervisors must have a means of independent validation of supervisory information either through on-site examinations or use of external auditors.

20. An essential element of banking supervision is the ability of the supervisors to supervise the banking group on a consolidated basis.

Information requirements

21. Banking supervisors must be satisfied that each bank maintains adequate records drawn up in accordance with consistent accounting policies and practices that enable the supervisor to obtain a true and fair view of the financial condition of the bank and the profitability of its business, and that the bank publishes on a regular basis financial statements that fairly reflect its condition.

Formal powers of supervisors

22. Banking supervisors must have at their disposal adequate supervisory measures to bring about timely corrective action when banks fail to meet prudential requirements (such as minimum capital adequacy ratios), when there are regulatory violations, or where depositors are threatened in any other way. In extreme circumstances, this should include the ability to revoke the banking licence or recommend its revocation.

Cross-border banking

23. Banking supervisors must practice global consolidated supervision over their internationally-active banking organizations, adequately monitoring and applying appropriate prudential norms to all aspects of the business conducted by these banking organizations worldwide, primarily at their foreign branches, joint ventures and subsidiaries.

24. A key component of consolidated supervision is establishing contact and information exchange with the various other supervisors involved, primarily host country supervisory authorities.

25. Banking supervisors must require the local operations of foreign banks to be conducted to the same high standards as are required of domestic institutions and must have powers to share information needed by the home country supervisors of those banks for the purpose of carrying out consolidated supervision.

2. "Objectives and Principles of Securities Regulation" of the International Organization of Securities Commissions

The principles are grouped into eight categories.

Principles relating to the regulator

1. The responsibilities of the regulator should be clear and objectively stated.

2. The regulator should be operationally independent and accountable in the exercise of its functions and powers.

3. The regulator should have adequate powers, proper resources and the capacity to perform its functions and exercise its powers.

4. The regulator should adopt clear and consistent regulatory processes.

5. The staff of the regulator should observe the highest professional standards including appropriate standards of confidentiality.

Principles for self-regulation

6. The regulatory regime should make appropriate use of Self-Regulatory Organizations (SROs) that exercise some direct oversight responsibility for their respective areas of competence, to the extent appropriate to the size and complexity of the markets.

7. SROs should be subject to the oversight of the regulator and should observe standards of fairness and confidentiality when exercising powers and delegated responsibilities.

Principles for the enforcement of securities regulation

8. The regulator should have comprehensive inspection, investigation and surveillance powers.

9. The regulator should have comprehensive enforcement powers.

10. The regulatory system should ensure an effective and credible use of inspection, investigation, surveillance and enforcement powers and implementation of an effective compliance program.

Principles for cooperation in regulation

11. The regulator should have authority to share both public and non-public information with domestic and foreign counterparts.

12. Regulators should establish information sharing mechanisms that set out when and how they will share both public and non-public information with their domestic and foreign counterparts.

13. The regulatory system should allow for assistance to be provided to foreign regulators who need to make inquiries in the discharge of their functions and exercise of their powers.

Principles for issuers

14. There should be full, timely and accurate disclosure of financial results and other information that is material to investors' decisions.

15. Holders of securities in a company should be treated in a fair and equitable manner.

16. Accounting and auditing standards should be of a high and internationally acceptable quality.

Principles for collective investment schemes

17. The regulatory system should set standards for the eligibility and the regulation of those who wish to market or operate a collective investment scheme.

18. The regulatory system should provide for rules governing the legal form and structure of collective investment schemes and the segregation and protection of client assets.

19. Regulation should require disclosure, as set forth under the principles for issuers, which is necessary to evaluate the suitability of a collective investment scheme for a particular investor and the value of the investor's interest in the scheme.

20. Regulation should ensure that there is a proper and disclosed basis for asset valuation and the pricing and the redemption of units in a collective investment scheme.

Principles for market intermediaries

21. Regulation should provide for minimum entry standards for market intermediaries.

22. There should be initial and ongoing capital and other prudential requirements for market intermediaries that reflect the risks that the intermediaries undertake.

23. Market intermediaries should be required to comply with standards for internal organization and operational conduct that aim to protect the interests of clients, ensure proper management of risk, and under which management of the intermediary accepts primary responsibility for these matters.

24. There should be procedures for dealing with the failure of a market intermediary in order to minimize damage and loss to investors and to contain systemic risk.

Principles for the secondary market

25. The establishment of trading systems including securities exchanges should be subject to regulatory authorization and oversight.

26. There should be ongoing regulatory supervision of exchanges and trading systems which should aim to ensure that the integrity of trading is maintained through fair and equitable rules that strike an appropriate balance between the demands of different market participants.

27. Regulation should promote transparency of trading.

28. Regulation should be designed to detect and deter manipulation and other unfair trading practices.

29. Regulation should aim to ensure the proper management of large exposures, default risk and market disruption.

30. Systems for clearing and settlement of securities transactions should be subject to regulatory oversight, and designed to ensure that they are fair, effective and efficient and that they reduce systemic risk.

3. Principles issued by the International Association of Insurance Supervisors

3.1. "Insurance Supervisory Principles"

The following are key issues for the insurance supervisor:

Licensing and changes in control

Licensing

Companies wishing to underwrite insurance in the domestic insurance market should be licensed. Where the insurance supervisor has authority to grant a license, the supervisor:

1. in granting a license, should assess the suitability of owners, directors, and/or senior management, and the soundness of the business plan, which could include pro forma financial statements, a capital plan and projected solvency margins; and
2. in permitting access to the domestic market, may choose to rely on the work carried out by an insurance supervisor in another jurisdiction if the prudential rules of the two jurisdictions are broadly equivalent.

Changes in control

The insurance supervisor should review changes in the control of companies that are licensed in the jurisdiction. The insurance supervisor should establish clear requirements to be met when a change in control occurs. These may be the same as, or similar to, the

requirements which apply in granting a license. In particular, the insurance supervisor should:

1. require the purchaser or the licensed insurance company to provide notification of the change in control and/or seek approval of the proposed change; and
2. establish criteria to assess the appropriateness of the change, which could include the assessment of the suitability of the new owners as well as any new directors and senior managers, and the soundness of any new business plan.

Corporate governance and internal controls

Corporate governance

It is desirable that standards be established in the jurisdiction which deal with corporate governance. Where the insurance supervisor has responsibility for setting requirements for corporate governance, the supervisor should set requirements with respect to:

1. the roles and responsibilities of the board of directors;
2. reliance on other supervisors for companies licensed in another jurisdiction; and
3. the distinction between the standards to be met by companies incorporated in his jurisdiction and branch operations of companies incorporated in another jurisdiction.

Internal controls

The supervisor should be able to:

1. review the internal controls that the board of directors and management approve and apply, and to require strengthening where necessary; and
2. require the board of directors to provide suitable prudential oversight, such as setting standards for underwriting risks and setting qualitative and quantitative standards for investment and liquidity management.

Prudential rules

Insurance companies, by the very nature of their business, are exposed to risk. Insurance companies should meet prudential standards established to limit or manage the amount of risk that they retain. In establishing the requirements the supervisor should consider whether standards that apply to companies that are incorporated in the jurisdiction should differ from those that apply to branches of companies incorporated in another jurisdiction.

Assets

Standards should be established with respect to the assets of companies licensed to operate in the jurisdiction. Where insurance supervisors have the authority to establish the standards, these should apply at least to an amount of assets equal to the total of the technical provisions, and should address:

1. diversification by type;
2. any limits, or restrictions, on the amount that may be held in financial instruments, property, and receivables;
3. the basis for valuing assets which are included in the financial reports;
4. the safekeeping of assets;
5. appropriate matching of assets and liabilities, and
6. liquidity.

Liabilities

Insurance supervisors should establish standards with respect to the liabilities of companies licensed to operate in their jurisdiction. In developing the standards, the insurance supervisor should consider:

1. what is to be included as a liability of the company, for example, claims incurred but not paid, claims incurred but not reported, amounts owed to others, amounts owed that are in dispute, premiums received in advance, as well as the provision for policy liabilities or technical provisions that may be set by an actuary;
2. the standards for establishing policy liabilities or technical provisions; and

3. the amount of credit allowed to reduce liabilities for amounts recoverable under reinsurance arrangements with a given reinsurer, making provision for the ultimate collectability.

Capital adequacy and solvency

The requirements regarding the capital to be maintained by companies which are licensed or seek a license in the jurisdiction should be clearly defined and address minimum levels of capital or the levels of deposits that should be maintained. Capital adequacy requirements should reflect the size, complexity, and business risks of the company in the jurisdiction.

Derivatives and "off-balance sheet" items

This section applies in jurisdictions where derivatives or other items are not reported on the balance sheet and are thus not subject to the reporting requirements established for financial statements.

The insurance supervisor should be able to set requirements with respect to the use of financial instruments that may not form a part of the financial report of a company licensed in the jurisdiction. In setting these requirements, the insurance supervisor should address:

1. restrictions in the use of derivatives and other off-balance sheet items;
2. disclosure requirements for derivatives and other off-balance sheet items; and
3. the establishment of adequate internal controls and monitoring of derivative positions.

Reinsurance

This section applies in jurisdictions where reinsurance companies are not subject to the same supervisory rules as insurance companies.

Insurance companies use reinsurance as a means of risk containment. The supervisor must be able to review reinsurance arrangements, to assess the degree of reliance placed on these arrangements and to determine the appropriateness of such reliance. Insurance companies

would be expected to assess the financial positions of their reinsurers in determining an appropriate level of exposure to them. The insurance supervisor should set requirements with respect to reinsurance contracts or reinsurance companies addressing:

1. the amount of the credit taken for reinsurance ceded. The amount of credit taken should reflect an assessment of the ultimate collectability of the reinsurance recoverables and may take into account the supervisory control over the reinsurer; and
2. the amount of reliance placed on the insurance supervisor of the reinsurance business of a company which is incorporated in another jurisdiction.

Monitoring and on site inspection

It is important that insurance supervisors get the information they need to properly form an opinion on the financial strength of the operations of each insurance company in their jurisdiction. The information needed to carry out this review and analysis is obtained from the financial and statistical reports that are filed on a regular basis, supported by information obtained through special information requests, on site inspections and communication with actuaries and external auditors.

Financial reporting

A process should be established for:

1. setting the scope and frequency of reports requested and received from all companies licensed in the jurisdiction, including financial reports, statistical reports, actuarial reports and other information;
2. setting the accounting requirements for the preparation of financial reports in the jurisdiction;
3. ensuring that external audits of insurance companies operating in the jurisdiction are acceptable; and
4. setting the standards for the establishment of technical provisions or policy and other liabilities to be included in the financial reports in the jurisdiction.

In so doing a distinction may be made:

- between the standards that apply to reports and calculations prepared for disclosure to policyholders and investors, and those prepared for the insurance supervisor; and
- between the financial reports and calculations prepared for companies incorporated in the jurisdiction and branch operations of companies incorporated in another jurisdiction.

On site inspection and access to information

The insurance supervisor should be able to:

1. carry out on site inspections to review the business and affairs of the company, including the inspection of books, records, accounts, and other documents. This may be limited to the operation of the company in the jurisdiction or, subject to the agreement of the respective supervisors, include other jurisdictions in which the company operates; and
2. request and receive any information from companies licensed in his jurisdiction, whether this information be specific to a company or be requested of all companies.

Sanctions

Insurance supervisors must have the power to take remedial action where problems involving licensed companies are identified. The supervisor must have a range of actions available in order to apply appropriate sanctions to problems encountered. The legislation should set out the powers available to the supervisor and may include:

1. the power to restrict the business activities of a company, for example, by withholding approval for new activities or acquisitions;
2. the power to direct a company to stop practices that are unsafe or unsound, or to take action to remedy an unsafe or unsound business practice; and
3. the option to invoke other sanctions on a company or its business operation in the jurisdiction, for example, by revoking the license of a company or imposing remedial measures where a company violates the insurance laws of the jurisdiction.

Co-ordination

Increasingly, insurance supervisors liaise with each other to ensure that each is aware of the other's concerns with respect to an insurance company that operates in more than one jurisdiction either directly or through a separate corporate entity. In order to share relevant information with other insurance supervisors, adequate and effective communications should be developed and maintained.

Co-operation

In developing or implementing a regulatory framework, consideration should be given to whether the insurance supervisor:

1. is able to enter into an agreement or understanding with any other supervisor both in other jurisdictions and in other sectors of the industry (i.e., insurance, banking, or securities) to share information or otherwise work together;
2. is permitted to share information, or otherwise work together, with an insurance supervisor in another jurisdiction. This may be limited to insurance supervisors who have agreed, and are legally able, to treat the information as confidential;
3. should be informed of findings of investigations where power to investigate fraud, money laundering, and other such activities rests with a body other than the insurance supervisor; and
4. is permitted to set out the types of information and the basis on which information obtained by the supervisor may be shared.

Confidentiality

All insurance supervisors should be subject to professional secrecy constraints in respect of information obtained in the course of their activities, including the conduct of on site inspections. The insurance supervisor is required to hold confidential any information received from other supervisors, except where constrained by law or in situations where the supervisor who provided the information provides authorization for its release. Jurisdictions whose confidentiality requirements continue to constrain or prevent the sharing of information for supervisory purposes with insurance supervisors in other

jurisdictions, and jurisdictions where information received from another supervisor cannot be kept confidential, are urged to review their requirement.

In addition to the above-stated principles, the IAIS has also issued the following principles for the supervision of cross-border business operations.

3.2. "Principles Applicable to the Supervision of International Insurers and Insurance Groups and their Cross-Border Business Operations"

The overall objective of insurance supervision is to maintain efficient, fair, safe and stable insurance markets for the benefit and protection of policyholders. To achieve this objective in an environment where many insurers and insurance groups are rapidly extending their international operations, often into new and emerging markets, there is an increasing need for insurance supervisors to co-operate with each other. The purpose of this paper is therefore to develop practical standards that members may chose to apply, and in this sense to establish principles for cooperation between insurance supervisors in the supervision of the foreign business operations of international insurers and insurance groups with a view to maintaining and enhancing its effectiveness. The main focus is on regulation in the interests of policyholders and potential policyholders of the financial strength of insurers and their ability to pay claims - and not on conduct of business regulation. The principles which are elaborated below should be implemented taking full account of any international obligations which may also be applicable.

3.2.1. Principles for the Supervision of Cross-Border Business Operations

Principle 1: No foreign insurance establishments should escape supervision.

A primary aim of co-operation between insurance supervisors is to ensure that no insurance establishment escapes supervision. Whilst being sensitive to the potential for

unnecessary duplication of supervision, each supervisor has a duty to ensure that *all* foreign insurance establishments in its jurisdiction are effectively supervised. Acceptance of this principle does not remove the possibility of gaps in supervision. Gaps may occur, for example, when an establishment is classified as an insurer by the home supervisor but not by the host supervisor, or vice versa.

There are differences in the supervision of subsidiaries and branches.

- Subsidiaries should always be supervised in the host jurisdiction where they are incorporated, and will be subject to host rules on capital adequacy/solvency.
- Branches will also usually come under host jurisdiction supervision (except where mutual recognition schemes operate as in the EU). However, branch solvency may be assessed under the provisions applying in both home and host jurisdictions. In some cases the branch's host supervisor may be willing to rely on the home supervisor's assessment.

Principle 2: All insurance establishments of international insurance groups and international insurers should be subject to effective supervision.

In deciding whether, and if so on what basis, to license or to continue a licence of a subsidiary or branch of a foreign insurer in its jurisdiction, the host supervisor may need to assess on a case by case basis the effectiveness of the supervision of the foreign insurer in its home jurisdiction, consulting the home supervisor as necessary. This assessment would take into account IAIS general supervisory principles and standards and the ability of the home supervisor to apply sanctions to prevent corporate structures that conflict with effective supervision.

The traditional approach to insurance supervision has laid the primary emphasis on effective solo supervision of individual insurance companies. Because insurance companies are less vulnerable to risks of contagion than, for example banks, and because they are more rarely a source of systemic risk to the wider financial system, insurance supervisors

seek to ring fence an individual insurer incorporated in their jurisdiction, isolating it from other companies in the same group.

Where, however, a parent insurer has material participations in other insurers (or in other financial institutions), it is important to take into account the potential additional risks created by the existence of a group in assessing the financial strength of the parent insurer and the group as a whole: notably the possible effects of double gearing of capital on solvency; intra-group transactions, and large exposures. Work on the prudent treatment of such situations is going on in other fora, and will need in due course to be incorporated into a "solo-plus" or group-wide view of the supervision of international insurance groups. This will not, however, diminish the importance of the effective supervision of international insurers on a solo basis.

Principle 3: The creation of a cross-border insurance establishment should be subject to consultation between the host and home supervisors.

The initial opportunity for collaboration between host and home supervisors occurs when an individual application by an insurer to establish a new foreign presence is first made. The licensing procedure also offers a good opportunity for host and home authorities to create the basis for future collaboration.

Host supervisors may wish to consult home supervisors on particular aspects of an licensing proposal, but in any event they should always consider checking that the home supervisor of the immediate insurance parent has no objection before granting a license. This process might give an opportunity to a home supervisor which disapproves of its insurer's plans to establish abroad to make its reasons known to the host supervisor, and perhaps recommend that the host supervisor refuse a license. Where such checks are made and where a host supervisor is unable to obtain a positive reply from a home supervisor with the legal authority to respond, or a qualified response is received, it should consider either refusing the application, increasing the intensity of supervision or imposing

conditions on the grant of a license. The host supervisor should inform the home supervisor of any restrictions or prohibitions imposed on a license.

Host supervisors should exercise particular caution in approving applications for a license from foreign entities which are not subject to prudential regulation of their capital strength in the home jurisdiction, or joint ventures for which there is no clear parental responsibility. In such circumstances, any license should be contingent on the host supervisor's capacity to impose specific restrictions on activities - or require specific guarantees - and supervise the company effectively.

The final decision on licensing should remain with the host supervisor on the basis of non-discriminatory criteria (except where a mutual recognition scheme operates as in the EU). Home supervisors should maintain a listing of all the cross-border establishments of their insurers.

Principle 4: Foreign insurers providing insurance cover on a cross-border services basis should be subject to effective supervision.

Whether or not foreign insurers are permitted to provide insurance services on a cross-border basis in any jurisdiction is usually a matter of law in the jurisdiction concerned.

Where consumers have the unrestricted freedom to seek insurance abroad on their own initiative, the presumption is normally that they take responsibility for their own actions. However, where the active promotion of insurance contracts on a cross-border services basis is permitted, the host supervisor may wish to be notified of the intention of a foreign insurer to promote insurance contracts within their jurisdiction, and to check that the foreign insurer is subject to prudential regulation of their capital strength in the home jurisdiction. Another legitimate approach might be the application of a special licensing procedure, or the introduction of specific safeguards to protect the policyholder.

If the active promotion of insurance contracts on a cross-border services basis is permitted, the home supervisor will retain the primary responsibility for ensuring that the insurer remains solvent, the host supervisor should consider very seriously any reservations or objections expressed by the home supervisor to the insurer's proposed activity. Home supervisors should have the power to prevent insurers within their jurisdiction from promoting contracts of insurance on a cross-border basis in foreign jurisdictions if they consider that the insurer does not have the required financial capacity, or the necessary expertise to manage this business prudently.

Where the host supervisor has been notified of the intention of a foreign insurer to promote insurance contracts within their jurisdiction, the host supervisor should consider what information should be made available to the consumer by the foreign insurer. This might include details of the authority responsible for the supervision of the insurer.

3.3.2. Recommendations regarding Cooperation between Supervisory Agencies

Mutual trust between supervisors is enhanced if information can flow with confidence in both directions on a broadly reciprocal basis. In seeking to improve the supervision of international insurers and insurance groups, efforts continue to be required to improve information exchange between insurers and supervisors, and between different supervisors. The purpose is to address material supervisory issues, not simply to circulate large amounts of routine information. The need to exchange information encompasses the following elements.

(a) Information needs of home supervisors
The principal requirement of the home supervisor is to ensure that its information needs from the parent insurer are fully met in a timely fashion. This will typically require a sound and verifiable system of reporting from any foreign establishment to the head office or parent insurer, and that practical solutions be found for dealing with particular information needs.

To this end:

- Home supervisors should seek to satisfy themselves that insurers' internal controls include comprehensive and regular reporting between an insurer's foreign establishments and its head office, so that the overall financial situation of the insurer and the effectiveness of its control systems can be accurately reported and assessed.
- If a host supervisor identifies, or has reason to suspect, problems of material nature in a foreign establishment, it should take the initiative to inform the home supervisor, subject to its own judgment. The level of materiality will vary according to the nature of the problem. Home supervisors may wish to inform host supervisors as to the precise levels of materiality which would trigger their concern. However, the host supervisor is often in the best position to detect problems and therefore should be ready to act on its own initiative.
- Home supervisors may wish to seek an independent check on data reported by an individual foreign establishment. Where inspection by home supervisors is permitted, host supervisors should welcome such inspections. Where inspection by home supervisors is not at present possible (or where the home supervisor does not use the inspection process), the home supervisor can consult the host supervisor with a view to the host supervisor checking or commenting on designated features of the insurer's activities. It is desirable that the results obtained should be available to both host and home supervisor.
- If serious problems arise in a foreign establishment, the host supervisor may wish to consult with the head office or parent insurer and also with the home supervisor in order to design possible remedies. Where such consultation with the home supervisor has taken place, and the host supervisor decides to withdraw the license of a foreign establishment or take similar action, the home supervisor should, where possible and appropriate, be given prior warning.
- In some instances the host supervisor may, by agreement with the home supervisor, share responsibility for and co-ordinate supervisory activities with the home supervisor.

Host supervisors should make the home supervisor aware of any material difficulties arising from the provision of insurance on a cross-border services basis.

(b) Information needs of host supervisors

Host supervision of foreign establishments will be more effective if it is undertaken with an awareness of the extent to which the home supervisor of the immediate parent insurer monitors the foreign establishment and of any prudential constraints placed on the parent insurer or the group as a whole. To this end:

- Home supervisors should inform host supervisors of changes in supervisory measures which have a significant bearing on the operations of their insurers' foreign establishments, subject to their own judgment. Home supervisors should respond positively to approaches from host supervisors for factual information covering, for example, the scope of the activities of a local establishment, its role within the insurance group and the application of internal controls and for information relevant for effective supervision by host supervisors.
- Where a home supervisor has doubts about the standard of host supervision in a particular jurisdiction and, as a consequence, is envisaging action which will affect foreign establishments in the jurisdiction concerned, the home supervisor should consult the host supervisor in advance.
- In the case of particular insurers, home supervisors should be ready to take host supervisors into their confidence as much as possible. Even in sensitive cases such as impending changes of ownership or when an insurer faces problems, liaison between home and host supervisors may be mutually advantageous, though decisions on both substance and timing on such sensitive issues can only be taken case by case.

Home supervisors should respond positively to approaches from host supervisors seeking factual information on individual insurers known to be providing insurance on a cross-border services basis.

(c) Confidentiality constraints on the flow of information

The freedom to exchange prudential information, subject to certain conditions designed to protect both the provider and receiver of the information, greatly enhances effective collaboration between supervisors. A possible obstacle to the transmission of prudential information is the different level of confidentiality regulations in different jurisdictions.

Jurisdictions whose confidentiality requirements continue to constrain or prevent the sharing of information for supervisory purposes with insurance supervisors in other jurisdictions, and the countries where information received from a foreign supervisor cannot be kept confidential, are urged to review their requirements in consideration of the following conditions:

- Information received should only be used for purposes related to the supervision of financial institutions.
- Information sharing arrangements should allow for a two way flow of information, but strict reciprocity in respect of the format and detailed characteristics of the information should not be demanded.
- The confidentiality of information transmitted should be legally protected, except in the event of criminal prosecution. All insurance supervisors should, of course, be subject to professional secrecy constraints in respect of information obtained in the course of their activities, including during the conduct of on-site inspections.
- The recipient should undertake, where possible, to consult with the supervisor providing the information if he proposes to take action on the evidence of the information received.

Supervisors may wish to consider, on a case by case basis, and consulting each other as necessary, the appropriateness of informing the companies on which they have exchanged information of the nature of the contact made.

3.2.3. Recommendations regarding External Audits

Supervisors can gain reassurance from sound international auditing and actuarial standards. At present, not all foreign establishments are subject to external audit and, even where they are, the audit work may not be sufficiently thorough. All foreign establishments should be subject to external audit, where necessary either at the instigation of the home or host supervisor.

The existence of adequate provision for external audit is an important consideration for insurance supervisors, and might be a factor taken into account in deciding on licences for new establishments. For the foreign establishments of international insurers and insurance groups the audit firm may often be the one that audits the parent insurer, provided the firm in question has the appropriate capacity and experience in the host jurisdiction. Where a foreign establishment is audited by a different firm, it is desirable that the external auditor and the insurance supervisor of the parent insurer satisfy themselves as to the proper audit of the foreign establishment.

Supervisors have a strong interest in the quality and thoroughness of audits. Where audits are inadequately conducted, supervisors should address criticism to the local representative body of auditors. It is desirable that the insurance supervisor be empowered, where necessary, to insist on a further audit by a different auditor or to have the auditor replaced. As a means of raising auditing standards for international insurance groups, it is desirable that auditors with recognized experience of insurance audit, including within the jurisdiction concerned, be appointed. Where any doubt arises, host and home supervisors should consider consulting.

External auditors may also be asked to verify the accuracy of reporting returns or compliance with special conditions. It is desirable that all supervisors should have the ability to communicate with insurance external auditors and vice versa. Effective co-ordination between insurance supervisors and external auditors is encouraged. However, whilst external auditors can play a key role, their involvement does not reduce in any way the need for sound internal controls, including provision for effective internal audit.

4. "Code of Good Practices on Transparency in Monetary and Financial Policies: Declaration of Principles" of the International Monetary Fund

Consistent with the focus of this document, we list here only those principles in parts 5, 6, 7 and 8 of the document that apply to financial policies:

5. Clarity of roles, responsibilities and objectives of financial agencies responsible for financial policies

5.1 The broad objective(s) and institutional framework of financial agencies should be clearly defined, preferably in relevant legislation or regulation.
5.1.1 The broad objective(s) of financial agencies should be publicly disclosed and explained.
5.1.2 The responsibilities of the financial agencies and the authority to conduct financial policies should be publicly disclosed.
5.1.3 Where applicable, the broad modalities of accountability for financial agencies should be publicly disclosed.
5.1.4 Where applicable, the procedures for appointment, terms of office, and any general criteria for removal of the heads and members of the governing bodies of financial agencies should be publicly disclosed.

5.2 The relationship between financial agencies should be publicly disclosed.

5.3 The role of oversight agencies with regard to payment systems should be publicly disclosed.
5.3.1 The agencies overseeing the payment system should promote the timely public disclosure of general policy principles (including risk management policies) that affect the robustness of systemically important payment systems.

5.4 Where financial agencies have oversight responsibilities for self-regulatory organizations (e.g., payment systems), the relationship between them should be publicly disclosed.

5.5 Where self-regulatory organizations are authorized to perform part of the regulatory and supervisory process, they should be guided by the same good transparency practices specified for financial agencies.

6. Open process for formulating and reporting of financial policies

6.1 The conduct of policies by financial agencies should be transparent, compatible with confidentiality considerations and the need to preserve the effectiveness of actions by regulatory and oversight agencies.
6.1.1 The regulatory framework and operating procedures governing the conduct of financial policies should be publicly disclosed and explained.
6.1.2 The regulations for financial reporting by financial institutions to financial agencies should be publicly disclosed.
6.1.3 The regulations for the operation of organized financial markets (including those for issuers of traded financial instruments) should be publicly disclosed.
6.1.4 Where financial agencies charge fees to financial institutions, the structure of such fees should be publicly disclosed.
6.1.5 Where applicable, formal procedures for information sharing and consultation between financial agencies (including central banks), domestic and international, should be publicly disclosed.

6.2 Significant changes in financial policies should be publicly announced and explained in a timely manner.

6.3 Financial agencies should issue periodic public reports on how their overall policy objectives are being pursued.

6.4 For proposed substantive technical changes to the structure of financial regulations, there should be a presumption in favor of public consultations, within an appropriate period.

1. Public availability of information on financial policies

7.1 Financial agencies should issue a periodic public report on the major developments of the sector(s) of the financial system for which they carry designated responsibility.

7.2 Financial agencies should seek to ensure that, consistent with confidentiality requirements, there is public reporting of aggregate data related to their jurisdictional responsibilities on a timely and regular basis.

7.3 Where applicable, financial agencies should publicly disclose their balance sheets on a pre-announced schedule and, after a predetermined interval, publicly disclose information on aggregate market transactions.
7.3.1 Consistent with confidentiality and privacy of information on individual firms, aggregate information on emergency financial support by financial agencies should be publicly disclosed through an appropriate statement when such disclosure will not be disruptive to financial stability.

7.4 Financial agencies should establish and maintain public information services.
7.4.1 Financial agencies should have a publications program, including a periodic public report on their principal activities issued at least annually.
7.4.2 Senior financial agency officials should be ready to explain their institution's objective(s) and performance to the public, and have a presumption in favor of releasing the text of their statements to the public.

7.5 Texts of regulations and any other generally applicable directives and guidelines issued by financial agencies should be readily available to the public.

7.6 Where there are deposit insurance guarantees, policy-holder guarantees, and any other client asset protection schemes, information on the nature and form of such protections, on the operating procedures, on how the guarantee is financed, and on the performance of the arrangement, should be publicly disclosed.

7.7 Where financial agencies oversee consumer protection arrangements (such as dispute settlement processes), information on such arrangements should be publicly disclosed.

8. Accountability and assurances of integrity by financial agencies

8.1 Officials of financial agencies should be available to appear before a designated public authority to report on the conduct of financial policies, explain the policy objective(s) of their institution, describe their performance in pursuing their objective(s), and, as appropriate, exchange views on the state of the financial system.

8.2 Where applicable, financial agencies should publicly disclose audited financial statements of their operations on a pre-announced schedule.
8.2.1 Financial statements, if any, should be audited by an independent auditor. Information on accounting policies and any qualification to the statements should be an integral part of the publicly disclosed financial statements.
8.2.2 Internal governance procedures necessary to ensure the integrity of operations, including internal audit arrangements, should be publicly disclosed.

8.3 Where applicable, information on the operating expenses and revenues of financial agencies should be publicly disclosed annually.

8.4 Standards for the conduct of personal financial affairs of officials and staff of financial agencies and rules to prevent exploitation of conflicts of interest, including any general fiduciary obligation, should be publicly disclosed.

8.4.1 Information about legal protections for officials and staff of financial agencies in the conduct of their official duties should be publicly disclosed.

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