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TWIN PEAKS: A THEORETICAL ANALYSIS

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I ABSTRACT

This paper provides a theoretical analysis of the twin peaks method of financial system regulation, with particular reference to the Australian iteration of the model. This includes a description of how twin peaks functions, its historical development, and its strengths and weaknesses. An analysis is also provided of an important bifurcation in the Australian model, as it has been emulated elsewhere in the world, namely the jurisdictional location of the bank regulator.

II INTRODUCTION

This article presents a theoretical analysis of the ‘twin peaks’ model of financial system regulation, with particular reference to the Australian iteration.

The purported benefits of this research are two-fold: first, in the aftermath of the global financial crisis (hereinafter ‘GFC’), any model of financial system regulation that has the potential to create a greater degree of financial system stability is worth investigating. Of

1 BA Honours LLB (Witwatersrand) PhD (Melbourne). The author acknowledges with gratitude the helpful comments made by Timothy Gapes, Centre Director, Centre for International Finance and Regulation.
the four models currently in use internationally, ‘twin peaks’ is widely regarded as the best suited to this task.2

This model has now been held up as the most effective model to address the flaws in unregulated or thinly regulated markets where the most problematic issues arose in the GFC.3

The Australia iteration of twin peaks serves as the touch-stone for this research, because Australia was first to adopt Twin Peaks, has the longest experience in operating this model, has recently subjected the model to a rigorous independent review (the Financial System Inquiry4), and in other countries where twin peaks is being adopted, it is the Australian model which is being emulated, for example in the Republic of South Africa.5

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As a regulatory structure, it is the envy of many in other countries, and more recent regulatory architecture reforms in other countries are often based on what is described as the Australian ‘twin peaks’ approach … .

Moreover, Australia, and in particular, its regulatory regime, fared better than most other countries during the GFC. Consequently a clear and balanced account of the strengths and weaknesses inherent in twin peaks, it is hoped, will facilitate debate on, and understanding of, the model, for academics and policy-makers alike.

The article commences with a description of twin peaks, followed by an historical account of the conditions in the United Kingdom that gave rise to its development.

Next, the article examines the deficiencies of twin peaks. This is followed by an analysis of an important variation in the model, as it exists in various countries, namely the jurisdictional location of the bank regulator, and the implications thereof.

Finally, this paper presents concluding observations.

III WHAT IS TWIN PEAKS?

(a) A definition

A twin peaks regulatory model comprises two peak regulators: one whose objective is financial system stability, the other whose objective is market conduct and consumer protection. In Australia

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6 Alan Erskine, “Regulating the Australian Financial System”, in Funding Australia’s Future, Australian Centre for Financial Studies, July, 2014, p 43.


these are the Australian Prudential Regulation Authority (APRA), and the Australian Securities and Investments Commission (ASIC) respectively. This method is known as ‘regulation by objective’,\(^9\) that is to say regulation which has the purpose of ‘achieving particular and concrete outcomes’\(^10\).

\(b\) Regulation by objective

Arguments in favour of this model include:

- Regulators can be more effective, with each having clear objectives that do not overlap;
- Regulators can, as a result, be more accountable and more focused;
- It creates checks and balances between agencies, and their objectives;
- It allows each regulator to create its own culture that best suits its objectives; and
- It allows each regulator to acquire expertise specifically required to meet its objectives.\(^11\)

\(c\) Adoption

Twin peaks was introduced in Australia in 1998 in response to the recommendations of the Wallis Inquiry.\(^12\) The original proposal was

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not Australian, however. It was first suggested by an Englishman, Michael Taylor, in 1995, principally as a reaction to the ‘blurring of the boundaries’ phenomenon in the financial services sector in the UK; an issue to which this paper will return.

Since its introduction in Australia, the model has been adopted in a number of countries. These include the Netherlands, New Zealand, the United Kingdom, Switzerland, Qatar, and Spain.


South Africa\textsuperscript{21} is in the process of adopting this method of financial regulation. France\textsuperscript{22} and Germany\textsuperscript{23} use elements of it.

\textit{(d) How it functions}\n
The essence of twin peaks is a regulatory model which ascribes equal importance to, and jurisdictional authority over, two core functions: one, the maintenance of financial system stability, and two, market conduct and consumer protection.\textsuperscript{24} Crucially, the model eschews the concept of a lead regulator\textsuperscript{25}: each agency must single-mindedly fulfil its own remit.\textsuperscript{26}

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20 Ibid, p 38ff.


24 David T. Llewellyn, op cit, p 27.


26 Gregg D. Kiloren, op cit, p 10, David T. Llewellyn, op cit, p 27.
\end{flushleft}
This ideal - separate but equal regulators - each with its own bailiwick, has much to commend it. After all, it is easy enough to understand the importance of the system stability regulator as a defence against financial crises. In the aftermath of the GFC however, and the market misconduct and consumer abuse that gave rise to the subprime disaster and then metastasized into a worldwide series of financial crises, there is left little doubt that for financial system stability, the market conduct objective is equally important.

… morphed the subprime crisis into a virulent global financial crisis.27

have identified many billions of dollars of fraudulent loans originated by Countrywide that were sold fraudulently to Fannie and Freddie through false representations and warranties. ... 97% of the Countrywide loans reviewed by Ambac ... had false reps and warranties. Countrywide also engaged in widespread foreclosure fraud. ... examined by a truly independent body has found widespread fraud — in loan origination, loan sales, appraisals, and foreclosures. ... one financially sophisticated entity after another found widespread fraud by Countrywide in the entire gamut of its operations, the administration, the industry ... Countrywide made hundreds of thousands of fraudulent loans ... It fraudulently foreclosed on large numbers of loans. It victimized hundreds of thousands of people and hundreds of financial institutions, causing hundreds of billions of dollars of losses. It has defrauded more people, at a greater cost, than any entity in history ... The financial media treats Bank of America as if it were a legitimate bank rather than a “vector” spreading the mortgage fraud epidemic throughout much of the Western world.28


(e) Separate but equal

The separation of the consumer protection function from the system stability function is the cornerstone and, supposedly, one of the principal advantages of a twin peaks system.29

In theory, protection of retail consumers would not be subordinated to financial system stability. Indeed, in theory, guarding consumers may in fact positively affect system stability by, *nipping in the bud*, malpractices that, while initially only detrimental to consumers, ultimately become systemic risks. Examples of market misconduct giving rise to the GFC are, in this regard, instructive:

‘We’ve known for some time that Goldman Sachs and other firms marketed mortgage-backed securities even as they sought to make profits by betting that such securities would plunge in value. This practice, however, while arguably reprehensible, wasn’t illegal. But now the S.E.C. is charging that Goldman created and marketed securities that were deliberately designed to fail, so that an important client could make money off that failure. That’s what I would call looting… So what role did fraud play in the financial crisis? Neither predatory lending nor the selling of mortgages on false pretences caused the crisis. But they surely made it worse, both by helping to inflate the

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housing bubble and by creating a pool of assets guaranteed to turn into toxic waste once the bubble burst.\textsuperscript{30}

Whether in practice this equality between consumer protection and system stability remains true, is debatable. It is arguable that systemic instability, by virtue of its potential severity, will always attract a more vigorous response from regulators, than would consumer protection, and historically there is evidence of that not only in the United States,\textsuperscript{31} but in the United Kingdom as well.\textsuperscript{32}

\textit{(f) Conclusion}

Ideally then, a twin peaks model will give equal priority to financial system stability, through a separate bank prudential regulator, as it will market conduct and consumer protection, through a separate consumer protection and market conduct regulator. In theory then, twin peaks aims to safeguard consumers as vigorously as it does the stability of the financial system.


\textsuperscript{32} For proposals to address this phenomenon, see: Bank of England HM Treasury, Financial Conduct Authority, “\textit{How fair and effective are the fixed income, foreign exchange and commodities markets? Consultation document}”, Bank of England, October, 2014, p 4/21/22/48. The outcome of this review will not be available until June 2015.
In times of distress, twin peaks can, in theory, tolerate financial firm failure, provided the firm is not of systemic importance.\textsuperscript{33}

In theory, twin peaks is better suited to performing all of these functions than any of the other systems of financial system regulation currently employed elsewhere in the world.\textsuperscript{34}

In practice, however, twin peaks has its shortcomings and its deficiencies, and these will be explored in greater detail, below.

IV HISTORICAL DEVELOPMENT

\textit{(a) The UK}

Prior to the advent of twin peaks, the UK’s financial sector had so many different overseers for conduct and systemic issues that it was described as constituting an ‘alphabet soup’ of regulators. Taylor


argued that those arrangements led to conflicts of interest, ‘confusion and damage’.35

Britain’s system for regulating financial services, as was once said of its Empire, has been acquired in a fit of absence of mind.36

The UK had a Byzantine system of disparate regulators, with each being assigned a jurisdiction defined by the type of entity being regulated. Contemporaneously, the financial system was increasingly experiencing a ‘blurring of the boundaries’ between different kinds of financial institutions. Banks were combining with insurers, and investment banks with stockbroking firms. Added to this was the presence of large, systemically important building societies37.

The combination of these factors was identified as necessitating a financial services regulator whose purpose it would be to ensure the stability of the financial system.38

This idea – one, combined financial services regulator - became the first half of a more substantial proposal – ‘Twin Peaks’. First put forward by Michael Taylor,39 who argued for a fusion of the multiple regulators then in existence - regulators charged with banking, securities, insurance, and investment management. These regulators included the Bank of England and the Building Societies Commission.40

Under Taylor’s plan, a new financial services regulator would henceforth assume authority for all deposit-taking institutions41 and,
crucially, would no longer simply enforce bank regulations against individual transactions. It would be charged with ensuring the overall stability of the financial system too, by regulating bank capital and the control of risk.

Specifically, Taylor envisaged that the bank regulator would address ‘financial soundness of institutions – including capital adequacy and large exposure requirements, measures relating to systems and controls and provisioning policies, and the vetting of senior managers to ensure that they possess an appropriate level of experience and skill.’

The collapse of Barings Bank in 1995 provided further impetus for the adoption of a single bank regulator.

Under Taylor’s proposal a second regulator would then be created, charged with protecting consumers from unscrupulous operators: a market conduct and consumer protection regulator, whose remit it would be to ensure that consumers were treated fairly and honestly, by protecting them against ‘fraud, incompetence, or the abuse of market power.’ Measures would include restrictions on the advertising, marketing and sale of financial products, as well as minimum fit and proper standards for salespeople.

In the event of conflict between the two regulators, the Chancellor of the Exchequer would provide a resolution.

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42 Ibid, p 3.


46 Ibid, p 3.
According to Taylor, \(^{47}\) this would address four issues simultaneously:

i. that henceforth a wide range of financial firms would have to be regarded as systemically important;

ii. that sprawling and disparate regulatory agencies present opportunities for regulatory arbitrage,\(^ {48}\) and turf battles over jurisdiction;\(^ {49}\)

iii. that in the ever increasing cases of financial conglomerates, a group-wide perspective on financial soundness is required;\(^ {50}\)

iv. and that rare and specialist expertise and limited supervisory resources would be pooled, instead of duplicated by overlapping.

‘The benefits of twin peaks are clear. The proposed structure would eliminate regulatory duplication and overlap; it would create regulatory bodies with a clear and precise remit; it would establish mechanisms for resolving conflicts between the objectives of financial services regulation; and it would encourage a regulatory process which is open, transparent and publically accountable.’\(^ {51}\)

\(^{47}\) Ibid, p 4.

\(^{48}\) And ibid, at p 7: [the same phenomenon that creates the potential for regulatory arbitrage also creates] the possibility for important issues to ‘disappear down the gaps’, and … among consumers [confusion is created] by an ““alphabet soup”’ of regulators.

\(^{49}\) Ibid, p 11.

\(^{50}\) At p 5, ibid, Taylor discusses the issue of psychological contagion, that is to say a collapse in depositor confidence, not because an entity is directly involved in a loss, but because another entity – a subsidiary – another part of the same conglomerate is involved in a loss. This possibility - that retail depositor panic can set-off a bank run across all associated entities - underscores the importance of a whole-of entity approach to regulation.

\(^{51}\) Ibid, p 1.
V  WEAKNESSES AS COMPARED TO OTHER MODELS

Space constraints do not permit a detailed examination of all the deficiencies that have been observed in existing twin peaks structures and, moreover, not all these deficiencies are exclusive to twin peaks.

These non-exclusive deficiencies include its failure to cover non-bank financial institutions (NBFIs), or so-called shadow banks; problems of co-ordination; and its failure to prevent the market misconduct and consumer abuse that led to the US subprime disaster, which metastasised into an international systemic stability crisis.

Instead, this paper will analyse the vulnerability of the model to bank runs; the limitations of the model as noted by the HIH Commission; the failures of the Australian Securities and Investments Commission; and twin peaks’ failure in the Netherlands.

(a) Bank runs & contagion

Banks are unlike other entities in one crucial respect: a failure in one bank can cause the failure of a different, unrelated bank, even one that is profitable and solvent.

More than anything else, it is the systemic risk phenomenon associated with banking and financial institutions that makes them different from gas stations and furniture stores. It is this factor—more than any other—that constitutes the fundamental rationale for the safety net arrangements that have evolved in this and other countries.55

52 Ibid. p 4.
This widely investigated phenomenon, ‘contagion’, and efforts to prevent it occurring, or at least mitigate its effects, are the core concerns of the regulatory model, twin peaks or otherwise.

Contagion is a term used to describe the spillover effects of shocks from one or more firms to others. It is widely considered to be both more likely to occur in banking than in other industries and to be more serious when it does occur. Bank (depository institution) contagion is of particular concern if adverse shocks, such as the failure or near-failure of one or more banks, are transmitted in domino fashion not only to other banks and the banking system as a whole, but beyond to the entire financial system and the macro economy. The risk of widespread failure contagion is often referred to as systemic risk.56

Typically, contagion originates with a bank run; that is to say, a situation in which a large number of bank customers attempt to withdraw their funds at once, and bank reserves are inadequate.57 Depositor panic in a failing bank can spread to depositors of other institutions. The resulting large-scale withdrawals from banks that are third parties to the original, failing bank can cause rapid insolvency in even profitable, well-capitalised and solvent banks. The cascading withdrawals-cum-insolvencies can become a full-blown financial crisis.58


This is an unavoidable consequence of how banks make money: they engage in maturity mismatching – that is to say, they borrow money short-term from demand depositors, and lend it longer-term, to homebuyers and the like.

It is the fundamental mismatch between bank demand-deposit liabilities ... and the illiquid, risky, and opaque loans collateralizing those insured deposits that gives rise to the current ... problem.\textsuperscript{59}

Secondly, banks engage in a transformative function\textsuperscript{60}: they transform opaque and illiquid assets into transparent and liquid liabilities. The effect of which is, however, that banks cannot liquidate assets fast enough in the face of widespread demand-depositor withdrawals. The ensuing fire sale of assets will further damage a bank’s balance sheet.\textsuperscript{61}

Consequently, while the argument can be made, and strongly, that twin peaks is the optimal model for financial system regulation, it is not a model that guarantees everlasting firm solvency, nor does it claim to be able to prevent the collapse of individual firms. Taylor


\textsuperscript{60} For more on the transformation function, see: Douglas W. Diamond & Philip H. Dybvig, “Bank Runs, Deposit Insurance, and Liquidity”, \textit{Journal of Political Economy}, Vol. 91, no. 3 (June, 1983), p 402.

\textsuperscript{61} For more on asset stripping by banks in times of distress, see: R. C. Merton & Z. Bodie, op cit, p 14/15.
acknowledges this, as do the Australian authorities (as the next section, dealing with HIH, will demonstrate).

While there are steps in place to manage the exit of a bank from the financial system, through such methods as ‘living wills’, twin peaks nonetheless does not have an answer if the collapse of one bank leads to widespread depositor panic and widespread financial firm distress. It is, therefore, susceptible to being overwhelmed by a crisis.

The interconnectedness of financial institutions can also result in the failure of one player quickly affecting others. This applies particularly in the banking sector, and can occur either because other institutions are directly or indirectly exposed to a failed bank or because of a loss of confidence amongst banks in each other’s ability to meet future obligations when they fall due, thus triggering a liquidity freeze as evidenced at the start of the GFC. Moreover, the public may lose trust in the banking system and a bank run may ensue. Although the Reserve Bank’s role of lender of last resort means that it has an effective response to any bank runs, these situations can easily spill over to the real economy; for example, in the form of a credit crunch. A key objective of prudential regulation and supervision is to reduce these risks.

(b) Australia’s twin peaks failures: the collapse of HIH
When HIH insurance collapsed on March 15 2001, it was the second largest insurance company in Australia. This makes HIH one of the biggest collapses in Australian corporate history. HIH was a

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64 Toby Fiennes & Cavan O’Connor-Close, op cit, p 6.

65 Rob Curtis, “Solvency as a Focal Point of Prudential Regulation: Supervisory Lessons and Challenges”, Chap. 6, in The Future of Insurance Regulation and
regulated entity, under the jurisdiction of the system stability regulator, APRA.

After HIH’s collapse, the Royal Commission constituted to investigate the incident found as follows:

APRA did not cause or contribute to the collapse of HIH. Nor could it have taken steps to prevent the failure of the company. APRA could not be expected to provide a guarantee that no company it regulated would ever fail. However, the regulatory function was designed to minimise the possibility that a general insurance company would fail. The system gave APRA the ability to detect the early warning signs that a company might fail. APRA’s failure to pick up the many signs that HIH was heading towards statutory and commercial insolvency highlighted a number of systemic weaknesses in its administration of the regulatory system.  

Two implications emanate from this.

The first is that weaknesses in the application of the model can bring the model undone. Several problems arise as a result. One such problem is that there are no guarantees that problems of application will be discovered through reviews and inquiries. The possibility remains that problems of application will only be discovered through failure or distress, as happened with HIH. Other obstacles to adequate and consistent application relate to the adequate resourcing of the regulator, the creation of the appropriate culture within the regulator, and the degree to which the legislator is captured by the financial industry.  

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The second implication from the HIH Royal Commission finding is that in Australia, the leading proponent of twin peaks, it is accepted that the model will have to tolerate, at least, individual firm failure. That position persists to this day.\(^70\)

VI VARIATIONS IN THE MODEL

It should be noted that twin peaks is a work in progress. Among the countries that now use this model - Australia, New Zealand, the Netherlands and the United Kingdom - differences exist.

(a) Monopolistic versus Non-monopolistic Location of the Bank Regulator

While in Australia the prudential regulator is an entity separate from the National Central Bank (NCB) – the Reserve Bank of Australia (RBA) - such non-monopolist arrangements are not universal. That is to say, there are instances where the regulator is part of the NCB (monopolist regimes), and others where the regulator is separate (non-monopolist regimes).

There is no definitive answer as to which regime is preferable, but the available evidence favours a non-monopolist approach. The advantages and disadvantages of each are as follows:

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(i) The monopolist approach

The monopolist approach has a number of advantages. Chief among these are the synergies and efficiencies enjoyed by locating the regulator within the NCB. Further, in jurisdictions lacking a strong tradition of independent regulatory agencies, advantages may be gained by locating the regulator within an NCB if the NCB has a strong tradition of independence, as is the case with the most recent adopter of twin peaks, South Africa and the South African Reserve Bank, whose independence is enshrined in the South African Constitution.

‘The South African Reserve Bank, in pursuit of its primary object, must perform its functions independently and without fear, favour or prejudice, but there must be regular consultation between the Bank and the Cabinet member responsible for national financial matters.’

‘So essentially, the SARB and the finance ministry-controlled national treasury are the monetary authority in South Africa, although the Constitution expressly enshrines the SARB’s independence … The apparent contradiction - being independent on the one hand and having joint authority over monetary matters with the finance ministry on the other - tends to cause confusion amongst South Africans and seemingly friction between the SARB and the government.’

Additionally, the NCB may be able to gain valuable insights into the state of the economy by conducting the activities of the Prudential Authority (PA). Di Noia et al state that an ability


73 Carmine Di Noia & Giorgio Di Giorgio, “Should banking supervision and monetary policy tasks be given to different agencies?”, International Finance, Vol.
to influence bank policy through regulatory pressure may add to the efficacy of monetary policy. They argue that, due to the interrelationship between the activities of the NCB and the PA, co-ordination is a necessary prerequisite. Management of the payments system to contain systemic risk may also require access control and monitoring of the participants in the system.

Doubtless this is correct, but co-ordination does not of necessity preclude two separate entities.

According to Haubrich, the information advantages derived from a monopolistic approach are ‘particularly needed in times of financial crisis, when only direct supervision can deliver the essential information on time.’ Similarly, a central bank supervising the banking system may be better placed to know whether a bank seeking assistance from the NCB as lender of last resort is insolvent or simply illiquid. However, as Goodhart et al. argue, ‘the revealed preference

2, no. 3 (November, 1999), p 367. The authors cite a study into the US economy in which confidential supervisory information on bank ratings allowed the Federal Reserve to make more accurate predictions on macro-economic variables such as rates of inflation and unemployment. Ibid, p 367.


76 Carmine Di Noia & Giorgio Di Giorgio, op cit, p 367.


79 Carmine Di Noia & Giorgio Di Giorgio, op cit, p 368. See also: Vasso P. Ioannidou, “Does monetary policy affect the central bank’s role in bank
of monetary authorities has been to rescue banks running into difficulties, so long as there appeared to be any risk of a systemic knock-on effect.\textsuperscript{81} and, that consequently the argument in favour of an NCB being better placed to know whether a bank seeking credit merits assistance, does not hold. Additionally Haubrich’s argument does not of necessity exclude a non-monopolist approach. Close co-ordination, as currently exists in Australia, between the NCB and the PA, with clearly defined processes,\textsuperscript{82} may provide the necessary mechanisms for systemic stability.\textsuperscript{83}


\textsuperscript{81} Vasso P. Ioannidou, “Does monetary policy affect the central bank’s role in bank supervision?”, \textit{op cit}, p 61.


\textsuperscript{83} Contra, see Vasso P. Ioannidou, “Does monetary policy affect the central bank’s role in bank supervision?”, \textit{op cit}, p 61, fn 3: ‘This argument assumes that it is not possible for a third party, responsible for bank supervision, to transfer information effectively to the LOLR. This assumption is clearly debatable. However, it seems more plausible during periods of financial instability, since the speed and the degree with which the condition of an institution deteriorates is significantly higher during periods of financial instability. Moreover, it is in “bad” times that institutions are more likely to “cook” their books and hide their true condition. Hence, under these
Moreover, a separation between the PA and the NCB may serve to insulate the NCB from the reputational harm\(^84\) associated with the failure of a regulated institution, as was the case with the collapse of the Australian insurer, HIH.\(^85\)

(ii) The non-monopolist approach

While empirical evidence remains scant, one survey \(^86\) finds that inflation is ‘considerably higher and more volatile’ in countries where the PA is located within the NCB.\(^87\) In addition, a non-monopolist regulatory approach can be said to comport more closely with the Core Principles in Basel III - in particular Principle 2\(^88\) - and is often synonymous with a more competitive financial system.\(^89\)

Di Noia et al \(^90\) find evidence of this in higher lending-borrowing spreads in countries with a PA integrated into the NCB, as well as the other indicators of bank profitability and efficiency, both of which are lower in countries with an integrated, monopolist NCB-PA structure. For example, staff costs are on average 50 per cent higher, and bank reserves as much as 300 per cent higher, in circumstances direct supervision could help deliver the essential information on time.’

\(^84\) Carmine Di Noia & Giorgio Di Giorgio, op cit, p 369.

\(^85\) See: The HIH Royal Commission, 16 April, 2003.

\(^86\) Carmine Di Noia & Giorgio Di Giorgio, op cit.

\(^87\) Ibid, pp 361, 372. According to their research, anywhere from 50 per cent to 100 per cent higher. Ibid, p 370. Contra, see: Vasso P. Ioannidou, “Monetary Policy And Bank Supervision”, op cit, p 1.


\(^89\) Carmine Di Noia & Giorgio Di Giorgio, op cit, p 373.

\(^90\) Ibid, p 373/4.
monopolistic jurisdictions. Crucially, such a major difference in reserves between monopolist and non-monopolist countries is ascribed to the difference in the way in which the compulsory reserve requirement is employed between the two. In the former this requirement is used both as a monetary policy tool and a form of depositor protection. 91 Furthermore, countries with monopolist regimes are typified by higher non-bank deposits, and less intensive use of the interbank market.92

Banking sectors in ‘monopolist’ countries are more protected and somehow less developed and efficient than those in ‘non-monopolist’ countries.93

There are, in addition, conflicts of interest94 that ought to be considered when locating the PA. The NCB’s focus is primarily a macro-prudential one, whereas the PA’s focus is chiefly micro-prudential. Consequently, as lender of last resort, the NCB may find itself under pressure to assist regulated institutions when the PA is located within the NCB. It is argued that such conflicts of interest are best avoided.

For example, a typical conflict that may arise is that the NCB is concerned with the stability of the banking system, primarily for the effect that that instability may have on the payments system, its capacity to transmit monetary policy signals, and the costs associated with its lender of last resort function in a crisis.95 Conversely, the PA’s primary concern is monetary stability, for the effect it has on interest rates and possibly exchange rates96 and, in turn, the effect those factors have on bank profitability and, by implication, bank soundness.

91 Ibid, p 375.
92 Ibid, p 376.
93 Ibid, p 376.
94 See also: ibid, p 368.
95 Ibid, p 367.
96 Ibid, p 367.
Within this more usual context, the conflict of interest may arise between the monetary authorities, who wish for higher rates (e.g. to maintain an exchange rate peg, to bear down on inflation, or to reduce the pace of monetary growth), and the regulatory authorities who are frightened about the adverse effects such higher rates may have upon the bad debts, profitability, capital adequacy and solvency of the banking system.97

The corollary to this is when the monetary authority displays a preference for lower interest rates. If, in such an environment, bank profitability is typically low, or bank balance sheet structures are vulnerable to lower interest rates, then a further lowering of interest rates may contribute to greater bank vulnerability, and may be opposed by the PA. This potentially creates an irreconcilable tension between the PA and the NCB. Conversely, excessive focus on the PA’s concerns in the setting of monetary policy may worsen bank fragility in the long run.98

The sign on the estimated coefficient of monetary policy indicates that when the Fed tightens monetary policy, it becomes less strict in bank supervision (i.e., an increase in interest rates or a decrease in reserves is associated with a lower probability of intervention). One possible explanation is that the Fed tends to be less strict on bank supervision in order to compensate banks for the extra pressure it puts on them when it tightens monetary policy. The Fed might be interested in compensating troubled banks either because it is concerned about possible adverse effects from bank failures on its reputation or because it is concerned about possible knock-on effects. After all, the Fed is responsible for maintaining the

97 Charles Goodhart & Dirk Schoenmaker, “Institutional separation between supervisory and monetary agencies”, op cit, p 361.
stability of the financial system and it is responsible for the supervision of some of the biggest banks in the United States.99

A further instance for potential conflicts of interest between the NCB and the PA include the expectation that the NCB will be influenced by stability considerations, when determining monetary policy,100 or that the NCB may employ open market operations and access to the discount window as a supervisory instrument.101

Lastly, Di Noia et al102 assert that conflicts may arise between macro (monetary) and micro (regulatory) policy. Monetary policy tends to be anti-cyclical, whereas regulatory policy tends to be pro-cyclical.103 Di Noia et al104 cite an example where, during an economic slowdown, a bank’s non-performing assets may increase, precipitating higher loan-loss provisioning rules, and pressure from the regulator to increase the quality of the bank’s portfolio. As Tuya et al105 point out, this leads to a restriction in credit at precisely the time when monetary policy should be expansionary.

VII CONCLUSION

The wisdom of the objectives-based architecture [has] been borne out to a considerable extent by the Australian experience.

“This model avoids the conflict of objectives faced by

99 Vasso P. Ioannidou, “Does monetary policy affect the central bank’s role in bank supervision?”, op cit, p 60.
100 Carmine Di Noia & Giorgio Di Giorgio, op cit, p 369.
102 Carmine Di Noia & Giorgio Di Giorgio, op cit, p 369.
104 Carmine Di Noia & Giorgio Di Giorgio, op cit, p 369.
105 José Tuya & Lorena Zamalloa, op cit, p 670.
regulators under virtually every other architecture. Where an agency faces multiple objectives there is a danger … that one will, for whatever reason, dominate the other in terms of visibility with senior management and/or allocation of resources (as appears to have been the case with Northern Rock in the UK).”

The twin peaks regime has principally six advantages. First, by assigning each regulatory agency a single objective, there is maximum regulatory focus.

Second, there are significant potential synergies in bringing together all regulators of a particular market. APRA, for example, was able to bring together best practices from banking and insurance regulation to create a stronger framework for both. APRA was also one of the first agencies to apply a broad risk-based supervisory approach to all prudentially regulated sectors of the financial system. Similarly, Australia was one of the first countries in the world to introduce a single licensing regime for market participants, by bringing all markets under ASIC’s purview.

Third, bringing all prudentially regulated entities under the one roof is conducive to eliminating regulatory arbitrage. Prior to the creation of APRA, there were at least three different types of institution able to issue demand deposits in Australia. These were regulated by nine different agencies. Following its creation, APRA introduced a fully harmonized regime for all deposit-taking institutions. These are now regulated as “Authorized Deposit-taking Institutions” (ADIs) under a single licensing regime. This coherence over deposit taking was important in preventing a shadow banking sector from emerging in Australia.

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Fourth, bringing all prudentially regulated institutions under one roof should facilitate a more consistent and effective approach to regulating financial conglomerates. APRA has been at the forefront of international efforts to develop a framework for consolidated supervision of conglomerates.

Fifth, allocating a single objective to each regulator minimizes the overlap between agencies and the inevitable turf wars that accompany such overlaps. There are always grey areas in practice, however neat the principles might appear in theory. The greatest potential overlaps are between prudential regulation and systemic stability regulation on the one hand (to the extent that prudential soundness provides one of the key foundation stones for systemic stability), and between prudential and conduct regulation on the other (to the extent that they each involve regulation of different aspects of the same institutions). Notwithstanding the potential for overlap, these have tended to diminish, rather than amplify, with time and experience. In part this is a consequence of the clear lines of responsibility in each situation. And, in part, it is a consequence of the determination by the key parties to cooperate in the interests of the system as a whole.

Sixth, the allocation of a single objective to each agency should minimize cultural clashes. As a general rule, conduct agencies are dominated by lawyers. Prudential agencies, in contrast, are typically dominated by accountants, economists, and finance experts. When these two groups are combined in the same agency there can be a clash of cultures as one seeks to dominate the other.107

VIII REFERENCES

(a) Statutes


(b) Other references


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