Integrated Financial Supervision
Lessons of Scandinavian Experience

Several industrial countries have recently merged their banking, securities, and insurance regulators. Of these, three Scandinavian countries have the longest experience with integrated financial sector supervisory agencies, which have enjoyed considerable success. Would such agencies also make sense in developing and transition countries?

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INTEGRATED financial regulation—in which banking, securities, and insurance regulation is combined within a single agency—was first tried in Scandinavia more than a decade ago. Although international interest in the idea has recently been kindled by the United Kingdom's recent, dramatic decision to form the Financial Services Authority, many countries considering this type of supervisory arrangement may have more to learn from the Scandinavian experience. Denmark, Norway, and Sweden not only have longer experience with operating integrated regulatory agencies but also introduced them for reasons that are more relevant to developing and transition countries than those that influenced more recent converts to integrated regulation, such as Australia and the United Kingdom.

First, Scandinavian interest in the concept of integrated financial regulation predated, to a large extent, the financial trends that have led to its adoption in other industrial countries. The chief argument advanced for integrated regulation during the last few years is that it has been made necessary by the creation of new financial instruments, owing to the unbundling and rebundling of services offered by different types of financial services firms. Consequently, the boundaries of the banking, securities, and insurance sectors have blurred. Integrated financial sector supervision offers a response to these developments by bringing all regulatory functions together within a single organization. Many developing and transition economies have yet to experience this type of financial innovation, however. Hence, developing the ability to respond to such innovations is less important to them than developing effective supervisory capacity.

The three Scandinavian countries embarked on supervisory integration for other reasons that also concern developing and transition economies. The first was the need to respond to the development of financial conglomerates—in which banking, securities, and insurance businesses are combined—that were coming to play a dominant role in their financial sectors. Equally important were their desires to build supervisory capacity and to achieve synergies and economies of scale in countries with comparatively small financial sectors. Given all these considerations, it is appropriate to examine the Scandinavian experience with integrated supervision to determine whether it holds any general lessons for other countries contemplating such a move.

Scandinavian experience

Norway was the first country to establish an integrated financial sector supervisory agency in 1986, followed by Denmark in 1988 and Sweden in 1991. There are a number of similarities in the general outline of their systems. The scope, powers, and governance arrangements of the three agencies bear a strong family resemblance. The Scandinavian agencies each have a broadly similar regulatory scope. They regulate banks,

nonbank investment firms, and insurance companies, mainly to ascertain their solvency. How such firms conduct business and other consumer protection concerns are not the agencies' primary responsibilities, but instead are assigned to various ombudsman schemes. The agencies have similar staffing levels and are funded by levies on the regulated industries rather than by general government revenues. Such funding secures the agencies some independence from their finance or economic ministries, to whom they ultimately report. Their independence in each country is further buttressed by a supervisory board, which oversees the general policy and operations of the agency. The strongest guarantee of agency independence in the three Scandinavian countries, however, is the transparency of the political process, which means that any directives ministers give to the regulatory agency are open to public scrutiny.

The backgrounds to regulatory consolidation in these countries also had a number of common features. First, each agency was formed at the end of a long process of regulatory consolidation. One consequence was that only the merger of the banking and insurance inspectorates was needed to bring an integrated supervisory agency into being. Second, the merger of the banking and insurance regulatory bodies took place against a background of enhanced linkages between banks and insurance companies. Finally, banking supervision had always been the responsibility of an agency separate from the central bank. This meant that the central bank's powers did not have to be reduced to form the agency.

The Scandinavian countries were also influenced by broadly similar considerations in their decisions to integrate. As noted above, the growth of "bancassurance" business—that is, business done by financial conglomerate groups engaging in both banking and insurance—was a powerful reason for creating an integrated agency, because it would permit better supervision of financial conglomerates. Equally influential, however, was the argument that an integrated agency could achieve significant economies of scale. Centralizing regulatory functions and activities permits the development of joint administrative, information technology, and other support functions. It also facilitates the recruitment and retention of suitably qualified regulatory personnel, because an integrated organization can offer them better career opportunities than small specialized agencies. Finally, it permits the regulatory authority effectively to deploy staff with scarce skills and experience. This economies-of-scale argument might also be referred to as the small-financial-system rationale for integration, because it is especially applicable to countries with small financial systems.

A decade after integrated agencies were established in Scandinavia, there is a strong consensus on the benefits of integrated supervision. In none of the three countries have any regrets been expressed about the decision to integrate financial supervision, and the new agencies are widely viewed as having delivered significant benefits. The small-financial-system rationale for integrated supervision is viewed as having been conclusively vindicated by experience. All three agencies believe that they have achieved efficiency gains and economies of scale.

There is also little doubt that the creation of integrated agencies has, in a number of different ways, significantly improved the standing of financial regulation in Denmark, Norway, and Sweden. First, the creation of a (comparatively) large, quasi-autonomous regulatory body has brought financial sector regulation a higher status within national governments than separate specialist agencies could have. Integrated regulatory agencies have been more successful than specialist agencies in securing the funding needed to carry out their responsibilities. Second, the creation of a high-profile agency of sufficient size to offer a degree of career progression for its staff has helped to overcome problems of staff recruitment and retention. This, in turn, has enabled each country's integrated regulatory agencies to develop a cadre of professional staff.

Although integrated regulation has contributed to improved regulatory standards and the building of supervisory capacity, it has made only limited progress to date in improving coordination of the supervision of financial conglomerates. One reason is that—except in Norway—administrative reorganizations were not accompanied by radical reviews of existing legislation. This has resulted in the absence of a single, coherent financial services statute under which conglomerates can be regulated. A second reason concerns the agencies' internal organizations. Most started life by preserving their predecessor agencies as separate divisions within the new organizations, an arrangement that has not significantly improved their ability to communicate. More recent attempts at reorganization have resulted in matrix management structures that are still being refined. It is too early to say whether these new organizational forms will help the integrated agencies to bring about the hoped-for improvements in the supervision of financial conglomerates.

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Effects on developing and transition countries

So, what light does the Scandinavian experience shed on whether developing and transition countries should adopt an integrated model of supervision? Several special characteristics of developing and transition countries differ from those of Scandinavian countries. In many developing and transition countries, banking supervison has, rightly, been seen as a priority, given that their financial sectors are dominated by banks. Accordingly, these countries have made significant efforts to strengthen their banking supervisory functions, which are almost always carried out by their central banks. A real risk of creating an integrated supervisory agency in this environment is that it may lead to a reduction in banking supervisory capacity, as professional staff opt to leave rather than to lose the pay and status usually associated with being a central bank employee. The reputation of banking supervison may also suffer if it is associated with weaker securities and insurance supervisory agencies.

Maintaining the banking supervisory function within the central bank may also have another advantage. In many transition economies, central banks have been established with strong guarantees of their independence, which can help to shield banking supervision from undue parliamentary or ministerial influence. Even the process of legislating to bring a new integrated supervisory authority into being will entail a variety of risks, not least that it could open a Pandora's box of issues as various special interests struggle to control the new legislation. Even if the legislative process proceeds smoothly, a dangerous vacuum of authority could be created as the new agency struggles to establish its credibility.

These considerations suggest that embarking on integration in a developing or transition country could have serious potential drawbacks. The Scandinavian experience suggests, however, that it could have some benefits as well, and both sides of the argument need to be carefully balanced.

The Scandinavian experience has indicated that the strongest justification for creating an integrated supervisory agency is the small-financial-system rationale. This consideration also seems to apply to many transition and developing countries because, even though their populations are often much larger than those of the Scandinavian countries, their financial systems, measured in terms of assets or capital, are approximately the same size or smaller. Human resources will inevitably be thinly spread in any small financial system. But in many of the developing and transition countries, this problem is compounded by the fact that they are still building up their human capital. One of the clear benefits from the Scandinavian experience is that integrated supervision has permitted the formation of a relatively strong cadre of regulatory professionals. Where such a cadre is still being developed, the argument that all the relevant human capital should be concentrated in a single organization becomes particularly strong.

Another aspect of the small-financial-system rationale—the desire to achieve economies of scale in support and infrastructure services—is also relevant to developing and transition countries. These benefits should not be underestimated in an environment of severe budgetary constraints on agencies. It should also be noted, however, that there are other possible approaches to obtaining the same economies of scale. Finland—as noted in the box—offers an alternative model to that of the integrated supervisory agencies adopted in the other Scandinavian countries.

The financial-conglomerate argument may also be relevant, despite the fact that transition and developing country financial systems remain bank dominated, with comparatively undeveloped securities markets and few nonbank financial intermediaries like insurance companies or mutual funds. In these countries' markets, a wide range of financial services are often provided by banks. In such cases, the bank regulatory agency might regulate not only banks but also all other types of financial intermediaries and activities to help ensure that all banks' activities are subject to effective consolidated supervision. The important point is that the organization of regulation must reflect the organization of the industry it regulates.

A final argument in favor of integrated supervision is that it is well adapted to financial sectors undergoing rapid change and innovation—for example, as a result of recent financial liberalization. Integrated supervision makes it comparatively difficult for potential problems to disappear through the cracks between regulatory jurisdictions. The financial sectors of many transition and developing countries are undergoing rapid transformation, especially in the immediate aftermath of liberalization. The emergence of new types of financial intermediaries and new financial products may leave conventional regulatory structures struggling to keep pace.

A decision to create an integrated supervisory agency also raises the issue of its relationship with the central bank. In some developed country markets, the formation of integrated agencies has been encouraged by the separation of banking supervision and monetary policy functions associated with central bank independence. By contrast, as mentioned earlier, there are strong reasons for retaining banking supervision as a central bank function in developing and transition countries. If a decision is taken to remove banking supervision from the central bank, careful consideration will need to be given to crisis-management arrangements. In this respect, the Scandinavian experience has comparatively little guidance to offer, because banking supervision has never been a central bank function there. By contrast, in the United Kingdom, the Financial Services Authority was formed in part from the Bank of England's banking supervision division. One consequence is that the United Kingdom has adopted a more formalized approach to crisis managment—based on a tripartite memorandum of understanding among the finance ministry, the central bank, and the integrated supervisory authority—than have the Scandinavian countries. This might also serve as a model for other countries considering integration of their financial supervisory agencies.

Provided a central bank has strong guarantees of its independence, there may be a case for establishing the integrated supervisory agency as an autonomous agency administratively connected to the central bank, following the Finnish model. Alternatively, these functions could be merged within the monetary authority, as in Singapore. An argument against pursuing either approach is that doing so may encourage moral hazard by implicitly extending the central bank's guarantee of support across the whole financial sector. If the integrated agency is not associated with the central bank, however, it will need to be operationally and financially independent of government.

Conclusion

The Scandinavian experience sheds some light on the question of the conditions under which a developing or transition country should consider moving to an integrated financial sector supervisory agency:

• The economies-of-scale argument for establishing an integrated agency in a small transition or developing country—or, indeed, any country with a small financial sector—is a strong one.

• 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 nonbank financial sector is unlikely to be able to sustain separate and effective regulatory agencies.

• Countries falling into neither of the above-mentioned categories must weigh the pros and cons of moving to the integrated model in the contexts of their own institutional settings. F&D

Supervisory organization in Finland

The main reason that Finland has not adopted an integrated financial sector supervisory agency is the difficulty of combining a unique system of compulsory pensions and other social insurance with market-based financial supervision. Finland's Financial Supervision Agency regulates only banks and securities firms, with insurance companies and compulsory private sector pension schemes regulated by the Insurance Supervisory Agency. Another explanation is that Finland's banking-insurance industry linkages are less developed than those of other Scandinavian countries. The Financial Supervision Agency is administratively connected to the central bank, sharing its support infrastructure—including data collection, administrative support, and human resource functions—and actively cooperating with it to provide professional expertise on financial market stability issues and to supervise payment and settlement systems. This is an alternative way of achieving economies of scale but also reflects the fact that the Finnish banking crisis of the early 1990s pointed to the need for enhanced linkages between the (then) Bank Inspectorate and the Bank of Finland.

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Suggestions for further reading:

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