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Twin Peaks: An Analysis of the Australian Architecture

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Twin Peaks: An Analysis of the Australian Architecture

Abstract

This article provides an analysis of the Australian 'Twin Peaks' model of financial system regulation. It does so by examining the theoretical underpinnings of Twin Peaks, and investigates the crucial question of the jurisdictional location of the prudential regulator. This includes a description of how Twin Peaks functions and its strengths and weaknesses. The article argues that while Twin Peaks is the best solution to the problem of regulating for financial system stability and consumer protection, it is nonetheless imperfect to the task, and susceptible to failures.

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TWIN PEAKS: AN ANALYSIS OF THE AUSTRALIAN ARCHITECTURE

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I ABSTRACT

This article provides an analysis of the Australian ‘Twin Peaks’ model of financial system regulation. It does so by examining the theoretical underpinnings of Twin Peaks, and investigates the crucial question of the jurisdictional location of the prudential regulator. This includes a description of how Twin Peaks functions and its strengths and weaknesses. The article argues that while Twin Peaks is the best solution to the problem of regulating for financial system stability and consumer protection, it is

¹ This research was undertaken in major part thanks to the generosity of financial support from the Centre for International Finance and Regulation (CIFR) in Sydney, Australia. That support, and support in numerous other forms from CIFR, is hereby acknowledged with gratitude. Helpful comments and suggestions from Dr Michael Taylor, the father of Twin Peaks, Professor Jeffrey Carmichael, Foundation Chair of the Australian Prudential Regulation Authority, Professor David Llewellyn, Chair of the Banking Stakeholder Group of the European Banking Authority, and Dr Patrick McConnell are acknowledged with great appreciation, as is the guidance and friendship of Mr Andrew Godwin.

nonetheless imperfect to the task, and susceptible to failures.

IIINTRODUCTION

This article presents a theoretical analysis of the ‘Twin Peaks’ model of financial system regulation², with particular reference to the Australian version³ and an analysis of the crucial question of the jurisdictional location of the prudential regulator.

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.⁴ Secondly, an understanding of the strengths and

² Originally proposed by Taylor in Michael W. Taylor, “*Twin Peaks*”: *A regulatory structure for the new century*, no. 20, Centre for the Study of Financial Innovation, December, 1995.

³ For a discussion of the alternative models of financial system regulation, such as the UK’s Financial Services Authority, see: Andrew D. Schmulow, “The four methods of financial system regulation: An international comparative survey”, *Journal of Banking and Finance Law and Practice*, Vol. 26, no. 3 (November, 2015).

⁴ For more on the benefits of financial system stability, see: David T. Llewellyn, “Institutional Structure of Financial Regulation and Supervision: The Basic Issues”, Paper presented at the World Bank seminar *Aligning Supervisory Structures with Country Needs*, Washington, DC, series editor: The World Bank, 6th and 7th June 2006, p 5.

weaknesses of the Twin Peaks model may be of benefit to academics and policy-makers alike.

While Twin Peaks is imperfect to the task of regulating to prevent financial crises or consumer abuse, of the four models currently in use internationally, ‘Twin Peaks’ is widely regarded⁵ as the best suited to this task.

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.⁶

The Australia version 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 Inquiry⁷), and in other countries where Twin Peaks has

⁵ See for example: John C. Coffee, Jr. & Hillary A. Sale, “Redesigning the SEC: Does the Treasury have a better idea?”, *Virginia Law Review*, Vol. 95 (June, 2009), p 774; Alex Holevas, “Twin Peaks: The envy of the world”, ‘News’, *Wealth Professional*, 22 February, 2012. See also John Manley, “Dutch regulator says “Twin Peaks” supervision best”, ‘Financial Regulatory Forum’, *Reuters*, US ed., 9 October, 2009. For IMF analysis of the model’s strengths see: International Monetary Fund, *Financial Sector Supervision: The Twin Peaks Model - Technical Note*, in ‘Financial Sector Assessment Program Update - Kingdom of The Netherlands-Netherlands, IMF Country Report’, no. 11/208, International Monetary Fund (IMF), June/July, 2011, p 12ff.

⁶ Financial Markets Authority (FMA), “Presentation by Sean Hughes to the New Zealand Capital Markets Forum”, ‘News, Speeches’, 17 March, 2011.

⁷ Financial System Inquiry, *Financial System Inquiry Final Report*, Commonwealth Government of Australia, November, 2014.

been adopted, it is the Australian model which has been emulated. The latest example of the adoption of the Australian model (save for the jurisdictional location of the regulator), is the Republic of South Africa⁸.

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’ approach⁹

Moreover, Australia, and in particular its regulatory regime, fared better than most other countries during the GFC.¹⁰ But how much of that success can be attributed to

⁸ Republic of South Africa National Treasury, *A safer financial sector to serve South Africa better*, in ‘National Treasury Policy Document’, National Treasury, Republic of South Africa, 23 February, 2011; Financial Regulatory Reform Steering Committee, *Implementing a twin peaks model of financial regulation in South Africa*, Financial Services Board, 1 February, 2013; Republic of South Africa National Treasury, “Implementing Twin Peaks Regulation in South Africa”, *Media Statement*, (1 February, 2013), (accessed: 19 December, 2014), published electronically; A. J. Godwin & A.D. Schmulow, “The Financial Sector Regulation Bill In South Africa: Lessons From Australia”, *South African Law Journal* (forthcoming, 2015); *Financial Sector Regulation Bill*, 11 December, 2013, (Republic of South Africa).

⁹ Alex Erskine, *Regulating the Australian Financial System*, in ‘Funding Australia’s Future’, Australian Centre for Financial Studies, July, 2014, p 43.

¹⁰ Jennifer G. Hill, *Why Did Australia Fare So Well in the Global Financial Crisis?*, in ‘The Regulatory Aftermath of The Global Financial Crisis, in Sydney Law School Research Paper’, no. 12/35, 20 May, 2012, p 16 ff.

Twin Peaks¹¹, and how much to a combination of good luck and good fiscal policy, remains unclear.

A quick analysis of APRA's media releases shows that of the 160 press statements since the beginning of 2008, only 16 relate to regulatory censure, or in regulator-speak "enforceable undertakings"¹².

To underscore this point it is of note that the Netherlands employed Twin Peaks prior to the GFC and, as this article will discuss in greater detail below, the Netherlands fared poorly.

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 capabilities of this model.

The article commences with a description of Twin Peaks, followed by an examination of the deficiencies thereof. A decision to adopt Twin Peaks requires a decision as to whether or not to locate the prudential peak within the Central Bank (NCB), and an analysis of this aspect follows. Finally, the article presents concluding observations.

¹¹ Cf. Australian banks were poorly regulated: Pat McConnell, "Debunking the myth of our 'well-regulated' banks", 'Business & Economy', *The Conversation*, 13 September, 2012 6.38am AEST.

¹² Ibid.

III WHAT IS TWIN PEAKS?

(a) A definition

A Twin Peaks regulatory model comprises two peak regulators: one, the objective of which is enforcement of prudential regulation; and a second, the objective of which is market conduct and consumer protection.¹³ In Australia these are the Australian Prudential Regulation Authority (APRA), and the Australian Securities and Investments Commission (ASIC) respectively. The title is somewhat of a misnomer, in that the National Central Bank (NCB), which in Australia is the Reserve Bank of Australia (RBA), has responsibilities as the Lender of Last Resort (LLR)¹⁴, and overall responsibility for financial system stability.¹⁵ Consequently it may be more correct to call the Australian model a Triple Peak system.

¹³ Working Group on Financial Supervision, *The Structure of Financial Supervision. Approaches and Challenges in a Global Marketplace*, in 'Special Report', Group of Thirty, Consultative Group on International Economic and Monetary Affairs, Inc., 2008, p 24. For a complete analysis of the four approaches to financial regulation, see also: David T. Llewellyn, op cit; Andrew D. Schmulow, *Journal of Banking and Finance Law and Practice*, op cit. For a more complete exposition of what is involved with financial system regulation, and conduct of business and consumer protection, see: David T. Llewellyn, op cit, p 6.

¹⁴ Glenn Stevens, "*Liquidity and the Lender of Last Resort*", in *Speeches*, published by Reserve Bank of Australia, 15 April 2008, accessed: 24 September, 2015.

¹⁵ Reserve Bank of Australia, "*Role of the Reserve Bank in Maintaining Financial Stability*", in *Financial Stability*, published by Reserve Bank of Australia, 2001-2015, accessed: 24 September, 2015.

It should be noted that the overall objective of prudential regulation is to prevent fragility among individual financial entities. Consequently it may be argued that both the prudential regulator and the central bank are concerned with financial system stability¹⁶; the regulator at the micro-level, the central bank at the macro-level. This has implications for the location of the regulator □ within the central bank or without □ to which this article will return.

(b) Adoption

Twin peaks was introduced in Australia in 1998 in response to the recommendations of the Wallis Inquiry.¹⁷ The original proposal was not Australian, however. It was first suggested by an Englishman, Michael Taylor, in 1995¹⁸,

¹⁶ In Working Group on Financial Supervision, 2008, p 24, the concepts ‘prudential regulator’ and ‘system-stability regulator’ is conflated to ‘safety and soundness supervision’.

¹⁷ The Report recommended the establishment of a Corporations and Financial Services Commission (CFSC), later ASIC, (Stan Wallis, Bill Beerworth, Professor Jeffrey Carmichael, Professor Ian Harper & Linda Nicholls, *Financial System Inquiry*, The Treasury, 31 March, 1997, p 235), and the creation of the Australian Prudential Regulation Commission (APRC), later APRA (ibid, p 298).

¹⁸ Michael W. Taylor, December, 1995, and subsequently: Michael W. Taylor, *Peak Practice: How to reform the UK’s regulatory system*, no. 23, Centre for the Study of Financial Innovation, October, 1996; Michael W. Taylor, ‘*Twin Peaks’ Revisited... a second chance for regulatory reform*, no. 89, Centre for the Study of Financial Innovation, September, 2009; Michael W. Taylor, “The Road from “Twin Peaks” - and the Way Back”, *Connecticut Insurance Law Journal*, Vol. 16, no. 1 (2009-2010); Michael Taylor, “Welcome to Twin Peaks”, *Central Banking Journal*,

principally as a reaction to the ‘blurring of the boundaries’ phenomenon¹⁹ in the financial services sector in the UK²⁰. Addressing the blurring of the functions between different kinds of financial entities was the progenitor for Twin Peaks. Since addressing that issue, however, its purposes have evolved, with the prudential authority, at least,

Electronic Article (17 August, 2010); Michael W. Taylor, “Regulatory reform after the financial crisis - Twin Peaks Revisited”, Oxford, UK, in ‘Law and Finance Senior Practitioner Lectures’, Wednesday 16 February 2011; Michael Taylor, “Regulatory reform after the financial crisis. *Twin Peaks* revisited”, Chap. 1, in *Institutional Structure of Financial Regulation: Theories and International Experiences* edited by Robin Hui Huang & Dirk Schoenmaker, in ‘Part I, Fundamental theories’, series editor: Routledge Research in Finance and Banking Law, 1st ed., 2014.

¹⁹ Henriëtte Prast & Iman van Lelyveld, *New Architectures in the Regulation and Supervision of Financial Markets and Institutions: The Netherlands*, in ‘DNB Working Paper’, no. 021/2004, De Nederlandsche Bank, 21 December, 2004, p 6/12ff/25; Eric J. Pan, “Structural Reform of Financial Regulation”, *Transnational Law & Contemporary Problems*, Vol. 19, no. 3 (Winter, 2011), p 830; Clive Briault, “The rationale for a single national financial services regulator”, *Financial Services Authority Occasional Paper*, no. 2 (1999), p 6/12/13/26; Heidi Mandanis Schooner & Michael Taylor, “United Kingdom and United States Responses to the Regulatory Challenges of Modern Financial Markets”, *Texas International Law Journal*, Vol. 38, no. 2 (Spring, 2003), p 320ff.

²⁰ For more on this see: Michael W. Taylor, “*Twin Peaks*”: *A regulatory structure for the new century*, December, 1995, p 1; Graeme Thompson, “Regulatory Policy Issues in Australia”, Paper presented at the The Future of the Financial System, Sydney, NSW, edited by Malcom Edey, series editor: Reserve Bank of Australia Economic Group, in ‘RBA Annual Conference’, Vol. 1996, 8-9 July 1996, p 5/46; Richard K. Abrams & Michael W. Taylor, *Issues in the Unification of Financial Sector Supervision*, in ‘IMF Working Paper’, no. WP/00/213, International Monetary Fund, December, 2000, p 10/11/26; Michael Taylor, “Welcome to Twin Peaks”, *Central Banking Journal*, op cit; Working Group on Financial Supervision, 2008, p 7/13/19.

having come to assume an overall safety and soundness role²¹.

Since its introduction in Australia, the model has been adopted in a number of other countries. These include the Netherlands,²² New Zealand²³ and the United Kingdom²⁴. South Africa²⁵ is in the process of adopting this

²¹ Working Group on Financial Supervision, 2008, p 24.

²² A.D Schmulow, *Approaches to Financial System Regulation: An International Comparative Survey*, in ‘The Centre For International Finance and Regulation (CIFR) Research Working Paper Series’, no. 053/2015 / Project No. E018, The Centre For International Finance and Regulation (CIFR), January, 2015, p 33ff; Henriëtte Prast & Iman van Lelyveld, 21 December, 2004, p 2/14/15.

²³ See the remarks of the Chief Executive of New Zealand’s Financial Markets Authority: Sean Hughes, “*Financial Markets Authority - a new era in regulation - Webinar package*”, series edited by New Zealand Law Society, in *Continuing Legal Education*, published by New Zealand Law Society, 25 November, 2011, accessed: 23 November, 2015.

²⁴ See Financial Conduct Authority, “*About us*”, series edited by Financial Conduct Authority, published by Financial Conduct Authority, 2014, accessed: 25 September, 2014 and Prudential Regulation Authority, “*About the Prudential Regulation Authority*”, series edited by Bank of England, in *Prudential Regulation Authority*, published by Bank of England, 2014, accessed: 25 September, 2014.

²⁵ National Treasury, Republic of South Africa, *Financial Sector Regulation Bill, Comments Received on the First Draft Bill Published by National Treasury for Comments in December 2013 (Comment Period from 13 December 2013 - 07 March 2014)*, in ‘Documents for Public Comments - 2nd Draft Financial Sector Regulation Bill’, Vol. 1, National Treasury, Republic of South Africa, December, 2014; A.J. Godwin & A.D Schmulow, *The Financial Sector Regulation Bill In South Africa: Lessons From Australia*, in ‘The Centre For International Finance and Regulation (CIFR) Research Working Paper Series’, no. 052/2015 / Project No. E018, The Centre For International Finance and Regulation (CIFR), January, 2015.

method of financial regulation. France²⁶ and Germany²⁷ use elements of it.

(c) How it functions

The essence of Twin Peaks is a regulatory model which ascribes equal importance to, and equal but separate jurisdictional authority over, two core functions: one, prudential regulation and two, market conduct and consumer protection.²⁸ Crucially, the model eschews the concept of a lead regulator²⁹: each agency must single-mindedly fulfil its own remit.³⁰

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 first peak □ the prudential regulator - as a defence against financial system instability leading to crises. In the

²⁶ A.D Schmulow, *Approaches to Financial System Regulation: An International Comparative Survey*, ibid no. 053/2015 / Project No. E018, p 10ff, C. Goodhart, P. Hartmann, D.T. Llewellyn, L. Rojas-Suarez & S. Weisbrod, “The institutional structure of financial regulation”, Chap. 8, in *Financial Regulation: Why, How and Where Now?*, in ‘Business & Economics’, 2013, p 185ff.

²⁷ A.D Schmulow, January, 2015, p 14ff. C. Goodhart, P. Hartmann, D.T. Llewellyn, L. Rojas-Suarez & S. Weisbrod, op cit, p 185ff.

²⁸ David T. Llewellyn, op cit, p 27.

²⁹ For a description of a ‘Lead Regulator’ model, see: C. Goodhart, P. Hartmann, D.T. Llewellyn, L. Rojas-Suarez & S. Weisbrod, op cit, p 164; Gregg D. Killoren, “Comparative Analysis of Non-U.S. Bank Regulatory Reform and Banking Structure”, *Law & Business*, edited by CCH Incorporated, in ‘Banking & Finance’, 2009, p 9.

³⁰ Gregg D. Killoren, op cit, p 10, David T. Llewellyn, op cit, p 27.

aftermath of the GFC, however, there is left little doubt that for financial system stability the market conduct objective is equally important; it was market misconduct and consumer abuse that gave rise to the subprime disaster, and then metastasized into a worldwide series of financial crises.

*...morphed the subprime crisis into a virulent global financial crisis.*³¹

And on the connection between the subprime crisis and the GFC:

have identified many billions of dollars of fraudulent loans originated by Countrywide^[32] that were sold fraudulently to Fannie and Freddie through false representations and warranties. ...

³¹ Frederic S. Mishkin, *Over the Cliff: From the Subprime to the Global Financial Crisis*, in 'NBER Working Paper Series', no. 16609, National Bureau of Economic Research, December, 2010, p 4; Steve Denning, "Lest We Forget: Why We Had A Financial Crisis", *Forbes*, (22 November, 2011), published electronically.

³² 'In 2006 Countrywide financed 20% of all mortgages in the United States, at a value of about 3.5% of United States GDP, a proportion greater than any other single mortgage lender.' Ray Martin, "Bank of America's great mortgage giveaway", series edited by CBS Money Watch, in *CBS News*, published by CBS Interactive Inc.. 9 May, 2012, 10:32 am, accessed: 26 September, 2015. Bank of America purchased the ailing sub-prime lender Countrywide in January 2008, for US\$ 2.5 billion, in a deal that subsequently incurred losses for Bank of America in excess of US\$ 50 billion. Rick Rothacker, "The deal that cost Bank of America \$50 billion – and counting", 'News, Business, Banking', *The Charlotte Observer*, 16 August, 2014. Bank of America covered those losses with a US\$ 45 billion dollar, taxpayer-funded, bail-out from the Troubled Asset Relief Program (TARP). Pro Publica, *Bailout Recipients*, in 'Bailout Tracker, Tracking Every Dollar and Every Recipient', Pro Publica, 24 September, 2015.

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.³³

³³ L. Randall Wray, “Setting the Record Straight One More Time: BofA’s Rebecca Mairone Fined \$1Million; BofA Must Pay \$1.3Billion”, *New Economic Perspectives*, (2 August, 2014), (accessed: 26 June, 2015), published electronically. See also: Edward Wyatt, “Promises Made, Then Broken, By Firms in S.E.C. Fraud Cases”, ‘Business Day’, *New York Times*, New York ed. 8 November, 2011. For a full list of firms fined for financial malpractice and fraud related to the GFC, see:

While the Australian model provides a high degree of statutory independence for the system stability regulator,³⁴ APRA, it is to a degree answerable to the Treasurer,³⁵ and both APRA³⁶ and ASIC³⁷ to the Federal Parliament by way of submission of Annual Reports. This comports with what Taylor envisaged for the model with either Ministerial or Parliamentary oversight.³⁸

Where the first peak □ APRA □ is responsible for the safety and soundness of banks, the second peak □ ASIC □ is responsible for market conduct and consumer protection. It was argued such a system would be more likely to resolve fragmentation, provide clarity of ambit, be more cost-effective due to rulebook simplification, and improve accountability - more likely, but not assuredly - as the recent failings of ASIC in Australia have demonstrated.³⁹ If the consumer protection and market

U.S. Securities and Exchange Commission, *SEC Enforcement Actions. Addressing Misconduct That Led To or Arose From the Financial Crisis*, U.S. Securities and Exchange Commission, 26 May, 2015.

³⁴ S 11, *Australian Prudential Regulation Authority Act (Cth)*, No. 50 of 1998, (Australia).

³⁵ S 12, *ibid*, p. 4/5.

³⁶ S 59, *ibid*.

³⁷ S 136, *Australian Securities and Investments Commission Act (Cth)*, No. 51 of 2001, (Australia).

³⁸ Michael W. Taylor, “*Twin Peaks*”: *A regulatory structure for the new century*, December, 1995, p. 11.

³⁹ Adele Ferguson, “Hearing into ASIC’s failure to investigate CBA’s Financial Wisdom”, ‘Business Day’, *The Sydney Morning Herald* 3 June, 2014; Adele Ferguson & Deb Masters, “Banking Bad”, in Four Corners, *Audiovisual Material*,

conduct regulator do prove effective, then advantages accrue to consumers for a ‘ “one-stop shop” ’⁴⁰ for complaints against a regulated firm.

In terms of inter-agency co-operation and co-ordination, the Australian model addresses this through various memoranda of understanding.⁴¹

Whereas the legislative framework for regulatory co-ordination is high-level and outcomes-focused, it does not, however, provide detailed provisions as to the nature of co-ordination or how it should be achieved.⁴² Instead, s 10A of the *APRA Act*⁴³ provides in general terms as follows:

(1) The Parliament intends that APRA should, in performing and exercising its functions and powers, have regard to the desirability of APRA coordinating with other financial sector supervisory agencies, and with other agencies specified in regulations for the purposes of this subsection. (2) This section does not override any restrictions that would otherwise apply to

Documentary, 5 May, 2014; Jane Lee, Cameron Houston & Chris Vedelago, “CBA customers lose homes amid huge fraud claim”, ‘Victoria’, *The Age* 29 May, 2014.

⁴⁰ Michael W. Taylor, “*Twin Peaks*”: *A regulatory structure for the new century*, December, 1995, p. 11.

⁴¹ Anonymous, *Memorandum of Understanding*, The Reserve Bank of Australia and The Australian Prudential Regulation Authority, 12 October, 1998.

⁴² A. J. Godwin & A.D. Schmulow, *South African Law Journal*, op cit., p 9 of the article.

⁴³ *Australian Prudential Regulation Authority Act (Cth)*, No. 50 of 1998.

APRA or confer any powers on APRA that it would not otherwise have.

The RBA has asserted that cultivating a culture of co-ordination, under which the main focus is on regulatory performance, rather than regulatory structure, is crucially important. The Assistant Governor (Financial) of the RBA has attributed the efficacy of co-ordination between the regulators in Australia to a culture -

‘where we regard cooperation with the other agencies as an important part of our job, and there is a strong expectation from the public and the government that we will continue to do so... Key aspects [of coordination] include an effective flow of information across staff in the market operations and macroeconomic departments of a central bank and those working in the areas of financial stability and bank supervision. Regular meetings among these groups to focus on risks and vulnerabilities and to highlight warning signs can be very valuable. A culture of coordination among these areas is very important in a crisis because, in many instances, a stress situation is first evident in liquidity strains visible to the central bank, and

*the first responses may be calls on central bank liquidity.*⁴⁴

The success Australia achieved in addressing the challenges arising out of the Global Financial Crisis, and the 2010 Sovereign Debt Crisis, has been attributed to this flexible approach to inter-agency co-operation.⁴⁵ Indeed, in interviews conducted with the regulators in Australia it was evident that over-prescription, or formalisation, would have stifled this flexibility.⁴⁶

⁴⁴ Malcom Edey, “Macroprudential Supervision and the Role of Central Banks”, Paper presented at the Regional Policy Forum on Financial Stability and Macroprudential Supervision Hosted by the Financial Stability Institute and the China Banking Regulatory Commission, Beijing, PRC, in ‘Speeches’, 28 September 2012.

⁴⁵ There are other, credible arguments to be made that the supervisory regime in Australia was incidental to Australia’s success during the GFC. Australian banks were, on the whole, ‘vanilla’. That is to say they were not heavily exposed to mortgage backed securities or collateralised debt obligations. One senior executive at ANZ Bank claimed this was as much foresight as luck: they had identified problems in trading markets and chose not to participate. Stephen Bell & Andrew Hindmoor, *Masters of the Universe, Slaves of the Market*, in ‘Business & Economics, Banks & Banking’, 2015, p 270-273. Australian banks also enjoyed a strong deposit base, they were not reliant upon wholesale funding, had a strong domestic lending portfolio, and were restricted in their own mortgage lending activities. Julia Black, “Regulatory Styles and Supervisory Strategies”, Chap. 8, in *The Oxford Handbook of Financial Regulation*, edited by Niamh Moloney, Eilís Ferran & Jennifer Payne, August, 2015, p 47, fn 129.

⁴⁶ A. J. Godwin & A.D. Schmulow, *South African Law Journal*, op cit., p 12 of the article.

To facilitate this co-operation, Australia has established the Council of Financial Regulators (CFR),⁴⁷ the purpose of which is to oversee inter-agency co-operation.

The CFR is the coordinating body for Australia's main financial regulatory agencies. Its membership comprises APRA, ASIC, the RBA and the Treasury. ... It is a non-statutory interagency body, and has no regulatory functions separate from those of its four members. ... CFR meetings are chaired by the Reserve Bank Governor, with secretariat support provided by the RBA. They are typically held four times per year but can occur more frequently... As stated in the CFR Charter, the meetings provide a forum for:

- identifying important issues and trends in the financial system, including those that may impinge upon overall financial stability;*
- ... appropriate coordination arrangements for responding to actual or potential instances of financial instability, and helping to resolve any issues where members' responsibilities overlap; ...*

⁴⁷ The Council of Financial Regulators, “*The Council of Financial Regulators*”, series edited by The Council of Financial Regulators, published by Reserve Bank of Australia, 2001-2014, accessed: 14 July, 2014.

Much of the input into CFR meetings is undertaken by interagency working groups, which has the additional benefit of promoting productive working relationships and an appreciation of cross-agency issues at the staff level.

The CFR has worked well since its establishment and, during the crisis in particular, it has proven to be an effective means of coordinating responses to potential threats to financial stability...

According to the Reserve Bank of Australia, the experience since its establishment, and especially during the crisis, has highlighted the benefits of the existing non-statutory basis of the CFR.⁴⁸ Furthermore, levels of co-operation and co-ordination between the peaks and the NCB have traditionally been strong⁴⁹.

(d) Separate but equal

The separation of the consumer protection function from the prudential regulation function is the cornerstone and,

⁴⁸ Reserve Bank of Australia, *Submission to the Financial System Inquiry*, Reserve Bank of Australia, March, 2014, p 66.

⁴⁹ Ian Beckett, "Financial regulation in Australia since the GFC", *JASSA, The Finsia Journal of Applied Finance*, no. 3 (2012), p 20.

supposedly, one of the principal advantages of a Twin Peaks system.⁵⁰

In theory, protection of retail consumers would not be subordinated in order not to leave banks distressed.⁵¹ Indeed, in theory, guarding consumers might in fact positively affect the safety and soundness considerations that underpin prudential regulation, by *nipping in the bud* malpractices that, while initially only detrimental to consumers, ultimately become systemic risks.⁵² The example of market misconduct giving rise to the GFC is, in this regard, instructive:

*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 housing bubble and by creating a pool of assets guaranteed to turn into toxic waste once the bubble burst.*⁵³

⁵⁰ Stan Wallis, Bill Beerworth, Professor Jeffrey Carmichael, Professor Ian Harper & Linda Nicholls, 31 March, 1997, in ‘Overview, Introduction’, p 29ff; Michael W. Taylor, “*Twin Peaks*”: *A regulatory structure for the new century*, December, 1995, p 1; Michael W. Taylor, “Regulatory reform after the financial crisis - Twin Peaks Revisited”, op cit, p 5ff; David T. Llewellyn, op cit, p 16/27.

⁵¹ David T. Llewellyn, op cit, p 28.

⁵² See further: *ibid*, § 2, p 10.

⁵³ Paul Krugman, “Looters in Loafers”, ‘Opinion’, *New York Times*, New York ed. 19 April, 2010. See also: Debra Cassens Weiss, “SEC Accuses Goldman Sachs of Selling Mortgage Investment Designed to Fail”, *ABA Journal, Law News Now, Securities Law*, (9:58 am, 16 April, 2010), (accessed: 25 June, 2014), published electronically. Goldman Sachs was fined US\$ 3.15 billion by the Federal Housing

Whether in practice the objective of equality between consumer protection and system stability is achieved, is debatable. Because the consequences of a failure by the prudential regulator □ system instability □ are more serious than the failure of the market conduct regulator □ consumer abuse □ some would argue that the former will always take precedence. Historically there is evidence of this not only in the United States,⁵⁴ but in the United Kingdom⁵⁵ and Australia as well.⁵⁶

Finance Agency for misstating the quality of investments sold to Fannie Mae and Freddie Mac. The 15th bank to settle such claims. Benjamin Snyder, “*Goldman Sachs in \$3.15 billion settlement with federal regulators*”, series edited by Fortune, in *Finance*, published by Time, Inc., 22 August, 2014, 7:50 pm EDT, accessed: 26 September, 2015. At least one Goldman Sachs trader, Fabrice Tourre, has been held financially liable – not imprisoned however - for creating financial products specifically designed, to fail, which he then bet against. Aaron Smith & James O’Toole, “*‘Fabulous Fab’ held liable in Goldman fraud case*”, series edited by CNN Money, in *News*, published by Cable News Network, 1 August, 2013, 6:21 pm ET, accessed: 26 September, 2015.

⁵⁴ For the need to address past regulatory failures, see: Daniel K. Tarullo, “Good Compliance, Not Mere Compliance”, Paper presented at the Federal Reserve Bank of New York Conference, “Reforming Culture and Behavior in the Financial Services Industry”, New York, NY, series editor: Federal Reserve Bank of New York, 20 October 2014, p 9/10; Lawrence G. Baxter, “Capture Nuances in Financial Regulation”, *Wake Forest Law Review*, Vol. 47, no. 3 (Fall, 2012), p 547.

⁵⁵ For proposals to address this phenomenon, see: HM Treasury, Bank of England & Financial Conduct Authority, *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 was not yet available at time of writing.

⁵⁶ See: IV WEAKNESSES AS COMPARED TO OTHER MODELS (c) Australia’s Twin Peaks failures: ASIC and the financial advice scandals.

(e) Advantages

Operating optimally a Twin Peaks model will give equal priority to safety and soundness considerations, 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 soundness of individual banks.

To this end there is evidence that Twin Peaks is better suited to performing these functions than any of the other systems of financial system regulation currently employed elsewhere in the world.⁵⁷ It is potentially more cost effective⁵⁸, and makes a more optimal use of specialist staff⁵⁹. As a model, it is also more likely to give expression

⁵⁷ Erlend W. Nier, Jacek Osiński, Luis I. Jácome & Pamela Madrid, *Institutional Models for Macroprudential Policy*, in 'IMF Staff Discussion Note', no. SDN/11/18, International Monetary Fund, 1 November, 2011, p 15/16. See also: De Nederlandsche Bank, "*IMF publishes its report on financial sector and supervision in the Netherlands*", in *News*, published by De Nederlandsche Bank, 22 June, 2011, accessed: 9 January, 2015; Michael Taylor, "Regulatory reform after the financial crisis. *Twin Peaks* revisited", op cit; Dirk Schoemaker & Jeroen Kremers, "Financial stability and proper business conduct. Can supervisory structures help to achieve these objectives?", Chap. 2, *ibid*; Professor Jeffrey Carmichael, "Implementing Twin Peaks. Lessons from Australia", Chap. 5, *ibid* in 'Part II, International experiences'; Brooke Masters, "Focus on G20 vow to raise financial standards", 'Front Page', *The Financial Times*, Morning ed. 15 October, 2009 03:00 am; John Manley, op cit; Eric J. Pan, *Transnational Law & Contemporary Problems*, op cit, p 822, Michael W. Taylor, *Peak Practice: How to reform the UK's regulatory system*, October, 1996, p 7.

⁵⁸ David T. Llewellyn, op cit, p 12/19.

⁵⁹ *Ibid*, p 19.

to the goal of regulatory competitive neutrality, through the avoidance of the inconsistencies, contradictions and opportunities for arbitrage that come from multiple regulators⁶⁰ - a condition which Taylor described as an 'alphabet soup' of regulators⁶¹, when it existed in the UK, prior to the establishment of the mega-regulator, the Financial Services Authority (FSA).

Twin peaks achieves all this through better regulatory focus through clearer objectives⁶², independence between the two peaks⁶³, one-stop shopping for aggrieved consumers seeking relief⁶⁴, an avoidance of conflicts and inconsistencies in regulation as a result of regulators too many, or internal failures, magnified by having regulators too few (as with the FSA⁶⁵), greater jurisdictional certainty through clearer mandates, an

⁶⁰ Ibid, p 19.

⁶¹ Michael W. Taylor, "*Twin Peaks*": *A regulatory structure for the new century*, December, 1995, p 7.

⁶² David T. Llewellyn, op cit, p 12.

⁶³ Jeremy Rudin, "Opening remarks to the Senate Standing Committee on Banking, Trade and Commerce, by Superintendent Jeremy Rudin", Ottawa, in 'Speeches and Presentations', 5 November 2014.

⁶⁴ Michael W. Taylor, "*Twin Peaks*": *A regulatory structure for the new century*, December, 1995, p 11.

⁶⁵ For the findings of the Inquiry into the failures of the FSA after the GFC, see: House of Lords, House of Commons, '*An accident waiting to happen*': *The failure of HBOS*, in '5: A failure of regulation', Vol. I, Parliament of the United Kingdom, 5 April, 2013, §§ 83/84/85, p 28; Financial Services Authority, *The failure of the Royal Bank of Scotland*, in 'Financial Services Authority Board Report', Financial Services Authority, December, 2011, § 30, p 28.

avoidance of issues falling between the gaps⁶⁶ because of too many regulators, potentially greater capacity for foreseeing and avoiding crises thanks to a more coherent and efficient regulatory architecture, an avoidance of turf-wars⁶⁷, greater certainty for the regulatees - a corollary to increased opportunity for regulatory arbitrage - and closer alignment with the Basel Core Principles and the G20⁶⁸. Finally, the successful performance of Twin Peaks during the GFC in Australia⁶⁹ warrants attention.

In times of distress, Twin Peaks can, in theory, maintain overall safety and soundness of banks, including in the face of one or more bank failures⁷⁰, provided the failed banks are not of systemic importance.⁷¹

However, Australia has witnessed regulatory failures and instances of financial distress under its Twin Peaks

⁶⁶ Professor Jeffrey Carmichael, “Australia’s Approach to Regulatory Reform”, Chap. 3, Making the Structural Decision, in *Aligning Financial Supervisory Structures with Country Needs*, edited by Jeffrey Carmichael, Alexander Fleming & David T. Llewellyn, in ‘WBI Learning Resource Series’, series editor: World Bank Institute, 2004, p 110.

⁶⁷ Ibid, p 110.

⁶⁸ Brooke Masters, op cit.

⁶⁹ John F. Laker, “APRA: The Global Financial Crisis And Beyond”, Paper presented at the The Australian British Chamber of Commerce, Melbourne, 26 November 2009, pp 1/5.

⁷⁰ Financial System Inquiry, November, 2014, pp 12/24.

⁷¹ Jeremy Cooper, “The integration of financial regulatory authorities—the Australian experience”, Paper presented at the Comissão de Valores Mobiliários (Securities and Exchange Commission of Brazil), 30th Anniversary Conference ‘Assessing the Present, Conceiving the Future’, Rio de Janeiro, Brazil, 4-5 September 2006, p 5.

regime. The extent to which these failures reflect upon the overall reliability of the Twin Peaks architecture is discussed below, and include its potential to be overwhelmed by the failure of a systemically important bank precipitating financial contagion; the potential to be blindsided by circumstances that pose an unforeseeable threat⁷² to the safety and soundness goals of the prudential regulator; and regulatory forbearance as with ASIC and the financial advice scandals in Australia. Put differently, Twin Peaks' is not infallible.

IV WEAKNESSES AS COMPARED TO OTHER MODELS

While Twin Peaks is an exercise in regulatory design, it is nonetheless a design for a purpose □ keeping the financial system safe and sound, and protecting consumers. Where this regulatory design has no answer to particular types of threats to its goals, those deserve to be investigated. Similarly, a failure to combat foreseeable threats also deserve investigation.

Consequently this article will analyse the vulnerability of the model to bank runs; the limitations of

⁷² See for example: Abayomi A. Alawode & Mohammed Al Sadek, *What is Financial Stability?*, in 'Financial Stability Paper Series', no. 1, Central Bank of Bahrain, March, 2008, p 14.

the model as noted by the HIH Royal Commission⁷³; the failures of the Australian Securities and Investments Commission; and Twin Peaks' failure in the Netherlands during the GFC, as outlined above.

(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.⁷⁴

This widely investigated phenomenon, 'contagion', and efforts to prevent it occurring, or at least mitigate its effects, are a core concern of the regulatory models, Twin Peaks or otherwise.

Contagion is a term used to describe the spillover [sic] ... effects of shocks from one or

⁷³ The HIH Royal Commission, *Report of the HIH Royal Commission*, The HIH Royal Commission, 16 April, 2003.

⁷⁴ E. Gerald Corrigan, "The Banking-Commerce Controversy Revisited", *Federal Reserve Bank of New York Quarterly Review*, Vol. 16, no. 1 (1991), p 3.

*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.*⁷⁵

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.⁷⁶

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

⁷⁵ George G. Kaufman, "Bank contagion: A review of the theory and evidence", *Journal of Financial Services Research*, Vol. 8, no. 2 (April, 1994), p 123.

⁷⁶ For a detailed discussion of bank runs, see: Charles W. Calomiris & Gary Gorton, *The Origins of Banking Panics: Models, Facts, and Bank Regulation*, paper presented at the Rodney L. White Center for Financial Research, The Wharton School, November 1990, p 222/223; Ted Temzelides, "Are Bank Runs Contagious?", *Federal Reserve Bank of Philadelphia Business Review* (November/December, 1997), p 3/10ff.

profitable, well-capitalised and solvent banks. The cascading withdrawals-cum-insolvencies can become a full-blown financial crisis.⁷⁷

This susceptibility to contagion 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 from other banks, 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 (sic) those insured deposits that gives rise to the current ... problem.*⁷⁸

⁷⁷ For more, see: Governor Daniel K. Tarullo, “Rethinking the Aims of Prudential Regulation”, Paper presented at the Federal Reserve Bank of Chicago Bank Structure Conference, Chicago, Illinois, series editor: Board of Governors of the Federal Reserve System, in ‘Speeches’, 8 May 2014, p 8.

⁷⁸ R. C. Merton & Z. Bodie, *Deposit insurance reform: a functional approach*, paper presented at the Carnegie-Rochester Conference on Public Policy, Vol. 38, 1993, p 5. Maturity mismatching was a significant contributor to the collapse of the Indonesian banking system during the Asian Crisis. P. Srinivas & D. Sitorus, “The Role of State Owned Banks in Indonesia”, Paper presented at the Brookings/IMF/World Bank conference on “The Role of State-Owned Financial Institutions: Policy and Practice” being held during April 26-27, 2004, Washington, DC, series editor: The World Bank, 2003, p 17; A. Crockett, “International Financial Arrangements: Architecture and Plumbing”, Paper presented at the Third David Finch Lecture, University of Melbourne, 12 November 1999.

Secondly, banks engage in a transformative function⁷⁹: they transform opaque and illiquid assets into transparent and liquid liabilities. The effect of which, however, is that banks cannot liquidate assets fast enough in the face of widespread demand-depositor withdrawals. The ensuing fire sale of assets will invariably further damage a bank's balance sheet.⁸⁰

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 bank solvency, even with best-practice regulations aimed at maintaining bank solvency, which in turn are adequately enforced. Nor does it claim to be able to prevent the collapse of individual banks, particularly in light of the unique vagaries and phenomena that affect them. Taylor acknowledges this⁸¹, 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

⁷⁹ For more on the transformation function, see: Douglas W. Diamond & Philip H. Dybvig, "Bank Runs, Deposit Insurance, and Liquidity", *Journal of Political Economy*, Vol. 91, no. 3 (June, 1983), p 402.

⁸⁰ For more on asset stripping by banks in times of distress, see: R. C. Merton & Z. Bodie, op cit, p 14/15.

⁸¹ Michael W. Taylor, "Twin Peaks": *A regulatory structure for the new century*, December, 1995, p 10.

methods as ‘living wills’⁸², Twin Peaks nonetheless does not have an answer when the collapse of one bank leads to widespread depositor panic and widespread financial firm distress, and this is an inadequacy in the architecture itself. While it is true that Twin Peaks is not alone in this shortcoming, the fact that it is susceptible to being overwhelmed by a crisis⁸³ should be recognised as a limitation in its design.

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

⁸² Elizabeth Fry, “Too big to bail: Aussie banks need a living will”, ‘Banking’, *Asia-Pacific Banking & Finance* Monday 4 May, 2015.

⁸³ Twin Peaks is a micro-prudential regulator. For more on a macro-prudential regulator, see *A current proposal in Australia, aimed at addressing past failures* on page 37ff.

*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.*⁸⁴

Supporters of Twin Peaks counter that this shortcoming - depositor panic precipitating contagion, which then leads to a financial crisis □ is one faced by all systems of financial regulation, and this is true. Supporters also counter that Twin Peaks is merely an architectural design, not a panacea, and this too is true. But true as those statements may be, they are little comfort to those individuals who are disadvantaged or displaced by financial crises. Moreover the architecture is an exercise in the pursuit of an ultimate goal: financial system stability. Consequently, and irrespective of whether Twin Peaks is not alone in this failing, and irrespective of what the brief to the original architects may have been, more recent experience indicates that there is a possibility of a Twin Peaks regime being overwhelmed by contagion, and this is a flaw that must continue to receive close attention.

⁸⁴ Toby Fiennes & Cavan O'Connor-Close, "The evolution of prudential supervision in New Zealand", *Reserve Bank of New Zealand: Bulletin*, Vol. 75, no. 1 (March, 2012), p 6.

(b) Australia's Twin Peaks failures: the collapse of HIH

When HIH insurance collapsed on the 15th of March 2001, it was the second largest insurance company in Australia. This made HIH's collapse one of the biggest in Australian corporate history,⁸⁵ and heralded the adoption of a new, risk-based approach to financial regulation, modelled on that of the Canadian regulator, the Office of the Superintendent of Financial Institutions.⁸⁶ HIH was a regulated entity under the jurisdiction of the system stability regulator APRA, at the time of its collapse.

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

*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.*⁸⁷

APRA's regulation of the HIH group was inadequate ... there was a systemic failure in

⁸⁵ Rob Curtis, "Solvency as a Focal Point of Prudential Regulation: Supervisory Lessons and Challenges", Chap. 6, in *The Future of Insurance Regulation and Supervision: A Global Perspective*, edited by Patrick M. Liedtke & Jan Monkiewicz, 2011, p 93.

⁸⁶ Julia Black, op cit, p 262.

⁸⁷ The HIH Royal Commission, 16 April, 2003, § 24.1.2.

*APRA to escalate the issues they identified to an appropriate level. Throughout 2000 and 2001 APRA missed every opportunity to act upon the warning signs that HIH was heading towards statutory and commercial insolvency.*⁸⁸

Two implications emanate from this: the first is that weaknesses in the enforcement of the model (as was the case with the supervision of HIH) can bring the model undone. Several issues arise as a result. One such issue is that there are no guarantees that problems to do with how well the regulator functions will be discovered through reviews and inquiries. The possibility remains that problems of enforcement, or lack thereof, will only be discovered through failure or distress, as happened with HIH. This presents the possibility that the system stability regulator can be blind-sided by its own internal management failings. Other obstacles to satisfactory and consistent enforcement relate to the adequate resourcing of the regulator⁸⁹, the creation of the appropriate culture within the regulator⁹⁰, and the degree to which parliament is captured by the financial industry.⁹¹

⁸⁸ Ibid, § 24.1.13.

⁸⁹ A. Campbell & R. Lastra, “Revisiting the Lender of Last Resort”, *Banking and Finance Law Review*, Vol. 24, no. 3 (June, 2009).

⁹⁰ APRA acknowledged that its ‘light-touch’ culture was responsible for its failures with HIH. John Garnaut, “Watchdog licks its wounds after commission mauling”, ‘Business’, *The Sydney Morning Herald* 16 January, 2003. Failures in the UK

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, from time to time at least, individual bank failure. That position persists to this day.⁹²

APRA does not pursue a zero failure objective. APRA cannot eliminate completely the risk that a regulated entity might fail and it recognises that any attempt to do so would impose unnecessary burden on regulated entities and harden the arteries of the financial system. ... Government's Statement of Expectations of APRA that "...prudential regulation cannot and should not seek to guarantee a zero failure rate of prudentially regulated institutions or provide

during the GFC were similarly attributed to the inadequacies of the light touch. Jill Treanor, "Farewell to the FSA – and the bleak legacy of the light-touch regulator", 'Business', *The Guardian/The Observer* 24 March, 2013.

⁹¹ See: Stephen Long, "APRA: Government accused of politicising bank watchdog over super fund briefing to crossbench senators", in *News*, published by Australian Broadcasting Corporation, 28 October 2015, 8:11pm, accessed: 22 November, 2015; Stephen Long, "Why banks want a default superannuation free-for-all", series edited by The Drum, in *Opinion*, The Drum Home ed., published by Australian Broadcasting Corporation, 28 October 2015, 12:03pm, accessed: 22 November, 2015. For the extent of this problem in the United States, see: Arthur E. Wilmarth Jr., "Turning a Blind Eye: Why Washington Keeps Giving In to Wall Street", *University of Cincinnati Law Review*, Vol. 81, no. 4/4 (2013).

⁹² Australian Prudential Regulation Authority, *Supporting Materials for Assessment Against the Basel Core Principles*, in 'IMF Financial Sector Assessment Program — Australia', Australian Prudential Regulation Authority, 2006, p 7.

*absolute protection for market participants
(including consumers).⁹³*

In light of the interconnectedness of financial entities, and in particular banks, the question arises whether it is realistic to assume that the financial system can indeed tolerate the failure of a single bank? Or whether the failure of even a single, small bank could endanger the financial system, and therefore necessitate that a failing bank be rescued by the taxpayer? If, in reality, a modern financial system is to be regarded as so interconnected that it cannot, in fact, tolerate a bank failure, then this presents a limitation of the capacity of the Twin Peaks model (and every other model for that matter): it cannot foresee all the circumstances in which a bank may fail, yet it cannot tolerate such a failure.

*... clearly demonstrate that small institutions can
pose their own challenges to stability...⁹⁴*

⁹³ Australian Prudential Regulation Authority, *Probability and Impact Rating System*, Australian Prudential Regulation Authority, June, 2012, p 7. See also: Julia Black, “Managing Regulatory Risks and Defining the Parameters of Blame: A Focus on the Australian Prudential Regulation Authority”, *Law & Policy*, Vol. 28, no. 1 (January, 2006), p 8; Charles Littrell, “*The APRA approach to insurance supervision*”, series edited by Australian Prudential Regulation Authority, in *Speeches*, published by Australian Prudential Regulation Authority, 16 May, 2003, accessed: 2 August, 2015, p 1; Financial System Inquiry, November, 2014, pp 4/11/24/36; The Treasury Australian Government, The Treasury Commonwealth Government of Australia, “*Statement of Expectations for the Australian Prudential Regulation Authority*”, 1-8, <http://www.apra.gov.au/AboutAPRA/documents/Statement-of-Expectations-from-Treasurer-20-Feb-07.pdf>, p 2.

*risk-based regulation may nonetheless be neither as “rational” nor as consistent in substance as its form suggests.*⁹⁵

*... however, to the individual who has just suffered financial loss because of the failure of a small bank... unlikely to share APRA’s view that APRA was perfectly justified ... Targeted regulation is inevitably going to conflict with public demands for universal protection.*⁹⁶

The collapse of HIH is therefore closely related to the first flaw, that of bank contagion. But despite bank contagion being a threat to the ultimate goal of Twin Peaks □ financial system stability □ and one for which Twin Peaks does not have an answer, even worse is that the threat of an individual firm’s insolvency □ as with HIH □ which could in turn precipitate contagion, can potentially be missed by the regulator, despite the warning signs.

⁹⁴ Financial Stability Board, *Increasing the Intensity and Effectiveness of SIFI Supervision*, in ‘Progress Report to the G20 Ministers and Governors’, Financial Stability Board, 1 November, 2012, p 2.

⁹⁵ Julia Black, “Managing Regulatory Risks and Defining the Parameters of Blame: A Focus on the Australian Prudential Regulation Authority”, *Law & Policy*, op cit, p 23.

⁹⁶ *Ibid*, p 24.

*(c) Australia's Twin Peaks failures: ASIC and the financial advice scandals*⁹⁷

The Australian regulatory model has not always fared well in respect of combatting market misconduct, or the protection of consumers, as the financial advice scandals at the Commonwealth Bank (CBA) and Macquarie Bank have demonstrated.⁹⁸ ASIC's inadequate performance and undue delays in addressing these malpractices at CBA and Macquarie were criticised by an inquiry led by the Upper House of Australia's Federal Parliament.⁹⁹ Considering the international fashionability of 'Twin Peaks', and in particular the influence of the Australian model, the failures and shortcomings of ASIC – one half of the two peaks – has been a significant and sobering outcome.

⁹⁷ Elements of this section appeared in substantial part in a previous article, published as a working paper by the Centre for International Finance and Regulation: A.D Schmulow, January, 2015, p 46ff.

⁹⁸ Adele Ferguson, op cit; Jane Lee, Cameron Houston & Chris Vedelago, op cit; Adele Ferguson & Deb Masters, op cit; Adele Ferguson & Ben Butler, "Commonwealth Bank facing royal commission call after Senate financial planning inquiry", 'Banking and Finance', *The Sydney Morning Herald*, Business Day ed. 26 June, 2014. For more on the cultural drivers underscoring changes in the ethics of banking, see: Ross Buckley, "Australia's banking culture: What has gone wrong?", 'Comment', *The Canberra Times*, 16 June, 2015, 16 June, 2015.

⁹⁹ Senator Mark Bishop (Chair), Senator David Bushby (Deputy Chair), Senator Sam Dastyari, Senator Louise Pratt, Senator John Williams, Senator Nick Xenophon, Senator David Fawcett & Senator Peter Whish-Wilson, *Performance of the Australian Securities and Investments Commission*, Parliament of Australia, The Senate, June, 2014.

In respect of this failure some may argue that the financial advice scandal has no bearing on Twin Peaks which is, after all, an exercise in regulatory architecture. I would argue that that assertion misses the point: the design purports, in the case of the market conduct peak, to be better equipped to protect consumers. Consequently, if that peak has failed to take steps to protect consumers, in what is a major national scandal requiring, as some assert, a Royal Commission to investigate, then one must question whether the architecture has failed to address something key? After all, a regulatory failure such as this one is not unforeseeable.

ASIC's failures are all the more glaring, considering the financial advice scandal affects thousands of consumers. Despite this, and despite repeated tranches of documentary evidence provided to ASIC by several whistle-blowers, which included evidence of document forgery and fraud, ASIC failed to investigate CBA for in excess of 18 months, and was not remedied before a significant amount of press exposure¹⁰⁰, and scrutiny from the Federal Senate¹⁰¹.

¹⁰⁰ See for example: Adele Ferguson, op cit; Adele Ferguson & Deb Masters, op cit; Adele Ferguson & Ben Butler, op cit; Jane Lee, Cameron Houston & Chris Vedelago, op cit.

¹⁰¹ Senator Mark Bishop (Chair), Senator David Bushby (Deputy Chair), Senator Sam Dastyari, Senator Louise Pratt, Senator John Williams, Senator Nick Xenophon, Senator David Fawcett & Senator Peter Whish-Wilson, June, 2014.

What the architecture needs to incorporate, therefore, are methods either to incentivise the market conduct regulator to act (by allowing, for example, ASIC to keep a portion of whatever damages flow from successful enforcement activities), or failing which, to compel the market conduct regulator to investigate and prosecute (through the establishment of a board of oversight, such as that contemplated by the Financial System Inquiry¹⁰²).

As Bhati points out¹⁰³, consumer requirements of trust are especially high in the provision of financial services. Consequently it is argued that ASIC, by exercising its powers to license¹⁰⁴, set standards for¹⁰⁵, and apply enforcement regimes, both criminal¹⁰⁶ and civil¹⁰⁷ against

¹⁰² Financial System Inquiry, November, 2014, ‘Regulator Accountability, Recommendation no. 27’, p 239. See further (e) *A current proposal in Australia, aimed at addressing past failures*, p 29, below.

¹⁰³ Shyam Bhati, “An Analysis of the Financial Services Regulations of Australia”, *International Review of Business Research Papers*, Vol. 4, no. 2 (March, 2008), p 20.

¹⁰⁴ Schedule 1 (Financial Services and Markets), Chapter 7 (Financial services and markets), Part 7.6 (Licensing of providers of financial services), especially Division 2 (Requirement to be licensed or authorized), s 911A-D, *Financial Services Reform Act (Cth)*, No. 122 of 2001, (enacted: 27 September), (Australia).

¹⁰⁵ Schedule 1 (Financial Services and Markets), Chapter 7 (Financial services and markets), Part 7.6 (Licensing of providers of financial services), especially Division 3 (Obligations of financial services licensees), s 912A-F, *ibid*.

¹⁰⁶ Schedule 1 (Financial Services and Markets), Chapter 7 (Financial services and markets), Part 7.7 (Financial services disclosure), Division 7 (Enforcement), Subdivision A (Offences), s 952A-M, *ibid*.

financial service providers, consumers are encouraged to assume regulated providers act appropriately. When a firm acts improperly, and ASIC fails to act, then consumer confidence in financial services is eroded¹⁰⁸, which in turn is inimical to the goal of creating thriving, healthy markets.

Furthermore, it is questionable whether the strategy employed by ASIC, which relies heavily on self-regulation¹⁰⁹ and industry codes of conduct¹¹⁰, is appropriate or trustworthy; especially in light of recent experiences with CBA and others.

(d) The Netherlands¹¹¹

The Kingdom of the Netherlands was second to adopt a ‘Twin Peaks’ model in 2002¹¹², retaining prudential

¹⁰⁷ Schedule 1 (Financial Services and Markets), Chapter 7 (Financial services and markets), Part 7.7 (Financial services disclosure), Division 7 (Enforcement), Subdivision B (Civil liability), s 953A-C, *ibid*.

¹⁰⁸ David T. Llewellyn, *op cit*, p 41.

¹⁰⁹ See for example Schedule 1 (Financial Services and Markets), Chapter 7 (Financial services and markets), Part 7.7 (Financial services disclosure), Division 3 (Regulation of market licensees), Subdivision A (Licensee’s obligations), s 792A (General obligations), (c), *Financial Services Reform Act (Cth)*, No. 122 of 2001. See also Standards Australia, “*The Australian Standard on Compliance Programs*”, AS 3806-2006, published by Standards Australia, Sydney, NSW, 9 March, 2006.

¹¹⁰ Shyam Bhati, *International Review of Business Research Papers*, *op cit*, p 20.

¹¹¹ Elements of this section appeared in a previous article, published as a working paper by the Centre for International Finance and Regulation: A.D Schmulow, January, 2015, p 33ff.

¹¹² International Monetary Fund, *Kingdom of the Netherlands-Netherlands: Publication of Financial Sector Assessment Program Documentation—Technical Note on Financial Sector Supervision: The Twin Peaks Model*, in ‘Financial Sector

supervision within De Nederlandsche Bank NV¹¹³ ('The Dutch Bank' (DNB)). This is similar to the arrangement in the UK, but distinct from Australia, where the prudential regulator (APRA) is separate from the NCB.

The Dutch copied the Australian approach, particularly as it applied to supervisory strategy - PAIRS and SOARS - both of which the Dutch regulator, the DNB, adopted.¹¹⁴

While the Netherlands managed to stave-off the worst of the GFC, success for the Dutch authorities in an economy with such an important financial sector was not achieved without 'drastic'¹¹⁵ government intervention.¹¹⁶

Total foreign claims of Dutch banks amounted to over 300% of GDP. The Dutch financial system therefore depended heavily on external developments. Only the Belgian and Irish

Assessment Program Update, IMF Country Report No. 11/208', International Monetary Fund, July, 2011, Table 1, p 6. See also: Henriëtte Prast & Iman van Lelyveld, 21 December, 2004.

¹¹³ De Nederlandsche Bank, *DNB Supervisory Strategy 2010 - 2014*, in 'Supra-institutional perspective, strategy and culture', De Nederlandsche Bank, April, 2010, p 21; Eddy Wymeersch, "The Structure of Financial Supervision in Europe: About Single Financial Supervisors, Twin Peaks and Multiple Financial Supervisors", *European Business Organization Law Review (EBOR)*, Vol. 8, no. 2 (June, 2007), p 16.

¹¹⁴ Julia Black, "Regulatory Styles and Supervisory Strategies", op cit, p 262.

¹¹⁵ De Nederlandsche Bank, *Annual Report 2009*, De Nederlandsche Bank NV, 24 March, 2010, p 37, and Chart, p 45.

¹¹⁶ See further: Julia Black, "Regulatory Styles and Supervisory Strategies", op cit, p 47, fn 128.

*banking sectors were in a similar position. The European average was less than half the Dutch figure at 135% of GDP. ... exposure of Dutch banks to the United States also was the highest in Europe, at 66% of GDP. ... whereas the average of European banks had kept limited exposure of less than 30% of GDP. By contrast, the exposure of Dutch banks to hard-hit Eastern European countries was at 11% of GDP just above the European average of 8% of GDP.*¹¹⁷

Intervention during the crisis took the form of measures to stimulate employment through construction and housing (€ 6 billion); capital injections for banks and insurers (€ 20 billion); state guarantees for banks (€ 200 billion); a guarantee on all deposits up to €100,000¹¹⁸; the nationalisation of the Fortis/ABN AMRO (€ 16.8 billion) and ING banking groups (€ 10 billion), comprising 85 per cent of the Dutch banking sector,¹¹⁹ the SNS REAAL

¹¹⁷ Maarten Masselink & Paul van den Noord, “The Global Financial Crisis and its effects on the Netherlands”, *ECFIN (Economic analysis from the European Commission’s Directorate-General for Economic and Financial Affairs) Country Focus*, Vol. 6, no. 10 (4 December, 2009), p 3.

¹¹⁸ Ministry of Finance, Government of the Netherlands, “*The Netherlands and the credit crisis*”, series edited by Ministry of General Affairs, in *Financial Policy*, published by Ministry of General Affairs, undated, accessed: 11 January, 2015.

¹¹⁹ Martin Van Oyen, “Ringfencing Or Splitting Banks: A Case Study On The Netherlands”, *The Columbia Journal of European Law Online*, Vol. 19, no. 1 (Summer 2012), p 6.

insurance and banking group (€ 3.7 billion)¹²⁰; and a reform of the financial system and the capital levels that had been enforced to date. Thereafter the Dutch government was compelled to drastically reduce spending in order to reduce its deficit.¹²¹

In the aftermath of the crisis, the conclusions reached about the performance of the Dutch regulators were less than positive:

*Both in the run-up to and during the credit crisis, supervisory instruments fell short in several areas. These deficiencies emerged in both the scope and the substance of supervision. The trend towards lighter supervision, reflecting developments within the financial sector as well as changed social attitudes, has gone too far.*¹²²

This finding supports the conclusions reached in the analysis of the performance of the UK regulatory authorities during the GFC, namely that regulatory architecture alone is not a panacea against financial crisis. Doubtless regulatory architecture is part of the solution, but no more so than the capacity of the regulator to

¹²⁰ Thomas Escritt & Anthony Deutsch, “Netherlands nationalizes SNS Reaal at cost of \$5 billion”, *Reuters*, US ed. Friday, 1 February, 2013, 6:30 am.

¹²¹ Ministry of Finance, Government of the Netherlands, op cit.

¹²² De Nederlandsche Bank, *DNB Supervisory Strategy 2010 - 2014 and Themes 2010*, De Nederlandsche Bank, April, 2010, p 5.

foresee, at times, the unforeseeable,¹²³ and regulate accordingly, and the willingness of the regulator to enforce its regulations. So while the Dutch experience does not support the argument that Twin Peaks is the optimal model, nor does its failure in the Netherlands detract from the argument that while Twin Peaks is not a complete solution, for other reasons as outlined above, it is better than the alternatives. Put differently, while Twin Peaks did not save the Netherlands, had one of the other three models of financial system regulation been used, under the same circumstances, and with the same regulatory culture, then in all likelihood the Dutch would have fared worse.

(e) A current proposal in Australia, aimed at addressing past failures

In its Final Report, the Australian Financial System Inquiry has recommended that in the future Australia establish a

¹²³ See for example: Mary Douglas & Aaron Wildavsky, *Risk and Culture: An Essay on the Selection of Technological and Environmental Dangers*, revised ed., 1983, p 1, where the authors state: ‘Can we know the risks we face, now or in the future? No, we cannot; but yes, we must act as if we do.’ See also the response of Lord Stevenson and Andy Hornby to the independent report into the FSA’s enforcement failures surrounding the collapse of HBOS (Andrew Green QC, *Report into the FSA’s enforcement actions following the failure of HBOS*, Prudential Regulation Authority, Bank of England & Financial Conduct Authority, November, 2015), in which they defended their roles in, and inability to prevent the collapse of, HBOS, as follows: ‘[the Report] downplays the unforeseen and unforeseeable effect of the financial crisis on HBOS’. Jim Armitage & Nick Goodway, ‘HBOS collapse back in spotlight’, ‘Business’, *Independent Newspapers*, 20 November, 2015 at 9:12pm.

Financial Regulator Assessment Board (FRAB), the purpose of which would be to provide advice annually to the Government on how financial regulators had implemented their mandates, and ‘ provide clearer guidance to regulators in Statements of Expectation and increase the use of performance indicators for regulator performance.’

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In addition to evaluating the performance of the regulators in respect of enforcement, the FRAB’s role would be to act as a Devil’s Advocate, while testing methodologies, questioning conclusions, and challenging prevailing orthodoxies of thought and belief in its ongoing assessment of the performance of the two peaks.

In behavioural economics, such “concurrency” across a group is called groupthink. ... Groupthink ... is unhealthy because, not only do people start to think alike, it is only a short step to believing people who are singing a different tune should be excluded and thrown out of the chorus. Dissent can be destructive, but the role of the Devil’s Advocate is well-understood to be

¹²⁴ Financial System Inquiry, November, 2014, Recommendation 27, ‘Regulator accountability’, in Chapter 5, ‘Regulatory system’, p 239 ff. See also: Andrew Schmulow, “Time for Abbott Government and ASIC to get serious about Australian banksters”, ‘Business’, *Independent Australia*, 10 August, 2015; Pat McConnell, “War on banking’s rotten culture must include regulators”, ‘Business & Economy’, *The Conversation*, 4 June, 2015 2.14pm AEST.

*valuable, drawing out important questions people would rather not answer. ... [the FRAB would comprise of] knowledgeable experts, crucially not tied to regulators, with a diverse membership that would “act as a safeguard against the FRAB being unduly influenced by the views of one particular group or industry sector”.*¹²⁵

Crucially, this proposal aims to introduce an arms length between those conducting the assessment □ the FRAB - and those being assessed. Apart from insulating the assessors - the FRAB - from a tendency towards the kinds of concurrence¹²⁶ that exists within the regulators, such distance will also, it is argued, be more likely to tease out instances of where the regulators have, or may become, suborned by the entities which they regulate, or by other powerful vested industry interests. If nothing more, a FRAB would constitute a double redundancy, a fail-safe, the aim

¹²⁵ Pat McConnell, “War on banking’s rotten culture must include regulators”, op cit. See further: Julie May, “Regulatory board to beef up watchdog accountability”, ‘News / Financial Planning’, *Financial Observer, Daily News for Financial Services Professionals*, 10 December, 2014; Marion Williams, “APRA and ASIC need cultural shift”, ‘Banking’, *Asia-Pacific Banking and Finance*, 9 March, 2015; Andrew Schmulow, “To clean up the financial system we need to watch the watchers”, ‘Business & Economy’, *The Conversation*, 4 March, 2015 2.11 pm AEDT; Ruth Williams, “Merit in oversight board for ASIC, but only if it’s got teeth”, ‘Business Day’, *The Sydney Morning Herald*, 28 January, 2015.

¹²⁶ This comports with anecdotal observations made by the author at APRA during the period October to December 2013.

of which would be to pick-up the problems that the regulators may have overlooked.

In addition, a FRAB could be expected to have a positive impact upon the corporate culture of the two peak regulators. Llewellyn points out that corporate culture within a regulator determines the extent to which it holds itself accountable, the way it exercises its discretion (which in turn affects its efficacy and its credibility, authority and public standing, and its ability to be a role model to regulatees for their own standards of corporate governance), the extent to which regulators continue to earn the public's trust and grow in esteem, the ease by which the regulator can be captured or subjected to undue political influence, the appropriate use of its own, considerable resources, and its ability to acquire and maintain international credibility.¹²⁷

This proposal has precedent in the UK which has established a Financial Policy Committee (FPC), the remit of which is to look for the roots of the next crisis.¹²⁸ Its role is to identify, monitor and take action to remove or reduce systemic risks. It has a secondary objective, which is to support the economic policy of the Government.¹²⁹

¹²⁷ David T. Llewellyn, op cit, p 41.

¹²⁸ Jill Treanor, op cit.

¹²⁹ Financial Policy Committee, "*Financial Policy Committee*", series edited by Bank of England, in *Financial Stability*, published by Bank of England, 2014, accessed: 26 September, 2014.

While the FPC is not identical to the proposed FRAB □ the latter is intended to be a regulator’s regulator and the former a macro-prudential regulator □ there are some similarities, particularly as regards the FPC’s binding authority over the system stability and market conduct regulators in the UK¹³⁰.

V 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. One key difference between the Australian model and those of the other countries listed is to be found in the jurisdictional location of the system stability regulator.

(a) Monopolistic versus Non-monopolistic Location of the Bank Regulator¹³¹

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

¹³⁰ Anonymous, “*Definition of Financial Policy Committee FPC*”, in *The Financial Times*, published by The Financial Times Limited, accessed: 18 November, 2015.

¹³¹ The term ‘monopolist’ is a term of art defined by David T. Llewellyn, op cit at p 8ff.

instances where the regulator is part of the NCB (monopolist regimes), and others where the regulator is separate (non-monopolist regimes).¹³²

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:

(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.¹³³ The converse of which, is that in a bifurcated system there will, of necessity, be a degree of overlap between the information gathering activities of the NCB and the prudential regulator.¹³⁴ As the NCB will always collect information about individual banks, purely by virtue of its role in the conduct of monetary policy,¹³⁵ an argument can be made that the most efficient arrangement is to build on this, and locate the prudential authority within the NCB.

Indeed some argue¹³⁶ that when a financial system is under strain, it is infeasible for the entity that regulates the

¹³² Ibid, p 28.

¹³³ Ibid, p 30.

¹³⁴ Ibid, p 30.

¹³⁵ Ibid, p 30.

¹³⁶ Ibid, p 30.

entire system to be separate from the entity that regulates each financial firm, and this has been the view of De Nederlandsche Bank.

Further, in jurisdictions lacking a strong tradition of independent regulatory agencies, advantages may be gained by locating the regulator within an NCB, provided the NCB has a strong tradition of independence¹³⁷. The Republic of South Africa serves as a good example. South Africa is the most recent adopter of Twin Peaks, and the South African Reserve Bank (SARB) will house the new Prudential Authority (PA). The SARB's 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.'*¹³⁸

However, as Nevin asserts:

'So essentially, the SARB and the finance ministry-controlled national treasury are the

¹³⁷ See further: *ibid*, § 9, p 11.

¹³⁸ Chapter 13, s 224(2), *Constitution of the Republic of South Africa*, No. 108 of 1996, (enacted: 1996), (Republic of South Africa). For an analysis of the degree of independence enjoyed by the SARB see: D. Schmulow & L. Greyling, "Monetary Policy in the New South Africa: Economic and Political Constraints", *South African Journal of Economics*, Vol. 64, no. 3 (September, 1996), p 176.

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.'

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This position has precedent, because it is not infrequently the case that the NCB enjoys a measure of statutory, if not constitutional independence.¹⁴⁰ This independence and reputational status are easier to extend to a prudential authority located within the NCB, than without. But, of course, the converse is also true: a failure by the prudential authority located within an NCB will damage the reputation of the NCB¹⁴¹. Moreover, the mere presence of the prudential authority within the NCB will contaminate the purity of the monetary stability objectives

¹³⁹ Tom Nevin, "How independent is the South-African Reserve Bank?", *African Business*, no. 332 (June, 2007), p 32.

¹⁴⁰ David T. Llewellyn, *op cit*, p 31.

¹⁴¹ See the remarks made by SARB Governor, Dr Chris Stals, quoted in C. Goodhart, P. Hartmann, D.T. Llewellyn, L. Rojas-Suarez & S. Weisbrod, *op cit*, p 170/1. See also Stals' solution through enactment of separate legislation for the PA and the SARB, *ibid*, p 171.

of the NCB, by introducing bank safety and soundness considerations.¹⁴²

Conversely the NCB may be able to gain valuable insights into the state of the economy by conducting the activities of the Prudential Authority (PA).¹⁴³ Heller¹⁴⁴ and Di Noia *et al*¹⁴⁵ state that an ability to influence bank policy through regulatory pressure may add to the efficacy of monetary policy.¹⁴⁶ They argue that due to the interrelationship between the activities of the NCB and the PA, co-ordination is a necessary prerequisite.¹⁴⁷ Management of the payments system to contain systemic

¹⁴² David T. Llewellyn, op cit, p 31.

¹⁴³ Carmine Di Noia & Giorgio Di Giorgio, “Should banking supervision and monetary policy tasks be given to different agencies?”, *International Finance*, Vol. 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.

¹⁴⁴ H. Robert Heller, “Prudential supervision and monetary policy”, Chap. 11, in *International Financial Policy: Essays in Honour of Jacques J. Polak*, September, 1991, p 272.

¹⁴⁵ Carmine Di Noia & Giorgio Di Giorgio, *International Finance*, op cit, p 367.

¹⁴⁶ See also: Vasso P. Ioannidou, “Monetary Policy And Bank Supervision”, Paper presented at the Federal Reserve Bank of Chicago Conference on Bank Structure and Competition, *Federal Reserve Bank of Chicago Conference on Bank Structure and Competition Proceedings*, Chicago, IL, series editor: Federal Reserve Bank of Chicago, in ‘Federal Reserve Bank of Chicago Conference on Bank Structure and Competition Proceedings’, May 2002, p 2.

¹⁴⁷ Carmine Di Noia & Giorgio Di Giorgio, *International Finance*, op cit, p 367.

risk may also require access, control and monitoring of the participants in the system.¹⁴⁸

Doubtless this assertion - the necessity of co-ordination - is correct. However, it is not correct to argue that co-ordination, of necessity, precludes two separate entities, as analysis of the Australian model demonstrates¹⁴⁹.

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.’

¹⁵⁰ 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.¹⁵¹ However, as Goodhart *et al*¹⁵² argue, ‘the revealed preference of monetary authorities has been to rescue banks running into difficulties, so long as there

¹⁴⁸ Ibid, p 368, citing Charles Goodhart & Dirk Schoenmaker, “Institutional separation between supervisory and monetary agencies”, *Giornale degli economisti e annali di economia*, Vol. 51, no. 9/12 (October-December, 1992), p 370.

¹⁴⁹ For more on inter-agency co-ordination, see: A.D Schmulow, January, 2015, p 45 ff.

¹⁵⁰ Joseph G. Haubrich, “Combining bank supervision and monetary policy”, *Economic Commentary* (November, 1996), p 4.

¹⁵¹ Carmine Di Noia & Giorgio Di Giorgio, *International Finance*, op cit, p 368. See also: Vasso P. Ioannidou, “Does monetary policy affect the central bank’s role in bank supervision?”, *Journal of Financial Intermediation*, Vol. 14, no. 1 (January, 2005), p 61.

¹⁵² Charles Goodhart & Dirk Schoenmaker, “Should the Functions of Monetary Policy and Banking Supervision Be Separated?”, *Oxford Economic Papers*, Vol. 47, no. 4 (October, 1995), p 549.

appeared to be any risk of a systemic knock-on effect'¹⁵³ 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 Australia¹⁵⁴, between the NCB and the PA, with clearly defined processes, may provide the necessary mechanisms for systemic stability.¹⁵⁵

¹⁵³ Vasso P. Ioannidou, "Does monetary policy affect the central bank's role in bank supervision?", *Journal of Financial Intermediation*, op cit, p 61.

¹⁵⁴ Anonymous, *Memorandum of Understanding*, 12 October, 1998; The Council of Financial Regulators, op cit: 'In the CFR, members share information, discuss regulatory issues and, if the need arises, coordinate responses to potential threats to financial stability. The CFR also advises Government on the adequacy of Australia's financial regulatory arrangements'; and The Council of Financial Regulators, *Memorandum of Understanding on Financial Distress Management between the Members of the Council of Financial Regulators*, The Reserve Bank of Australia, The Australian Prudential Regulation Authority, The Australian Securities and Investments Commission and The Treasury of the Commonwealth of Australia, 18 September, 2008.

¹⁵⁵ Contra, see Vasso P. Ioannidou, "Does monetary policy affect the central bank's role in bank supervision?", *Journal of Financial Intermediation*, 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 [Lender of Last Resort]. 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 circumstances direct supervision could help deliver the essential information on time.'

Moreover, a separation between the PA and the NCB may serve to insulate the NCB from the reputational harm¹⁵⁶ associated with the failure of a regulated institution, as was the case with the collapse of the Australian insurer, HIH.¹⁵⁷

(ii) The non-monopolist approach

In selecting to separate the PA from the NCB, and thereby adopt a non-monopolist approach, the Wallis Commission¹⁵⁸ set forth its main reasons as entailing the avoidance of the inefficiencies that arise when combining deposit taking, insurance and superannuation regulation, carried out by a 'central bank whose primary operational relationships are with banks alone and whose operational skills and culture have long been focused on banking'; and further that that separation would clarify that there are no guarantees of solvency for any financial institution, or its promises; and that separation would enable both the RBA (NCB) and the APRC (now APRA □ the PA) to focus on their primary objectives, while clarifying lines of accountability¹⁵⁹.

¹⁵⁶ Carmine Di Noia & Giorgio Di Giorgio, *International Finance*, op cit, p 369.

¹⁵⁷ See: The HIH Royal Commission, 16 April, 2003.

¹⁵⁸ Stan Wallis, Bill Beerworth, Professor Jeffrey Carmichael, Professor Ian Harper & Linda Nicholls, 31 March, 1997.

¹⁵⁹ Ibid, p 21.

*We argue that conducting supervision through two separate agencies (one for macro- [NCB] and one for micro-prudential [PA] supervision) could introduce the necessary checks and balances in the supervisory process that could potentially strengthen governance.*¹⁶⁰

While empirical evidence in support of a non-monopolist approach remains scant, one survey¹⁶¹ finds that inflation is ‘considerably higher and more volatile’ in countries where the PA is located within the NCB.¹⁶² In addition, a non-monopolist regulatory approach can be said to comport more closely with the Core Principles of Basel III - in particular Principle 2¹⁶³ - and is often synonymous with a more competitive financial system.¹⁶⁴

¹⁶⁰ Donato Masciandaro, Rosaria Vega Pansini & Marc Quintyn, *The Economic Crisis: Did Financial Supervision Matter?*, in ‘IMF Working Paper’, no. WP/11/261, International Monetary Fund, November, 2011, p 5. See also an earlier study: Donato Masciandaro, Marc Quintyn & Michael Taylor, *Financial Supervisory Independence and Accountability – Exploring the Determinants*, *ibid* no. WP/08/147, June, 2008, p 23.

¹⁶¹ Carmine Di Noia & Giorgio Di Giorgio, *International Finance*, *op cit*.

¹⁶² *Ibid*, pp 361, 372. According to their research, anywhere from 50 per cent to 100 per cent higher. *Ibid*, p 370. See also David T. Llewellyn, *op cit*, p 29. *Contra*, see: Vasso P. Ioannidou, “Monetary Policy And Bank Supervision”, *op cit*, p 1.

¹⁶³ Principle 2 states ‘– *Independence*, accountability, resourcing and legal protection for supervisors: The supervisor possesses *operational independence*, transparent processes, sound governance, budgetary processes that do not undermine *autonomy* and adequate resources, and is accountable for the discharge of its duties and use of its resources. The legal framework for banking supervision includes legal protection for the supervisor.’ (Emphasis added). Basel Committee on Banking Supervision, *Core Principles for Effective Banking Supervision*, Bank for

Di Noia *et al*¹⁶⁵ 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 monopolist 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.¹⁶⁶ Furthermore, countries with monopolist regimes are typified by higher non-bank deposits, and less intensive use of the interbank market.¹⁶⁷

*Banking sectors in 'monopolist' countries are more protected and somehow less developed and efficient than those in 'non-monopolist' countries.*¹⁶⁸

International Settlements, September, 2012, § 41, p 10. See also David T. Llewellyn, *op cit*, p 41.

¹⁶⁴ Carmine Di Noia & Giorgio Di Giorgio, *International Finance*, *op cit*, p 373.

¹⁶⁵ *Ibid*, p 373/4.

¹⁶⁶ *Ibid*, p 375.

¹⁶⁷ *Ibid*, p 376.

¹⁶⁸ *Ibid*, p 376.

There are, in addition, conflicts of interest¹⁶⁹ 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.¹⁷⁰ Conversely, the PA's primary concern is monetary stability, for the effect it has on interest rates and possibly exchange rates¹⁷¹ and, in turn, the effect those factors have on bank profitability and, by implication, bank soundness.

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

¹⁶⁹ See also: *ibid*, p 368.

¹⁷⁰ *Ibid*, p 367.

¹⁷¹ *Ibid*, p 367.

*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.*¹⁷²

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.¹⁷³

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

¹⁷² Charles Goodhart & Dirk Schoenmaker, "Institutional separation between supervisory and monetary agencies", *Giornale degli economisti e annali di economia*, op cit, p 361.

¹⁷³ H. Robert Heller, op cit, p 273.

*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 stability of the financial system and it is responsible for the supervision of some of the biggest banks in the United States.*¹⁷⁴

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,¹⁷⁵ and those stability considerations may override the enforcement considerations of the PA. This is especially so in respect of sanctions imposed by the PA, for malfeasance. If those sanctions were to occur simultaneous with a crisis, the NCB may be expected to persuade the PA to forebear.

¹⁷⁴ Vasso P. Ioannidou, “Does monetary policy affect the central bank’s role in bank supervision?”, *Journal of Financial Intermediation*, op cit, p 60.

¹⁷⁵ Carmine Di Noia & Giorgio Di Giorgio, *International Finance*, op cit, p 369.

Lastly, Di Noia *et al*¹⁷⁶ assert that conflicts may arise between macro (monetary) and micro (regulatory) policy, in that monetary policy tends to be anti-cyclical, whereas regulatory policy tends to be pro-cyclical.¹⁷⁷ Di Noia *et al*¹⁷⁸ cite an example where, during an economic slowdown, a bank's non-performing loans may increase, precipitating higher loan-loss provisioning rules, and pressure from the regulator to increase the quality of the bank's loan portfolio, by ceasing to extend funds to higher risk borrowers. As Tuya *et al*¹⁷⁹ point out, this leads to a restriction in credit at precisely the time when monetary policy should be expansionary.¹⁸⁰

VI CONCLUSION

¹⁷⁶ Ibid, p 369.

¹⁷⁷ Charles Goodhart & Dirk Schoenmaker, "Institutional separation between supervisory and monetary agencies", *Giornale degli economisti e annali di economia*, op cit, p 362.

¹⁷⁸ Carmine Di Noia & Giorgio Di Giorgio, *International Finance*, op cit, p 369.

¹⁷⁹ José Tuya & Lorena Zamalloa, "Issues on Placing Banking Supervision in the Central Bank", Chap. 26, in *Frameworks for Monetary Stability: Policy Issues and Country Experiences. Papers presented at the sixth seminar on central banking, Washington, D.C., March 1-10, 1994*, edited by Tomás J.T. Baliño & Carlo Cottarelli, series editor: the International Monetary Fund, December, 1994, p 670.

¹⁸⁰ For more on the correlation between an expansionary monetary policy and a monopolist regulatory structure, see: David T. Llewellyn, op cit, p 29; H. Robert Heller, op cit, p 272.

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 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).”¹⁸¹

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

¹⁸¹ Alex Erskine, July, 2014, p 43, citing Professor Jeffrey Carmichael, “Regulation by Objective – The Australian Approach to Regulation: Statement to the US Senate Committee on State Homeland Security and Governmental Affairs”, Washington, DC, in ‘Statement to the US Senate Committee on State Homeland Security and Governmental Affairs’, 21 May 2009, p 6.

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 one roof is conducive to eliminating regulatory arbitrage.¹⁸² Prior to the creation of APRA there were at least three different types of institutions able to issue demand deposits in Australia. These were regulated by nine different agencies. Following its creation, APRA introduced a fully harmonised regime for all deposit-taking institutions. These are now regulated as "Authorised Deposit-taking Institutions" (ADIs) under a single licensing regime. This coherence over deposit taking was important in retarding the growth of a significant shadow-banking sector in Australia.

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 minimises 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

¹⁸² Cf David T. Llewellyn, *op cit*, p 22.

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 co-operate in the interests of the system as a whole.

Sixth, the allocation of a single objective to each agency should minimise 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.¹⁸³

A fairly typical phenomenon of financial regulation is that in most countries the regulatory system was designed in response to a financial system which, thanks

¹⁸³ Professor Jeffrey Carmichael, “Regulation by Objective – The Australian Approach to Regulation: Statement to the US Senate Committee on State Homeland Security and Governmental Affairs”, *op cit*, p 6/7.

to innovation, no longer exists.¹⁸⁴ Consequently, financial innovation also requires regulatory system reform. On balance, Twin Peaks is the regulatory paradigm most well-suited to respond to these innovations. It is to be expected, therefore, that an increasing number of countries will, over time, adopt this system. Twin Peaks is not, however an irrevocable guarantee of financial system stability.

*New structures do not guarantee better regulation. More appropriate structures may help but, fundamentally, better regulation comes from stronger laws, better-trained staff and better enforcement. Any country that thinks that tinkering with the structure of agencies will, by itself, fix past shortcomings is doomed to relive its past crises.*¹⁸⁵

... institutional structure does not in itself guarantee effective regulation and supervision, and it would be hazardous to assume that changing the structure of regulatory institutions is itself a panacea. What institutional structure does is establish the framework in which to optimise a regulatory regime. In effect,

¹⁸⁴ David T. Llewellyn, op cit, p 9.

¹⁸⁵ Professor Jeffrey Carmichael, "Australia's Approach to Regulatory Reform", op cit, p 95/6.

*institutional structure provides the architecture of regulation and supervision.*¹⁸⁶

To this must be added a regulatory culture that enshrines, as Das *et al*¹⁸⁷ assert, independence, accountability, transparency, and integrity. If the contention contained in this paper is correct, that regulators, and particularly prudential regulators, are required to foresee the unforeseeable, then in addition there should be a culture that rewards regulators that display those characteristics of independence, accountability, transparency and integrity, while inculcating a culture of curiosity and robust self-criticism.

With apologies to Sir Winston Churchill¹⁸⁸, Twin Peaks is not the end. It is not even the beginning of the end. It is merely the end of the beginning.

¹⁸⁶ David T. Llewellyn, *op cit*, p 42.

¹⁸⁷ Udaibir C. Das & Marc Quintyn, *Crisis Prevention and Crisis Management: The Role of Regulatory Governance*, in 'IMF Working Paper', no. WP/02/163, International Monetary Fund, September, 2002, p 48.

¹⁸⁸ Churchill's address to The Lord Mayor's Luncheon, Mansion House, 10 November, 1942. The original quote reads: "Now this is not the end. It is not even the beginning of the end. But it is, perhaps, the end of the beginning. Henceforth Hitler's Nazis will meet equally well armed, and perhaps better armed troops. Hence forth they will have to face in many theatres of war that superiority in the air which they have so often used without mercy against others, of which they boasted all round the world, and which they intended to use as an instrument for convincing all other peoples that all resistance to them was hopeless....". The Churchill Society, "*The Lord Mayor's Luncheon, Mansion House, "The End of the Beginning", November 10, 1942*", published by The Churchill Society, Undated, accessed: 8 October, 2015.

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