Working paper summary

Twin peaks: a theoretical analysis

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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.

In essence, Twin Peaks is a regulatory model that assigns equal importance to the maintenance of financial system stability, and market conduct and consumer protection. Twin Peaks eschews the concept of a lead regulator, and accordingly there are separate jurisdictional authorities for each of these two functional areas.

In Australia, financial system stability and market oversight are the respective responsibilities of the Australian Prudential Regulation Authority (APRA) and the Australian Securities and Investments Commission (ASIC).

In theory, Twin Peaks is better suited to the performance of these functions than any alternative system of regulation currently in practice. It is potentially more cost effective, and better utilises specialist staff. It is also more likely to achieve regulatory competitive neutrality, through the avoidance of policy inconsistencies and opportunities for regulatory arbitrage.

There are six principal advantages associated with the Twin Peaks regulatory regime.

1. Assigning each agency a single regulatory objective maximises regulatory focus.
2. There are significant potential synergies to be gained from bringing together all the regulators of a particular market. For example, APRA brought together the best practices from banking and insurance regulation to create a stronger framework for both.
3. Bringing all prudentially regulated entities under one roof is conducive to eliminating regulatory arbitrage. Following its creation, APRA introduced a fully harmonised regime for deposit-taking institutions who were previously regulated by nine different agencies. The resultant coherence
over deposit-taking regulation was important in preventing a shadow-banking sector from emerging in Australia.

4. Bringing all prudentially regulated institutions under one roof ideally facilitates a more consistent and effective approach to the regulation of financial conglomerates.

5. The allocation of a single objective to each regulator minimises any overlap between agencies, and the inevitable conflicts that flow from such overlaps.

6. The allocation of a single regulatory objective is conducive to the likelihood of a uniform organisational culture developing within the agency. This largely obviates conflicts that may arise between operational groups that have differing perceptions of the broader organisation’s overall goal.

Notwithstanding its advantages, the Twin Peaks regulatory model also has certain shortcomings and deficiencies. In particular, it is not a model that guarantees perpetual bank solvency, nor can it prevent the collapse of individual banks. When such an event occurs, Twin Peaks cannot prescribe a solution when the failure of one bank leads to widespread depositor panic and broader distress among financial firms.

If the financial system is regarded as being so interconnected that it cannot tolerate a bank failure, this presents a critical point of failure for the Twin Peaks model. It cannot foresee all the circumstances in which a bank may fail, yet it cannot adequately address a situation in which such a failure occurs. Hence, Twin Peaks is vulnerable to being overwhelmed by any contagion effect of a crisis.

Another potential weakness presented by a model in which a bank regulator is combined with an insurance regulator, relates to differences in the nature of the assets and liabilities of banks versus those of insurers. Insurers typically have long-term liabilities that are ill-defined in value. Conversely, their assets are generally transparent in value, and are thus readily marketable. Banks on the other hand have relatively short-term liabilities, while their assets may be illiquid and opaque in value. Accordingly, banks and insurers warrant their own particular prudential supervisory focus, which raises doubts about the efficiency of combining these two functions within one organisational body.

A fairly typical phenomenon of financial regulation is that, in most countries, the regulatory system has been designed in response to a financial system which, thanks to innovation, no longer exists. Consequently, financial innovation also requires regulatory system reform. On balance, Twin Peaks is the regulatory paradigm most suited to respond to these innovations. Therefore, it is likely that, over time, an increasing number of countries will adopt this type of system.