Peterson Institute for International Economics

Is "Twin Peaks" the future of financial supervision?

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[00:00:24.22] - Nicolas Véron

Good morning, good afternoon, good evening, wherever you are in the world. I'm Nicolas Véran. I'm delighted to introduce this new session of the Financial Statement Series at the Peterson Institute for International Economics. And today we take a step back from the daily news flow, which is maybe a bad idea these days, to look at the structural issue in financial supervision and especially the concept of twin peaks financial supervision. That concept was coined a long time ago, 30 years ago by Michael Taylor. So we're particularly grateful to Michael for attending today and also We are very grateful to Mrs. Shimizu Tokiko, who joins us from Japan and can bring the experience of a major jurisdiction with a different supervisory organization. Michael studied at Oxford. He got a bachelor's degree in philosophy, politics, and economics and a doctorate in philosophy in 1989. And then he entered the Bank of England, where he stayed for a number of years. He authored the essay on Twin Peaks financial supervision in 1995. Later on, he had a very international career. He worked at the International Monetary Fund. He worked in Hong Kong at the Hong Kong Monetary Authority as head of their banking policy department.

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In the mid-2000s, he was then in Bahrain, advisor to the governor of the central bank in Manama. He was a member of the secretariat of the Financial Stability Board headquartered in Basel. And then in 2013, Michael joined Moody's, where he stayed for a full decade as Chief Credit Officer for Asia Pacific based in Hong Kong. He left Moody's a year or two ago, and he's now a senior fellow at the Melbourne Law School in Australia. So both our speakers today are very— we're very grateful to them for them staying late in the night Tokiko Shimizu studied at the University of Tokyo in urban engineering, where she got her degree in 1987. She then joined the Bank of Japan. She also got a degree in the '90s at the— in international political— in international policy, sorry, policy studies at Stanford. At the Bank of Japan, she had a very distinguished career going into a number of different specialties in international financial markets, different branches of the Bank of Japan financial institutions. So she's ideally placed to

comment on all the dimensions of the, um, the role of the Bank of Japan, but also the financial supervision aspects, including when the Japanese FSA was created in the late '90s, early 2000s.

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She was importantly one of the 6 executive directors of the Bank of Japan from 2020 to 2024. That's a 4-year term, and I think the woman ever to serve in that role. And since leaving the Bank of Japan in 2024, she's been an independent board member at Toyota Industries, one of the companies of the Toyota Group. I have, of course, to mention that Toyota is a longstanding and very cherished supporter of the Peterson Institute. And Tokiko has also started her own company called Emeco for Human Empowerment Ecosystem, which is working at empowering especially women including female engineers in the economic environment. With that, Michael, over to you. I will say— I think I will put your slides on the screen and the floor is yours.

[00:04:17.12] - Michael Taylor

Okay, well, thank you very much, Nicolas, for the introduction and for the invitation. And as you mentioned, I'm planning to talk for the next 10 minutes about The concept of Twin Peaks, the history, the policy, and some implementation issues. And as you also said in your remarks, introductory remarks, it's the 30th or will be the 30th anniversary of the publication of the original Twin Peaks paper at the end of this year. It was actually published in December 1990. Well, we'll see. I don't know whether I'm going to be invited to many parties, but certainly if there is, if there's an appetite for it, I'm quite up for it. But anyway, I'm going to cover pretty much the same ground that I covered in an essay that was published a few years ago in the Cambridge Handbook of Twin Peaks Regulation, which was edited by one of my colleagues at Melbourne, Andrew Godwin, and Andrew, Andrew Schmollo, who's a professor in the University of Wollongong, just down the road from here. So I'll talk about what motivated the original Twin Peaks plan, why the single regulator model seemed to win out over Twin Peaks for a period of time, some of the lessons that were learned from the global financial crisis, but, and finally, I want to end with a few reflections on what reforming the institutional structure of regulation can achieve, and more importantly perhaps what it can't achieve.

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So maybe if we move to the next slide please. Why Twin Peaks? What was the original motivation for it? Well, if we go back to the mid-1990s, it was very much a product of a debate which was taking place in the UK at the time that revolved around several different issues. The first one was the role of the central bank. There was a discussion around Bank of England

England independence starting to gather pace around that time. And at the same time, there was a perception of regulatory failure. BCCI had collapsed in 1991. In 1995, Baring Brothers collapsed in the early part of that year, and that had raised questions about the Bank of England's role as a bank supervisor, and particularly if it became independent, politically independent. Then there was the growth of financial conglomerate groups. In the 1980s, we'd seen widespread structural deregulation in the UK along with a number of other countries. That had led to the formation of diversified financial groups, and that in turn raised the question of how best to regulate them. And in turn, the evolution of financial markets had created new interconnections between different sectors of the financial system, which had previously been kept fairly distinct by structural regulation.

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New financial markets, particularly in derivatives, had emerged, which again had created new forms of interconnectedness between the parts of the financial system. And then finally, there was a consumer protection issue in terms of what I called the blurring of boundaries, the, the fact that some types of financial product no, no longer fitted neatly into the traditional categories of deposits, securities, or insurance. So all of these factors went into this broad-based discussion in the UK about the future structure of the regulatory system. And if we move to the next slide, what was new in the Twin Peaks Plan was essentially this proposal for a fundamentally different, very radically different structure to financial regulation to that which had existed previously. Prior to the proposal for a Twin Peaks structure, the UK's supervision had been essentially institutional with separate regulators for banking, securities, insurance. On the securities side, there were a multiplicity of regulators and Twin Peaks essentially proposed streamlining that system and also structuring it differently to the way it had been done in the past, moving away from an institutionally based structure to one where regulation was essentially based around function and two functions in particular.

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First one, preserving the stability of the financial system, and the second one, protecting the consumer. And that was the, the basis on which I proposed Twin Peaks in the paper for the Center for the Study of Financial Innovation at the end of 1995. Subsequently, it was adopted by the Wallace Inquiry here in Australia. That was an inquiry on the financial system inquiry, as it was known, or the Wallace Inquiry after the name of its chairman. They proposed in 1996 the adoption of a Twin Peaks structure in Australia, and that was legislated by the government in 1997. And we ended up with APRA, the Australian Prudential Regulatory Authority, and ASIC, the Australian Securities and Investments Commission, which became the first adoption in practice of a twin peaks structure. If we move to the next slide. Now, twin peaks was adopted in

Australia, it was adopted in the Netherlands, but for Through— for most of the 2000s up to the global financial crisis, the model that prevailed was one of a single regulator. It had been adopted in the UK, much to my disappointment I might say, in 1997 with the New Labor government which came in at that time.

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They had shown some interest in Twin Peaks prior to the election. After the election, they went for a single regulator. In which everything was combined into a single— all regulatory functions were combined into a single agency. And that became a model that was widely emulated in the early 2000s. And a number of countries adopted this single regulator model, often with technical assistance coming from the international financial institutions like the IMF and the World Bank. The reasons for the adoption of the single regulator model were mainly that it was argued that there was too much overlap between the two agencies in a Twin Peaks model, that it was much simpler and administratively less duplicative to have one regulatory body. So that was one of the main reasons why we saw a prevalence of the single regulator model during the 2000s up until the Global Financial Crisis of 2008. And if we move to the next slide. What the GFC did was to expose some of the shortcomings of the integrated model, and there were three things in particular that it really brought to prominence. The first one was the importance of crisis management and coordination between the regulatory agencies, the central bank, and the fiscal authority as the provider of bailout funds.

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I think in the UK there hadn't been a major financial crisis for a long period of time prior to the creation of a single regulator. There hadn't really been a lot of thought devoted to crisis management arrangements, and the GFC brought those shortcomings out very clearly. The second takeaway from the GFC was the importance of macroprudential supervision. The concept of macroprudential supervision had started to develop in the 1990s, but it wasn't really well understood, I think, prior to the GFC. And once the experience of the GFC had highlighted the importance of understanding risks across the financial system as a whole rather than focusing on individual institutions, that brought out the question of who should be the macroprudential supervisor, which— with which agency should that responsibility reside. And then finally, There was also a recognition which came out of the UK's experience as well, which was that in normal times a single regulator tended to prioritize consumer protection over prudential regulation, and that was for the very clear reason that it was consumer protection which tended to receive the highest political priority in normal times. That was the issue that filled politicians' postbags, that was the issue where members of Parliament tended to put most pressure on the regulatory agency to respond.

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And so inevitably, when everything was combined in a single agency, there was a tendency to prioritize consumer protection over prudential regulation. So if we move to the next slide. So the GFC essentially destroyed the fashion for a single regulator model, which I previously mentioned. And I think the UK shift to a twin peak structure, which occurred in 2011 was really the turning point. If we move to the next slide. I think it's important to be clear about what can and can't be achieved by institutional reform. And I think, and I still believe 30 years later, that Twin Peaks has significant advantages as a regulatory structure. I think it provides the regulatory agencies with a clarity of purpose which they don't otherwise have. It provides flexibility and adaptability to changing financial markets. And I think the rise of the various new forms of finance, of fintech, of crypto, all illustrate the importance of having that flexibility. And I also think that the experience tends to show that coordination in crisis management is also superior under a twin-peak structure to a— certainly to an integrated model. But it isn't a universal solution. It very much depends on a country's degree of integration of its financial markets, whether a Twin Peaks structure makes sense.

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If you don't have the degree of integration to which Twin Peaks was a response, then maybe you don't need to consider a Twin Peaks structure at this stage of development. It also, in terms of stages of development, depends on the stage of development of the consumer protection regime. I think for— in some emerging market economies, for example, consumer protection regimes are still relatively undeveloped, so having a separate consumer protection regulator in those circumstances probably doesn't make a lot of sense. And then ultimately, high-quality regulation depends on the availability of resources. I think one of the advantages of Twin Peaks is that it does help to pool and coordinate the available resources, but ensuring that regulators have adequate resources is one of the keys to high-quality supervision. So if we move to the last slide, I think what ultimately matters, irrespective of the institutional structure we're looking at is that regulation should be effective. And what do I mean by effective regulation? First, that it's proactive in identifying risks. Secondly, that the regulatory agencies have adequate legal powers. Thirdly, that they have those adequate resources and particularly are able to attract and retain well-qualified individuals. And then finally, that they are able to take tough decisions in the face of sometimes quite intense political pressure.

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And that comes to another topic on which I've written in the past, which is about the independence of regulatory agencies and how best to secure that. So those are the various factors that go, in my view, to make up high-quality regulation. A good regulatory structure is an important part of that overall equation, but it's only one variable among several. And with that, Nicola, I'll hand back to you.

[00:17:22.20] - Nicolas Véron

Thank you so much. Tokiko.

[00:17:25.26] - Tokiko Shimizu

Yes, thank you. Thank you for your invitation, and it's a great honor to meet the legendary, uh, SS Michael tonight. Thank you very much for your presentation. I'd like to give you first a brief comment about the Japanese financial supervisory structure, and then add a few points to Michael's points to which we should pay attention to in coming years, and especially with the view of the central banker, ex-central bankers, because it is very important to shed light on the relationship between the financial regulator and the central banks. So, in Japan, we have a system in which the government and the central bank both are responsible for financial stability. And Japan FSA is, of course, the primary institution with responsibility as a financial regulator and the supervisor. At the same time, Bank of Japan has some functions in the financial policy. Of course, the Bank of Japan conducts monetary policy, and financial stability is legally stated as the prerequisite for making monetary policy functioning. So actually, Bank of Japan itself has a capacity to cover on-site micro-examination as well as macro-prudential policymaking. So, as a last result, the Bank of Japan continues such functioning, especially paying attention to each individual institution as well.

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So, such an insight based on the micro and macro analysis provides an indispensable guidance for monetary policy. This structure in Japan It can be called the double eyes or compound eyes system, monitoring system. So such a system enables financial authorities to take more timely and better designed actions, especially in a very critical situation. One of the heads, ex-head of JFSA, he is now the Deputy Governor of the Bank of Japan, once As pointed out, this double eyes or compounded eyes system is very good suited for the Japanese system, because we need to check from the both sides the financial stability condition in Japan. And recent efforts, probably you may notice that the Bank of England conduct the capture to capture the risks in the financial system as a whole, namely system-wide exploratory scenario last year, which remind me that our efforts just 30 years ago. So I was a member of the Bank of Japan team for

setting up the Systemic Risk Conference. The series of conference were hosted by 3 central banks, including Bank of Japan, Federal Reserve, and Bank of England, because at that time we didn't have an ECB yet. So at the first conference in 1995, then Chairman Greenspan made an opening remark pointing out the importance of understanding entire financial system's behavior.

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—that is the systemic risk. So at that time, macro-prudential policy or systemic risks and stress testing were not so popular yet. So at that time, we just started to learn and explore how financial system as a whole behave from a dynamic viewpoint in the globally integrated economy. So 30 years ago, that was the timing. To start considering macro-prudential policy as a financial authority. But after spending 3 decades since then, we need to admit that we still not yet capture wholly about the systemic risk yet. Of course, I, I should admit that after Having the experience of the GFC, relatively speaking, global financial regulations have become more robust and effective. So during the recent crisis of COVID and following the high inflation, the global financial system showed the robustness. So mainly because the newly set regulation has made the risk control culture common, across the globe. But from now on, we need to pay more attention to variety of players in our financial system and also geopolitical risks, which could make international coordination more difficult. So under such a complicated and divided world, financial authorities, including central banks, need to understand untraditional players and transactions, including a digital payment system, with a closer coordination with each other.

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Also, we need to re-establish a foundation which makes us enable to support with each other in a crisis by sharing necessary information. It is easy to expect that ring-fencing action would be taken in each country's States, but at least among the financial authorities, we should keep our network as close and deep as possible. Thank you very much. I stop here.

[00:23:42.10] - Nicolas Véron

Thank you so much. I have tons of questions. We have very qualified participants in the Zoom audience as well, so I encourage them to use the Q&A tool to ask questions. I'm very interested as a European also in terms of the implications of this debate for the organization of supervision in the European Union, which is a live debate. I have to mention, since Michael referred to the Cambridge Handbook of Twin Peaks Financial Regulations, there's a whole literature about that. You can see it. I'm gratified to have coauthored the section on the EU with Dirk Schumacher in that volume. Recommended reading. And And I may start maybe with, with this

question that you mentioned, Michael, of the independence of supervisors in terms of the decisions they can make and the way they can, you know, act independently from political authorities, particularly, but not only in crisis scenario. I think this was— this is very topical because we saw in the US, of course, Michael Barr resigning after the change in the executive branch. Echoing a pattern that had occurred before, of course, when Dan Tarullo resigns and then Randy Quarles was not renewed after the end of his term.

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So we appear to have a pattern in which the supervisors— there are several of them, of course— in the US are bound to political cycles in a way that they are not in the UK or, for that matter, in the zone with European banking supervision at the ECB. So that is not the same issue as Twin Peaks. But can you give us a little bit more of your thinking of the interrelationship between Twin Peaks, the independence of supervisors, and also how during that, you know, multi-decade period you have seen that issue of supervisory independence evolve over time? Because after all, we come from from situations many decades ago when supervision was inside ministries, as it still is in some jurisdictions. Sorry, it's many questions in one question, but I'm very curious about your point of view.

[00:26:09.28] - Michael Taylor

Okay, well, let me try and unpack those various questions. I mean, I think first of all, you know, to start with at the end, I mean, I think one of the positive developments over the past 30 years has been the tendency to take supervision and regulatory responsibilities out of ministries, where in a number of countries it had been located historically, and put that into a separate standalone regulatory agency. And I think that has been a positive development. As far as the case for regulatory independence itself is concerned, I think it has many parallels with central bank independence and the same kind of time inconsistency issues that were used to justify central bank independence as far as monetary policy is concerned apply in the case of regulation. And that, I think, is because especially when, when we're talking about prudential regulation, It's one of those issues where there is a potential time inconsistency and a potential for the regulatory agency to come under pressure to relax its rules in certain circumstances. And I think we're seeing that pattern play out again now, actually, where a number of countries around the world— and if I think back to the UK, UK regulators are now coming under pressure from, from the new government to again relax rules because it's seen as being— regulatory requirements are seen as stifling economic growth, for example.

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And I think that, you know, this is just an indication of how politicians' memories can sometimes be a little bit too short. I mean, they forget. It's easy to forget the last crisis. So I think, you know, that's really the main justification for regulatory independence in general terms. I think if you look at the emerging economies and, you know, in my post-Twin Peaks career, I spent a lot of my career in the emerging economies. I think that becomes particularly acute where you often don't have the same degree of separation of powers that you would have done in the more advanced economies, where often the, the banks and the financial institutions themselves are owned by politically extremely well-connected individuals. and they are able to put pressure on regulatory agencies. And I have enormous respect for those regulators in emerging economies that I've worked with over the years who have been able to withstand those kinds of pressures, which at times become incredibly intense. In terms of what is happening now and this political cycle that you've mentioned, I think it, you know, as I mentioned, it is a reflection of the fact that memories tend to be short.

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It's very disappointing that less than 15 years on from the global financial crisis, we're now seeing an attempt to roll back some of the regulatory measures that were introduced following that. Yes, there is always some overreaction on the part of regulation after a big crisis, but I think we, we run the risk of forgetting just how serious that crisis was, how profound its implications were, and how close we were to suffering a second Great Depression. And it was good policymaking at the time which actually avoided that. We need high-quality regulation to avoid repeats of those kinds of experiences. And I think that just gets forgotten over the years.

[00:30:04.24] - Nicolas Véron

So, Kiko, on this issue of supervisory independence, I mean, of course, the Bank of Japan is independent, the FSA maybe less so. So how are these issues debated in Japan?

[00:30:18.11] - Tokiko Shimizu

So, regarding the independence of the supervisor, the supervisor regulator in Japan, I would say the JFSA itself is of course independent, but basically it is included in the government, I would say. So that means the central bank is the independent player in, of course, in the monetary policy area. But at the same time, we are— does Bank of Japan itself can play a very independent role even in the macro-prudential policy as well as prudential policy itself. So this is a little bit different for the independence in the supervisory function and monetary policy functions.

[00:31:07.22] - Nicolas Véron

So, in Japan, about supervisory structures, or it's generally viewed that, you know, the current situation as it was established 25 years ago is satisfactory?

[00:31:20.13] - Tokiko Shimizu

So I would say the Bank of Japan's independence, especially in the monetary policy, is a very good situation in Japan. But at the same time, regarding the supervisory functioning, so we experienced very severe Japanese financial crisis during the 1990s. Based on those experiences, the Bank of Japan is, of course, as a result, we pay more attention to the prudential policy as well. But we also need the Bank of Japan itself recognize the first institution to be responsible for the prudential policy is the FSA. So it is very complicated, but Bank of Japan itself is necessary to pay attention to the financial stability, to conducting, to conduct the very good monetary policy as an independent institution.

[00:32:18.12] - Nicolas Véron

I see.

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Michael, coming back to the Twin Peaks debate, you mentioned your frustration in the late '90s when the UK decided to go for a a universal single supervisor with the creation of the UK FSA. It was not the first one because the Nordic countries, Scandinavian countries, had been there before. Can you give us a little bit of a sense of what that debate looked like, how much the Scandinavian experience had influenced the UK debate, how you look at the Scandinavian experience also issues of country size and market size, that cluster of issues back in the '90s?

[00:33:04.16] - Michael Taylor

Yeah, I mean, the Scandinavian experience was a very interesting one. And I did actually study it and published a couple of papers on that, actually subsequent to the Twin Peaks paper. The Scandinavian countries had created integrated regulators quite some time earlier, um, and in most cases that had been a response to the formation of financial conglomerates. So the, the thinking was, was very similar to the, the thinking that went into the Twin Peaks proposal. The big difference was that in the Scandinavian countries at that time, in the mid-'90s, the consumer protection regime was still relatively undeveloped. It the responsibility of the integrated regulators in Scandinavia in the mid-'90s was, was still predominantly a prudential responsibility. And so they didn't have the same broad scope that the UK's FSA, Financial Services Authority,

was subsequently given in the legislation. So that was one major difference. Of course, the second major difference was the size of financial markets. In Scandinavia were, you know, of a completely different magnitude to the ones in London and then the UK. None of the Scandinavian countries hosted major international financial markets in the way that the UK did. So there was a, there was a difference in size as well as a difference in scope, which made the Scandinavian example not necessarily applicable to the UK.

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When the UK decided to go down the route of having a single regulator, the surprising thing was just how little debate there was about that prior to it. It was— the Twin Peaks proposal had been discussed fairly extensively over a couple of years between the publication of the paper and the general election, which took place in May 1997. And the expectation was with the change of government that there would be some changes to the regulatory system, but they'd been quite vague in terms of what exactly they were planning to do. And so these, these, this proposal for this single, completely integrated regulator came very much left field. I mean, I don't think there were very many people in the policy community or in the financial services industry itself who had really had much opportunity to think about this as an option. And as a result of that, I mean, you know, it was a new government with a strong mandate, a large majority, and there was very little discussion around the merits of a single regulator model prior to it being adopted in the UK. And I think that was a failure in terms of the policy process.

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There should have been more discussion at that time.

[00:36:06.24] - Nicolas Véron

Continuing maybe a little tour of jurisdictions. China a year or two ago adopted a new organization for its financial supervision. So maybe, Tokiko, I know the Bank of Japan is the best center of expertise outside of China on the Chinese financial system. So, so I cannot resist asking you that question. How, how do you view the Chinese reform of supervisory architecture? And especially, is there any point in looking at it through the lens of Twin Peaks, or is that, uh, completely irrelevant? Uh, there have been comments when the changes were announced along those lines, so I'm, I'm very curious about your analysis.

[00:36:51.24] - Tokiko Shimizu

Uh, yes, so the— that's kind— that's kind of a transformation in the Chinese supervisory structure was happening during my tenure as the assistant governor. So at that time, I heard the

story that such a transformation or restructuring in the Chinese financial supervisory system was not coming from such a Twin Peaks kind of consideration. Rather, the Communist Party or government government itself need to have larger power to make the financial system robust. That means, of course, the central bank itself, Chinese PBOC itself, had a very large power in the financial stability area before that restructuring. So that means the government or the Communist Party itself decided to enlarge their power in the financial stability area. So that might be the most important motivation for them. How did you look at the Chinese reform? Yes, so in order to conduct the very timely restructuring of the financial system, including the real estate problem, that might be good for them. But at the same time, as I mentioned in my presentations, the double-check system from the central bank viewpoint is not so well functioning now. So that means the government only has a single eye on the financial stability policy.

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That might be that kind of risk for the Chinese financial stability issues, I would say.

[00:38:44.01] - Nicolas Véron

Michael?

[00:38:44.06] - Michael Taylor

Yeah, just to add a couple of points to the ones that Tokihiko has already made. I mean, I think another factor in terms of the Chinese system is the balance on the State Council. So the PBOC, the People's Bank of China, the governor sits on State Council, which is the kind of cabinet of China. And so question, right, if you have a single integrated regulator, or if you have a Twin Peaks sort of model, the question is how is that balance reflected in terms of the State Council? That's always been an issue in China. And then I think secondly, one of the factors that led to reform— I mean, I completely agree with what Takahiko said. I mean, I think, you know, the reforms were largely a reflection of the desire on the part of the party to to exert stronger control. And that came about largely because of the experience of 2015 when there was a major stock market correction for which the, the CSRC, the Chinese Securities Regulatory Commission, I think it attracted a certain degree of blame in, in high policy circles in China, and which required substantial government support to, to try to prop up the market.

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And following that, I think we did see a series of reforms. So it was, I think, connected to what was perceived to have been a regulatory failure.

[00:40:17.28] - Nicolas Véron

Going to another part of the world, South Africa is perhaps the most prominent example of an emerging market that has adopted the Twin Peaks architecture. I'm sure you've been very involved in that, Michael. You mentioned the fact that for emerging markets, it could be more the balance of arguments could be different because they don't have the same strengths of consumer protection regimes. What lessons do you draw from the South African experience so far?

[00:40:48.16] - Michael Taylor

Well, I'm probably not the best person to talk about South Africa because I haven't been following it particularly closely. But I mean, I can talk about the emerging markets more generally, and there I think You know, it does really reflect the extent to which there is a consumer protection regime in place. And in many emerging economies, consumer protection is relatively undeveloped. There are relatively few consumer protection laws. And in fact, I mean, given the experience in many emerging economies, prudential supervision is the aspect which really needs to carry the priority because you know, the economic backdrop to financial— the financial system tends to be more volatile, and therefore bank failures tend to be more frequent, and the possibility of a banking crisis tends to be higher probability than in more advanced economies with more stable economic regimes. So in my view, you know, certainly in the past, the important part of regulation to get right first in the emerging economies was prudential supervision. And the other side of supervision was certainly important, but it didn't have quite the same priority in terms of prudential supervision.

[00:42:17.05] - Nicolas Véron

We have a question from Dan Fiheny on the rise of crypto and fintech and technological shifts. How does that alter the balance and Concluding on what you just talked about, Michael, because now we have all this fintech range of offerings coming to emerging markets at the same time as it comes to advanced economies, sometimes even more so given the, you know, potential for leapfrogging that exists there. Do you think that changes the debate on how to organize supervision or it's basically the same tradeoffs? In a different form? Maybe Michael first.

[00:43:02.17] - Michael Taylor

Yeah, I mean, I think it's the same trade-offs in a slightly different form, but certainly, you know, the ease with which operators based outside of a jurisdiction can now enter that jurisdiction

poses a new set of regulatory challenges. In the past, I mean, it was you know, to, to provide a financial service in a country, you either had to have some sort of physical presence, whether it was a branch, or at least you had to have people with suitcases show up from time to time in the country. So from a regulatory perspective, it was, you know, there were some constraints in terms of the ability of foreign players to, to penetrate a domestic market. And now, of course, with technological change, that has become much easier to do. I mean, you, you, and that poses a completely new set of challenges, I think, for a regulator. But I think overall the important issue here is that the regulators need to have the flexibility to be able to regulate these new types of financial products as and when they emerge. And in my view, that is where the, the Twin Peaks structure remains very relevant because inherent in it is this idea that you can adapt the regulatory framework quite rapidly to changes in financial markets and products.

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And that's something which I think remains essential.

[00:44:40.05] - Nicolas Véron

So Kiko, from your experience at the Bank of Japan, you mentioned the importance of having two pairs of eyes, but that's primarily for banks. How does that work for non-banks and how does that affect the debate on fintech?

[00:44:53.17] - Tokiko Shimizu

Yes, we already experienced a very rapid deposit withdrawal in the United States 2 years ago. So at the time, the— among the G7 central banks, as well as their financial regulators, discussed that we need to be well prepared for such a very rapid changing situations, especially based on those digital transactions. So in that context, of course, the flexibility is necessary. At the same time, we need more well-coordinated and speedy reactions across the supervisory financial authorities.

[00:45:39.02] - Nicolas Véron

Non-banks. Does the Bank of Japan look at non-banks at all, or in the context of all these fintech offerings, Or is it something it needs entirely?

[00:45:49.08] - Tokiko Shimizu

Yes, yes, yes, we need to enlarge our coverage, not only banks as well as other non-banks, including such digital players. It is not already defined as financial institutions, but we also need to pay attention to those very new players in the market.

[00:46:15.21] - Nicolas Véron

Michael, coming back to the questions of design, and maybe you will want or not to comment on Japan, but in the jurisdictions that have adopted the Twin Peaks framework, there is a big divide, of course, on whether the prudential function resides with the central bank or outside of the central bank. So Australia is an example of prudential authorities that is not with the central bank and conversely, most of the other jurisdictions that have adopted Twin Peaks like UK, Netherlands or Belgium for that matter, or South Africa, they have a central bank in charge of prudential supervision. Can you give us a little bit more of a sense of the trade-off here and whether that matters and how you look at it?

[00:47:00.05] - Michael Taylor

Yeah, that's an interesting question. I mean, when I originally proposed the Twin Peaks model it was with the idea of having a separate regulatory agency, prudential regulatory agency outside the central bank. And that was essentially the pure Twin Peaks model that was adopted in Australia by the— with the creation of APRA. Now, I think it depends partly on whether the Twin Peaks model was adopted pre or post GFC. GFC, because post-GFC, I think there's been a greater tendency to create a single agency within the central bank or under the wing of the central bank. I mean, there are some advantages in doing that. I mean, one of them is in terms of coordination on crisis management. Another is in terms of providing some degree of independence to regulators as well, because again, having a prudential regulator, which is part of the central bank or a subunit of the central bank, it can often borrow the independence that the central bank has in monetary policy. And that also helps. The— I mean, the differences are that I think in the pure Twin Peaks model, I think my assumption was that it would be difficult for a central bank to attract and retain staff that it would have expertise in, especially in the non-bank prudential regulation side of things, things like insurance.

[00:48:45.01]

I mean, here in Australia, the APRA also covers superannuation funds. So for a central bank to attract and retain people with that kind of expertise may be more difficult because it's— it doesn't really provide much of a career path. For regulators with that sort of expertise. So those are the kinds of factors that come in. I mean, in the UK, the original Twin Peaks proposal was to remove banking supervision from the central bank, largely because, as I mentioned in those

introductory slides, at the time there was this ongoing debate about the Bank of England's competence as a bank supervisor. There had been a couple regulatory failures on its watch, and that had led to a feeling that perhaps it wasn't the best institution to be doing prudential supervision. That was certainly a factor. On the other side, improved coordination, macroprudential, those kinds of factors I think were influential in the 2011 decision to move back to a, a twin-peak structure or to move to a twin-peak structure.

[00:49:59.28] - Nicolas Véron

There's another set of questions about design, and maybe here I'm particularly influenced by what I see in the European Union, but also maybe in the US, which is the, uh, extent to which these, um, regulators or supervisors, these independent agencies, whatever they're called, uh, should be in charge of the rulemaking as opposed to individual decisions, uh, on individual entities or transactions. And obviously the debate in the European Union is the so-called Meroni Doctrine, which stipulates that EU agencies cannot actually issue rules on their own. But there's also in the US a very lively debate, very polarized as well, on the ability of government agencies to make their own decisions as opposed to the powers of Congress. I'm very curious about your insights and your views on this issue of essentially, you know, should supervisors be regulators? Should the regulatory power be outside of the scope of supervision? It's not purely an issue of semantics. So maybe Michael first on that.

[00:51:18.20] - Michael Taylor

Yeah, it's, I mean, it's, that's, again, it's a very good question. I mean, I think The rulemaking and the supervision, in my view, are two sides of the same coin. That, you know, to be able to enforce the rules, you need to understand the rules and you need to have had a role in creating the rules. And so I don't see that there is such a clear distinction between rulemaking and rule enforcement, as I think some discussions have indicated. So I think that, you know, and again, it goes back to the point that I made at the beginning in the introductory slides, that good quality supervision depends on having supervisors who are proactive, and that proactivity includes the ability to make new rules and to adapt existing rules as circumstances change, as markets evolve, and I think having people who are close to the markets, who see developments, who see where the challenges come from in terms of existing rules, is important in terms of having that level of proactivity. So I think it's, it is an essential function of regulators that they should have that rulemaking authority and that they should be able to adapt their rules as they need to.

[00:52:37.06]

Of course, that rulemaking authority needs to be subjected to various kinds of checks and balances. There needs to be accountability built into the system. I've emphasized the importance of regulatory independence. Regulatory accountability is also important, and making sure that those two fit together, that you provide both an independent regulator but you provide mechanisms for its accountability in ways that don't undermine its independence, that it— those are key considerations. So Yes to rulemaking authority, but also yes to accountability, to having proper checks and balances in place.

[00:53:19.10] - Nicolas Véron

Does it work in Japan, Tokiko? Does the FSA have unlimited rulemaking ability, or what are the other organizations involved?

[00:53:28.02] - Tokiko Shimizu

Yeah, of course, as part of the government, they can, of course, write new rules in the financial stability area, but at the same time, they need to have an, uh, uh, acceptance from the Congress as well. So that means, uh, the supervisor, uh, is the rule maker in Japan, but they cannot change the rules by themselves. That means they need to have some admission from the Congress. So that means there are the balance between balance of the power between the government and the Congress in this area.

[00:54:10.27] - Nicolas Véron

For example, when there are, say, new capital requirements, there is a rule for the Japanese Parliament, the Diet, to—

[00:54:16.06] - Tokiko Shimizu

In that case, the FSA can introduce those rules by themselves. Oh, okay. Yeah, because this is the global rules, we need to adopt those global rules.

[00:54:32.22] - Nicolas Véron

And, and the Bank of Japan is involved in the rulemaking. I guess it is consulted, but does it have a formal—

[00:54:39.12] - Tokiko Shimizu

Basically, the Bank of Japan is not the rulemaker. Yeah, but as Michael pointed out, the rulemaker needs to have very well knowledge and awareness what happens in the financial stability area. In that sense, the Bank of Japan is always having a good discussion with the FSA and Congress. So we are— the Bank of Japan is the provider of those information.

[00:55:09.12] - Nicolas Véron

I'd like to conclude about international coordination. If we take the Twin Peaks approach, there is, of course, international coordination and including standard setting on the prudential side that is provided by the Bank for International Settlements, the Basel Committee, the Financial Stability Board. You've served on the Financial Stability Board sector yet, Michael. So there's an international machinery for that. For conduct of business supervision, yes, there is the International Organization of Securities Commission, which is not as prominent an organization by and large as is the Bank for International Settlements and its committees. And this is primarily focused on wholesale markets and securities, as its name indicates. Is there a gap in the international architecture for conduct of business coordination, or is that a matter that is intrinsically more fragmented jurisdiction by jurisdiction? How do you look at this, Michael?

[00:56:15.10] - Michael Taylor

Yeah, I think it is inherently more fragmented, and I think it is Conductive business supervision tends to be more domestically focused. In part, it depends on the appetite of the domestic authorities, just how far they— and what type of conduct of business supervision they want to have in place. And in contrast to prudential supervision, the spillovers from one market to another are more limited than is the case, you know, potential spillovers from a bank failure in one country into other countries are much greater. So you do need a stronger international coordination mechanism as far as the prudential side of things is concerned. Now, now that the world is becoming more integrated, that we're seeing the ability of financial firms to offer products cross-border without going through the traditional process of establishing a branch, as I've talked about before, that as we're seeing the rise of fintech and other distribution mechanisms, maybe the need for greater coordination is rising in conduct of business supervision. But I think inevitably it will always be lagging as far as prudential supervision is concerned.

[00:57:46.05] - Nicolas Véron

And indeed, you mentioned the fact that the financial system is becoming more integrated at a time when the world may not become more integrated in other dimensions. So there's a lot of food for thought here. Thank you so much to both of you for an illuminating conversation. As I

said at the beginning, this was a bit taking a step back from the Daily News. We'll get back to the Daily News flow in our next session on February 26th. We'll discuss the potential global financial stability implications of the policies of the Trump administration. So that's very much in the news with the legendary Charles Goodhart, formerly and still emeritus at the London School of Economics and also, of course, at the Bank of England, and, and Agathe de Marais of the European Council Council on Foreign Relations. Again, many, many thanks to Shimizu Tokiko and to Michael Taylor. Thanks particularly for staying in the middle of the night in Tokyo and Melbourne, and I look forward to seeing you soon again.

[00:58:52.22] - Tokiko Shimizu

Thank you.

[00:58:53.11] - Michael Taylor

Thank you.