

The Rationale for
Integrating Financial Supervision
in Latin America and the Caribbean

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Foreword

There is strong interest around the world in the institutional aspects of financial regulation and supervision. This interest increased as several developed and developing countries started to integrate their specialized supervisory institutions into a single entity during the past few years. Of particular relevance is the relatively recent experience in the United Kingdom, where several specialized supervisory agencies were integrated into the Financial Services Authority (FSA).

Although some countries began adopting integrated supervision as early as the 1980s, a debate on the pros and cons of integrated supervision models emerged only recently. Issues in favor and against integration have been identified, but they have not yet been discussed in the context of a formal analytical framework or with a regional perspective.

The present study fills both gaps. It examines the rationale for the adoption of an integrated approach utilizing a methodology to analyze the efficacy and the efficiency of the specialized and integrated approaches in meeting the main objectives of financial regulation in the context of Latin America and the Caribbean countries. The paper considers the main arguments against and in favor of integration that are known to affect both approaches in practice and that have been discussed in the existing literature.

Consumer protection, systemic stability, and financial system efficiency are identified as the three main objectives of financial regulation and represent the benchmarks for the analysis. The paper analyzes how well and how efficiently the specialized and integrated approaches to regulation facilitate the achievement of the three main objectives. Based on this analysis of the integrated and specialized approaches, the paper finds good reasons for the adoption of an integrated approach in circumstances similar to those prevailing in most Latin American and Caribbean countries.

The study breaks grounds in assessing the cost and benefits of different supervision regimes in the region and prompts additional research in this field.

The issue of an integrated versus a specialized approach to financial regulation is particularly relevant for the countries of Latin America and the Caribbean, some of which have already started to move towards an integrated approach. We believe that this study will greatly contribute to promote an active discussion on this issue and to reach conclusions for the implementation of institutional reforms in the supervisory frameworks of countries in our region.

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Introduction

There has recently been a strong interest around the world in the organization of financial regulation. During the last few years, a significant number of developed and developing countries have moved toward integrating their specialized regulatory agencies into a single entity.¹ An active debate on the pros and cons of integrated supervision models² began only recently, despite the fact that some countries, most notably those in the Scandinavian region, began adopting integrated supervision models as early as the 1980s. In the case of the Scandinavian countries, the decisions to fully integrate financial regulation in a single institution were part of an evolutionary process. In some of the more recent cases, reform was implemented after holding a debate on the main advantages and costs of integration.

Nowadays, the question about the factors stimulating the debate on the institutional design of financial regulation arises naturally. According to Goodhart et al. (1998), there are five main reasons behind its recent emergence.

1. The rapid structural change that has taken place in financial markets was spurred by the acceleration in financial innovation. The main question here is whether the institutional structure of regulation and supervision should mirror the evolution of the structure of the financial system. Financial innovation has led to a change in the risk characteristics of financial firms. As a result, the capacity of existing specialized regulators to adapt to these changes is in question.
2. Financial activities have become increasingly complex, as evidenced by the emergence of financial conglomerates.³ The question is whether a series of agencies supervising parts of a complex financial institution can have a good grasp of developments taking place in the institution as a whole.
3. The realization that the actual financial regulatory and supervisory structure is the result of a series of ad hoc policy measures put in place, at times, in the wake of financial crises. The question is whether, after the crises, a more coherent structure should be put in place.
4. There is an increased demand for enhanced regulation and supervision of financial products like insurance and pension schemes, which raises two concerns. First, it might not be clear which regulator should oversee a particular issue and, as a result, more than one specialized regulator, or none at all, might be doing it. Additionally, there is the concern regarding the ability of existing specialized regulators to deal with new challenges without an enhanced set of regulatory and supervisory faculties.
5. The increasing internationalization of banking and other financial services has implications for the institutional structure of agencies at national and international levels. Again, the capacity of existing specialized regulators to adapt to these changes is in question.

¹ See Abrams and Taylor (2000), Briault (1999 and 2002), Demaestri and Cohen (2000), and Demaestri and Sourrouille (2002).

² Following Carmichael (2001) and other authors, this paper does not distinguish between the terms “regulation” and “supervision”. They are used interchangeably.

Indeed, factors 1, 2, 3 and 4 were found to be crucial in the adoption of the integrated approach in the Scandinavian countries (see Taylor

³ Usually defined as a group that undertakes at least two major financial service activities.

and Fleming, 1999), while factors 1, 2, 3, 4, and 5 were of particular importance in the British reform (see Briault, 1999). All these factors are relevant for countries in Latin America and the Caribbean (LAC), where the debate about the optimal financial regulatory and supervisory structure is gaining momentum.

However important these factors may be when addressing the problems affecting the specialized approach to financial regulation and supervision in LAC countries, the case for an integrated approach is not a straightforward one. There remain differences between banks, securities firms, and insurance companies that refer to the nature of their businesses, the type of contracts they issue, the maturity structure of their assets and liabilities, and the nature and type of the risk and asset transformation functions they perform. Financial firms have diversified their portfolios, but often it is their main business that continues to dominate their activities. Additionally, differences in the nature of the risks involved in financial activities could warrant some degree of specialization in the approach to prudential and conduct-of-business regulation.⁴

Furthermore, it should be recognized from the start that there is no single “optimal” model for the organizational structure of financial regulation. Local circumstances in a particular country are very important in determining the best institutional arrangement for that country. Therefore, no specific organizational model can be applicable to all countries, including countries in the same region. Moreover, it must be noted that the countries that have adopted an integrated approach have done so in different ways.⁵

Consequently, the issue of an integrated versus a specialized approach to financial regulation is well defined, of much interest, and very relevant to the countries of Latin America and the Carib-

⁴ Considering that the vast majority of financial sector supervisors focus on prudential regulation rather than on conduct-of-business issues, this paper will concentrate on the prudential aspects of financial regulation.

⁵ We thank Briault for calling our attention to the importance of emphasizing this issue. This point is also underlined in Carmichael (2001).

bean. The different trade-offs need to be carefully balanced to assess the relative efficacy and efficiency of each institutional arrangement in meeting the main objectives of regulation. The issue is of particular relevance for the countries of Latin America and the Caribbean, some of which have already started their move toward an integrated approach. An active discussion of this issue is likely to surface soon in many others.

The present study further develops the findings in Demaestri and Cohen (2000), which presented the main issues and provided an overview of current conditions in Latin America. This paper moves a step beyond and articulates the rationale for the adoption of an integrated approach in the countries of the region. It provides a methodology to analyze the efficacy and the efficiency of each approach in meeting the main objectives of financial regulation,⁶ and also discusses the main problems that are known to affect both approaches in practice.

The three main objectives of financial regulation identified in this paper are consumer protection, systemic stability, and financial system efficiency. The paper analyzes how well (efficacy) the specialized and integrated approaches to regulation allow the achievement of the three main objectives, and whether those objectives are obtained at a lower cost (efficiency). This analysis considers the main arguments against and in favor of integration that have been discussed in existing literature. The main arguments against integration considered in the analysis are the issues of moral hazard, regulatory capture, Christmas tree effect, and bureaucratic leviathan. In terms of arguments in favor of integration, consideration is given to the issues of economies of scale and scope, prevalence of financial conglomerates, competitive neutrality, and transparency and accountability. Some issues associated with the eventual separation of financial supervision from the central bank are also considered.

⁶ Jean Roy, Ecole des Hautes Etudes Commerciales, Canada (2000), utilized a similar methodology to analyze the effectiveness and efficiency of different funding arrangements to achieve the potential objectives of deposit insurance schemes.

The second section of the present study discusses the main objectives of financial regulation. The third section analyzes the main problems and advantages of the integrated approach vis-à-vis the specialized approach, in light of country experiences and economic theory. In

particular, the efficacy and efficiency in attaining the objectives of financial regulation are discussed taking into account the particular situation of the countries of Latin America and the Caribbean. The fourth section concludes with a summary of results and some final thoughts.

Objectives of Financial Regulation

The economic rationale for financial regulation is a complex matter that exceeds the scope of this paper. There is a vast literature on this topic and the interested reader is referred, for instance, to Llewellyn (1999a). This section does not evaluate that rationale but poses and addresses the more concrete question of what is expected from financial regulation. Two general types of financial regulation and supervision are usually identified: (i) prudential regulation, which focuses on the solvency, safety and soundness of financial institutions, and (ii) conduct-of-business regulation, which focuses on how financial firms conduct business with their customers.

Different approaches to the subject arise when the normative issues of prudential regulation and supervision of financial institutions are discussed in the literature. Goodhart (1996) distinguishes between consumer protection and systemic protection. Alternative approaches consider a more comprehensive set of objectives.⁷ However, there seems to be a certain consensus in the specialized literature about the necessity to have a limited range of well-defined set of objectives for financial prudential regulation and supervision.⁸ This belief can be explained in a very straightforward manner: avoidable costs are imposed on the economy if prudential regulation focuses upon inappropriate objectives (a chance that increases with the number of objectives). In that regard, there is a consensus in the literature about the need for a narrow and well-defined list of *core objectives* for financial regulation that includes consumer protection, and systemic stability. Considering that the cost of access to di-

⁷ For instance, the Financial Services Authority in the United Kingdom has four main statutory objectives: (i) to maintain confidence in the financial system; (ii) to promote public understanding of the financial system; (iii) to secure an appropriate degree of protection for consumers; and (iv) to contribute to reducing financial crime.

⁸ Llewellyn (1999a) is a prominent example in that regard.

versified financial services in most of the financial systems in LAC is very high, we propose adding a third core objective to the list: efficiency of the financial system.

Consumer Protection. Consumer protection issues arise for two main reasons: (i) an institution where clients hold funds might fail (an issue of prudential regulation); and (ii) the way in which a financial firm conducts its business with its customers might be unsatisfactory (an issue of conduct of business regulation). The ultimate rationale for financial regulation designed to protect the consumer is to correct for market imperfections or failures that would compromise consumer welfare in a regulation-free environment.⁹ As stated before, this paper focuses on the prudential aspects of financial regulation. In that regard, the general case for prudential regulation and supervision of financial firms is that consumers are not in a position to effectively judge the safety and soundness of financial firms.

Systemic Stability. Given that financial markets are usually driven by market sentiments¹⁰ that give rise to a variety of crises, plus the fact that market failures are intrinsic characteristics of financial markets, preserving the stability of the financial system should be a main objective of financial authorities.

Efficiency of the Financial System. If the financial sector is of critical importance for the normal operation of the overall economy but it is rendering services at unacceptably high costs, then the efficient operation of the system should be a relevant concern for the financial services authorities. In addition to private cost considerations, the issue of efficiency also arises because regulation imposes a wide range of costs, which

⁹ Carmichael (2001) identifies four main sources of market failures in the financial system: (i) anti-competitive behavior; (ii) market misconduct; (iii) asymmetric information; and (iv) systemic instability.

¹⁰ For instance: manias, panics, bubbles, and runs.

are ultimately reflected in the price of financial services. If these costs are “excessive” in the sense that they exceed the economic benefits to be derived from achieving the limited objectives behind regulatory services, then financial regula-

tion ends up imposing a net burden on the economy. Therefore, a main objective for financial authorities in LAC should be to adopt and implement a regulatory and supervisory approach that contributes to the efficient operation of the financial sector.¹¹

¹¹ A narrower view of efficiency may be taken in more developed countries. For instance, financial regulators may make explicit the objective of reducing the costs that their interventions impose on the financial system.

Financial Supervision: Integrated or Specialized Approach?

This section discusses how the integrated and specialized approaches to financial regulation and supervision deal with the objectives of consumer protection, efficiency of the financial system, and systemic stability. In particular, we compare how effectively and efficiently each approach fulfills the core objectives of financial regulation. Since the goal of the present analysis is to assess the viability of an integrated approach for the countries of Latin America and the Caribbean, the discussion will make explicit reference to the characteristics of these countries whenever possible.

The existing literature on the subject has dealt with the benefits and costs of each approach,¹² but, to the best of our knowledge, it has not linked them explicitly to the core objectives of financial regulation.¹³ It is important to proceed in this way because, without a clear analytical foundation based on the rationale and objectives of regulation, any institutional structure is likely to be ad hoc and arbitrary. Moreover, it may even compromise the objectives of financial regulation, as recognized by Goodhart et al. (1997).

Why is the issue of integrated versus specialized financial regulation interesting and relevant? To start answering this question it is worth noticing that over the last several years the world financial services landscape has shifted. As a result, many of the products and services offered to consumers by the insurance, deposit-taking and securities industries are becoming increasingly

hard to distinguish. Many financial services providers are developing products and services that cut across traditional regulatory boundaries. The mismatch between the regulatory structure and the marketplace has resulted in duplication and overlap of regulations, different regulatory treatment of similar products, and gaps in consumer protection. Regulatory and supervisory authorities are concerned about this. For example, this has led authorities in the Canadian province of Ontario to conclude that:

The pace of change in the provision of financial services is extremely fast, and all indications point to that path accelerating... A regulatory framework designed in the era when deposit-taking institutions, securities firms and insurers operated entirely different businesses cannot adapt fast enough to address new issues... both consumer protection and industry efficiency may be at risk of being compromised... It is timely for Ontario to create a new regulatory agency by merging the Ontario Securities Commission and the Financial Services Commission of Ontario into the Ontario Financial Services Commission. (Young, 2000)

However, the case for integration is not straightforward. Some researchers, policymakers, and supervisors disagree on the relative merits of integration. As pointed out before, there are some differences between the businesses, activities, maturity structures, and risks associated to the assets and liabilities of banks, securities firms, and insurance companies that may imply that some kind of specialized approach to prudential regulation could indeed be advisable. The Reserve Bank of Australia provides an interesting example of the differences between the core businesses of banks and insurance companies:¹⁴

¹² Briault (1999 and 2002), Taylor and Fleming (1999), and Abrams and Taylor (2000) are prominent examples of the literature that identifies and discusses the costs and benefits of the integrated and the standardized approaches.

¹³ Abrams and Taylor (2000) analyze the costs and benefits of unified supervision in connection with a set of proposed prerequisites for effective supervision.

¹⁴ It is worthwhile to note that, despite the identified differences, Australia brought together the prudential regulation of banks and insurance companies.

...insurance companies have long-term liabilities with ill-defined value, while their assets are generally marketable with readily ascertainable values. Banks, in contrast, tend to have relatively short-term liabilities, with assets that are difficult to liquidate and to value. Consequently, the applicable prudential supervisory regimes are different and there would be few (if any) efficiencies in bringing their supervision together. (Thompson, 1996, quoted by Goodhart et al, 1997)

As the discussion shows, the analysis of an integrated versus a specialized approach to financial regulation has to be carefully developed to assess the relative efficacy and efficiency of each institutional arrangement to fulfill the core objectives of regulation. In what follows we first discuss the main costs that have been attributed to the integrated approach¹⁵ and then turn to the potential benefits of adopting it. In all the cases, the theoretical arguments are discussed in light of available empirical evidence from experiences of reform, and take into consideration the situation prevailing in the countries of Latin America and the Caribbean.

The discussion that follows tries to make clear that many of the problems are not exclusive to the integrated approach. Moreover, it is shown that the prevalence of these problems is widespread in Latin America and the Caribbean, even when the vast majority of these countries currently have multiple specialized regulators in place. Among the main costs that are said to have a special effect on the integrated approach to financial supervision, moral hazard, regulatory capture, Christmas tree effects, and bureaucratic leviathan are of particular interest. The perils of separating banking regulation and supervision from the central bank are also studied. We start the discussion addressing the issues that the literature has identified as the most problematic ones for the successful working of the integrated approach. We show that the pessimistic conclusions that are usually drawn based on

¹⁵ Although, as pointed out before, we recognize that there is not a single *optimal* way of integrating financial regulation, for simplicity, in what follows we will refer in generic terms to *the integrated approach*.

these grounds are not always warranted. Indeed, it is not always clear how they operate in the Latin American and Caribbean context. Moreover, we show that the same problems usually affect the specialized approach as well, in some cases harming its operation even more than they do in the case of an integrated system. After discussing the presumably more relevant problems associated with integration and the perils of separating banking regulation from the central bank, we then turn to a discussion of the more advantageous issues associated with the integrated approach, mainly economies of scale and scope, the prevalence of financial conglomerates, competitive neutrality, and better transparency and accountability.

MAIN ARGUMENTS AGAINST INTEGRATION

This section considers the issues of moral hazard, Christmas tree effect, bureaucratic leviathan, and regulatory capture.

Moral Hazard

The moral hazard issue in implicit contracts is usually ranked as a prominent cost of the integrated approach. Llewellyn (1999b) notes:

A potential moral hazard might be created in that a public perception could emerge that the risk spectrum among financial institutions had disappeared or become blurred. In particular, the distinction between deposits which are redeemable on demand at face value, and investments (e.g. life assurance) where the value of an institution's liability is a function of the performance of the institution in managing its assets, could become obscured.

The main idea is that a new implicit contract could be created between a newly integrated financial authority and the public, leading to excessive risk taking behavior on the part of the public if the risk spectrum between different financial products becomes blurred. Excessive risk-taking behavior on the part of the public could eventually jeopardize the stability of the financial system.

Briault (1999) disputes this point on practical grounds, arguing that “in practice, the public’s understanding of the regulatory system is—regrettably—likely to be so low that this type of moral hazard should not arise.” Even if this problem were bound to arise, Briault argues that its effects can be substantially mitigated by including a legal provision in the form of a specific statutory objective for the unified financial services regulator to raise public awareness of the risks, costs and benefits of different financial services. This was done in the United Kingdom, where the objective of raising public awareness was legally imposed on the Financial Services Authority.

To the best of our knowledge, the existing specialized literature has not concentrated on moral hazard problems different than those of the implicit contract variety. However, in practice, other types of moral hazard problems could be associated with different institutional regulatory arrangements. Indeed, some of those moral hazard problems could have especially serious adverse consequences on the effectiveness of the specialized approach to fulfill the core objectives of regulation.

In this regard, we have identified a type of moral hazard related to excessive risk taking by financial institutions. This type of moral hazard would not result from the existence of implicit contracts, but instead it would originate in hidden action/information by financial institutions. Holes, under-laps, and inconsistencies in the legal framework are bound to become apparent in situations in which the regulatory framework was originally established to avoid cross-institutional financial activity but was progressively modified by the behavior of market participants. If holes and/or under-laps in legislation/regulation (or supervision) are prevalent, excessive risk-taking behavior on the part of financial institutions could take place with the intention of profiting from those inconsistencies in financial regulation and/or supervision. Holes and under-laps in the regulatory framework may create a moral hazard problem of the *hidden information* and/or a *hidden action* type.

The literature has recognized the existence of holes, inconsistencies, overlaps and under-laps in the legal framework. However, to the best of our knowledge, it has not considered the potential moral hazard problems that could arise as a consequence of them. So far, overlaps and under-laps have been treated symmetrically and both are seen to lead to excessive regulatory costs. This is especially relevant for the case of overlaps and inconsistencies, but not for the remaining cases. The most problematic issue associated with under-laps and holes in the regulatory framework is the neglected possibility of moral hazard problems resulting from excessive risk-taking behavior on the part of financial institutions acting in an environment of hidden information or action. As a way of example, consider what could happen during a period of financial distress (such as a situation of strong pressure against the national currency) in countries where banks participate, directly or indirectly, in administering private pension funds if specialized financial regulation and supervision are subject to holes and/or inconsistencies. Since private pension schemes are generally administered by limited-liability companies, which operate under weak supervision,¹⁶ banks could engage in highly speculative activities in futures markets for the domestic currency, using pension fund resources for that purpose. In this case, banks can take excessive risks, while their actions remain unsupervised by either the pension system regulator or the banking regulator. Under those circumstances, the state may end up bearing the costs of eventual losses incurred by banks if they exceed the limited legal liability of pension funds. This case is not a mere theoretical possibility; it did occur in Argentina during some episodes of strong pressure against the domestic currency. A case like this is much less likely to arise if an effective integrated supervisory approach were adopted.

According to Taylor and Fleming (1999):

One undoubted benefit of the integrated approach when compared with specialist regulatory agencies is that it is less likely that specific regulatory problems will be lost in the gaps be-

¹⁶ Meaning, lack of consistent integrated supervision.

tween regulatory jurisdictions. A number of cases in the U.K.—ranging from Barings to the so-called Home Income Plans—had contributed to the perception that too many problems were simply falling between regulatory agencies. The formation of a single regulatory body has been deliberately designed to eliminate the possibility that disputes over regulatory turf may result in certain types of financial activity going unregulated, or inadequately regulated.

What objectives of financial regulation and supervision are in danger if moral hazard problems arise? The answer is that both consumer protection and systemic stability would be compromised. In the examples of moral hazard due to implicit contracts that have been considered in the literature so far, mainly consumer protection is shown to be at risk. However, as argued above, both consumer protection and systemic stability could be compromised if generalized holes in the regulatory framework are prevalent under the specialized approach.

In terms of the *efficacy* of the specialized and integrated approaches to fulfill the core objectives of financial regulation when faced with problems of moral hazard, the answer depends on what specific kind of moral hazard is thought to be more relevant. Given the prevalence of the specialized approach and the existence of quite obvious gaps in the statutory objectives of specialized financial regulators in most Latin American and Caribbean countries, the possibility of moral hazard problems due to hidden action/information cannot easily be dismissed. At the same time, if LAC countries decide to start moving toward an integrated approach, the problem of moral hazard due to implicit contracts needs to be taken seriously, paying special attention to the remedies discussed above.

In terms of the *efficiency* of both approaches to fulfill the core objectives when faced with moral hazard problems, the integrated approach is probably more efficient. Including a legal provision in the statutory objectives of the financial regulatory authority seems less costly than correcting holes in legislation and devoting the resources to improving supervision in the various areas in which holes are prevalent. These last

two actions could be rapidly subject to diseconomies of scale. The case-by-case approach to correct inconsistencies and holes in the financial regulatory framework could also have a negative impact on the enforcement capabilities of the supervisory authorities.

Yet another problem when trying to correct legal holes on a case-by-case basis is the different relative speed of reaction of the financial industry and that of the financial authorities. Indeed, part of the reason that the regulation of various restrictions on private financial activities has been relaxed in recent years is that it has become ineffective, given the ability of market participants to find ways to bypass those restrictions.

In conclusion, two types of moral hazard problems could indeed affect the effectiveness and efficiency of financial regulation and supervision to fulfill the core objectives of regulation. The first involves excessive risk-taking behavior by the public and could jeopardize the protection of consumers and the stability of the financial system under an integrated approach. However, there are methods to mitigate this problem, and they are less costly than the case-by-case alternative of trying to correct various inconsistencies in a legal framework originally designed to fulfill a set of objectives different from the core ones. More importantly, the specialized approach cannot be said to be free of moral hazard problems either.

The second type of moral hazard problem identified in this section involves excessive risk taking by financial institutions when key aspects of market participants' behavior or crucial information are hidden from the financial regulator. This moral hazard is likely to affect the specialized approach more, jeopardizing both consumer protection and the stability of the financial system. Moreover, trying to correct or eliminate holes in legislation and in supervision could indeed be very costly, involving numerous case-by case modifications.

Christmas Tree Effect

Another potential problem that could adversely affect the integrated approach is the so-called

“Christmas tree effect,” according to which the number of heterogeneous objectives to be fulfilled by an integrated agency might grow progressively in an endogenous, maybe unbounded, fashion. The basic idea is that, since it may be difficult to include all the relevant objectives in the legislation creating the new integrated financial authority, additional objectives may have to be incorporated after the new authority is established.¹⁷ The risk of this initial *remit incompleteness* is that it opens the possibility for heterogeneous objectives to be later introduced, even ones that could be in conflict with the main objectives of financial regulation. Consequently, this problem has the potential to affect the fulfillment of the three core objectives of financial regulation. There seems to be some evidence of this serious problem in the Scandinavian experience with integration (see Taylor and Fleming, 1999).

When considering the Latin American and Caribbean cases, a clear picture emerges: a wide range of heterogeneous functions already exists at the level of specialized regulators, with consumer protection being usually neglected as a main objective. Take the case of the banking regulators, for example. A review of 20 banking regulators across different countries in the region reveals that only six of them clearly and explicitly include consumer protection as a main regulatory objective of regulation (see table 1 in the appendix). In some cases, mandatory objectives are to fully develop the skills of the employees, to use up-to-date information systems, to give advice to financial institutions on portfolio strategies, to encourage a culture of excellence and leadership, or to strengthen the capabilities of the employees to work as a team. In 11 of the 20 cases, the number of objectives exceeds the number of core objectives, and in all but two of the cases the list of core objectives is not complete; that is, at least one main objective is missing. At the same time, some *noisy* objectives are typically included. A rather natural

¹⁷ We are referring to the possibility of adding new (less relevant) objectives and not to extending the scope of a single financial regulator, which is a (necessary) feature naturally associated to the process of integration.

question arises at this point: can the integration of financial regulation and supervision worsen the situation in these countries? In theory, the answer is yes. However, in practice the answer is probably no. Indeed, the move to integration could act as an opportunity to adopt a consistent, sensible, narrow, and well-defined set of objectives. In fact, the LAC countries that recently modified their regulatory framework and started to move toward integration now have a less heterogeneous, better defined, set of objectives.

As shown by the previous empirical analysis, a Christmas tree effect seems to be already affecting specialized banking regulators in Latin America and the Caribbean. In particular, the objective of consumer protection is generally absent from their statutory objectives. This does not happen in some cases (Peru and El Salvador, for instance) that have recently moved in the direction of the integrated approach to regulation and supervision. Given these developments, it seems that the move toward the adoption of an integrated approach to regulation can be *less costly* than a case-by-case revision of mandatory objectives at the level of the specialized regulators. Furthermore, the integrated approach also seems to be *more effective* in achieving the fulfillment of the core objectives of regulation, given the large amount of heterogeneous objectives currently in place in LAC countries under the prevalent specialized approach.

Bureaucratic Leviathan

Another main concern that has been raised in connection with the integrated approach is that a single regulator could potentially become a bureaucratic leviathan divorced from the industry it regulates. As argued by Taylor (1995):

...(a single regulator), with a remit covering both prudential and conduct of business regulation in banking, securities and insurance and with the power to undertake civil proceedings against those it suspected of insider dealing or market abuse, could potentially become an over mighty bully, a bureaucratic leviathan divorced from the industry it regulates.

This is indeed a meaningful critique, one that arose in the debate prior to the establishment of the integrated agency in the United Kingdom. In his analysis of the British case, Briault (1999) acknowledges that there is no easy way to avoid the perception of this risk. However, there are ways to prevent it from occurring. The key principles that the legislative framework of an integrated approach to financial regulation should take into account are the *predictability, transparency and accountability* of the integrated agency regarding its actions and procedures. According to Briault (1999), the British government has addressed this problem in two main ways: (i) by strengthening the statutory accountability mechanisms in the legislation, and (ii) by improving the legislative provisions that govern the investigation and discipline powers of the single regulator agency. To strengthen statutory accountability, the Financial Services Authority established and published clear rules regarding supervision, investigation and competence in a single handbook of rules and guidance, and a single complaint-handling regime. To improve the legislative provisions on the investigation and powers of the regulatory authority, the Financial Services Authority was explicitly required to establish and publish procedures on disciplinary actions and to act in accordance with them.

At the same time, the integrated agency itself published clear rules concerning: (i) how it intended to meet its responsibilities under the new single agency act; (ii) how it planned to consult with interested parties in formulating its standards and requirements; and (iii) how it planned to establish the internal procedures necessary to ensure that its enforcement processes are used fairly and are widely accepted as fair ones. This explicitly included a *clear internal separation of functions between the staff that investigate a case from those who take the decision to proceed with enforcement actions*. The institutional arrangement in the United Kingdom also included the establishment of an independent Tribunal to hear cases against the FSA brought by firms that disagree with disciplinary actions proposed by the FSA against them.

We do not know of any evidence that the recently created single financial regulator in the United Kingdom has become “a bureaucratic leviathan divorced from the industry it regulates.” However, the potential for this to happen exists. It should come as no surprise if it occurs in a case in which no precaution is taken. However, there are effective remedies (in the form of legal provisions and mandatory statutory limits) at hand. In this regard, an interesting question arises: How many specialized regulators in Latin America and the Caribbean include provisions like these to limit arbitrariness? A review of the legislation and regulatory framework indicates that only a few.

Concluding with the issue of the bureaucratic leviathan effect, we notice that in the countries of Latin America and the Caribbean, the integrated approach has the potential to be both more effective and more efficient in fulfilling the core objectives of financial regulation. In particular, this derives from the prevalent lack of internal separation within specialized regulators between the staff who investigate potential cases of crime or corruption and those who proceed with enforcement activities.

Regulatory Capture

Another relevant problem that could affect an integrated approach is the potential for regulatory capture. The basic underlying idea is that bribing many regulators would be considerably more difficult than bribing only one if competition among them were possible. Consumer protection is mainly at risk in this case.

Claessens and Klingebiel (1999) notice that competition between regulators has been usually advocated in other similar contexts as a means to avoid regulatory capture. At face value, this argument gives the specialized approach a strong advantage relative to an integrated one. However, the case is less clear-cut once some relevant qualifications are introduced. First, the argument that competition is a strong barrier against regulatory capture applies forcefully in cases in which information among participants (regulators, in this case) is perfect, the number of participants is large, anonymity is assured,

and the activity is a legal one. In the present case, these conditions do not fully apply. Second, in practice, a financial conglomerate might not need to bribe all the regulators to be able to get rid of the firewalls that impede profit maximization on a group-wide basis. Usually, the binding firewall is just one. Third, problems of information among the regulators could be present, so that the bidding process that is necessary for competition to preclude regulatory capture could not materialize. This argument of asymmetric information among regulators seems to be particularly strong in the present case in which trade involves an illegal activity and only a few nonanonymous regulators are involved. Fourth, at least to some extent, organization along functional activity lines would be preserved in the case of an (new) integrated agency. This would be especially true during the transition phase. It also tends to make the case for competition a less clear-cut one in the present context. Last, but not least, there is the issue of the enforcement of rules by a superior authority. In principle, it seems easier for the Judiciary and its financial police branch to enforce the law (thus making bribing more difficult) if only one supervisor is in charge, than if multiple ones are in place.

A more radical argument can be used to make the point that the potential for regulatory capture is not necessarily important in practice. As noted by Claessens and Klingebiel (1999), what matters to determine the degree of competition in a market is not the number of competitors, but how contestable the market is, which is mainly determined by the existence of barriers to entry. If the institutional arrangements set up to put in place the integrated authority are organized in such a way that the legislature has the power to replace officials involved in cases of corruption in an expedited and legal manner, strong incentives against accepting bribes are present, thus making potential regulatory capture more difficult. That is, the existence of a credible threat to remove officials involved in bribing using a legal, transparent, publicly known, and expedited procedure may reduce the potential risk for regulatory capture when an integrated authority is established.

Based on the previous discussion, it seems that an integrated regulatory authority would be both more effective and more efficient to assure consumer protection. An integrated agency would be better in dealing with a potential regulatory capture than many specialized regulators operating in a legal framework characterized by holes and inconsistencies.

THE PERILS OF SEPARATING BANKING REGULATION FROM THE CENTRAL BANK

In some countries, one effect of creating a single financial services regulator would be to move banking regulation and supervision away from the central bank. This section approaches the problem from two perspectives: monetary policy issues, and banking regulation issues.

Monetary policy issues pose two main questions. First, what are the costs and benefits of combining the monetary policy function and the banking regulation responsibility within the central bank? Second, does the lender of last resort function provide a rationale for the central bank to undertake financial regulation of those financial institutions that are deemed to give rise to systemic risk? The answers are as follows: First, even when it is not generally possible to provide an unambiguous cost-benefit result on purely theoretical grounds, in the case of the Latin American and the Caribbean countries, the costs probably outweigh the benefits of combining monetary policy with the financial regulator role in a single institution, that is, the central bank. Second, the central bank role as lender of last resort does not generally provide a rationale for making it the financial sector regulator. The lender of last resort function (like the benefits of combining monetary policy and banking regulation) only provide support for close links and a proper flow of information between the relevant banking regulator and the monetary authorities, but has no unambiguous implications for the structure of regulation.

We now focus on the first question. The informational *advantages* of combining monetary policy and regulatory responsibilities in a single institution have been recently highlighted by

Peek et al. (1999) who find evidence that confidential supervisory information on the financial conditions of U.S. banks has been successfully used in setting U.S. monetary policy.¹⁸ However, this finding seems of limited relevance for the economies of Latin America and the Caribbean because the nature of monetary policy is very different in some countries of this region. A big central bank, like the U.S. Federal Reserve System, can engage in a truly independent monetary policy that sets interest rate targets. However, only a few of the central banks of the region are in a position to engage in that kind of policy.

In an environment of high international capital mobility, the scope for that type of policy is limited by the degree of substitution of domestic and foreign bonds. That is, the problem with the line of argument posed above when applied to the countries of Latin America and the Caribbean is that the scope for an independent monetary policy like the one pursued by 'big' central banks, is itself severely limited in the first place. Given this, the case made in favor of merging the conduct of monetary policy and financial regulator functions within the central bank is not particularly strong. However, this does not mean that, in general, there will be no need for close links (and a proper flow of information) between the monetary authority and the financial sector regulator. This becomes particularly relevant during periods of financial distress when the core objective of financial stability could potentially be in jeopardy. This has been explicitly recognized in the recent British move toward the adoption of the integrated approach to financial regulation. As expressed by the Governor of the Bank of England:

Monetary and financial stability are inter-related. It is inconceivable that the monetary authorities could quietly pursue their stability-oriented monetary policy objectives if the financial system through which policy is carried on—and which provides the link with the real economy—were collapsing around their ears...This

¹⁸ The credit channel literature, summarized by Bernanke and Gertler (1995), provides a reason why monetary policy may need to pay close attention to financial sector developments.

inter-relationship means that, whatever the precise institutional arrangements for financial regulation and supervision, central banks necessarily have a vital interest in the soundness of the financial system. (George, 1994)

Another recent example of institutional reform that separated banking regulation and monetary policy, while keeping close links between the banking regulators and the monetary authorities, is the creation of the European Central Bank. This institution has separated financial regulation and monetary policy functions across the euro area, leaving some central banks with responsibility for banking supervision, but not for monetary policy, and some with responsibility for neither function.

The fact that some (prominent) central banks in a position to implement independent monetary policies have recently decided to separate the banking regulatory and supervisory functions from monetary policy suggests that there are indeed some *costs* associated with the merger of both functions under the same authority. What are those costs? First, there might be a conflict of interest that tempts the central bank to loosen monetary policy because of concerns about the financial health of the banks it regulates. As a consequence of this, there would be an upward bias in the rate of inflation à la Barro-Gordon. This case constitutes a canonical example of time inconsistent policies due to conflicts of interest (Drazen, 1999).¹⁹ The problem could be especially serious in the case of liquidity assistance credits to ex-post insolvent commercial banks. The Southern Cone banking crises of the early 1980s illustrates this point neatly.²⁰

A second important cost, as stressed in Cukierman (1992) and Bruni (1997) among others, stems from the fact that a wider central bank role increases the risk that its functions will be subject to political pressures or political control. This argument seems particularly relevant in the case of the Latin American and Caribbean coun-

¹⁹ The issue of time inconsistent policies in a monetary economy was first addressed in Calvo (1978).

²⁰ See Sundararajan and Baliño (1991) for a study of these banking crises.

tries. The removal of the governor of the Central Bank of Argentina in 2001 is just one example. According to the report written by the legislators, the argument for removal of both the governor of the central bank and the superintendent of banks²¹ was that they failed to act free of political influence in issues ranging from money laundering to financial assistance to distressed banks.

Turning to the issue of the lender of last resort, there is a clear rationale for financial regulation in response to *systemic* liquidity risk (see Llewellyn 1999a, for instance). But does this provide an argument in favor of the central bank undertaking banking regulation? The answer is probably no. The decision to provide official support will, more often than not, involve the government rather than just the central bank. In fact, recent experiences in crisis management point in this direction. In the Venezuelan banking crisis of 1995, for instance, the creation of the *Junta de Emergencia Financiera* involved the participation of the fiscal authority, the central bank, the banking regulator, and the deposit insurance corporation.

Does the fact that more often than not the fiscal authority will be involved in managing banking crises mean that we have found a rationale for their undertaking banking regulation? Clearly, the answer is no. Similarly, the participation of the central bank in the resolution of systemic banking crises does not provide a rationale for the monetary authority to undertake banking regulation. Moreover, as is the case in many countries, the institution-specific information available to regulators can be transmitted rapidly to the central bank and to the fiscal authorities once problems arise.

So far, the analysis has been done from the point of view of the central banker. We now turn to the benefits and costs that the *banking regulator* could derive from the merger of monetary policy. From the benefits side, it can be argued that merging monetary policy with banking regula-

tion functions reduces the coordination problems, facilitates the access to relevant information, and diminishes the risk of the deteriorating quality of human resources.

The advantage of reducing the problems of coordination is undeniable, but has to be carefully balanced against the potential for different conflicts of interests to arise, as discussed above. It is not at all clear, on purely theoretical grounds, if the benefits of the merger are high enough to outweigh the costs stemming from conflicts of interest.

In practice, it is even less clear that the benefits in terms of facilitating coordination will outweigh the costs from potential conflicts of interest. The experience of many of the countries of Latin America and the Caribbean in dealing with financial crises of different varieties is rich enough and provides plenty of cases of loose, time inconsistent, supervisory policies. The case of Chile in the early 1980s, as described in Diaz Alejandro (1985), may constitute a paradigmatic example of loose financial supervisory policies undertaken by a banking regulator that was subordinated to the monetary authority. The *tablita* exchange rate plan in the 1980s put a strain on banks' balance sheets, deteriorating the quality of loans already allocated to firms operating in the tradable sector (and also generating strong incentives for banks to venture into speculation in nontradable business). However, given the prevailing institutional arrangements, the banking regulator was unable to elicit these problems in lieu of exposing the weaknesses of the central bank's monetary policy.

The second potential advantage of the merger of functions from the standpoint of the banking regulator is related to the increased amount of information (regarding monetary conditions) and of the number of instruments that the banking regulator could have available. As an example, consider the access to the discount window, in the context of strengthening programs for banking institutions that include increasing conditionality clauses as the program is being implemented. In the presence of adverse aggregate (systemic) liquidity shocks, access to the discount window could give the banking regulator

²¹ In Argentina, the Superintendency of Banks operates under the authority of the Central Bank. See Table 2 in the appendix.

extra degrees of freedom to continue with the implementation of the reform program, even in an adverse environment. Again, this has to be taken with a grain of salt. In the presence of conflicts of interest, given the usual institutional arrangement in which the banking regulator is subordinated to the monetary authority, the quality of banking regulation and supervision could be compromised.²² Moreover, borrowing once again from evidence of the Southern Cone banking crises during the early 1980s, a dangerous cost of the merger of functions would be the potential for compounding errors in regulation and supervision when an inconsistent monetary policy is in place and the institutional arrangement is such that the banking regulator depends on the monetary authority.

The concern among some banking regulators of the danger of deteriorating the quality of human resources goes along the following lines. The quality of human capital in a central bank typically tends to be high. If it happens to be higher than the average quality prevailing in the other specialized financial regulators, the creation of a single financial authority that moves banking regulation outside of the central bank could lead to a reduction in the quality of both banking regulation and supervision. This could even lead to a reduction in the quality of financial regulation across financial products and firms in the industry. This does not need to be the case, however, if the creation of the single financial services authority is done following best practices in institutional reform. In particular, insofar as the potential economies of scope and scale that exist in financial regulation can successfully materialize, an upgrade in the quality of human capital in financial regulation and supervision would be possible (see, below, the section on economies of scale and scope in financial regulation).

²² Additionally, it should be noted that even if banking regulation is separated from the central bank, this does not of itself preclude the possibility of using central bank instruments in situations of banking distress and of ensuring an adequate flow of information between the regulator and the central bank.

Finally, even if the separation of banking regulation from the central bank were to be accepted as an important cost in the move to the integrated approach (thus potentially jeopardizing financial stability), which, as the previous discussion has made clear, does not have to be the case, we still would like to know for how many countries in LAC this can be a concern. Table 2 in the appendix provides an answer: less than half of the countries in the region surveyed in this paper (10/24) currently have banking supervision in the orbit of the central bank. Therefore, whatever our impression about the impact of this issue on the effectiveness of the integrated approach, for more than half of the countries in Latin America and the Caribbean this will not be a problem. Moreover, in the case of those for which the issue of separating banking regulation from the central bank could be a problem, the message of this paper is that, if properly done, the move toward an integrated approach does not have to constitute a major risk for financial stability. We believe that the arguments discussed above and the experiences of recent successful institutional reforms clearly justify this point.

MAIN ARGUMENTS FOR INTEGRATION

Although the literature considers several arguments in favor of integration, we will concentrate in this section on four of the more relevant issues: economies of scale and scope, the prevalence of financial conglomerates, competitive neutrality, and transparency and accountability.

Economies of Scale and Scope

One crucial issue that is usually cited as providing support for the adoption of an integrated approach to financial regulation and supervision is related to the existence of economies of scale and scope in regulation. Conditional on the existence of such economies, there might be advantages in having a small number of agencies or even a single authority. There are economies of scope in regulation if the joint costs of regulating two or more financial activities simultaneously are less than the sum of the costs of regulating each financial activity separately. Similarly, there are economies of scale if, for a single

financial activity the average cost of regulation and supervision falls as the volume of that activity increases.²³

The concept of scale economies is relatively well known. However, the concept of economies of scope is not as usual. Thus, at this point it could be asked what economies could be achieved by centralization, *in excess of pure scale economies*. In addition to pure scale economies, a single agency could be more efficient in the allocation of regulatory and supervisory resources both across firms and types of regulated activities. One crucial element here is the elimination of overlaps from multiple specialized regulators concentrating their attention on the same subset of issues. Indeed, one of the main criticisms that the financial industry in the United Kingdom had about the earlier fragmented structure of regulation and supervision was the frequency with which different specialized regulators wanted to discuss with the senior management of a firm how its business was structured and operated (Briault, 1999). Second, another crucial element that could help promote a better allocation of regulatory and supervisory resources under the integrated approach is the development of a single system of risk-based supervision. Under such a system, regulatory resources are devoted to those firms and areas of business that imply the greatest risks when judged against the main objectives of financial regulation, as was the case in the United Kingdom.

After this brief introduction to the subject, we can go back to the main course of reasoning. In trying to evaluate the potential cost reductions that could be achieved in financial regulation and supervision from the move to integration, it is useful to identify the type of costs imposed by financial regulation. Those costs can be classified, following Goodhart et al. (1995), in three categories: (i) institutional costs (the costs of running regulatory agencies); (ii) compliance

costs (the costs imposed on firms through regulation); and (iii) structural costs (such as excess burdens, stifling of innovation, etc.).

The existence of economies of scale and scope in regulation and supervision would imply that an integrated approach would have the potential to reduce institutional costs. But does it *necessarily* imply an advantage of the integrated approach in terms of reducing compliance and structural costs vis-à-vis the specialized approach? The answer is no. Once again, the importance of a clearly defined and narrowly limited set of objectives guiding the actions of the financial authority applies forcefully. If a single regulator encompassing a wide variety of financial institutions adopts an inappropriate regulatory regime (say because its remit is too wide and unfocused), the compliance and structural costs of regulation would rise, potentially outweighing the benefits stemming from the economies in purely institutional costs. Thus, if the existence of potential economies of scale and scope in regulation has been identified, the adoption of the integrated approach requires the simultaneous establishment of a narrow and clearly defined set of objectives in order to make those economies effective.

Once a narrow and well-defined set of objectives has been put in place, and the potential for relatively important scale and scope economies in regulation have been identified, is there any practical way to realize the potential institutional cost reductions? This is an important question in the practice of institutional reform, and no definite answer can be provided. The answer depends on implementation. However, there is some guidance that can be obtained from both theory and recent case studies in the institutional reform of financial regulatory frameworks.

Economic theory would suggest some pre-commitment mechanism to alleviate the potential for time inconsistency that could be present in a case like this one, in which the policymaker could be tempted not to realize the economies, once the reform has already taken place and the time to economize has come. The United Kingdom provides a prominent example in which these economies were successfully realized. To

²³ Formally, there are economies of scope in the regulation of activities x and y , if: $c(x,y) < c(x)+c(y)$. Similarly, there are economies of scale in regulating activity x , if: $AVG C(aX) < AVG C(X)$, where $a > 1$ and C denotes costs.

ensure these economies, during the first year of operation, the newly created Financial Services Authority (FSA) budgeted costs that were lower in real terms than the aggregated costs of all the regulatory institutions being integrated in the FSA in either of the previous two years. That restriction was imposed despite the FSA having a slightly wider scope than that of the nine regulatory bodies being brought together (Briault, 1999). Budgeting the projected savings from scale and scope economies provides the pre-commitment technology necessary to avoid the time inconsistent solution and minimizes the risks of not realizing the potential scale economies when moving to the integrated approach.

The Scandinavian countries provide another example in which these economies of scale and scope in regulation seem to have been realized to an important extent. According to Taylor and Fleming (1999): "In Denmark, Norway and Sweden it is maintained that the small country rationale for integration has been conclusively vindicated by subsequent experience."

So far, we have been discussing the possibility of achieving scale and scope economies in financial sector regulation through institutional reform in somewhat abstract terms. But what concrete examples of economies of scale and scope are usually provided in the literature? Moreover, which of them have been stressed in recent experiences of institutional reform? The answer to the first question has a number of different dimensions. First, it has been argued that centralizing regulatory functions and activities can permit significant economies through the development of joint administrative, information and technology (IT), and other support functions (Goodhart et al., 1995; Taylor and Fleming, 1999; Briault, 1999). Second, it has also been argued that centralizing regulatory functions would assist in the recruitment and retention of suitably qualified regulatory personnel, who might perceive that the career opportunities available to them in an integrated agency would be significantly better than in a series of specialized organizations (Taylor and Fleming, 1996). Third, economies can also be attained with regard to the gathering and using of know-how in special areas and to the development and im-

provement of supervisory methods. Finally, it has been argued, especially in the case of the Scandinavian countries, that centralization of functions permits the regulatory authority to achieve efficiencies in the deployment of staff with rare intellectual capital. The Scandinavian countries, the argument goes, had the need to optimize their use of scarce, highly specialized, human resources to be able to participate fully in international regulatory forums (Taylor and Fleming, 1999). The last two considerations seem to have played an especially significant role in the move toward the adoption of an integrated approach in both Norway and Sweden.

A review of the experience of the United Kingdom in its move to an integrated regulatory agency highlights a couple of additional examples of economies that could potentially be achieved from the centralization of functions in a single organization. On top of the already discussed elimination of unnecessary duplication across multiple specialized regulators (apparently very relevant in this case), Briault (1999) stresses: (i) the introduction of a unified statistical reporting system for regulated firms; (ii) the operation of a single database for the authorization of firms (and the approval/registration of individuals); (iii) the introduction of a consolidated set of rules and guidance; and (iv) the provision of a single fixed point of contact to both regulated firms and to consumers, through a single complaints handling regime and a single compensation scheme.

Is there room for economies of scale/scope in regulation to be realized in the Latin America and the Caribbean? How can the situation in Latin America and the Caribbean compare to the situation in countries like the United Kingdom, or the Scandinavian countries that decided to reform their institutional financial regulation arrangements? The relevance of these questions is twofold. First, different institutional configurations have implications for the cost of regulation, as argued above. Second, the costs of regulation have a direct, first order impact on one of the core objectives of regulation: the efficiency with which the financial system operates.

As a first attempt at addressing the two questions posed above, the reader should notice that the discussion about scale economies in regulation could be restated as an application of the *small country* principle.²⁴ Hence, countries with smaller financial systems would benefit more from adopting the single agency approach. We use the size of money and quasi-liquid banking liabilities (M3) as a proxy for the size of the financial system. We are aware of the shortcomings of proceeding in this way, but availability of data restricted our choice. Many interesting observations can be drawn from Table 3, presented in the appendix.

In terms of the first question posed above, it should be noticed that with the exception of Brazil, Mexico, Argentina, Chile, Colombia and Venezuela, all the remaining countries have financial banking systems below the regional mean size. At least eighteen countries with banking systems below the regional median value could be unambiguously called *small countries*: Panama, the Dominican Republic, El Salvador, Costa Rica, Guatemala, Bolivia, Ecuador, Trinidad and Tobago, The Bahamas, Jamaica, Honduras, Paraguay, Barbados, Nicaragua, Haiti, Guyana, Belize, and Suriname.²⁵

Moving to the second question posed above (i.e., how do these figures compare to those of the United Kingdom or the Scandinavian countries, for instance), all the countries in the region have smaller financial systems than the United Kingdom. Second, with the exception of Brazil, Mexico, and Argentina, the size of banking systems in Latin America and the Caribbean is significantly smaller than in Sweden, Denmark, and Norway. Similar arguments apply when the comparison is made against other reformers elsewhere. Unless one thinks that the situation would change dramatically when including proxies for the size of the securities, pension, and insurance sectors, the present evidence sug-

gests that the case in favor of a single financial regulator cannot be easily dismissed by appealing to a *diseconomies* of scale argument based on cross-country comparisons.

There is an important additional reason why the small country rationale would also seem to apply to many of the countries in Latin America and the Caribbean. That reason is simply that many of the regulatory agencies in the region are still in the process of building up their human capital. Hence the problem of thinly spread human resources among different specialized agencies would be compounded in Latin America and the Caribbean. Where regulatory resources are scarce, and a cadre of regulatory professionals is being developed, the argument that all the relevant human capital should be concentrated in a single organization becomes particularly strong.

The previous discussion has made clear that institutional costs of regulation affect the efficiency with which the financial system operates. A proxy for the efficiency of the banking system is the size of the spread between lending and deposit rates. Some quick, back-of-the-envelope, calculations reveal that there is plenty of room for improvement in terms of spreads in Latin America and the Caribbean. Accordingly, the adoption of effective, cost-economizing methods of financial regulation could indeed be beneficial. The extent to which the adoption of an integrated approach can contribute to reduce costs is difficult to evaluate. However, the previous discussion seems to suggest that an integrated approach can be both more effective and more efficient than a specialized one for the achievement of an efficient financial system.

The previous small country argument in favor of the integrated approach has to be carefully balanced against the potential loss of valuable information and knowledge that the centralization of decisions could bring about. If relevant knowledge is already spread along institutional lines among the different specialized regulators, and centralization does not take this fact into account, relevant human capital could be destroyed and relevant information could not be communicated. This case resembles certain key features (information destruction due to central-

²⁴ As correctly pointed out by Taylor and Fleming (1999, p. 10).

²⁵ Even when they do not belong in our sample of countries, it is worth noticing that this argument would also apply to the Eastern Caribbean economies.

zation) of the classical Hayekian case against central planning. However, there is a crucial difference: in the case of regulation and supervision, centralization will not imply the disappearance of the market price mechanism. In any event, the potential loss of knowledge/information could still be important, even if not decisive, suggesting that the rationale for the division along institutional lines should be preserved, at least to some extent, even if a single agency is to be put in place. Since this is an issue of implementation closely linked to the transitional phase from a specialized regime of financial regulation to an integrated one, and this largely exceeds the purpose of the present paper, we do not expand our reflections on this issue here. However, we stress that if the transitional phase is not handled carefully, this could potentially become a serious problem.

Prevalence of Financial Conglomerates

One of the most prominent arguments in favor of integrating regulation is based on the need to better regulate and supervise the activities of financial conglomerates. *“The rise of financial conglomerates, which operate diverse groups of financial institutions domestically, and often internationally as well, has led regulators to seek to identify ways to efficiently and effectively oversee their operations”* (Abrams and Taylor, 2000, p. 10). Financial conglomerates, generally through individual institutions, offer a vast assortment of products related to at least two of the operations associated with banking, insurance and securities.

The diverse nature of the activities developed by financial conglomerates requires that the risk of the group be assessed on a consolidated basis and that its supervision be free of gaps. In addition to assessing the risk and determining the minimum level of capital for each of the member institutions, there is a need to determine an adequate level of capital for the conglomerate as a whole. This capital requirement should take into account the risks assumed by the conglomerate, as well as the existence of intra-group risks. Demaestri and Sourrouille (2002) describe some relevant aspects of the experience of coun-

tries with integrated supervisors in regulating and supervising financial conglomerates.

There are also systemic considerations. As pointed out by Briault (1999): “the increasing prevalence of financial conglomerates means that a multiple regulator structure might make it more difficult to assemble and to assess the available regulatory information in times of emergency, than would be the case with a single regulator. The synergies arising from a single regulator may outweigh those arising from undertaking the regulation of a sub-set of financial institutions within a central bank.” However, if banking is the most important activity of the conglomerate and the establishment of an integrated supervisor implies the separation of the supervision from the central bank, the efficiency in achieving the stability of the financial system may be affected.

The presence of financial conglomerates seems to be particularly relevant for LAC countries. Table 4 in the appendix presents an index of conglomeration of financial activities in a sample of countries from the region. Half of the countries in the sample (5/10) has indices of conglomeration that are greater than or equal to the one in Norway, which is one of the main reformer countries in Scandinavia where the issue of conglomeration was one of the critical elements that contributed to the adoption of the integrated approach to financial regulation and supervision (Taylor and Fleming, 1999).

Under these circumstances, achieving the core objectives of financial regulation requires the elimination of supervisory gaps and the sharing of information related to the different institutions that form the conglomerate. Close cooperation among supervisors is also required, as well as the definition of a lead supervisor in case the conglomerate as a whole should implement certain actions to preserve its health and reduce systemic risks. Clearly, an integrated regulator is in a much better position to effectively achieve the objectives of consumer protection and system stability. The costs associated with the functioning of an integrated supervisor are also probably lower than those required to coordinate the actions of specialized institutions. Consequently,

there are also gains in terms of efficiency in the achievement of the objectives by an integrated regulator.

If the participation of conglomerates in the financial sector were significant, the achievement of the objective of increasing the efficiency of the system would be both more effective and less costly in the case of integrated regulation. The requirements of information and other costs associated to actions of a single supervisor would be much lower than those resulting from the coordination of individual, specialized supervisors.

Competitive Neutrality

During recent years, market developments have been characterized by consumers demanding a set of diverse and relatively more sophisticated financial products and financial institutions supplying diversified products to maximize benefits in a more competitive environment. These developments have been accompanied by a blurring of the boundaries between financial products and services. As Briault (2002) points out: "Banks, insurance companies and securities firms are now competing in the same market for the same customers, with similar and often even identical products, and via the same distribution channels."

In a context of specialized regulation, the blurring of boundaries between financial products may imply that financial institutions offering similar products are supervised by different agencies. This may result in those institutions being subject to different regulations and requirements of information and, consequently, facing uneven supervisory costs. This differential regulatory treatment and costs would lead to competitive advantages for certain institutions. Incentives to engage in supervisory arbitrage would also develop. The behavior of the financial institutions in this environment would run against the efficacy in achieving the core objective of consumer protection and market efficiency. Also, the increases in costs for both the supervisors and the financial institutions will make more costly the achievement of consumer protection. Under integrated regulation, the ac-

tivities of a single supervisor will minimize the risks of introducing competitive advantages among the financial institutions and promoting supervisory arbitrage.

The arguments regarding the achievement of the objective of systemic stability are less clear-cut. Based on the diverse potential systemic risks associated with different financial institutions, as Abrams and Taylor (2000) point out: "... supervisors can argue that it is proper to supervise the same operation differently depending on the nature of the institution which is carrying out the transaction." Consequently, integration appears to be neutral regarding the efficacy in achieving systemic stability in the presence of competitive advantages. However, integration may still be more efficient (less costly) because it would discourage the engagement in supervisory arbitrage.

Transparency and Accountability

The adoption of the integrated approach to financial regulation and supervision provides an excellent opportunity to give the single agency a clear set of responsibilities. The definition of clear responsibilities will make possible a substantial increase in the transparency and accountability with which the financial regulator operates, not only in terms of its performance relative to the statutory objectives, but also in terms of the regulatory regime, the costs of regulation, the application of its disciplinary policies, etc. In this respect, as discussed in the section about the potential for the single agency to become a bureaucratic leviathan, it is important for governments deciding to move toward a single agency to:

1. Strengthen the statutory accountability mechanisms in the legislative framework, introducing a single complaint handling regime and a single compensation scheme;
2. Improve the provisions in the legislative framework that govern the investigation and discipline powers of the single regulator, including a requirement on the single regulator to establish and publish

simple and clear procedures on taking disciplinary action and to act in accordance to them; and

3. Establish the internal procedures to ensure that its enforcement processes are

used fairly and are seen to be fair, including a clear internal separation of functions between the staff who investigate a case and those who take the decision to proceed with enforcement actions.

Summary of Results and Final Thoughts

This section summarizes the main results of the analysis about the pros and cons of both the integrated and the specialized approach to financial regulation and supervision in Latin America and the Caribbean. The following table presents

the summary of findings, taking into account both the three main objectives of financial regulation and the effectiveness and efficiency of each approach to fulfill them.

Efficacy and Efficiency of Integrated and Specialized Approaches to Fulfill ‘Core Objectives’ in LAC					
ISSUES	OBJECTIVES	INTEGRATED APPROACH		SPECIALIZED APPROACH	
		Efficacy	Efficiency	Efficacy	Efficiency
Moral hazard	Consumer Protection	+/-		+/-	
	Financial System Efficiency	+		-	
	Systemic Stability				
Regulatory capture	Consumer Protection	+	+	-	-
	Financial System Efficiency				
	Systemic Stability				
‘Christmas Tree’ Effect	Consumer Protection	+		-	
	Financial System Efficiency				
	Systemic Stability				
Bureaucratic Leviathan	Consumer Protection				
	Financial System Efficiency	+	+/-	-	+/-
	Systemic Stability				
Separation from Central Bank	Consumer Protection				
	Financial System Efficiency				
	Systemic Stability	+/-		+/-	
Economies of Scale and Scope	Consumer Protection				
	Financial System Efficiency	+	+	-	-
	Systemic Stability				
Financial Conglomerates	Consumer Protection	+	+	-	-
	Financial System Efficiency	+	+	-	-
	Systemic Stability	+	+/-	-	+/-
Competitive Neutrality	Consumer Protection	+	+	-	-
	Financial System Efficiency	+		-	
	Systemic Stability	+/-	+	+/-	-
Transparency and Accountability	Consumer Protection	+	+	-	-
	Financial System Efficiency	+	+	-	-
	Systemic Stability	+	+	-	-

The table shows clearly which objective is mainly affected by each of the issues and how effective and efficient each approach is in fulfilling the core objectives of regulation in the presence of that issue. A plus sign (+) indicates that the corresponding approach to which the (+) sign is attached has an advantage in fulfilling a certain objective of financial regulation. If when analyzing a certain issue, a (+) sign is attached to a particular approach, then a corresponding minus sign (-) is attached to the alternative approach. A (+/-) sign indicates ambiguity (that is, it is not clear which approach is more effective/efficient).

The first thing to notice from the table is the concentration of (+) signs in the columns corresponding to the integrated approach. Moreover, the advantage of the integrated approach seems to stem more from its effectiveness than from its efficiency. A second thing to notice is that the distribution of the signs is more or less uniform across the different issues. That is, the overall relative superiority of the integrated approach is not stemming from its advantage on some particular issues, but aside from some ambiguities it seems to apply along the whole range of issues. A third thing to notice from the table (which complements the previous statement) is the strong advantage of the integrated approach in terms of the prevalence of financial conglomerates and the transparency and accountability to fulfill the three core objectives of financial regulation. Another thing to notice is the unambiguous advantage of the integrated approach regarding the issues of regulatory capture and economies of scale and scope. In the case of the regulatory capture, the integrated approach is superior to the specialized one in terms of both the efficacy and efficiency to achieve the objective of consumer protection. Regarding the economies of scale and scope, the integrated approach is also preferable regarding the efficacy and efficiency to achieve the objective of promoting efficiency in the financial system.

Three issues about the *efficacy* of the integrated approach are inconclusive in the table. They are: (i) moral hazard problems affecting consumer protection; (ii) separation of the banking regulation from the central bank that could potentially affect systemic stability; and (iii) competition

neutrality that does not have a conclusive effect regarding systemic stability.

We opted to underscore the inconclusiveness in terms of efficacy regarding these three issues to highlight where the main difficulties may lie when trying to move toward an integrated approach. We have done that even when the discussion presented in the third section was about potential remedies that could make the integrated approach a more effective one, when dealing with consumer protection in the face of moral hazard problems, and better suited when dealing with systemic stability issues in the presence of conflicts of interest. Additionally, the inconclusiveness associated with the separation from the central bank would only be a relevant issue for those countries where the supervision of banks is currently performed by the central bank. However, it should be noticed that in most Latin American and Caribbean countries the supervision of banks is already performed outside the monetary authority.

For the remaining issues, the integrated approach seems to be more *effective* in fulfilling the core objectives of financial regulation than the specialized one in the case of countries with characteristics similar than those prevailing in Latin America and the Caribbean.

Turning to the *efficiency* with which each approach fulfills the core objectives of financial regulation in the region, the only ambiguities arise when the potential for the single agency to become a bureaucratic leviathan is present and regarding the prevalence of financial conglomerates and systemic stability. In all the remaining cases, the integrated approach is potentially more efficient in the fulfillment of the core objectives of financial regulation.

Since the comparison in the table is done under the implicit assumption that the integrated approach is introduced following the guidelines and principles discussed in the third, we summarize them here. It should be noticed that if a generalized failure to follow these principles is observed, many of the conclusions may change, diluting all or part of the benefits from reform, or even leading to additional costs. Nevertheless, if the recommendations made here are generally

followed, substantial benefits could be expected from the move to an integrated approach.

Among the main principles that a move to the integrated approach should take into account in order to minimize the chances that the new institutional arrangements either fail to lead to the expected benefits or, even contribute to making things worse, the following ones are worth considering:

1. Including a specific statutory objective for the unified financial services regulator to raise public awareness about the risks, costs and benefits of different financial services should help to deal with the potential moral hazard problems arising from implicit contracts between the single agency and the public.
2. Introducing a new legal framework that gives the legislature the power to remove officials involved in cases of corruption in a simple, transparent, and predetermined way should help to deal with potential problems of regulatory capture.
3. Including clear rules to govern the investigation and discipline powers of the single regulator agency. In this way, the new legal and regulatory framework would help to enhance accountability and reduce the scope for the single agency turning into a bureaucratic leviathan.
4. Budgeting the projected savings from economies of scale and scope to be realized by the newly created single regulator agency helps to avoid the time-inconsistent solution in which no ex post economies are realized.
5. Including a legal provision for the automatic and immediate disclosure of information when requested by the central bank would contribute to alleviating the potential costs of separating the banking regulator from the monetary authority.
6. Introducing a well defined, restricted set of mandatory objectives should help to avoid Christmas tree-type of problems, and would also contribute to making the cost savings stemming from economies of scale and scope effective. Ideally, the three core objectives should be included, thus avoiding ambiguities, reducing the scope for holes and inconsistencies, and helping to enhance accountability as well.
7. Publishing a clear, unified set of rules regarding operational procedures, including a clear internal separation of investigative functions and enforcement tasks; a single complaints handling; and a single compensation scheme. In this way, the integrated regulator agency would contribute to enhance accountability and reduce arbitrariness.
8. Developing a single system of risk-based supervision under which regulatory resources are devoted to those firms and those areas where risk is the highest, the single regulatory agency would help to improve the allocation of regulatory resources.

One final, important issue is related to the enforcement of rules. This issue clearly exceeds the scope of this paper, but a brief reflection is appropriate. In environments with weak legal enforcement, as is the case in several LAC countries, one could argue that there is no guarantee that the new, clearer and more transparent legal framework will indeed be enforced. However, as soon as one notices that in such an environment simpler rules are preferred, the case in favor of the integrated approach can be perceived as presenting a unique opportunity to introduce a more transparent, effective and efficient regulatory framework for financial services activities across countries. Indeed, this adds to the reasons for the adoption of the integrated approach to financial regulation and supervision in circumstances similar to those prevailing in most of the countries of Latin America and the Caribbean that have been presented in this paper.

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Appendix

TABLE 1
Statutory Objectives of Banking Regulators

Country	Number of Objectives > 3	Objectives Include Consumer Protection	Objectives Include all Remaining Core Objectives	INDEX
Argentina	No	No	No	1
Barbados	Yes	No	No	0
Bolivia	No	No	No	1
Brazil	Yes	Yes	Yes	2
Chile	No	No	No	1
Colombia	Yes	Yes	No	1
Costa Rica	Yes	No	Yes	1
Dominican Republic	Yes	Yes	No	1
Ecuador	N/A	N/A	N/A	N/A
El Salvador	No	Yes	No	2
Guatemala	Yes	No	No	0
Honduras	Yes	No	No	0
Mexico	Yes	Yes	No	1
Nicaragua	No	Yes	No	2
Panama	Yes	No	No	0
Paraguay	Yes	No	No	0
Peru	No	No	No	1
Trinidad and Tobago	No	No	No	1
Uruguay	No	No	No	1
Venezuela	Yes	No	No	0
	Number of countries with number of objectives > 3	Number of countries with consumer protection as an objective	Number of countries with all remaining 'core objectives'	Average Index
	11	6	2	0.8

Source: Elaborated on the basis of information from banking regulators' websites in the region (2000).

TABLE 2
Structure of Banking, Securities and Insurance Regulation and Supervision in Latin America and the Caribbean

Country	Issue	Banking	Securities	Insurance
Argentina	<i>Regulation</i>	Central Bank (Through the <i>Superintendencia de Entidades Financieras y Cambiarias</i>)	National Securities Commission (<i>Comisión Nacional de Valores-CNV</i>)	Superintendency of Insurance (<i>Superintendencia de Seguros de la Nación - SSN</i>)
	<i>Supervision</i>	Same	Same	Same
	<i>Central Government or Independent</i>	Independent (<i>Autonomous entity</i>)	Independent (<i>Autonomous entity</i>)	Independent (<i>Decentralized entity</i>)
	<i>Chief Executive</i>	President of the Central Bank ¹	CNV Chair	Superintendent of Insurance
	<i>Budget Financed by</i>	Government and Industry	Government and Industry	Government and Industry ²
	<i>Year of Establishment</i>	1936	1968	1938
The Bahamas	<i>Regulation</i>	Central Bank	Securities Commission	Ministry of Economic Development
	<i>Supervision</i>	Same	Same	Same
	<i>Central Government or Independent</i>	Independent	Independent	Government
	<i>Chief Executive</i>	Governor of the Central Bank	Executive Director of the Securities Commission	Insurance Registrar
	<i>Budget Financed by</i>	Government ³	Government and Industry ⁴	Government
	<i>Year of Establishment</i>	1974	1999	1969
Barbados	<i>Regulation</i>	Central Bank (Through its Department of Bank Supervision)	Securities Commission	Ministry of Finance (Through its Office of the Supervisor of Insurance)
	<i>Supervision</i>	Same	Same	Same
	<i>Central Government or Independent</i>	Independent	Government	Government
	<i>Chief Executive</i>	Director of Banking Supervision ⁵	Securities Commission Chair	Insurance Supervisor
	<i>Budget Financed by</i>	Government ⁶	Government	Government
	<i>Year of Establishment</i>	1972	2001	1970

Country	Issue	Banking	Securities	Insurance
Bolivia	Regulation	Committee on Prudential Financial Regulations (<i>Comité de Normas Financieras de Prudencia-CONFIP</i>) ⁷	Committee on Prudential Financial Regulations (CONFIP)	Committee on Prudential Financial Regulations (CONFIP)
	Supervision	Superintendence of Banks and Financial Entities (<i>Superintendencia de Bancos y Entidades Financieras-SBEF</i>)	Superintendence of Pensions, Securities and Insurance (<i>Superintendencia de Pensiones, Valores y Seguros-SPVS</i>)	Superintendence of Pensions, Securities and Insurance (<i>Superintendencia de Pensiones, Valores y Seguros-SPVS</i>)
	Central Government or Independent Chief Executive	Independent	Independent	Independent
	Budget Financed by Year of Establishment	Superintendent of the SBEF Industry 1993 ⁸	Superintendent of the SPVS Industry 1998 ⁹	Superintendent of the SPVS Industry 1998
Brazil	Regulation	National Monetary Council (CMN) and Central Bank (<i>The latter through its Financial System Regulation and Organization Dept.</i>)	Securities Commission (<i>Comisión de Valores Mobiliarios-CVM</i>)	National Council of Private Insurance (<i>Consejo Nacional de Seguros Privados-CNSP</i>) ¹⁰
	Supervision	Central Bank (<i>Through its Supervision Department</i>)	Same	Superintendence of Private Insurance (<i>Superintendencia de Seguros Privados-SUSEP</i>)
	Central Government or Independent Chief Executive	Government / Independent CMN Chair (The Minister of Finance) President of the Central Bank ¹²	Independent CVM Chair	Government / Independent ¹¹ CNSP Chair
	Budget Financed by Year of Establishment	Government and Industry 1964	Government and Industry 1976	Superintendent of the SUSEP Industry 1966
Chile	Regulation	Superintendence of Banks and Financial Institutions (<i>Superintendencia de Bancos e Instituciones Financieras-SBIF</i>) ¹³	Superintendence of Securities and Insurance (<i>Superintendencia de Valores y Seguros-SVS</i>)	Superintendence of Securities and Insurance (<i>Superintendencia de Valores y Seguros-SVS</i>)
	Supervision	Same	Same	Same
	Central Government or Independent Chief Executive	Independent	Independent	Independent
	Budget Financed by Year of Establishment	Superintendent of the SBIF Government and Industry 1926	Superintendent of the SVS Government 1931	Superintendent of the SVS Government 1931

Country	Issue	Banking	Securities	Insurance
Colombia	Regulation	Superintendence of Banks (<i>Superintendencia Bancaria</i>) ¹⁴	Superintendence of Securities (<i>Superintendencia de Valores</i>) ¹⁵	Superintendence of Banks (<i>Superintendencia Bancaria</i>) ¹⁶
	Supervision	Same	Same	Same
	Central Government or Independent	Independent	Independent	Independent
	Chief Executive	Superintendent of Banks	Superintendent of Securities ¹⁷	Superintendent of Banks
	Budget Financed by	Industry	Government and Industry	Industry
	Year of Establishment	1923	1979	1923
Costa Rica	Regulation	Financial System Supervision National Council (<i>Consejo Nacional de Supervisión del Sistema Financiero- CONAS-SIF</i>)	Financial System Supervision National Council (<i>Consejo Nacional de Supervisión del Sistema Financiero- CONASSIF</i>)	Financial System Supervision National Council. (<i>Consejo Nacional de Supervisión del Sistema Financiero- CONASSIF</i>) ¹⁸
	Supervision	Superintendence of Financial Entities (<i>Superintendencia General de Entidades Financieras-SUGEF</i>)	Superintendence of Securities (<i>Superintendencia General de Valores-SUGEVAL</i>)	Superintendence of Financial Entities (<i>Superintendencia General de Entidades Financieras-SUGEF</i>)
	Central Government or Independent	Independent ¹⁹	Independent	Independent
	Chief Executive²⁰	CONASSIF Chair Superintendent of the SUGEF	CONASSIF Chair Superintendent of the SUGEVAL	CONASSIF Chair Superintendent of the SUGEF
	Budget Financed by	Government and Industry ²¹	Government and Industry	Government and Industry
	Year of Establishment	1998 (CONASSIF) 1988 (SUGEF)	1998 (CONASSIF) 1998 ²²	1998 (CONASSIF) 1988
Ecuador	Regulation	Superintendence of Banks and Insurance (<i>Superintendencia de Bancos y Seguros</i>)	National Securities Council (<i>Consejo Nacional de Valores- CNV</i>) ²³	Superintendence of Banks and Insurance (<i>Superintendencia de Bancos y Seguros</i>)
	Supervision	Same	Superintendence of Corporations (<i>Superintendencia de Compañías</i>) ²⁴	Same
	Central Government or Independent	Independent (<i>autonomous entity</i>)	Independent (<i>autonomous entity</i>)	Independent (<i>autonomous entity</i>)
	Chief Executive	Superintendent of Banks and Insurance ²⁵	Superintendent of Corporations ²⁶	Superintendent of Banks and Insurance
	Budget Financed by	Industry	Industry	Industry
	Year of Establishment	1927	1998/1964 ²⁷	1927

Country	Issue	Banking	Securities	Insurance
El Salvador	Regulation	Superintendence of the Financial System (<i>Superintendencia del Sistema Financiero-SSF</i>) ²⁸	Superintendence of Securities (<i>Superintendencia de Valores-SV</i>)	Superintendence of the Financial System (<i>Superintendencia del Sistema Financiero-SSF</i>)
	Supervision	Same	Same	Same
	Central Government or Independent Chief Executive	Independent	Independent	Independent
	Budget Financed by	Superintendent of the SSF Government and Industry ²⁹	Superintendent of Securities Government and Industry	Superintendent of the SSF Government and Industry ³⁰
	Year of Establishment	1961	1996	1961
Guatemala	Regulation	Monetary Board	Ministry of Economy	Ministry of Economy
	Supervision	Superintendence of Banks	Securities and Commodities Markets Registry ³¹	Superintendence of Banks
	Central Government or Independent Chief Executive	Government/ Independent President of the Monetary Board (The President of the Central Bank) Superintendent of Banks ³²	Independent Minister of Economy	Government/ Independent Minister of Economy
	Budget Financed by	Government	Registrar ³³	Superintendent of Banks
	Year of Establishment	1946 ³⁴	Government 1996	Govern. and Industry 1946
Guyana	Regulation	Central Bank	N.A. ³⁵	N.A. ³⁶
	Supervision	Same	N.A.	N.A.
	Central Government or Independent Chief Executive	Independent	N.A.	N.A.
	Budget Financed by	Governor of the Central Bank Government and Industry	N.A.	N.A.
	Year of Establishment	1965	N.A.	N.A.
Haiti	Regulation	Central Bank (<i>Through its Supervision Depart</i>)	N.A. ³⁷	Ministry of Finance and Economy
	Supervision	Same	N.A.	Same
	Central Government or Independent Chief Executive	Government	N.A.	Government
	Budget Financed by	Director of Supervision ³⁸	N.A.	N.A.
	Year of Establishment	Government 1979	N.A.	Government N.A.

Country	Issue	Banking	Securities	Insurance
Honduras	Regulation	National Banking and Insurance Commission (<i>Comisión Nacional de Banca y Seguros-CNBS</i>)	National Banking and Insurance Commission (<i>Comisión Nacional de Banca y Seguros-CNBS</i>)	National Banking and Insurance Commission (<i>Comisión Nacional de Banca y Seguros-CNBS</i>)
	Supervision	Superintendence of Banks, Financial Corporations and Savings and Loans (<i>Superintendencia de Bancos, Sociedades Financieras y Asociaciones de Ahorro y Préstamo</i>)	Superintendence of Securities and Other Institutions (<i>Superintendencia de Valores y Otras Instituciones</i>)	Superintendence of Insurance and Pensions (<i>Superintendencia de Seguros y Pensiones</i>)
	Central Government or Independent Chief Executive	Independent ³⁹	Independent	Independent
	Budget Financed by	President of CNBS Superintendent of Banks, Financial Corps. and S&L Government and Industry ⁴⁰	President of CNBS Superintendent of Securities and Other Institutions Government and Industry	President of CNBS Superintendent of Insurance and Pensions Government and Industry
	Year of Establishment	1995 (CNBS)	1995 (CNBS)	1995 (CNBS)
Jamaica	Regulation	Central Bank (<i>Through its Department of Supervision of Banks and Financial Institutions</i>)	Financial Services Commission (FSC)	Financial Services Commission (FSC)
	Supervision	Same	Same	Same
	Central Government or Independent Chief Executive	Independent ⁴¹	Independent	Independent
	Budget Financed by	Governor of the Central Bank ⁴² Industry ⁴³	Executive Director of the FSC Government and Industry	Executive Director of the FSC Government and Industry
	Year of Establishment	1961	2001 ⁴⁴	2001
Mexico	Regulation	National Banking and Securities Commission (<i>Comisión Nacional Bancaria y de Valores-CN BV</i>) ⁴⁵	National Banking and Securities Commission (<i>Comisión Nacional Bancaria y de Valores-CN BV</i>)	National Insurance and Finance Commission (<i>Comisión Nacional de Seguros y Finanzas-CNSF</i>)
	Supervision	Same	Same	Same
	Central Government or Independent Chief Executive	Independent (<i>Decentralized body</i>) President of the CNBV	Independent (<i>Decentralized body</i>) President of the CNBV	Independent (<i>Decentralized body</i>) President of the CNSF
	Budget Financed by	Government and Industry ⁴⁶	Government and Industry	Government and Industry
	Year of Establishment	1995 ⁴⁷	1995	1946

Country	Issue	Banking	Securities	Insurance
Nicaragua	Regulation	Superintendence of Banks and Other Financial Institutions (<i>Superintendencia de Bancos y Otras Instituciones Financieras-SIBOIF</i>)	Superintendence of Banks and Other Financial Institutions (<i>Superintendencia de Bancos y Otras Instituciones Financieras-SIBOIF</i>)	Superintendence of Banks and Other Financial Institutions (<i>Superintendencia de Bancos y Otras Instituciones Financieras-SIBOIF</i>)
	Supervision ⁴⁸	Same	Same	Same
	Central Government or Independent	Independent	Independent	Independent
	Chief Executive	Superintendent ⁴⁹	Superintendent	Superintendent
	Budget Financed by	Government and Industry ⁵⁰	Government and Industry	Government and Industry
	Year of Establishment	1991 (SIBOIF)	1991 (SIBOIF) ⁵¹	1991 (SIBOIF) ⁵²
Panama	Regulation	Superintendence of Banks	National Securities Commission (Comisión Nacional de Valores-CNV)	Superintendence of Insurance and Reinsurance (<i>Superintendencia de Seguros y Reaseguros-SSR</i>)
	Supervision	Same	Same	Same
	Central Government or Independent	Independent (<i>autonomous entity</i>)	Independent (<i>autonomous entity</i>)	Independent (<i>autonomous entity</i>)
	Chief Executive	Superintendent of Banks ⁵³	President of the CNV ⁵⁴	Superintendent of the SSR
	Budget Financed by	Industry	Government and Industry	Industry
	Year of Establishment	1998	1999 ⁵⁵	1984 ⁵⁶
Paraguay	Regulation	Central Bank (<i>Through its Superintendence of Banks</i>)	National Securities Commission (<i>Comisión Nacional de Valores-CNV</i>)	Central Bank (<i>Through its Superintendence of Insurance</i>)
	Supervision	Same	Same	Same
	Central Government or Independent	Independent	Independent (<i>Autonomous entity</i>)	Independent
	Chief Executive	Governor of the Central Bank ⁵⁷	President of the CNV	Governor of the Central Bank ⁵⁸
	Budget Financed by	Government ⁵⁹	Government and Industry	Government ⁶⁰
	Year of Establishment	N.A.	1992 ⁶¹	N.A.

Country	Issue	Banking	Securities	Insurance
Peru	Regulation	Superintendence of Banks and Insurance (<i>Superintendencia de Banca y Seguros -SBS</i>)	National Corporations & Securities Supervisory Commission (<i>Comisión Nacional Supervisora de Empresas y Valores -CONASEV</i>)	Superintendence of Banks and Insurance (<i>Superintendencia de Banca y Seguros -SBS</i>)
	Supervision	Same	Same	Same
	Central Government or Independent	Independent (<i>autonomous entity</i>)	Independent (<i>autonomous entity</i>)	Independent (<i>autonomous entity</i>)
	Chief Executive	Superintendent of the SBS	President of CONASEV	Superintendent of the SBS
	Budget Financed by	Industry	Industry ⁶²	Industry
	Year of Establishment	1931	1970	1931
República Dominicana (Dominican Republic)	Regulation	Monetary Board	Monetary Board ⁶³	Monetary Board
	Supervision	Superintendence of Banks	Superintendence of Securities ⁶⁴	Superintendence of Insurance
	Central Government or Independent	Government ⁶⁵	Government	Government ⁶⁶
	Chief Executive	Superintendent of Banks	Superintendent of Securities	Superintendent of Insurance
	Budget Financed by	Government and Industry	Government	Government and Industry
	Year of Establishment	1965 ⁶⁷	2002 ⁶⁸	2001 ⁶⁹
Trinidad & Tobago	Regulation	Central Bank (<i>Through its Department of Inspection of Banks</i>)	Securities and Exchange Commission (SEC)	Ministry of Finance (<i>Through its Office of the Supervisor of Insurance</i>)
	Supervision	Same	Same	Same
	Central Government or Independent	Independent	Independent	Government ⁷⁰
	Chief Executive	Governor of the Central Bank ⁷¹	President of the Board of the SEC	Supervisor of Insurance
	Budget Financed by	Government	Government	Government
	Year of Establishment	1964	1995	N.A.
Uruguay	Regulation	Central Bank (<i>Through its Superintendence of Financial Intermediaries</i>) ⁷²	Central Bank (<i>Through the Securities Market Department</i>)	Central Bank (<i>Through its Superintendence of Insurance and Reinsurance</i>) ⁷³
	Supervision	Same	Same	Same
	Central Government or Independent	Independent	Independent	Independent
	Chief Executive	Board of the Central Bank ⁷⁴	Board of the Central Bank ⁷⁵	Board of the Central Bank ⁷⁶
	Budget Financed by ⁷⁷	Government	Government	Government
	Year of Establishment	1988	N.A.	1993

Country	Issue	Banking	Securities	Insurance
Venezuela	Regulation	Superintendence of Banks and Other Financial Institutions (<i>Superintendencia de Bancos y Otras Instituciones Financieras-SUDEBAN</i>)	National Securities Commission (<i>Comisión Nacional de Valores-CNV</i>)	Ministry of Finance (<i>Through its Superintendence of Insurance</i>) ⁷⁸
	Supervision	Same	Same	Same
	Central Government or Independent Chief Executive	Independent (<i>functional autonomy</i>) Superintendent of SUDEBAN	Independent (<i>functional autonomy</i>) President of the CNV	Government Superintendent of Insurance ⁷⁹
	Budget Financed by	Government and Industry	Government and Industry ⁸⁰	Government and Industry
	Year of Establishment	N.A.	1973	2001

Notes:

¹ Supervisory responsibilities are performed by the Superintendent of Financial Entities, which is a member of the Central Bank's Board of Directors. The nation's President with Congress approval designates the Superintendent. However, the Organic Law of the Central Bank states in Article 10 that the activities of the Superintendence are direct responsibility of the President of the Central Bank.

² The Insurance Superintendency charges the industry for its regulatory and supervisory activities. However, industry contributions are actually transferred to the Ministry of Economy, which then provides funding for the Superintendency's activities.

³ Funding for supervision activities is provided through the central bank's regular annual budget and also with license fees paid by industry members. There are no specific charges for supervision activities performed by the central bank.

⁴ License fees paid by mutual funds and by the firms managing these funds determine funding provided by the industry.

⁵ Designated by the Board of Directors of the Central Bank.

⁶ Funding for supervision activities is provided through the central bank's regular annual budget.

⁷ The CONFIP is a collegiate body, which approves all financial prudential regulations (except those related to the Central Bank of Bolivia) with a view of achieving consistency throughout the financial system. It is also an entity through which the SBEF and the SPVS coordinate their efforts.

⁸ The CONFIP was created in 1998 with the enactment of the Popular Property and Credit Law. The Superintendency of Banks and Financial Entities was established by the Banking and Financial Entities Law of 1993 and replaced the former Superintendency of Banks created in 1928.

⁹ The SPVS was created in 1998 with the enactment of the Popular Property and Credit Law and it merged the three former agencies that existed for each of these sectors (securities, pensions and insurance).

¹⁰ The SUSEP only regulates specific operational issues and any other delegated to it by the CNSP.

¹¹ The CNSP is classified here as dependent of the Central Government since it is chaired by the Minister of Finance and does not have its own legal status. The SUSEP is an autonomous body, which functions under the Ministry of Finance.

¹² The Directors of the Financial System Regulation and Organization Department and of the Supervision Department are responsible for regulation and supervision, respectively. Both are Central Bank Board members.

¹³ Some prudential regulations are actually issued by the Central Bank of Chile.

¹⁴ Both the Banking and Securities Superintendency are technical agencies that function under the umbrella of the Ministry of Finance and Public Credit. Some prudential regulations, particularly those related to banks, are issued directly by the Ministry through the Finance Technical Vice ministry.

¹⁵ The Superintendency of Securities has a regulatory body above it, the "Sala General", which has regulatory powers.

¹⁶ Supervision of insurance activity is performed by the Deputy Superintendent for Insurance and Capitalization (*Delegatura para Seguros y Capitalización*).

- ¹⁷ The top authority within the Superintendency of Securities is the “Sala General”, chaired by the Minister of Finance.
- ¹⁸ In Costa Rica all insurance activity is carried out by a state-owned entity, the Insurance National Institute. Thus, properly considered there is no insurance market in the country.
- ¹⁹ CONASSIF, SUGEF and SUGEVAL are all agencies with a “maximum decentralization” (*máxima desconcentración*) status and function under the umbrella of the Central Bank.
- ²⁰ All Superintendents are designated by CONASSIF.
- ²¹ The Securities Market Law states that the three Superintendencies of the financial system are to be financed by the Central Bank (80 per cent) and by supervised entities (20 per cent).
- ²² SUGEVAL replaced the former Securities Commission that had been created in 1990.
- ²³ This body was created by the Securities Markets Law of 1998 as part of the Superintendency of Corporations to establish the market’s general policies and to regulate its activities.
- ²⁴ The Department of Securities Markets (*Intendencia del Mercado de Valores*) is the executive body of the National Securities Council (CNV). Although it functions within the Superintendency of Corporations, it is actually governed by the CNV.
- ²⁵ The Superintendent of Banks chairs the Banking Board, the governing body of the Superintendency. The Board comprises 5 members, including the General Manager of the Central Bank of Ecuador.
- ²⁶ The Superintendent of Corporations chairs the National Securities Council, which is comprised of 7 members: 4 corresponding to the public sector (Superintendent of Corporations, Superintendent of Banks, President of the Central Bank and a delegate of the nation’s President) and 3 of the private sector.
- ²⁷ 1998 stands for the year of incorporation of the CNV, while 1964 represents the year of incorporation of the Superintendency of Corporations.
- ²⁸ Some aspects are regulated by the Central Bank, for example, rules regarding deposit-taking activities.
- ²⁹ The Central Bank contributes with 50 per cent of the budget and commercial banks with the other half.
- ³⁰ As stated in the previous footnote, it should be noted that insurance institutions do not make contributions to finance the SSF’s budget.
- ³¹ In Guatemala there is no formal supervisory agency for the securities market. The Securities and Commodities Markets Registrar is an exclusively technical body whose purpose is to register the activities performed in this market.
- ³² The Superintendent of Banks is designated by the nation’s President for a 4-year term. The Superintendent is elected from a group of three candidates proposed by the Monetary Board.
- ³³ The Registry is designated by the nation’s President for a 6-year period. The Registrar is elected from a group of three candidates proposed by the Monetary Board.
- ³⁴ Represents the year of incorporation of the Superintendency of Banks.
- ³⁵ The Financial Institutions Law of 1995 and the Law of the Bank of Guyana state that the Central Bank is the sole regulator and supervisor of all financial institutions in the country. The Securities Industry Law of 1998 states that a Securities Council will be created, under the umbrella of the central bank, to regulate and oversee securities market participants. This Council has not been created so far.
- ³⁶ As mentioned in the previous footnote, the Central Bank is the regulator and supervisor of all financial institutions in the country. However, the Insurance Law of 1998 states that the Minister of Finance will designate an Insurance Commissioner who will be in charge of applying the contents of this Law.
- ³⁷ There are no financial institutions participating in a formal securities market.
- ³⁸ Designated by the Governor of the Central Bank.
- ³⁹ The CNBS and the Superintendencies are autonomous agencies operating under the umbrella of the Central Bank of Honduras.
- ⁴⁰ In a reform to the CNBS Law it was established that the Central Bank will finance up to 50 per cent of the CNBS’s budget, and that the rest should be financed by supervised entities. In turn the CNBS provides funding to the Superintendencies.
- ⁴¹ The Governor and other 6 members of the Board (from a total of 9) are designated by the Minister of Finance, who can also designate other Deputy Governor(s) to be part of the Board.
- ⁴² A Deputy Governor has general responsibility for the Financial Institutions Supervisory Division. Day to day responsibility is vested in the Supervisor of Banks and Financial Institutions, who is designated by the Minister of Finance.
- ⁴³ Funding for supervision activities is provided through the central bank’s regular annual budget and also with license fees paid by industry members. There are no specific charges for supervision activities performed by the central bank.
- ⁴⁴ The Financial Services Commission was created by law in 2001. It replaced the former Securities Commission and merged the Office of the Superintendent of Insurance.

- ⁴⁵ Some prudential regulations are issued by Mexico's Central Bank (*Banco de México*) and by the Ministry of Finance and Public Credit (*Secretaría de Hacienda y Crédito Público-SHCP*).
- ⁴⁶ Both the CNBV and the CNSF charge their respective industries for regulatory and supervisory activities. However, these funds are transferred to the SHCP. Funding for the Commissions' budget provides from the nation's overall budget.
- ⁴⁷ The CNBV merged the National Banking Commission created in 1924 and the National Securities Commission created in 1946.
- ⁴⁸ Supervision is performed by the Department of Banks and Other Financial Institutions, the Department of Securities and the Department of Insurance, respectively.
- ⁴⁹ The SIBOIF has a Board, which is chaired by the Minister of Finance and Public Credit. Congress designates the Superintendent, who participates in Board's meetings although with no voting powers.
- ⁵⁰ Law 316 states that the Central Bank of Nicaragua will provide up to 25 percent of SIBOIF's budget. The rest is to be financed by supervised entities.
- ⁵¹ The Department of Securities (*Intendencia de Valores*) was created in 1999 by Law 316.
- ⁵² The Department of Insurance (*Intendencia de Seguros*) was created in 1999 by Law 316.
- ⁵³ The Superintendency of Banks is governed by a Board which comprises five members and the Superintendent. The Superintendent has no voting powers and may be excluded from any of the Board's meeting if the latter deems this is appropriate in view of the agenda.
- ⁵⁴ The CNV is governed by a Commission comprising 3 persons, which are designated by the nation's President. The Commission itself is entitled to elect its President from these 3 persons.
- ⁵⁵ Until 1999 the CNV functioned under the umbrella of the Ministry of Commerce and Industry. Currently it is an autonomous technical body operating under the umbrella of the ministry of Economy and Finance.
- ⁵⁶ Until 1996 the SSR functioned under the Ministry of Commerce and Industry, and, among other activities, it was the executive body of the National Reinsurance Commission. In 1996 a new insurance law granted autonomy to SSR to regulate, supervise and oversee the insurance sector.
- ⁵⁷ The Organic Law of the Central Bank of Paraguay of 1995 states that the Superintendency of Banks is a technical body of the central bank, with no legal self-standing. It has functional, administrative and financial autonomy. The Superintendent is designated by the nation's President. However, the General Banking Law of 1996 states that the Superintendency of Banks performs control supervision and oversight functions in representation of the Central Bank.
- ⁵⁸ The Insurance Law created the Superintendency of Insurance under the umbrella of the Central Bank. It has functional, administrative and financial autonomy. The Superintendent is designated by the nation's President.
- ⁵⁹ The budget of the Superintendency of Banks is part of the Central Bank's annual budget.
- ⁶⁰ The budget of the Superintendency of Insurance is part of the Central Bank's annual budget.
- ⁶¹ The CNV experienced a major reform with the Securities Market Law of 1998.
- ⁶² However, CONASEV is entitled to receive allowances from the Nation's Treasury.
- ⁶³ The draft version of the Monetary and Financial Law (which is expected to be enacted in 2003) states that the regulation and supervision of securities and insurance markets will be governed by its corresponding laws. Thus, only those supervisory matters related to banks and other institutions performing financial intermediation will remain under the control of the Financial and Monetary Administration (*comprised by the Monetary Board, the Central Bank and the Superintendency of Banks*).
- ⁶⁴ The Securities Market Law was enacted in 2001. Functioning of the Superintendency of Securities began in 2002.
- ⁶⁵ Currently this is a department of the Ministry of Finance. The draft version of the Monetary and Financial Law states that the Financial and Monetary Administration, which comprises the Superintendency of Banks, will have functional, administrative and budgetary autonomy. The Superintendency of Banks will remain under the umbrella of the Monetary Board, which is chaired by the Governor of the Central Bank.
- ⁶⁶ This is currently a Department of the Ministry of Finance.
- ⁶⁷ Year of Incorporation of the Superintendency of Banks.
- ⁶⁸ Year of Incorporation of the Central Bank.
- ⁶⁹ Year of Incorporation of the Superintendency of Insurance.
- ⁷⁰ This Office works within the Ministry of Finance.
- ⁷¹ The Financial Institutions Law states that the Central Bank is responsible for the regulation and supervision of banks. These activities are to be carried out through the Department of Inspection of Banks. The Inspector of Banks, designated by the nation's President hearing the opinion of the Governor of the Central Bank, is responsible for day-to-day activities.
- ⁷² The Superintendency of Financial Intermediaries (*Superintendencia de Instituciones de Intermediación Financiera-SIIF*) has technical and operational autonomy and it is dependant of the Central Bank's Board.
- ⁷³ This is a decentralized entity of the Central Bank of Uruguay.

⁷⁴ The Superintendent in charge of the SIF executes the corresponding responsibilities by delegation of the Central Bank's Board. This Superintendent is designated by the Board for a 8-year period, which differs from that of the President of the Central Bank's Board.

⁷⁵ The Securities Markets Department exercises control responsibilities and it may not be distinguished from the Central Bank. The Central Bank's Board is actually responsible for this control activity.

⁷⁶ The Superintendent of Insurance and Reinsurance is designated by the Central Bank's Board.

⁷⁷ All supervisory/regulatory activities are financed with the Central Bank's general budget.

⁷⁸ According to the Insurance and Reinsurance Law of 2001, the Superintendency of Insurance is an autonomous technical service. The Superintendency does not have its own legal standing and it operates within the Ministry of Finance. SUDEBAN and the CNV are both autonomous institutions. They function under the umbrella of the Ministry of Finance only for administrative compliance (*tutela administrativa*).

⁷⁹ The Minister of Finance may designate or dismiss the Superintendent with no further requirements.

⁸⁰ Industry contributions are constituted by annual or event-based fees related to the National Securities Registry, license and annual fees to operate as securities firms or securities depositories, fees related to the authorization of a Public Securities Offering, etc.

Source: Elaborated on the basis of information from García, J.A. (2002) and Courtis, N. (2001).

TABLE 3
Size of the Banking System (M3)¹

COUNTRY	IN US\$ BILLION	AS % OF GDP
Latin America		
Brazil	173.7	29.2
Mexico	135.5	23.6
Argentina	90.8	31.9
Chile	35.5	50.3
Colombia	26.6	32.8
Venezuela, RB	22.8	18.9
Peru	17.2	32.1
Uruguay	10.1	51.3
Panama	8.6	86.9
Dominican Republic	6.8	34.7
El Salvador	6.1	46.2
Costa Rica	5.9	36.9
Guatemala	5.4	28.6
Bolivia	4.5	54.6
Ecuador	4.3	31.3
Trinidad and Tobago	4.2	57.2
Bahamas	3.5	73.6
Jamaica	3.5	47.3
Honduras	3.1	52.1
Paraguay	2.8	36.7
Barbados	1.9	75.0
Nicaragua	1.5	64.2
Haiti	1.5	37.0
Guyana	0.6	79.1
Belize	0.4	54.2
Suriname	0.3	40.0
<i>Average</i>	<i>22.2</i>	<i>46.4</i>
<i>Median</i>	<i>5.0</i>	<i>43.1</i>
Europe		
United Kingdom	1,552.3	109.7
Sweden	106.9	44.8
Denmark	96.3	55.3
Norway	82.3	50.9
Hungary	21.1	46.3
Iceland	2.9	33.7
Latvia	2.2	30.4
Estonia	2.0	39.3
Asia		
Japan	9,192.1	189.9
Korea, Rep.	447.5	97.9
Singapore	99.1	107.5
Other countries		
Canada	515.7	75.0
Australia	259.4	66.5
Maldives	0.3	46.6

¹ M3 includes money and quasi – liquid liabilities. Data for year 2000, except for Sweden and Denmark (1999).

Source: Elaborated on the basis of information from World Development Indicators World Bank (2002). For United Kingdom, IMF International Financial Statistics.

TABLE 4
Index of Conglomeration of Financial Activities in Selected LAC countries

Country	PERMISSIBLE ACTIVITIES ¹		PERMISSIBLE INVESTMENTS ¹		INDEX ² of Conglomeration
	Securities	Insurance	Bank Investments in Industrial Firms	Industrial Firm Investments in Banks	
Brazil	YES	YES	LIM	YES	3.5
Venezuela	YES	YES	LIM	YES	3.5
Argentina	YES	LIM	LIM	YES	3.0
Bolivia	YES	YES	NO	YES	3.0
Uruguay	YES	YES	NO	YES	3.0
Panama	YES	NO	LIM	YES	2.5
Mexico	YES	YES	NO	LIM	2.5
Colombia	YES	NO	LIM	YES	2.5
Chile	YES	LIM	NO	LIM	2.0
Peru	YES	NO	NO	YES	2.0
Reformers					
United Kingdom	YES	YES	YES	YES	4.0
Sweden	YES	YES	LIM	YES	3.5
Norway	YES	YES	LIM	LIM	3.0

¹ NO implies that neither the bank can conduct the specific activity directly nor through any of its subsidiaries. LIM implies limited permissibility.

²INDEX: Each YES counts as 1, each NO as 0, and each LIM as 0.5. The Index is the overall sum.

Source: Elaborated on the basis of information from the Institute of International Bankers, 2001. Global Survey 2001. Regulatory and Market Developments. Banking - Securities - Insurance.