

Michael, Bryane

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Does Objectives-Based Financial Regulation Imply A Rethink of Legislatively Mandated Economic Regulation? The Case of Hong Kong and Twin Peaks Financial Sector Regulation

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Does Objectives-Based Financial Regulation Imply A Rethink of Legislatively Mandated Economic Regulation?

The Case of Hong Kong and Twin Peaks Financial Sector Regulation

Bryane Michael, University of Hong Kong

Abstract

Objectives-based legislation – or laws which focus on achieving particular and concrete outcomes – has become a new and important tool that financial sector regulators use to tackle large and varied financial system risks. Yet, objectives-based legislation – and the frequent principles-based regulation underpinned by such legislation – represents a stark departure from traditional ways of legislating. In this paper, we describe the problems and prospects of implementing objectives-based financial regulation in Hong Kong – in the form of a Twin Peaks regulatory structure. A focus on the objectives of achieving financial market stability and proper market conduct would require a different approach to legislating and regulating in Hong Kong (and most other countries). By describing the way Hong Kong’s legislators would adopt such objectives-based legislation putting a Twin Peaks regulatory structure in place, we hope to shed light on the broader trend in academic and practitioner circles toward thinking about how to use objectives-based legislation to tackle complex social risks. Such an approach may also reduce the use of patchworks of complex inter-agency agreements and rulemaking between traditional regulators as they try to solve large and difficult regulatory problems.

Keywords: Twin Peaks, financial regulation, objectives-based regulation, comparative financial law, government-by-results

JEL Codes: G18, G28, K23,

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Introduction

A revolution has been occurring in all kinds of government contracting since the mid-1980s. Government bodies have increasingly used performance-based contracts, results-based budgeting and outcomes-based performance management as ways to focus on regulatory outcomes rather than processes. Nowhere has the trend toward outcomes-based regulation been more pronounced than in financial sector regulation. Bank regulators (like the UK's Prudential Regulation Authority) focus on risks to the UK's financial markets, whether they come from banks, broker-dealers or insurance companies. The UK's Financial Services Act of 2012 looks very different than previous acts and acts in other countries. The Act defines general objectives of the Authority – rather than describing the mechanics of how such an Authority would work. Such a legislative approach represents a watershed change in legislative drafting. Imagine if the Crime Act legislatively required a murder rate below 5 per 1000 – and set up law enforcement agencies using statutory instruments which only defined broad objectives? Such an example shows the important – and controversial nature – of such objectives-based legislation.

In this paper, we show how objectives-based legislation provides a new paradigm for thinking about the way jurisdictions like Hong Kong create and organise regulatory agencies. We illustrate this broader question in legal theory using a specific case – namely whether Hong Kong should move toward a Twin Peaks financial regulatory approach. The move – if it occurs – will require far more than just adding and moving competencies between agencies. An objectives-based approach to legislation would challenge the fundamentals of legislative and administrative jurisprudence in Hong Kong (and elsewhere). The first section reviews what we know about objectives (or results-based) legislative drafting. We describe theories for thinking about the division (and sharing) of competencies between regulatory agencies with the aim of tackling particularly large and complex regulatory challenges. The second section describes Twin Peaks regulation as an objectives-based regulatory approach – and gives examples of such regulation for readers not particularly well-versed on financial sector regulation. The section also describes the objectives and circumstances under which a jurisdiction may choose a Twin Peaks model. The third section describes macroeconomic and financial sector conditions which may make Twin Peaks regulation better for Hong Kong than the current institutional-based approach. Large and unpredictable economic shocks and a relatively costly and complex regulatory structure make Hong Kong a candidate for such a regulatory approach. The fourth section uses Hong Kong as a concrete example of thinking about using objectives-based lawmaking (particularly governing the financial sector). The section describes how such an approach requires a rethink of Hong Kong's traditional approach to legislation and regulation. The section also describes how the city-state's previous adoption of risk-based regulation and slow adoptions of objectives-based

regulations may make an objectives-based Twin Peaks model in Hong Kong not-so-foreign after all. The final section concludes – with a brief discussion of the appropriateness of objectives-based legislation more generally.

Groping Toward Objectives-Based Legislation: A Literature Review

Legislating government bodies focusing on particular outcomes

To what extent should legislation define public policy objectives? Traditionally, legislative acts have focused on defining rights and obligations of various persons and providing the legal basis for the government bodies which police the enforcement of these rights and obligations.¹ Public policy defines goals and legislation/regulation outlines the way the government helps achieve these (often changing) policies.² Legislation – and regulation based on that legislation -- represents the method of putting policy priorities into practice.³ Traditionally, legislation defines one administrative body to deal with a specific social problem – the police deal with local law enforcement, the health ministry deals with hospitals, and so forth. Yet, many scholars have noticed a significant rethink of the traditional role of legislation. Increasingly complex social problems have required organisational structures which involve overlapping competencies, inter-agency cooperation and a focus on the outcomes (rather than process) of executive action.⁴

New approaches to public agency organisational design focus on methods of inter-agency cooperation and focusing on outcomes rather than processes. Figure 1 shows the major research areas which have grappled with these issues in recent years. The **quality of legislation school** focuses on the mechanics of writing laws, arguing that the clarity of drafting and public participation in such drafting can affect implementation (and thus the laws' effectiveness).⁵ According to this mechanistic approach to assigning agency

¹ We do not have the space to describe the extent to which legislative drafters define the intent of a particular Bill in the text of the document itself or the way that legislators chose the ambiguity/specificity of particular black letter statutory provisions. The “canonical” view of legislation focuses on law as transmitting legislators’ desire for some outcome into the creation of rights and obligations and instructions to executive agencies for enforcing/supervising those rights and obligations. For a recent discussion of the issues, see John Manning, *Textualism and Legislative Intent*, 91 VA. L. REV. 419, 2005.

² The process, of course, is far more complex than this. In practice, administrative agencies have great latitude in determining legislative intent – and administrative and other courts have latitude in questioning a regulator’s interpretation of a statute’s objectives. For a recent discussion of some of these issues, see Daniel Gifford, *The Emerging Outlines of a Revised Chevron Doctrine: Congressional Intent, Judicial Judgment, And Administrative Autonomy*, 59 ADMIN. L. REV. 4, 2007.

³ The line between legislation and regulation has become increasingly blurry – with administrative agencies often given extremely wide latitude to make laws. See Peter Shane, *Legislative Delegation, the Unitary Executive, and the Legitimacy of the Administrative State*, 33 HARV. J. L. & PUB. POL’Y 103, 2010.

⁴ A variety of scholars have argued that increasingly complex social risks and challenges require a rethink of the traditional structure of government. For a recent take on this long-standing debate, see Donald Kettl, *Managing Boundaries in American Administration: The Collaboration Imperative*, 66 PUB. ADMIN. REV. S1, 2006.

⁵ We can cite the entire literature. For a recent example, see Wim Voermans, *Concern about the Quality Of EU Legislation: What Kind Of Problem, By What Kind Of Standards?* 2 ERASMUS L. REV. 1, 2010. See also Helen Xanthaki, *The Problem of Quality in EU Legislation: What on Earth is Really Wrong?* 38 COMMON

competencies, large social problems can be tackled by allocating competencies rationally among existing agencies – or create a new agency. According to this approach, if a regulatory agency does not deal adequately with complex issues (like financial crises), better legal drafting can solve the problem. The **administrative discretion school** might argue that, with loosely defined legislation and regulation, administrative agencies can adopt their own rules to respond to complex social issues.⁶ Unlike the quality of legislation school, this school of authors argues that murkier (less clear) legal drafting provides the best way of allowing regulatory agencies to deal with complex social issues. Because public policy objectives change over time, regulatory discretion provides executive agencies with the latitude they need to respond to increasingly complex regulatory environment.⁷ Regulatory interpretation represents an on-going process of matching those regulations with the agency’s needs to tackle particular social needs.⁸ For both these schools, sufficiently clearly (or unclear) legislation and rulemaking can resolve any problems in assigning competencies between agencies.

Figure 1: How To Deal With Complex Social Problems (like Financial Crises)? A Prospective from Several Branches of Literature

Research area	Description	Critiques
quality of legislation (drafting) school	Focuses on the mechanics of drafting legislation, focusing on clarity and consultation.	Does not deal with the goal of legislative drafting. Putting same words in different legal system can have adverse consequences.
Administrative discretion school	Either <i>de jure</i> or <i>de facto</i> administration discretion encourages focus on important objectives	Does not define which objectives and subject to abuse (capacious and arbitrary regulatory behaviour).
inter-agency administrative networks in a multi-layered public administrative school	New, complex challenges – combined with IT technologies – allow for greater scope of inter-agency collaboration.	Often based on models and jargon instead of hard data. Challenges to inter-agency coordination often shown to be greater than benefits of such collaboration. Why not just make agencies that focus on objectives rather than processes?
inter-agency administrative law school	focuses on the legal rationale for dividing competencies among agencies. Also focuses on the politics behind	

MARKET L. REV. 3, 2001. See also Ann Seidman, Robert Seidman, and Nalin Abeyesekere, LEGISLATIVE DRAFTING FOR DEMOCRATIC SOCIAL CHANGE: A MANUAL FOR DRAFTERS, 2000.

⁶ Like with all the “schools” we describe, our caricature descriptions can not hope to describe all the complexity of the views espoused by the various authors whose work with cite. For a recent discussion of some of these issues, see William West, *Administrative Rulemaking: An Old and Emerging Literature*, 65 PUB. ADMIN. REV. 6, 2005. For a legal angle, see Cass Sunstein and Adrian Vermeule, *Interpretation and Institutions*, 101 MICH. L. REV. 4, 2003.

⁷ Such an approach has gained proponents among scholars like Stack, who argue that a “purposive approach, not a textualist one, best suits the distinctive legal character of regulations.” Even though rulemakers originally wrote very specific regulations, new social and administrative values require new interpretations of even specific regulations. Given the need to adapt to ever-changing values and needs, the reader might ask, why not just adopt a more objectives-based approach to interpretation? See Kevin Stack, *Interpreting Regulations*, 111 MICH. L. REV. 3, 2012.

⁸ Andromachi Georgosouli *Regulatory Interpretation: Conversational or Constructive?*, 30 OXF. J. OF LEG. STUD. 2, 2010.

	such a partition. Ignores analysis of the actual problems these agencies try to solve.	
“public policy implementation” school	Focuses on organisational conditions for successfully implementing policies.	Assumes “implementation” of legislative objectives, despite most not defined in law.
performance-based budgeting	Agencies receive resources to the extent they achieve particular objectives. Thus, their existence and size depends on extent they achieve objectives.	Objectives can change and reflect the political priorities of the day.

financial regulatory reform

The figures summarises some of the recent literature dealing with the size and scope of executive agencies. We focus on literature dealing with the way that structure follows strategy – mapping organisation to policy challenges.

Source: see figure (with interpretation provided by authors).

Authors writing in **inter-agency public administration school** argue that cross-agency collaborations sometimes represent best approach to tackling large, complex regulatory challenges. Often more positive than normative, authors writing in this school explain why inter-agency collaboration has increased – and if such inter-agency collaboration represents the best public sector organisational form for dealing with complex social problems. For example, in Hall and O’Toole’s study of US legislation between 1965-1966 and 1993-1994, they find that inter-agency work increased over time.⁹ Roughly 84% of programmes in the sixties required multi-agency support. By the 1990s, that proportion rose to 90%. Most studies in this school find that “networked” or “joined up” policy implementation must occur – because the objectives of legislation span beyond the institutional silos inherited from decades (or centuries) of use.¹⁰ Public sector managers can overcome the inherent difficulties and ambiguities of inter-agency relationships by managing for results.¹¹ Such a solution begs the question – why not structure administrative agencies around desired outcomes in the first place?¹²

⁹ See Thad Hall and Laurence O’Toole, *Structures for Policy Implementation: An Analysis of National Legislation, 1965-1966 and 1993-1994*, 31 ADMIN. & SOC. 6, 2000.

¹⁰ See Robyn Keast, Myrna Mandell, Kerry Brown and Geoffrey Woolcock, *Network Structures: Working Differently and Changing Expectations*, 64 PUB. ADMIN. REV. 3, 2004. See also Bob Hudson, Brian Hardy, Melanie Henwood & Gerald Wistow, *In Pursuit of Inter-Agency Collaboration In The Public Sector: hat is the contribution of theory and research?*, 1 PUB. MAN 2, 1999. See also Christopher Pollitt, *Joined-up Government: A Survey*, 1 POL. STUD. REV. 1, 2003.

¹¹ See Stephen Page, *Measuring Accountability for Results in Interagency Collaboratives*, 64 PUB. ADMIN. REV. 5, 2004. See also John Bryson, Barbara Crosby, and Melissa Stone, *The Design and Implementation of Cross-Sector Collaborations: Propositions from the Literature*. 66 Pub. Admin. Rev. s1, 2006.

¹² Indeed, failures in inter-agency cooperation related to the fight against terrorism and other aspects of law enforcement have led to a broader disenchantment with inter-agency collaboration. See Ashton Carter, *The Architecture of Government in the Face of Terrorism*, 26 INT’L SEC. 3, 2002. The failure of interagency cooperation to prevent and quickly resolve the 2007-8 financial crisis further cast doubts about interagency cooperation as an effective method of dealing with large and serious social risks.

Rather pointlessly, authors in the **interagency administrative law school** have looked at legal issues surrounding the design and operation of inter-agency collaboration. Most authors in this school describe small issues in administrative law, usually arguing why particular administrative decisions may – or may not – represent the best outcome for the development of administrative law in general.¹³ A “shared regulatory space” (usually some form of collective action problem between agencies) requires action by multiple agencies.¹⁴ Some authors argue that the “best” agency design may not be achievable – as political processes often determine the structure of agencies and regulators.¹⁵ In general, legal schools have completely failed to write about how objectives help shape law and the development of administrative traditions.¹⁶

Two seemingly unrelated schools of thought have struggled with ways of improving the performance of executive agencies when they work in combination on complex social problems. Unique to public administration, authors in the **public policy implementation school** look at the extent to which various types of executive agency design help promote certain policy outcomes.¹⁷ Many commentators point to stupidity (for lack of a better word) by policymakers at all levels to change government agencies and their processes in order to improve policy implementation.¹⁸ Cooperation between government agencies – and the outcomes of such collaboration – may improve only when agencies tackle complex tasks.¹⁹ Yet, such collaboration needs deliberate design. The **performance-based budgeting school** argues that rule-makers and executive agency creators need worry too much about organisational design – as long as they provide cross-agency incentives for executive agencies to maximise performance. Budgets should allocate resources based on social needs, not based on past or requested budgets. For example, a performance-based budget for tackling HIV/AIDS might allocate funds to the Ministry of Education, Interior Ministry, local governments and even Ministry for Foreign Affairs (if relevant) to the extent their activity can help achieve a set decrease in new infections.²⁰ Such an approach basically represents an objectives-based approach to executive agency design. Budgets set objectives – and agencies must work in collaboration in order to

¹³ For an overview of many of the issues and authors, see Jason Marisam, *Interagency Administration*, 45 ARIZ. STATE L. J. 1, 2013.

¹⁴ For a recent take on inter-agency coordination, see Jim Rossi & Jody Freeman, *Agency Coordination in Shared Regulatory Space*, 125 Harv. L. Rev. 1131, 2012.

¹⁵ Elizabeth Magill and Adrian Vermeule, *Allocating Power Within Agencies*, 120 YALE L.J. 5, 2011.

¹⁶ Authors writing in the New Comparative Economics perspective represent a refreshing (if brief) look at how economic objectives and incentives shape the development of administrative law and agency design. For one of the first comprehensive discussions about how incentives drive legal development, see Simeon Djankov, Edward Glaeser, Rafael La Porta, Florencio Lopez-de-Silanes, and Andrei Shleifer, *The New Comparative Economics*, 34 J. OF COMP. ECON. 4, 2003.

¹⁷ See Jill Schofield, *Time for a revival? Public policy implementation: a review of the literature and an agenda for future research*, 3 INT’L J. OF MAN. REV. 3, 2001. See also Harald Saetren, *Facts and Myths about Research on Public Policy Implementation: Out-of-Fashion, Allegedly Dead, But Still Very Much Alive and Relevant*, 33 POL. STUD. J. 4, 2005.

¹⁸ For an oldie-but-goodie take on this issue, see Benjamin Crosby, *Policy implementation: The organizational challenge*, 24 WORLD DEV. 9, 1996.

¹⁹ See Martin Lundin, *When Does Cooperation Improve Public Policy Implementation?* 35 POL. STUD. J. 4, 2007.

²⁰ See Matthew Andrews, *Performance-Based Budgeting Reform*, In Anwar Shah, FISCAL MANAGEMENT, 2005.

receive budget line-item funding. However, such budgeting in such a way does not allow for unpredictability and resource overruns.²¹ Moreover, like with inter-agency collaboration, performance-based budgeting has not necessarily resulted in significant improvements in multiple agencies' ability to solve certain social problems.²²

No where has the discussion about organising public administrative agencies gone further than discussion by the **financial regulatory reform school**.²³ The 2008 financial crisis led to wide-spread acceptance that previous regulatory structures failed to manage risks inherent in the New Financial Architecture of the 2000s.²⁴ The lack of regulatory supervision over the financial sector, and regulators' *ad hoc* response to the crisis showed that existing financial regulatory agencies either lacked the authority or ability to engage in necessary financial supervision.²⁵ Naturally, policymakers and academics called for a restructuring of financial regulators in many financially developed jurisdictions. Both the UK and US came out with Blueprints for reforming financial regulators like the Financial Services Authority and the Securities and Exchange Commission (respectively).²⁶ Both Blueprints came out in favour of objectives-based regulation focusing on macro-prudential surveillance and rulemaking and monitoring of market conduct.²⁷ Academics reached pretty much the same conclusion.²⁸ Because the UK approach to implementing a Twin Peaks approach to financial regulation centred around objectives-based legislation, the discussion about Twin Peaks regulation and objectives-based regulation often go hand-in-hand.

²¹ See Matthew Andrews, Authority, acceptance, ability and performance-based budgeting reforms, 17 INT'L J. OF PUB. SEC. MANAGE. 4, 2004.

²² See Jack Yun-Jie Lee and Xiao-Hu Wang, *Assessing the Impact of Performance-Based Budgeting: A Comparative Analysis across the United States, Taiwan, and China*, 69 PUB. ADMIN. REV. S1, 2009. For a more general review, see Marc Robinson and James Brumby, *Does Performance Budgeting Work?: An Analytical Review of the Empirical Literature*, IMF WP 05/210, 2005.

²³ For a discussion, see Saule Omarova and Adam Feibelman, *Risks, Rules, and Institutions: A Process for Reforming Financial Regulation*, 39 U. MEM. L. REV. 881, 2009.

²⁴ The New Financial Architecture refers to the "globally integrated system of giant bank conglomerates and the so-called 'shadow banking system' of investment banks, hedge funds and bank-created Special Investment Vehicles" that emerged after financial sector deregulation of the 2000s in the US and EU. See James Crotty, *Structural causes of the global financial crisis: a critical assessment of the 'new financial architecture'*, 33 CAMB. J. ECON. 4, 2009.

²⁵ Instead of a proper system of supervision and resolution (saving or winding-up financial institutions in times of crisis), US authorities had to engage in "regulation by deals" in order to put in place micro and macro-prudential measures. See Steven Davidoff and David Zaring, *Regulation By Deal: The Government's Response To The Financial Crisis*, 61 ADMIN. L. REV. 3, 2009.

²⁶ See HM Treasury, A new approach to financial regulation: the blueprint for reform, Cm 8083, 2011, available [online](#). See also Dep't of Treasury, *Blueprint for a Modernized Financial Regulatory Structure*, 2008, available [online](#).

²⁷ To take one example, the "Treasury believes that a regulatory structure centered on an objectives-based regulatory framework should represent the optimal structure." *Id* at 143.

²⁸ Authors like Levine argued for objectives-based legislation creating "an informed, expertly staffed, and independent institution that evaluates financial regulation from the public's perspective." Wymeersch, after considering the range of institutional structures present across Europe, notes that consolidation of regulators seems to be the trend – with objectives-based approaches often preferred. See Ross Levine, *The Governance of Financial Regulation: Reform Lessons from the Recent Crisis*, 12 INT'L REV. OF FIN. 1, 2012. See also Eddy Wymeersch, *The Structure of Financial Supervision in Europe: About Single Financial Supervisors, Twin Peaks and Multiple Financial Supervisors*, 8 Euro. Bus. Org. L. Rev. 2, 2007.

Twin Peaks Regulatory Systems and Objectives-Based Legislation

Creating and organising regulators to achieve specific objectives represents one (and relatively new) way of regulating a financial sector. Figure 2 shows the major approaches to financial regulation – broadly describing each approach and showing several countries following that approach.²⁹ Traditionally, regulators have taken an institutional or functional approach to financial sector regulation. Banking laws tended to place the authority to oversee banks with the central bank or a separate banking regulator. Securities acts world-wide tended to put a securities regulator in charge of capital markets surveillance.³⁰ By the early 2000s, both policymakers and academics alike asked in integrating financial sector supervisors could provide higher risk-adjusted returns to the national financial sector as a whole.³¹ The trend toward unifying regulators increased – with more countries merging financial regulators from sectoral to more integrated structures. Yet, by the time of the 2007-8 financial, many countries’ lawmakers realised that a single, integrated regulator probably would not provide the best level of regulatory oversight.³² The global financial crisis also led to intense debate around objectives-based (rather than institutions or services based) regulators. Inspired by both policymaker and academic support for Twin Peaks financial sector regulation, more countries have drafting objectives-based legislation putting a Twin Peaks regulatory framework in place.³³

²⁹ See Group of 30, *The Structure of Financial Supervision: Approaches and Challenges in a Global Marketplace*, 2008, available [online](#).

³⁰ For a historical cross-country overview of countries’ financial sector regulatory choices (including the extent of integration between these regulators), see Jose de Luna-Martinez and Thomas Rose, *International Survey of Integrated Financial Sector Supervision*, WB PRWP 3096, 2003, available [online](#). We describe their data in detail in a subsequent section.

³¹ See Martin Cihak and Richard Podpiera, *Is One Watchdog Better Than Three? International Experience with Integrated Financial Sector Supervision*, IMF WPAPER 06/57, 2006, available [online](#).

³² Many countries’ changes in financial regulation had the UK experience well in mind. The failure of the UK’s integrated Financial Services Authority (which inspired other countries to adopt such an approach) led to a groping around for “something better.” Some might argue that the UK’s Twin Peaks approach came about from the need to dismantle the FSA-approach, more than from its intrinsic qualities. See Joseph Norton, *Global Financial Sector Reform: The Single Financial Regulator Model Based on the United Kingdom FSA Experience - A Critical Reevaluation*, 39 INT’L LAW. 15, 2005. See also Michael Taylor, *The Road from Twin Peaks - and the Way Back*, 16 CONN. INS. L.J. 61, 2010.

³³ Two recent prominent analyses of the suitability of a Twin Peaks regulatory structure concern Canada and South Africa. Pan’s misnamed article basically assesses the positive features of a financial sector regulatory structure, looks at various regulatory structures and decides on a Twin Peaks model for Canada. The South African study basically cojoles the public into adopting a Twin Peaks approach. See Eric Pan, *Structural Reform of Financial Regulation*, 19 Transnat’l L. & Contemp. Probs. 796, 2011. See also South Africa Financial Regulatory Reform Steering Committee, *Implementing a Twin Peaks Model of Financial Regulation in South Africa*, 2013, available [online](#).

Figure 2: Major Approaches to Financial Sector Regulation

Approach	Description	Country Examples
Institutional Approach	A firm's legal status (for example a bank, broker-dealer, or insurance company) determines which regulator oversees its activity.	China, Mexico, Hong Kong
Functional Approach	The type of business conducted determines which regulator oversees that transaction. For example, a bank selling securities and insurance products may have three different regulators overseeing its operations.	Brazil, France, Italy, Spain.
Integrated Approach	One single regulator oversees all financial sector actors.	Canada, Germany, Japan, Qatar, Singapore.
Twin Peaks Approach	Separates regulators by objective – such that one regulator oversees the safety and soundness of the financial system and the other focuses on the conduct of business.	Australia, UK, Netherlands (possibly South Africa in the future?)

Source: summarised from Group of 30 (2008). The country examples may not reflect changes made after 2008.

Twin Peaks financial regulation – and specifically such regulation based in objectives-based legislation – provides an interesting development for scholars of legislative drafting and jurisprudence for three reasons. First, most legislative regulation does not “put it on the line” by defining specific objectives – and therefore outcomes. Central banks often have had particular objectives (like inflation control, encouraging economic growth and regulating banks).³⁴ Securities regulators also had specific objectives enshrined in legislation.³⁵ However, legislation – whether financial or otherwise – has rarely if ever explicitly stated risks targeted and objectives of legislature action. Second, legislatively defined objectives create objective yardsticks by which to measure executive agencies' success. A specific objective allows independent analysts to assess versus

³⁴ Congress added the US Federal Reserve Bank's objectives to the 1913 Federal Reserve Act only in 1977. That objective requires the Fed to “maintain long run growth of the monetary and credit aggregates commensurate with the economy's long run potential to increase production.” Banking regulation does not appear as a primary objective. Article 127(5) of the Treaty on the Functioning of the European Union appears to give the Central European Bank regulatory authority to supervise banks almost as an afterthought, as “the [European] Council...may ...confer specific tasks upon the European Central Bank concerning policies relating to the prudential supervision of credit institutions and other financial institutions with the exception of insurance undertakings.” Such a conferral requires a special legislative procedure, must be adopted unanimously, and must offer after consulting the European Parliament and the European Central Bank itself. See Federal Reserve Act of 1913, 12 USC 3, available online. See also Consolidated version of the Treaty on the Functioning of the European Union, OJ C 326, 26/10/2012, available [online](#).

³⁵ The original US Securities and Exchange Commission Act had a section titled Necessity for Regulation. However, the section does not provide explicit objectives *per se*. The European Securities and Markets Authority probably represents best-in-practice, having a clear statement of objectives to “protect the public interest by contributing to the short, medium and long-term stability and effectiveness of the financial system, for the Union economy, its citizens and businesses.” The objective includes regulatory and supervisory objectives, objectives for ensuring the integrity, transparency, efficiency and orderly functioning of financial markets, proper regulation and supervision of the taking of regulatory risks, and enhancing customer protection. See Securities Exchange Act of 1934, 15 U.S.C. § 78a. See also Establishing a European Supervisory Authority Regulation, OJ L 331 REG. 1095/2010, 2010, available [online](#).

outcomes.³⁶ Such a structure also focuses democratic accountability on executive agencies for achieving these clearly-defined legislative objectives.³⁷ Third, less prescriptive legislation allows for less prescriptive regulation. In other words, because legislation defines broad objectives (like financial stability), financial regulators and/or other executive agencies can engage more freely in risk-based and principles-based regulation.³⁸ Principles-based regulation (as a system – including the agency-level rules that focus on risk) clearly represent a new form of governance.³⁹ Despite its detractors, principles-based regulation – and the objectives-based legislation that underpins such regulation – still represents one of the best ways of dealing with complex social and economic problems (risks).⁴⁰ To the extent that a country’s first objectives-based legislation represents a “framework law,” that law clearly and unambiguously represents a completely different approach to legislation.⁴¹ Legislation-by-objectives (even in the form of a financial markets act) can create a precedent for future lawmaking-by-objectives.⁴²

Yet, such objectives-based financial sector legislation and regulation is not without its critics. Jones, for example, might argue that lawmakers should not design financial regulators around financial markets’ risks, institutions, and actors.⁴³ To make the argument less abstract (and to paraphrase Jones to the breaking point), the US SEC should not just sit back and figure out how to apply rules to JP Morgan, Goldman Sachs,

³⁶ Such a legislative approach in some ways enshrined the same principles that the UK introduced at the regulatory level through its Citizens Charter policy. As a Prime Ministerial policy, the UK’s Citizens Charter policy required UK public agencies to agree on service performance targets and report on these. See Bruce Doern, *The UK Citizen’s Charter: Origins and Implementation in Three Agencies*, 21 *Pol. & Politics* 1, 1993. For the problems that initiative encountered, see also Mary Bowerman, *Auditing Performance Indicators: The Role of the Audit Commission in the Citizen’s Charter Initiative*, 11 *Fin. Acc. & Manage.* 2, 1995.

³⁷ For a discussion in the case of prudential regulation, see Julia Black, *Managing Regulatory Risks and Defining the Parameters of Blame: A Focus on the Australian Prudential Regulation Authority*, 28 *L. & POL.* 1 2006.

³⁸ Legislation which defines very specific obligations on regulators and financial institutions leaves very little room for such regulators and institutions to develop their own methods of addressing the risk the statute targets. See Cristie Ford, *Principles-Based Securities Regulation in the Wake of the Global Financial Crisis*, *MCGILL L. J.* 55, 2010, available [online](#).

³⁹ Cristie Ford, *New Governance, Compliance, and Principles-Based Securities Regulation*, 45 *Amer. Bus. L. J.* 1, 2008.

⁴⁰ For a review of the issues (including the arguments against), see Julia Black, *The Rise, Fall and Fate of Principles Based Regulation*, *LSE Leg. Stud. WP* 17/2010, available [online](#).

⁴¹ Scholars have recently described laws that change the way the legislature makes laws – or “framework laws.” Such framework laws impose obligations on future legislative members to pass laws in particular formats. See Elizabeth Garrett, *The Purposes of Framework Legislation*, *USC L. & PUB. POL. RES. P.* 04-3, 2004.

⁴² Why does much UK financial law focus so heavily on objectives, whereas other countries’ do not. Some may argue in the UK, mental legislative entrenchment has affected such objectives-based thinking. Once legislature start thinking and using new concepts (like cost-benefit analysis, impact assessment, objectives-based-legislation and so forth) later bills reflect these trends. See Oona Hathaway, *Path Dependence in the Law: The Course and Pattern of Legal Change in a Common Law System*, *JOHN M. OLIN CENT. FOR STUD. IN L., ECON. & PUB. POL. WP* 270, 2003.

⁴³ See Renee Jones, *Back to Basics: Why Financial Regulatory Overhaul is Overrated*, 4 *ENTREPRENEURIAL BUS. L.J.* 391, 2010.

AIG and other financial sector actors as they are. The SEC, Federal Reserve and other regulators should not react to financial markets. They should shape them – requiring Goldman Sachs to break up (for example) at their pleasure. Government should drive markets – not the other way around. Yet, Von Nessen, almost as if responding to the Jonesian challenge, argues that government *diktat* has caused large difficulties in the adoption of Australia’s Twin Peaks legislation.⁴⁴ Australian financial firms have had large difficulties accepting and adapting their rules and compliance systems to Twin Peaks regulators requirements down under. White warns that integrated regulatory approaches – like Twin Peaks – provide financial regulators and central banks with too much discretionary authority.⁴⁵ For his part, Pan argues that the approach adopted for financial sector regulation (and the organisational structure of financial regulators) does not matter very much.⁴⁶ Instead, the resources available and grant of legal authorities to engage in effective regulation represents the most important part of successful financial sector regulation. Even if regulatory approaches – like the UK’s integrated model or its subsequent Twin Peaks model – represent the best model for the UK, nothing guarantees that such an approach will work when exported.⁴⁷

Yet, who could deny that Twin Peaks regulation based on objectives-centre legislation (for better or worse) represents a new approach to lawmaking? Proponents like Bakir mistakenly claim that Twin Peaks regulation serves as a way of creating inter-agency collaboration and through “steering and coordinating policy networks...[and] governance through hierarchy in the financial services.”⁴⁸ These proponents argue that inter-agency collaboration still represents a challenge.⁴⁹ Other analysts put Twin Peaks regulation – sometimes with or sometimes without objectives-based regulation – head-to-head with other regulatory models in a menu fashion.⁵⁰ Regardless of whether Twin Peaks regulation represents a new regulatory model or not, objectives-based regulation does. Objectives-based legislation – and the objectives-based regulation that gives it force – represents a new way of thinking about all kinds of legislation, not just financial sector ones.

⁴⁴ See Paul Von Nessen, *Financial Services Reform: What Can be Learned from the Australian Experience*, J. S. AFR. L. 64, 2006.

⁴⁵ See Lawrence White, *The Rule of Law or the Rule of Central Bankers?* CATO J. 30, 2010.

⁴⁶ See Eric Pan, *Four Challenges to Financial Regulatory Reform*, 55 VILL. L. REV. 743, 2010.

⁴⁷ See Joseph Norton, *Global Financial Sector Reform: The Single Financial Regulator Model Based on the United Kingdom FSA Experience— A Critical Reevaluation*, 39 INT’L LAWYER 1, 2005.

⁴⁸ Canir Bakir, *The Governance of Financial Regulatory Reform: The Australian Experience*, 87 Pub. Admin. 4, 2009.

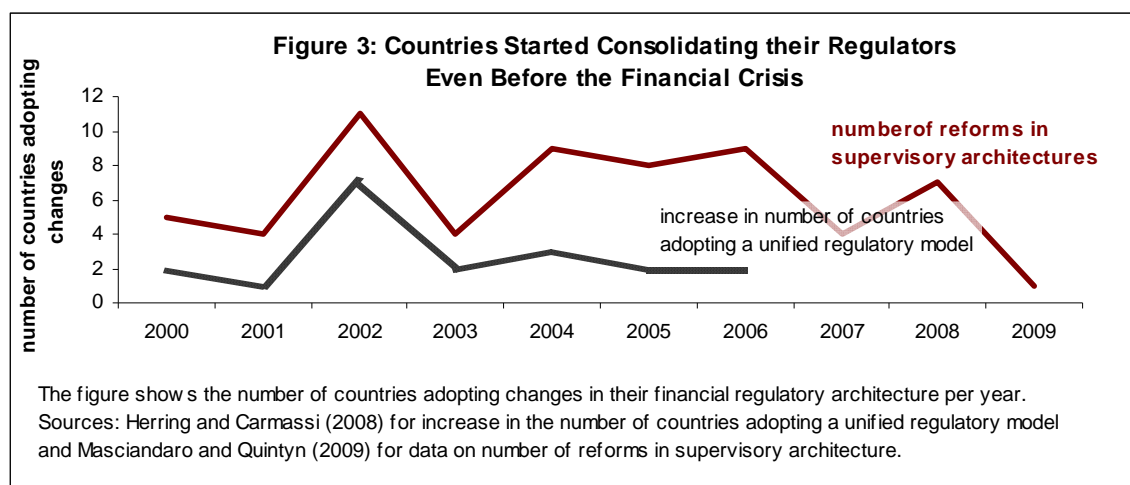
⁴⁹ See Adriane Fresh and Martin Baily, *What does international experience tell us about regulatory consolidation?* PEW FIN. REF. PROJ. WP 6, 2009, available [online](#).

⁵⁰ Talyor represents one of the many authors who compares Twin Peaks side-by-side with other approaches. To his unending credit, he represents one of the only authors to actually classify “regulation by objective” as a separate system. See Charles Taylor, *Choosing Financial Regulatory Agency Mandates*, PEW FIN. REF. PROJ. WP 6, 2009, available [online](#).

What Do We Know About Twin Peaks Financial Regulation and the Objectives-Based Legislation that Puts it in Place?

Twin Peaks as the Next Step of Regulatory Integration?

Financial regulators world-wide have struggled to find a regulatory structure which fulfils the objectives of promoting financial stability and protecting customers.⁵¹ Such a search has resulted in changes (sometimes several of them) in financial sector regulatory structure in the 2000s. Figure 3 shows the number of financially sophisticated countries changing their financial regulatory structure in the 2000s (and the number of changes).⁵² The impetus for financial sector regulatory reform began well before the 2007-2008 crisis – with regulators recognising that previous structures did not adequately generate macro and micro-prudential regulation and protect customers adequately – while still encouraging financial sector innovation and growth. Except for a jump in 2002, both numbers of countries adopting changes and number of reforms have remained relatively constant throughout the decade. We can not judge though from these data the extent to which these reforms focus on aligning regulations with particular objectives.



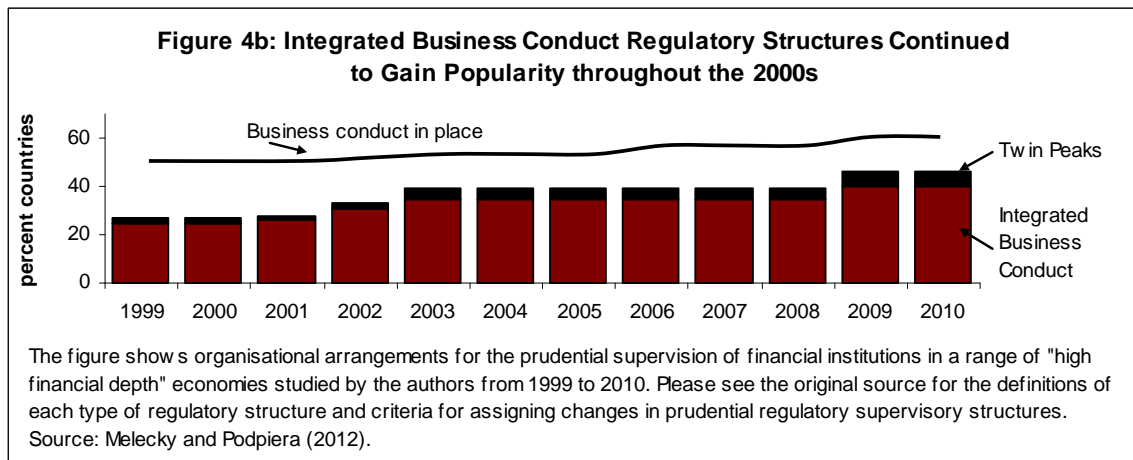
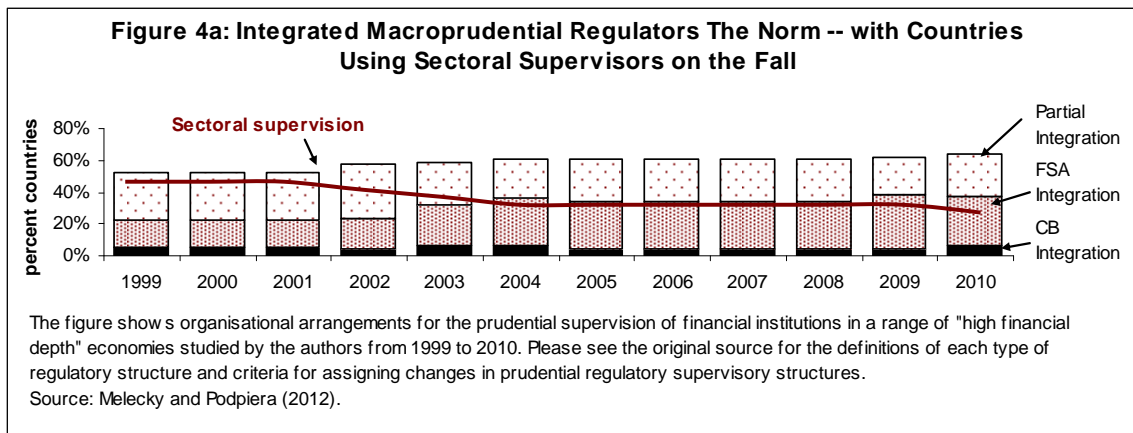
Yet, the trend toward integrating financial regulators suggests a regulatory focus on objectives rather than financial institutions themselves. Figures 4 show the nature of changes in financial sector regulation among a range of countries.⁵³ As shown in Figure 4a, sectoral supervision – the kind Hong Kong has – decreased dramatically over the

⁵¹ Financial sector regulators' objective may vary from country to country – yet they all agree on the basics of stable financial markets and protecting customers. For a fuller description of how various Twin Peaks regulatory model objectives converge on these ultimate outcomes, see Jeroen Kremers and Dirk Schoenmaker, *Twin Peaks: Experiences in the Netherlands*, LSE Fin. Mar. WP 196, 2010, available [online](#).

⁵² See Richard Herring and Jacopo Carmassi, *The Structure of Cross-Sector Financial Supervision*, 17 FIN. MAR., INSTIT. & INSTRU, 2008. See also Donato Masciandaro and Marc Quintyn, *Regulating the regulators: the changing face of financial supervision architectures before and after the crisis*, In Sylvester Eijffinger and Donato Masciandaro, *HANDBOOK OF CENTRAL BANKING, FINANCIAL REGULATION AND SUPERVISION AFTER THE FINANCIAL CRISIS*, 2009.

⁵³ See Martin Melecky and Anca Podpiera, *Institutional structures of financial sector supervision, their drivers and emerging benchmark models*, MPRA PAPER 37059, 2012, available [online](#).

decade from 45% of the countries Melecky and Podpiera studied -- to 34%.⁵⁴ Financial legislation world-wide has integrated competencies for prudential supervision over the decade – mostly with a central bank (or to a lesser extent a financial services authority). Integration of prudential supervisory functions in central banks (like Hong Kong’s Monetary Authority) has not necessarily been the preferred method for a variety of countries. Furthermore, as shown in Figure 4b, the trend toward integrating business (market) conduct competencies has also increased. Only a handful of countries have adopted Twin Peaks style integration (assigning market conduct to a separate agency). Yet, the trend toward looking at business conduct at all has surged – from 50% of countries putting in place such a system of oversight – to 62% by 2010.



Unsurprisingly, integration among regulated entities has encouraged integration of their regulators. A number of factors contribute to the benefits of integration among financial regulators exceeding their costs – including more cross-border financial transactions, economies of scale in regulation, computerisation, and conglomeration of financial

⁵⁴ Hong Kong follows a functional approach in the Group of 30 and other academics’ taxonomy. Using the Melecky and Podpiera taxonomy, Hong Kong uses a sectorally-based system of financial regulation. While the words differ, the underlying concept remains the same. Hong Kong regulates financial institutions according to their legal form and (to a limited extent) the services they provide.

organisations.⁵⁵ Bureaucratic politics can also play an important role.⁵⁶ Relative “bargaining power” between regulators and the regulated can also play a role.⁵⁷ Kremers and co-authors in particular have argued that the presence of financial conglomerates in the Netherlands has militated for an integrated regulatory structure.⁵⁸ Figure 5 illustrates the forces encouraging the integration of financial regulators – and the need for objectives-based regulation. In the US, acquisitions by financial firms outside of their sub-sector constituted about 18% of the value of all transactions. In the EU, such acquisitions (by value) came to about 25% of all mergers and acquisitions between 1990 and 2006. Many financial service providers offer banking, insurance and securities simultaneously. In such a market environment, dividing regulators by function makes less and less sense.

Figure 5: Increased Financial Integration Militates for Integrated Regulators

		target					
		US			EU-27		
acquirer	banks	52%	<1%	7%	54%	1%	5%
	insurance	2%	12%	<1%	<1%	13%	<1%
	securities	5%	3%	18%	14%	3%	8%

The figure shows the value of mergers and acquisitions in the US and EU financial services sectors from 1990-2006. Acquisitions outside of each sector came to about 18% for the US and 25% for the EU. Source: Herring and Carmassi (2008).

What do the data say about the effectiveness of financial regulator integration in achieving particular objectives like encouraging compliance with macroprudential regulation and protecting customers? At first glance, such integration produces mixed results (to say the least). Figure 6 provides some of the first evidence about the effectiveness of regulator integration on compliance with prudential and market conduct standards established by the IMF.⁵⁹ Integrated supervision statistically significantly correlates with compliance with Basel Core Principles. However, it doesn’t correlate with

⁵⁵ Luna-Martinez and Rose provide one of the first through analyses of such factors. In their comprehensive econometric study of factors influencing the extent of financial regulator integration, Melecky and Podpiera find that GDP per capita, population trade-to-GDP ratios, central bank autonomy, number of previous economic crises, stock market capitalisation and private credit to deposit ratios have statistically significant relationships with the integration of prudential supervision. Business conduct integration statistically significantly correlated with GDP per capita, trade-to-GDP ratios, credit-to-GDP ratios, and banks’ net interest margins. See Jose de Luna-Martinez and Thomas Rose, *International Survey of Integrated Financial Sector Supervision*, WB PRWP 3096, 2003, available [online](#). See also Martin Melecky and Anca Podpiera, *Institutional structures of financial sector supervision, their drivers and emerging benchmark models*, MPRA PAPER 37059, 2012, available [online](#).

⁵⁶ For example, see Donato Masciandaro, *Divide et impera: Financial supervision unification and central bank fragmentation effect*, 23 EURO. J. OF POL. ECON. 2, 2007.

⁵⁷ See Donato Masciandaro, *Politicians and financial supervision unification outside the central bank: Why do they do it?*, 5 J. OF FIN. STAB. 2, 2009.

⁵⁸ See Jeroen Kremers, Dirk Schoenmaker, and Peter Wierst, *Cross-Sector Supervision: Which Model?* BROOKINGS-WHARTON PAP. ON FIN. SERV., 2003.

⁵⁹ See Martin Cihak and Richard Podpiera, *Is One Watchdog Better Than Three? International Experience with Integrated Financial Sector Supervision*, IMF WPAPER 06/57, 2006, available [online](#).

much else. Instead, factors like overall regulatory environment and level of economic development matter far more. Interestingly, the extent of integration does not affect the number of regulatory staff monitoring financial institutions.

Figure 6: At First Glance, Data on Integrated Financial Supervision Mixed at Best

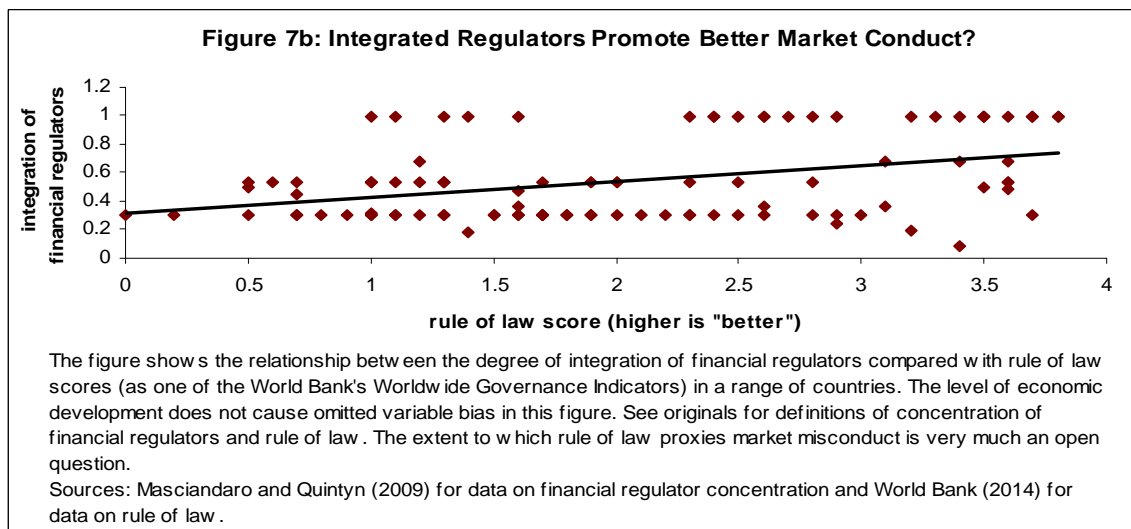
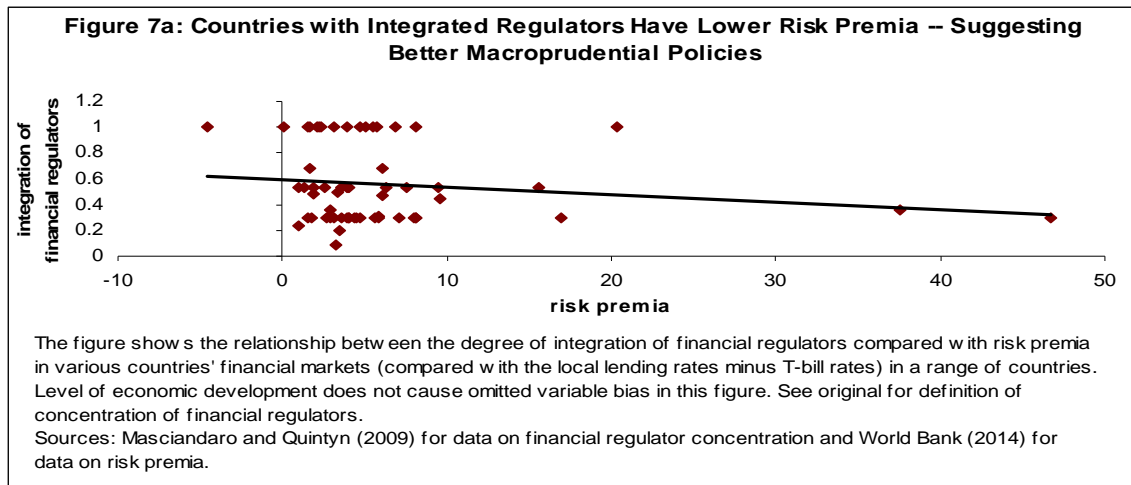
Effect of Integrated Supervision on...	Effect?	Reason	reference
Compliance with Basel Core Principles	Yes	A higher proportion of countries with integrated supervisors had higher levels of compliance with the Basel Principles	Figure 3
Regulatory governance in banking and securities markets?	No	Regression analysis shows no statistically significant effect for having an integrated regulator.	Table 6
Prudential frameworks in banking and securities markets?	No	Ditto	Table 6
Regulatory PRACTICES in banking and securities markets?	No	Ditto	Table 6
Financial integrity and safety nets in banking and securities markets?	No	Ditto	Table 6
Compliance with International Standards	No	Ditto	Table 7
Does the overall regulatory environment matter?	Yes	Having an integrated regulator matters far less for Basel Principle compliance when taking regulatory environment into account	Table 4
Does level of economic matter?	Yes	Having an integrated regulator matters far less for Basel Principle compliance when taking GDP per capita into account	Table 4
Number of regulatory staff in government	No	Regression analysis shows no statistically significant effect for having an integrated regulator.	Table 8

Source: Cihak and Podpiera (2006).

Some trends in the data suggest that regulator integration may lead to better macro-prudential policymaking and market conduct. The data need far more analysis than the illustrative graphs we have put together. However, these illustrative graphs (shown as Figures 7) suggest that regulator integration may help financial regulators achieve their objectives.⁶⁰ Figure 7a shows a positive relationship between integration of financial regulators and decreases in risk premia associated with a country's investments. Figure 7b shows a positive relationship between integration of a country's financial regulators

⁶⁰ The reader should see these graphs as only illustrative. We compared the organisation of financial sector supervision with the banking crises internationally. We found that countries which changed their prudential supervision organisational structures had a 43% average output loss as a result of banking crises (with our results unadjusted for country size). In contrast, countries without any change in their prudential supervisory structures had a unweighted output loss as a result of banking crisis of only 32%. To repeat our analysis, see Martin Melecky and Anca Podpiera, *Organization of Financial Sector Supervision Dataset*, 2012, available [online](#). See also Luc Laeven and Fabian Valencia, *Systemic Banking Crises Database: An Update*, IMF WP 12/163, 2012, available [online](#).

and rule of law (as a possible proxy for the extent to which financial firms engage in illegal activity).⁶¹ These relationships do not control for macroeconomic factors or even control for potential outliers. However, if further analysis confirms that integration among countries' financial regulators has positive macro-prudential regulatory and market conduct impacts – such results would provide support for further integration world-wide. A Twin Peaks regulatory structure would certainly represent one of the more integrated regulatory models considered by lawmakers in these countries.

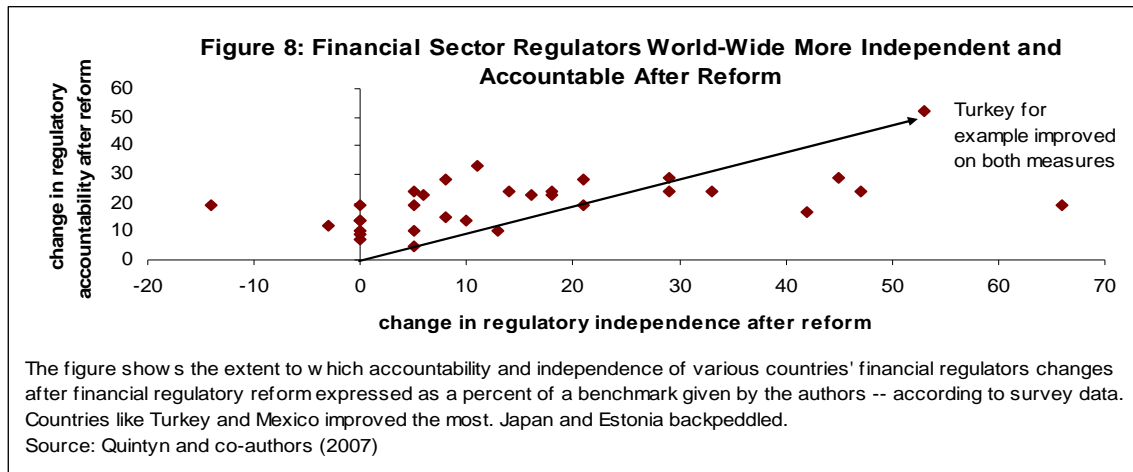


Financial regulator integration also seems to improve their independence and accountability – making them more likely to achieve their objectives. Figure 8 shows the change in scores of financial regulators' independence and accountability after a change in regulatory structure.⁶² Bird – talking specifically about the accountability of Australia's Twin Peaks regulators – finds the accountability arrangements covering the country's Prudential Regulatory Authority and Securities and Investments Commission

⁶¹ See World Bank, *Worldwide Governance Indicators*, 2014, available [online](#).

⁶² See Marc Quintyn, Silvia Ramirez, and Michael Taylor, *The Fear of Freedom: Politicians and the Independence and Accountability of Financial Sector Supervisors*, IMF WP 07/25, available [online](#).

adequate.⁶³ Masciandaro and co-authors find this effect increases when the prudential regulator sits outside of the central bank.⁶⁴ Integration, particularly outside the central bank, correlates with greater financial stability (namely fewer systemic banking crises).⁶⁵



Many authors have reviewed the pros and cons of using a principles-based as opposed to a rules-based financial sector regulatory approach.⁶⁶ These authors miss the point. Legislators should not simply balance pros and cons of principles versus rules from a priori principles. Instead, they should match regulatory structure to regulatory environment. In other (simpler) terms, structure should follow strategy.⁶⁷ Melecky and Podpiera (among others) find a strong relationship between the structure of financial sector regulators and various macroeconomic and financial sector variables. As we have previously mentioned, some of these factors include GDP per capita, population trade-to-GDP ratios, extent of central bank autonomy, number of previous banking crises, stock market capitalisation, credit-to-GDP ratios, and banks' net interest margins.⁶⁸ The question isn't whether countries (like Hong Kong) should have a sectoral basis of financial regulation as opposed to a Twin Peaks one. **Instead, countries like Hong Kong**

⁶³ Joanna Bird, *Regulating the Regulators: Accountability of Australian Regulators*, 35 MELB. U. L. REV. 739, 2011.

⁶⁴ Such a finding holds particular relevance for jurisdictions like Hong Kong, where the central bank has always played a pivotal and undisputed role in establishing macro-prudential regulations. See Donato Masciandaro, Marc Quintyn, and Michael Taylor, *Inside and outside the central bank: Independence and accountability in financial supervision*, 24 EURO. J. OF POL. ECON 4, 2008.

⁶⁵ Barry Eichengreen and Nergiz Dincer, *Who Should Supervise? The Structure Of Bank Supervision and the Performance of the Financial System*, NBER WP 17401, available [online](#).

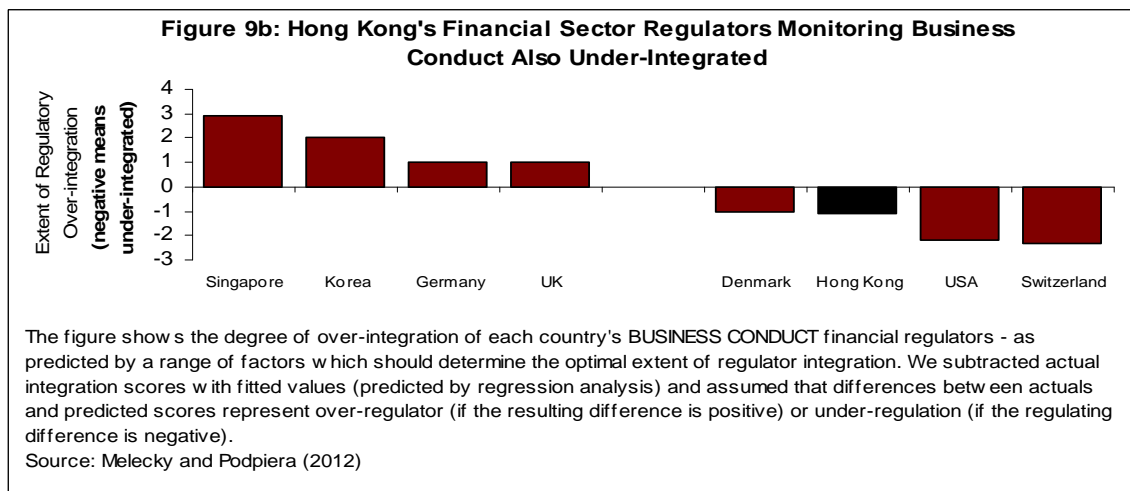
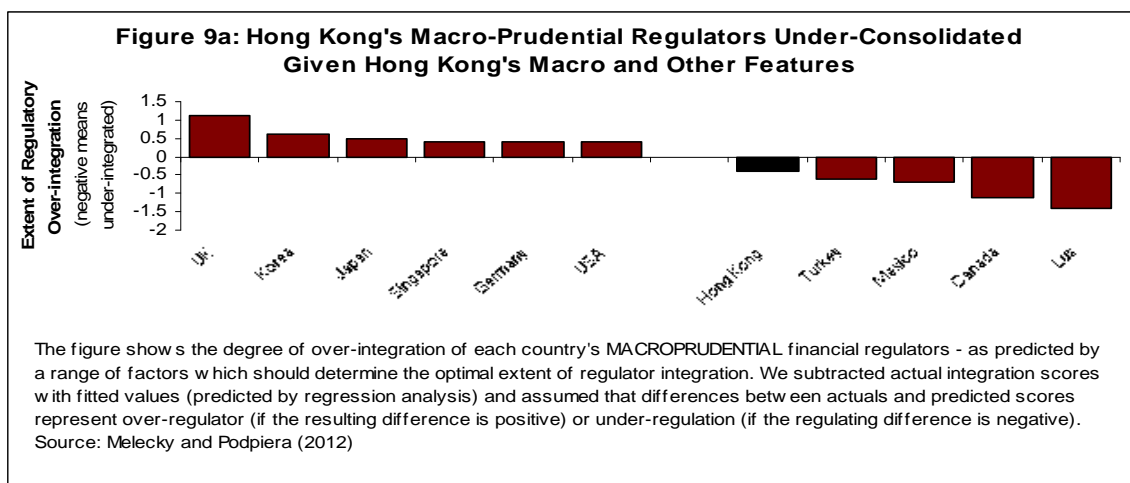
⁶⁶ For a recent description in the financial regulation context, see John Coffee and Hillary Sale, *Redesigning the SEC: Does the Treasury Have a Better Idea*, 95 VA. L. REV. 707, 2009. See also Richard Abrams and Michael Talyor, *Issues in the Unification of Financial Sector Supervision*, IMF WP/00/213, 2000.

⁶⁷ The question about whether public sector organisational design adapts to the broader organisational environment remains an open one. For an empirical analysis of the extent to which government agency size and specialisation (structure) responds to the macroeconomic environment see Bryane Michael and Maja Popov, *The Size and Structure of Government*, Working Paper, 2012, available [online](#).

⁶⁸ See also Martin Melecky and Anca Podpiera, *Institutional structures of financial sector supervision, their drivers and emerging benchmark models*, MPRA PAPER 37059, 2012, available [online](#).

should choose the regulatory approach most appropriate for their financial markets (as measured by a range of macroeconomic and other variables).

As the economic crisis already illustrated, some countries' lawmakers can make incorrect decisions about the structure of the country's financial regulators. Figure 9 shows the extent of the over or under integration of several countries' financial regulators.⁶⁹ Some prudential regulators – like the UK's and Korea's – have over-integrated (compared with other countries with similar levels of GDP-per-capita and other factors). Other countries' prudential regulators – like Hong Kong's, Canada's and Mexico's – have under-integrated. Similarly, regulators focusing on financial sector business conduct have over-integrated in Singapore and Germany. Such regulators have under-integrated in Hong Kong and Switzerland.



⁶⁹ The authors ran regression analysis on the extent of financial sector regulatory integration and a range of variables for most of the world's economies. Such regression would show which countries have higher (or lower) levels of regulator integration compared with other countries having similar levels of GDP-per-capita and other factors. Any judgment about over or under integration would thus assume that the average or normal level of integration for any chosen level of GDP-per-capita (and other factors) represents the right level. Naturally, such value judgments should be taken with scepticism.

Financial sector regulatory integration does not need to correlate with objectives-based financial legislation. However, the two trends have coincided over the years. Larger financial regulators need to define objectives (outcomes) rather than specific activities to regulate. Regulator size provides economies of scope and scale in overseeing a range of financial sector activities.⁷⁰ Larger financial sector risks have also militated for a focus on specific types of risks – rather than focus on simply focusing on processes of regulated entities. With increasing leverage, larger sizes and more international exposure, financial entities pose systemic risks unknown even 20 years ago.⁷¹ Thus, larger and more integrated financial regulators would usually do well to focus on objectives.

Legislating Twin Peaks Regulatory Structures through Objectives-Based Legislation

A number of jurisdictions have adopted a twin-peaks regulatory structure (or other similar structure). In the UK, a review of regulators' response to the financial crisis has led the Government to adopt a Twin Peaks structure.⁷² According to recent surveys, "79% of firms believe the changes to the regulatory system will result in improved effectiveness, which can be expected to contribute to promoting the UK as a global hub for the financial sector."⁷³ Regarding Australia's twin peaks system, Professor Brown echoes the many voices in the literature that have argued that Australia's twin peaks regulatory model helped it during the crisis.⁷⁴ "The evidence from this examination suggests that Australia was able to avoid many of the problems that arose in the United States and the United Kingdom, partly due to its twin peaks regulatory structure."⁷⁵ The Dutch experience with Twin Peaks regulation shows that such a regulatory structure helped the Netherlands weather the global financial crisis.⁷⁶ South Africa's consultation on its upcoming Twin Peaks reforms also points to the promise of such regulation.⁷⁷ Given its promise, the EU is considering adopting a twin-peaks approach in its Union-wide surveillance and monitoring actions.⁷⁸ As previously mentioned, the US Treasury

⁷⁰ See Richard Abrams and Michael Talyor, *Issues in the Unification of Financial Sector Supervision*, IMF WP/00/213, 2000.

⁷¹ We do not have space to describe these risks here. Interestingly, authors like Allen and Gale note that inappropriate financial regulation may have actually contributed to systemic and other risks (like counterparty risks). See Franklin Allen and Douglas Gale, *Systemic risk and regulation*, THE RISKS OF FINANCIAL INSTITUTIONS. University of Chicago Press, 2007.

⁷² See Alison Lui, *Single or twin? The UK financial regulatory landscape after the financial crisis of 2007–2009*, J. OF BANK. REG. 13, 2012. For a more readable exposition, see KPMG, *Twin Peaks Regulation: Key Changes and Challenges*, available [online](#).

⁷³ BDO & DLA Piper, *The New Twin Peaks Model*, available [online](#).

⁷⁴ Elizabeth Brown, *A Comparison of the Handling of the Financial Crisis in the United States, the United Kingdom, and Australia*, 55 VILLANOVA LAW REVIEW 3, 2010.

⁷⁵ *Id* at 1.

⁷⁶ Like with all regulatory approaches, the Netherlands's Twin Peaks model had good as well as bad aspects. For an illuminating discussion of the Dutch experience (and succinct recommendations for improving the Dutch version), see IMF, *Technical Note on Financial Sector Supervision: The Twin Peaks Model*, 2011, available [online](#).

⁷⁷ The Financial Sector Regulation Bill looks a lot like the UK's implementing legislation – with a focus on objectives. See National Treasury, *Financial Sector Regulation Bill*, 2013, available [online](#).

⁷⁸ The EU currently follows a sectoral approach for Union-wide surveillance. However, several politicians and senior advisors have started militating for a twin peaks approach. For an overview of the EU system of financial regulation, see Eddy Wymeersch, *The Structure of Financial Supervision in Europe: About Single*

and General Accountability Office have already come out in favour of an objectives-based Twin Peaks approach for the USA.⁷⁹

A Twin Peaks approach to financial sector regulation does not strictly require objectives-based legislation. Indeed, the legislation setting up Australia's Twin Peaks approach to financial sector regulation focuses on setting up the organisations sitting on one each of the Peaks, and defining their activities. The Australian 1998 Prudential Regulation Authority Act provides no objectives at all.⁸⁰ The Act notes that the “the [Australian Prudential Regulation Authority] exists...[for] regulating bodies in the financial sector in accordance with other laws of the Commonwealth that provide for prudential regulation or for retirement income standards, administering the financial claims schemes...and developing the administrative practices and procedures to be applied in performing that regulatory role and administration.”⁸¹ Hardly an inspiring vision statement for the Authority. The Act contains, what looks like, an objectives-based requirement to “balance the objectives of financial safety and efficiency, competition, contestability and competitive neutrality and, in balancing these objectives, is to promote financial system stability in Australia.”⁸² Yet, the existence of these abstract and multiple regulatory objectives would make derived rulemaking (based on article 8(2)) extremely difficult. In other words, one could hardly imagine the Authority promulgating a rule about the central clearance of derivative transactions based on the authority of the singular and concrete mandate derived from article 8(2). Yet, if we must point to one article in the Act as the objectives-based legislative mandate for the Authority's function, article 8(2) of the Prudential Regulation Authority Act would provide the natural candidate.⁸³

The UK's Financial Services Act could not provide a starker contrast of the way legislation defines objectives, rather than organisations and their processes. Figure 10 shows the objectives defined in various parts of the UK 2009 Banking Act.⁸⁴ Objectives appear scattered across various parts of the Act. In the case of special resolution regimes, the Act outlines the objectives – leaving the Treasury to issue a Code of Practice.⁸⁵ In the case of bank insolvency, the Act provides liquidators with general powers, which they use to achieve their objectives.⁸⁶ With regard to bank administration, the Act makes plain

Financial Supervisors, Twin Peaks and Multiple Financial Supervisors, 8 EURO. BUS. ORG. L. REV. 2, 2007. For one example of a senior EU legislator arguing for a twin peaks approach, see Pervenche Beres, *First Step towards 'twin peaks' model of financial supervision*, available [online](#).

⁷⁹ We have previously discussed Treasury's *Blueprint*. Interestingly, the GAO was looking at reform of the US financial regulatory structure well before the global crisis. See GAO, *Financial Regulation: Industry Changes Prompt Need to Reconsider U.S. Regulatory Structure*, GAO-05-61, 2004, available [online](#).

⁸⁰ See Australian Prudential Regulation Authority Act 1998, No. 50, 1998, available [online](#).

⁸¹ *Id* at 8(1). We have removed lettered-list formatting for ease of reading. Later in the article, the Act requires the Authority to

⁸² *Id* at 8(2).

⁸³ We could have done the same analysis for the Australian Securities and Investments Commission Act. In order to keep our paper at the readable length, we will focus our discussion mostly on prudential regulatory legislative provisions rather than business conduct ones. See Australian Securities and Investments Commission Act 2001, Act No. 51, 2001, available [online](#).

⁸⁴ See Banking Act 2009, available [online](#).

⁸⁵ *Id* at 5.

⁸⁶ *Id* at 103.

that “a bank administrator may do anything necessary or expedient for the pursuit of the Objectives.”⁸⁷

Figure 10: The UK’s Legislative Design of Objectives-Based Twin Peaks Regulatory Structure: The Financial Conduct Authority

Part I: Special Resolution Regime	Objectives and code	4. Special resolution objectives
<p>The Act provides the UK’s Treasury, Financial Services Authority, and Bank of England with stabilisation powers, use of bank insolvency procedures, or bank administration procedures to (in no particular order):</p> <ul style="list-style-type: none"> • Protect and enhance the stability of the UK’s financial systems (objective 1). • Protect and enhance public confidence in the stability of the banking systems of the United Kingdom (objective 2). • Protect depositors (objective 3) • Protect public funds (objective 4) and • Avoid interfering with property rights in contravention of a Human Rights Act convention right (objective 5). <p>The order in which the objectives are listed in this section is not significant; they are to be balanced as appropriate in each case.</p>		
Part II: Bank Insolvency	Process of bank liquidation	99. Objectives
<p>Bank liquidators should pursue two objectives (with objective 1 taking precedence over objective 2):</p> <ul style="list-style-type: none"> • Work with the Financial Services Compensation Scheme to ensure that eligible depositors either have their accounts moved to another financial institution or receive payment from the Scheme (objective 1) • Wind up the bank’s affairs for the greatest benefit of the bank’s creditors (objective 2), 		
Part 3 Bank Administration	Introduction	137-140.Objectives
<p>The Act provides bank administrators with two objectives (with the first objective taking priority),</p> <ul style="list-style-type: none"> • Provide support for commercial purchaser or bridge bank (objective 1), and • Provide “normal” administration (objective 2). <p>If the purchaser or “normal” administration is no longer required, these objectives cease to exist.</p>		
Part 5 Inter-Bank Payment Systems	Regulation	188.Principles

The Bank of English may publish – after receiving the Treasury’s okay – any principles it deems appropriate.
The figure provides a plain English explanation of the legislation, omitting original formatting. *See original for exact measures and specific language.*
Source: UK 2009 Banking Act

The organic provisions governing the UK’s Twin Peaks regulators also revolve around defining objectives – leaving the new organisations to define their own rules. Figure 11 shows an example of legislation creating the UK’s Financial Conduct Authority (though we could have presented the Prudential Regulatory Authority without any change in the tenor of our analysis).⁸⁸ As shown, the Act outlines three objectives (sections 1C-1E). The Act further devolves rulemaking authority to the Financial Conduct Authority (in section 1K). Rather than defining the Authority’s powers and processes in a detailed manner, the Act authorises a number of panels to oversee the Authority’s work (sections 1N-1Q). The Act thus uses ex-post evaluation – rather than ex-ante rulemaking – as the main way of regulating the regulator.

⁸⁷ *Id* at 145.
⁸⁸ *See* Financial Services Act 2012, Part 2 at 6 (amending sections 1 to 18 of the Financial Services and Markets Act 2000 as part 1A Chapter 1), available [online](#).

Figure 11: The UK’s Legislative Design of Objectives-Based Twin Peaks Regulatory Structure: The Financial Conduct Authority

Provision	Location
Overview	1B
1. defines overall objective “ensuring that the relevant markets function well”	
2. provides requirement to uphold the “strategic objectives” defined in the Act	
3. gives authority to engage in rulemaking needed to ensure fulfilment of objective	
Consumer Protection Objective	1C
Defines an 8 part list of principles which the Authority should keep in mind when regulating)	
Integrity Objective	1D
Defines 5 part inclusive list of characteristics defining integrity of the “UK financial system”	
Competition Objective	1E
sets out a 5 part criteria for assessing “effective competition in the interests of [financial consumers”	
Definitions which define Authority’s jurisdiction	1F-1I
Power to Amend Objectives	1J
Treasury may amend	
Rulemaking authority	1K
Duty to engage in supervision	1L
Duty to Consult	1M
Authority Oversight	1N-Q
Defines a group of panels which oversee the Authority’s work	
Right to Conduct Market Review	1S
Authority to Obtain Documents Needed for Reviews	1T

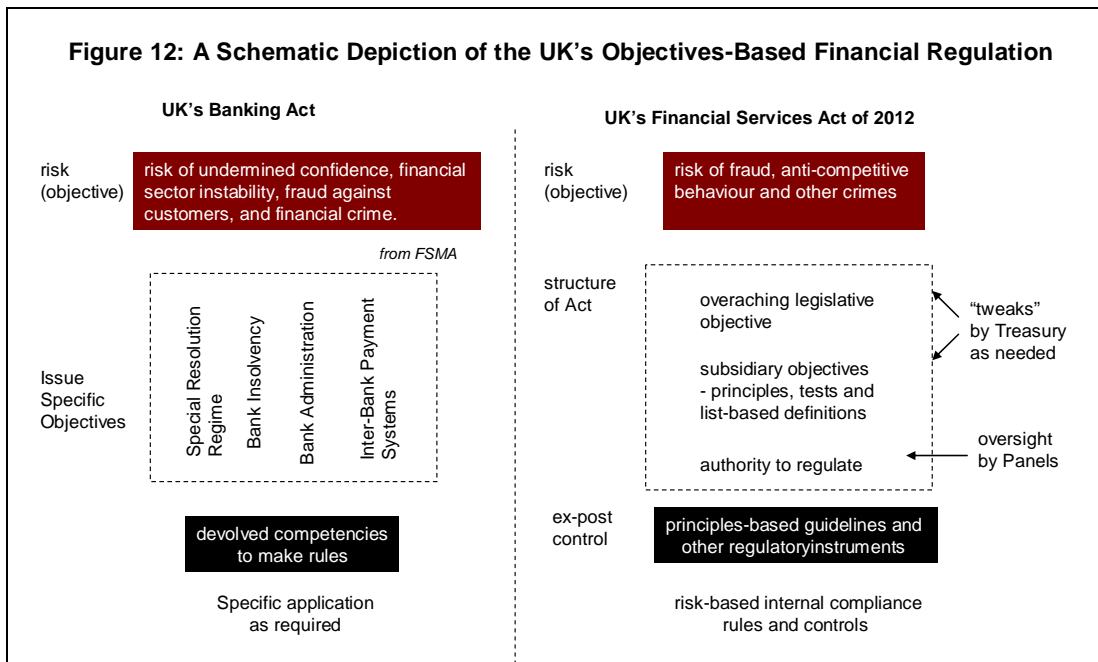
The figure provides a paraphrasing of the provisions of the relevant sections of the 2012 Financial Services Act (Part 2 amending the Financial Services and Markets Act of 2000). The reader should consult the original text for authoritative text.

Objectives-based legislation thus sets general objectives (tied to risks) and allows regulators adopt rules which achieve those objectives.⁸⁹ As if to belabour the point, Figure 12 summarises our presentation of several pieces of the UK’s objectives-based financial sector legislation in graphical form. The legislation focuses on risks identified by regulators and the public during the legislative process.⁹⁰ Besides initial identification of risks by government agencies like Treasury, business and civil society groups have

⁸⁹ Omarova and Feibelman represent perhaps some of the most avid proponents of designing a financial sector regulatory structure around objectives. At the risk of over-interpreting their proposal, they suggest starting from a clean slate – first deciding on regulatory objectives and then designing regulatory agencies around those objectives. See Saule Omarova and Adam Feibelman, *Risks, Rules, and Institutions: A Process for Reforming Financial Regulation*, 39 U. MEM. L. REV. 881, 2009.

⁹⁰ Some of these can be seen in preliminary documents leading up to the passage of the Financial Services Act. See UK Treasury, *Treasury - Twenty-Sixth Report, Financial Conduct Authority*, 2012, available [online](#). See also Treasury, *Treasury - Twenty-Eighth Report: Financial Conduct Authority: Report on the Government Response*, 2012, available [online](#).

their say on the risks and objectives targeted by the Twin Peaks legislation.⁹¹ In the Banking Act, various policy areas have their own objectives (defined in different parts of the Act). In the case of the Financial Services Act, the section outlining the Financial Conduct Authority places all the objectives up front. In each case, the relevant executive (or public sector) agencies charged with obtaining the objectives receive authority to engage in delegated legislation. As we will see in the upcoming sections, administrative agencies often further devolve rulemaking – in the form of risk-based or principles-based regulation – on financial institutions directly.



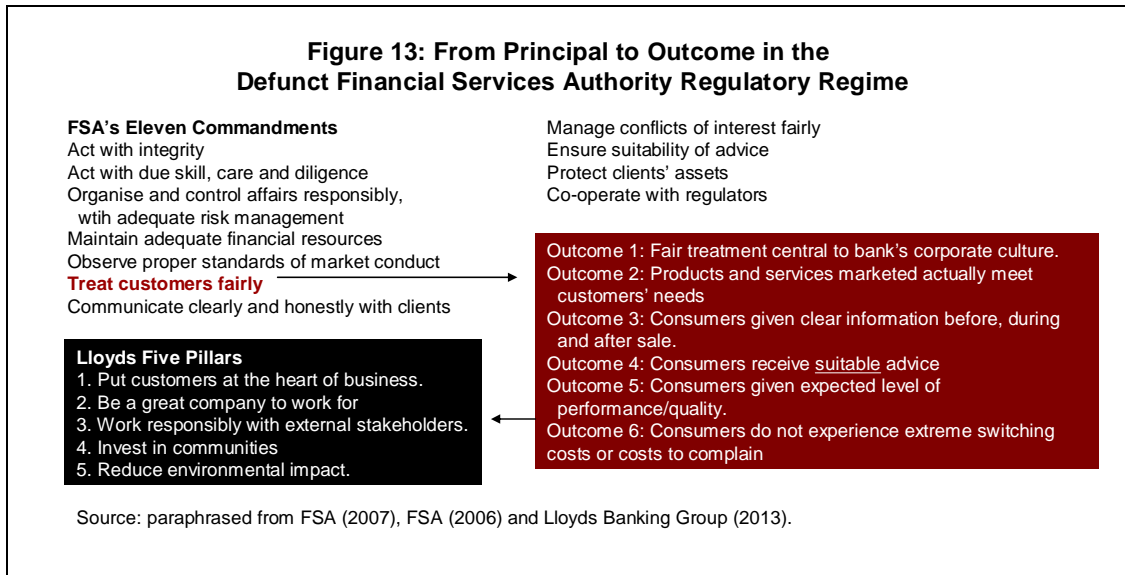
One attraction of objectives-based legislation lies in the ability to devolve responsibility for achieving the objectives to industry in the form of principles-based regulation.⁹² Objectives-based legislation would obviously provide the objectives for use in principles-based regulation.⁹³ Figure 13 shows how objectives (as enshrined in the UK's principles-based regulation) translate into outcomes – and how financial institutions (like Lloyds

⁹¹ In the case of the establishment of the Financial Conduct Authority, the House of Commons heard testimony from almost 70 persons and organisations – including names like the City of London Corporation, AXA UK, Financial Services Practitioner Panel, Aviva and others.

⁹² Authors like Ford have argued principles-based regulation represents a new governance paradigm. Indeed, objectives-based legislation may represent the same new governance paradigm at the legislative level that principles-based regulation provides at the rulemaking level. See Cristie Ford, *New Governance, Compliance, and Principles-Based Securities Regulation*, 45 AMER. BUS. L. J. 1, 2008, available [online](#).

⁹³ Prof. Di Lorenzo argues that regulations must have “legislative congruence” in order to compliance with the statute’s dictates, while achieving the objectives which legislators sought in the first place. Naturally, any system which just “passes on” objectives from legislators’ podiums to regulators desks (or directly passes objectives from the statute to the rulebook) naturally achieves such congruence more efficiently. See Vincent Di Lorenzo, *Principles-Based Regulation and Legislative Congruence*, 15 N.Y.U. J. LEGIS. & PUB. POL’Y 45, 2012.

Banking Group) translate these outcomes into their own principles.⁹⁴ In this particular example, the Financial Services Authority’s *Business Principles* led to the publication of a guidance document for use by UK financial institutions.⁹⁵ The guidance provides further guidance for the general objectives set out by the regulator. Each financial institution responds to the regulators’ objectives and principles in their own internal policies. We show the 5 “pillars” (or objectives) that Lloyds used to translate national regulatory objectives into their own specific objectives (and specific policies which we do not show in the figure).⁹⁶ Objectives “cascade” from national regulator to financial institution.



Principles-based financial sector regulator has its proponents and detractors. Many authors note that principles-based regulation (if supported better by regulatory enforcement) could have mitigated some of the worst parts of the 2007-2008 crisis. Ford, in her analysis of the UK’s principles-based regulation, argues that inadequate enforcement – rather than the nature of principles-based regulation in itself—led to inadequate regulator responses to the crisis.⁹⁷ Yet others note that the UK’s controversial experience with principles-based financial sector regulation provides some lessons for

⁹⁴ Unsurprisingly, the simple illustration we provide grossly simplifies the way regulations (and particularly principles-based regulations) promulgate through the financial system. Black discusses the various channels used; while Cunningham even questions the use of the term “principles-based” as a valid description. See Julia Black, *The Rise, Fall and Fate of Principles Based Regulation*, LSE LEG. STUD. WP 17/2010, 2010, available [online](#). See also Lawrence Cunningham, *Prescription to Retire the Rhetoric of Principles-Based Systems in Corporate Law, Securities Regulation, and Accounting*, 60 VAND. L. REV. 1409, 2007.

⁹⁵ See FSA, *Principles-based regulation: Focusing on the outcomes that matter*, 2007, available [online](#). See also FSA, *Treating customers fairly – towards fair outcomes for consumers*, 2006, available [online](#). We refer to FSA rulemaking, as the Financial Services Authority did not just disappear overnight when the UK’s Twin Peaks regulators appeared.

⁹⁶ See Lloyds Banking Group, *Code of Personal Responsibility*, 2013, available [online](#).

⁹⁷ Cristie Ford, *Principles-Based Securities Regulation in the Wake of the Global Financial Crisis*, MCGILL L. J. 55, 2010, available [online](#).

other countries – like Hong Kong. The biggest criticism of principles-based regulation comes from the uncertain responses companies had in implementing the new rules.⁹⁸ An equally valid critique has been that principles-based regulation has coincided with “light touch” regulation.⁹⁹ To sum up the prevailing view from the literature, **principles-based regulation thus trades regulatory simplicity decreased certainty about what the regulator will accept ex-post as financial institutions’ response to regulation.**¹⁰⁰

The literature suggests two things about the way that objectives-based financial sector legislation would translate into regulations and thus financial institutions’ internal policies. First, objectives-based legislation – and attendant principles-based regulation – could allow for a greater regulatory focus on risks. Clearly, more and tighter regulations should govern areas of financial sector activity with higher risks – leaving less risky areas relatively under-regulated.¹⁰¹ By focusing on objectives rather than on processes, financial institutions can spend more time and energy drafting complex internal regulations controlling complex risks – leaving less risky areas with fewer (lighter) rules. Second, such policies would shift competencies for financial section regulation directly onto financial institutions – increasing costs as well as risks.¹⁰² Allowing banks and broker-dealers to basically regulate themselves (self-regulation) seem counterproductive. However, as shown in Figure 14, the cost and benefits of such an approach will depend on a number of variables. Depending on the values of the variables described in the figure, either a rules-based or principles-based approach will work better. The best system depends on the country in question.

⁹⁸ Authors like Conceicao and Gray warned that companies might have difficulty drafting internal rules based on abstract principles. They were right. See Carlos Conceicao and Rosalind Gray, *Problems of Uncertainty - The FSA Cannot Underestimate the Risk of Fewer Rules Creating More Fear and Less Innovation*, 26 INT’L FIN. L. REV. 42, 2007.

⁹⁹ See Julia Black, *Forms and paradoxes of principles-based regulation*, 3 CAP. MAR. L. J. 4, 2008. For the media analysis of the confusion between principled-based and light-touch regulation, see Harry Wilson, *Hector Sants calls time on FSA's 'light touch' regulation*, TELEGRAPH, 12 Mar 2010, available [online](#).

¹⁰⁰ To continue with our example from Lloyds Banking Group, the recent fines for treating customers unfairly shows how banks can see and implement regulators’ controls, but misjudge whether they have reacted correctly. Lloyds put in place incentive schemes designed to increase sales which the FCA thought, “led to a serious risk that sales staff were put under pressure to hit targets to get a bonus or avoid being demoted, rather than focus on what consumers may need or want.” See FCA, *FCA fines Lloyds Banking Group firms a total of £28,038,800 for serious sales incentive failings*, 2013, available [online](#).

¹⁰¹ For a review of the promises of risk-based regulation (and a review from several jurisdictions), see Julia Black, *The Development of Risk Based Regulation in Financial Services: Canada, the UK and Australia*, 2004, available [online](#).

¹⁰² Regulators using financial institutions to regulate for them represents a way to lever public resources – which in the private sector context is called “leveraging off the client.” Authors like Omarova see strong incentives for financial firms to create optimal self-regulation which minimises systemic risks. Authors like Helm are not convinced. See Saule Omarova, *Wall Street as Community of Fate: Toward Financial Industry Self-Regulation*, 159 U. PA. L. REV. 411, 2011. See also Dieter Helm, *Regulatory Reform, Capture, and the Regulatory Burden*, 22 OXF. REV. ECON. POL. 2, 2013.

Figure 14: Factors affecting whether an objectives-based financial sector legislation and regulation would outperform a rules-based approach

variable	way variable affects objectives-based legislation
number of government regulators needed	As the number of regulators rises, their cost increases making the country's regulatory regime more expensive. Moreover, the taxes raised to pay their salaries may reduce financial sector and overall economic growth.
relative efficiency of government versus banks' legal departments and economics department staff	Nothing requires regulators to have superior abilities to draft regulations based on legislation and analyse regulatory impacts better than in-house counsel and economists. Bank-based analysts (if they have long time-horizons) have stronger personal financial incentives to strike right balance between prudence and profit.
co-operation between compliance departments	Cooperation – though a national banking association for example – can ensure financial institutions' in-house counsel and economists do not create institution-specific rules from scratch. By communicating, they can agree on fundamental provisions in all financial institutions' policies. Naturally, free-riding and collective action problems may make the costs of such cooperation exceed the benefits.
Relative asymmetry of shocks between financial institutions	To the extent that financial institutions requiring differing responses to shocks (for example one bank will suffer more than others from a change in interest rates), delegated rule-making may allow them to better tailor a response.
reduction in profits from rules	McKinsey estimates that return on equity from banks will fall from 20% to 7% due to lower profits and quantities traded from new financial sector regulations. ¹⁰³ The more firms can tailor their own rules, the less this damage from excess rulemaking.
Marginal change in financial institutions' staff time dealing with compliance rather than policy writing	Financial institutions will need to adjust their policies, no matter which regulatory approach used. If these institutions need about the same amount of time to create substantive rules as to simply adopt policies to comply with prescriptive rules, then companies should just write these substantive rules for themselves.
Relative effectiveness of self-written rules on reducing the probability of financial distress	The benefits of regulator-written rules versus industry (or company) written rules depends on whose rules provide better protection against systemic and other risks (while offering the possibility of profit). If financial institutions write better rules, then clearly they should have self-regulatory powers.
Relative monitoring and punishment costs under principles-based vs. rules-based regime	Rules control risks only if financial institutions follow them. If financial institutions can ignore regulators' rules (due to low detection probabilities or penalties), self-regulation of a principles-based system could provide superior results.

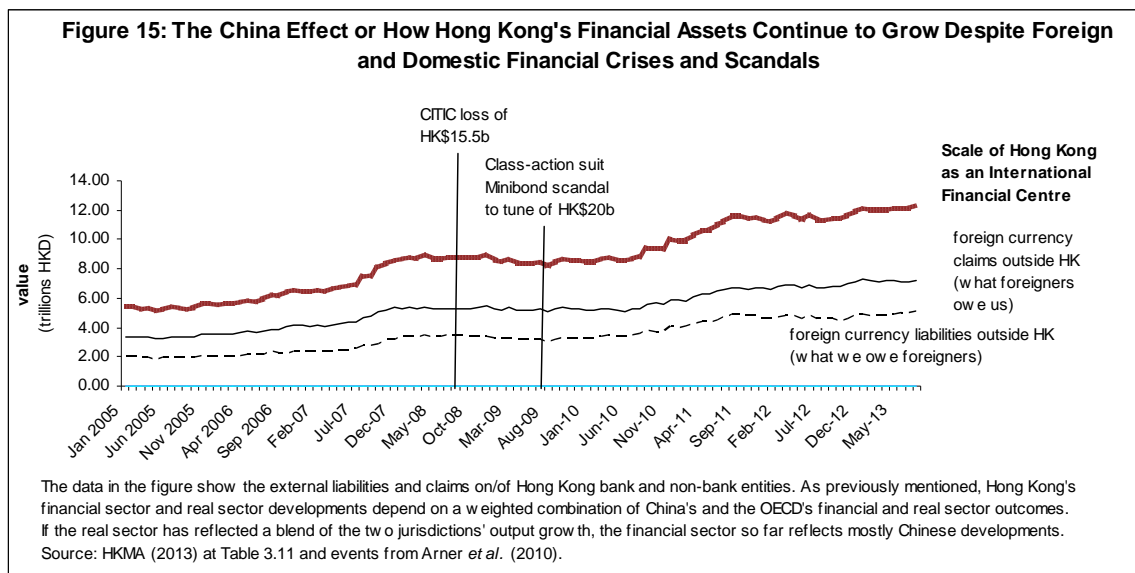
The figure shows the factors that would determine whether the costs and benefits of a government regulator promulgating specific financial sector rules would exceed those of a decentralised approach (with firms deciding specific policies which comply with general objectives). We do not show the actual equation(s) in order to keep the paper readable for a general audience. We do not show concrete results (using simulation or regression analysis) due to lack of data. We assume that government regulators and professionals working in financial firms earn the same salaries.

¹⁰³ Markus Bohme, Daniele Chiarella, Philipp Harle, Max Neukirchen, Thomas Poppensieker, Anke Raufuss, *Day of reckoning? New regulation and its impact on capital-markets businesses*, 2011, available [online](#).

Why Does Hong Kong Represent a Candidate for Objectives-Based Twin Peaks Financial Regulation?

A Large and Complex Financial Services Sector to Supervise

Hong Kong's financial sector is susceptible to certain kinds of risks which could make objectives-based financial legislation very attractive.¹⁰⁴ Hong Kong's extremely close ties with the Mainland represent a key risk requiring closer surveillance. Figure 15 shows Hong Kong's increasingly close financial linkages with the Mainland – in climbing foreign currency liabilities and claims. Even during one of the most severe crises since the 1920s, Hong Kong's banks continued to amass deposits and other assets as well as increase lending on the Mainland (the second largest economy in the world). Even during the mini-bond scandal, banking assets and liabilities continued to grow.¹⁰⁵



Is Hong Kong's reliance on Chinese economic growth leading to a financial crisis waiting to happen? Figure 16 shows some of the likely effects on the Hong Kong economy of economic disruptions on the Mainland.¹⁰⁶ Unlike the US or UK, Hong Kong's economy is tied to a large economy with data of sometimes questionable

¹⁰⁴ As previously mentioned, large and complex financial sectors represent good candidates for Twin Peaks and objectives-based financial regulation. We focus on macro-prudential risks, ignoring market conduct risks, in order to keep this paper relatively short. For a description of Hong Kong's likely higher than usual market conduct risk, see Bryane Michael and Say Goo, *Last of the Tai-Pans: Improving the Sustainability of Long-Term Financial Flows by Improving Hong Kong's Corporate Governance*, HKUL Paper 2013/039, available [online](#).

¹⁰⁵ See Douglas Arner, B.F.C. Hsu, and Antonio Da Roza, *Financial Regulation in Hong Kong: Time for a Change*, 2010, HKUL RES. PAP. 10722/123850, 2010, available [online](#).

¹⁰⁶ See Douglas Arner, David Donald, Say Goo, Richard Hu, Chen Lin, Bryane Michael, Frank Song, Wilson Tong, Chenggang Xu, Dariusz Wojcik, and Simon Zhao, *Assessing Hong Kong as an International Financial Centre*, 2014, available [online](#).

reliability. Arner and co-authors point to two large risks – risks of rapidly declining real estate prices and risks of declining equities prices. Yet, several of the factors presented in the figure represent large and important objectives which Hong Kong’s regulators might well officially target in the city-state’s financial legislation.¹⁰⁷

Figure 16: Several Reasons Why Hong Kong’s Financial Sector Exposed Particularly Large, Complex and Difficult-to-Predict Financial Risks

Factor	Effect on Hong Kong’s financial sector	Illustration
Contraction of China’s real estate sector	Real estate companies’ share prices and “domestic”* consumption decreases as China’s real estate sector contracts.	Figure 6.7
Sudden contraction of excess credit on the Mainland	Sudden contraction of credit would lead to decreased deposits and investments in Hong Hong Kong	Figure 6.3
Chinese banks’ earnings decline	Many Chinese companies list on the Hong Kong Stock Exchange. Decreases in their earnings would affect Hong Kong’s equity market indices.	Figure 6.5
Inaccurate reporting of Chinese banking information	If Hong Kong’s regulators and bank executives do not know true values of variables like non-performing loans, banking sector risks may be higher than they appear.	Figure 6.12
Large local banks collapse	A collapse of one of Hong Kong’s larger banks still carries large probability of causing general economic crisis	Figure 6.16
Shadow banking on Mainland expands	Under-regulated and under-reported shadow banking activities on the Mainland difficult for Hong Kong’s financial regulators to deal with.	Figure 6.14
Linkages between HK and Mainland equities markets	A fall in Mainland share prices would cause a similar fall in Hong Kong.	Figure 6.17

* We put the word “domestic” in quotes, as Hong Kong’s financial and other markets are closely tied to the Mainland’s. As integration continues, the question of where Hong Kong’s “domestic” economy ends and the Mainland’s begins will become more and more fuzzy. While we provide an analysis of Hong Kong, the issues we raise could be equally as valid for other small economies with close ties to larger ones (like Eastern Europe to Western Europe, Mexico to the US, and so forth).

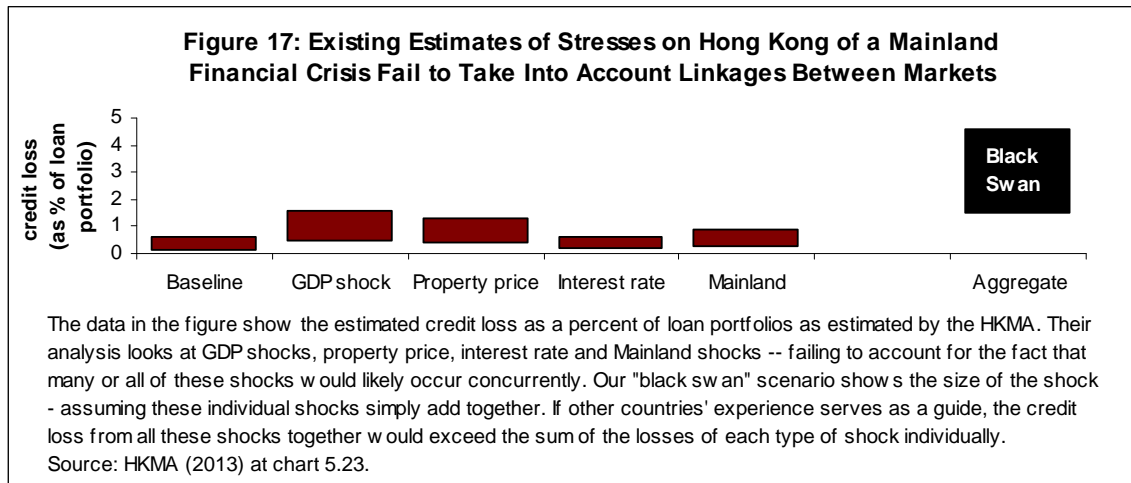
Source: Arner et al. (2014).

Focusing on objectives might help Hong Kong’s regulators (and other countries’ regulations like them) better spot risks and craft regulatory responses tailored to those risks. Figure 17 shows the estimated credit losses to Hong Kong’s banks for a GDP shock, property price shock, interest rate shock and slow-down on the Mainland.¹⁰⁸ Each of the shocks described in the figure represent a risk to Hong Kong’s financial system of large enough importance to concern Hong Kong’s legislators. No one regulator can adequately cover these risks. A GDP shock would affect borrowers’ ability to repay loans (of interest to the HKMA) and their ability to make dividend payments, bond coupon payments and provide collateral for securities-based borrowing (of interest to the SFC). A Mainland shock would affect Mainland banks operating in Hong Kong (of interest to the HKMA) and Mainland oil, communications and other companies listed on the Hong Kong Stock

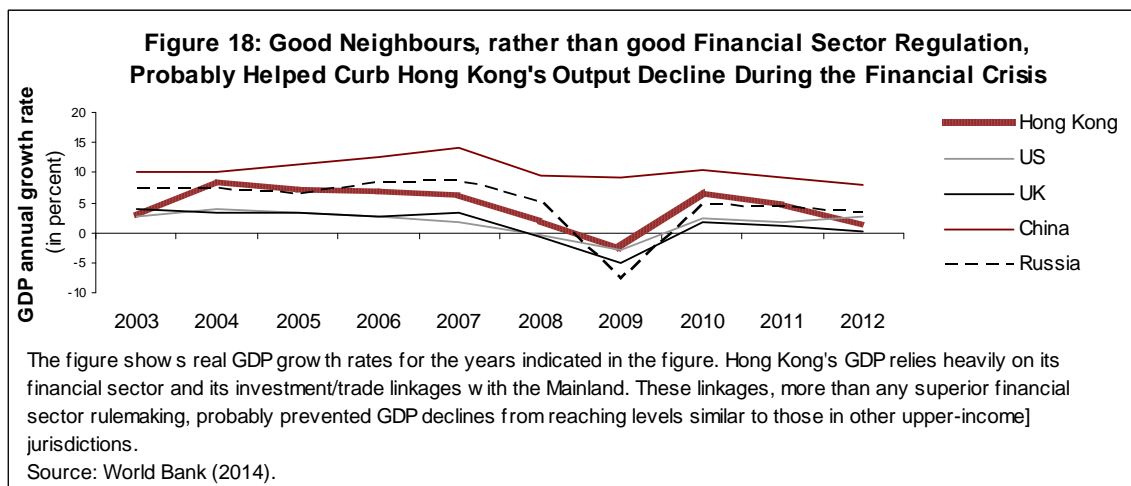
¹⁰⁷ We discuss Hong Kong to present a concrete example of the theoretical analysis we have presented. The issues appear similar for other small, open financially developed jurisdictions.

¹⁰⁸ See HKMA, *Half-Yearly Monetary and Financial Stability report*, (Sept) 2013, available [online](#).

Exchange (of interest to the SFC). Both the HKMA and SFC must exercise prudential regulatory competencies and conduct surveillance over markets.



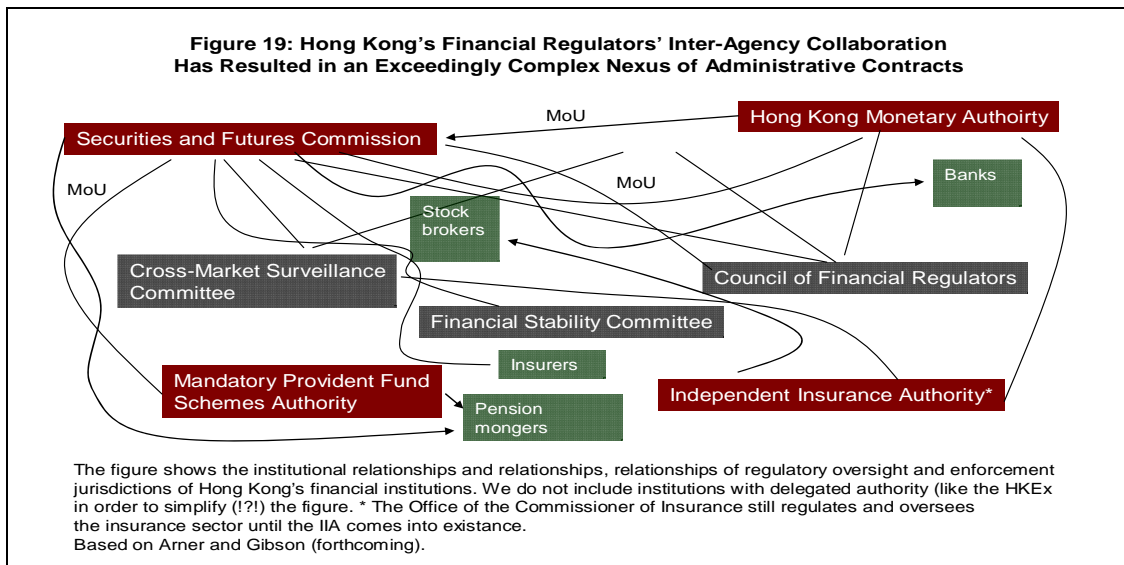
Even a causal glance at the macroeconomic data suggests that Hong Kong's financial sector regulation has not effectively protected the city-state from foreign financial shocks. Figure 18 shows Hong Kong's overall economic growth rate (growth of GDP), compared with several large economies. Hong Kong's GDP growth shrank with those of most OECD members – despite having significant trade and investment ties with the Mainland. These data suggest that Hong Kong's previous regulation has not helped protect the city-state from foreign economic shocks.¹⁰⁹ These data also beg the question – what will happen to Hong Kong's financial markets when China's economic growth more closely resembles the other economies shown in the figure? Clearly, these questions provide important objectives to organise Hong Kong's financial regulation around.



¹⁰⁹ Qualitative evidence also supports this assertion. See Douglas Arner, Berry Hsu, Antonio Da Roza, Francisco A. Da Roza, Syren Johnstone and Paul Lejot, *The Global Financial Crisis and the Future of Financial Regulation in Hong Kong*, AIIFL WP 4, 2009, available online.

An Increasing Complex and Convoluted Regulatory Structure

Hong Kong’s financial sector regulator structure (like in most countries) reflects years of accretion. Since their foundation, the Hong Kong Monetary Authority (HKMA) has overseen Hong Kong’s banks – while the Securities and Futures Commission (SFC) has overseen its securities’ broker-dealers.¹¹⁰ Confronted with the changes in the financial services industry we have previously described, Hong Kong’s regulators have patched together a regulatory regime based on inter-agency cooperation. Figure 19 depicts this cooperation. An array of inter-institutional committees and memoranda of understandings act as surrogates for what might consist of internal regulations if Hong Kong’s legislators integrated these regulators.¹¹¹ Such an arrangement has unsurprisingly attracted considerable criticism from Hong Kong’s financial industry.¹¹²



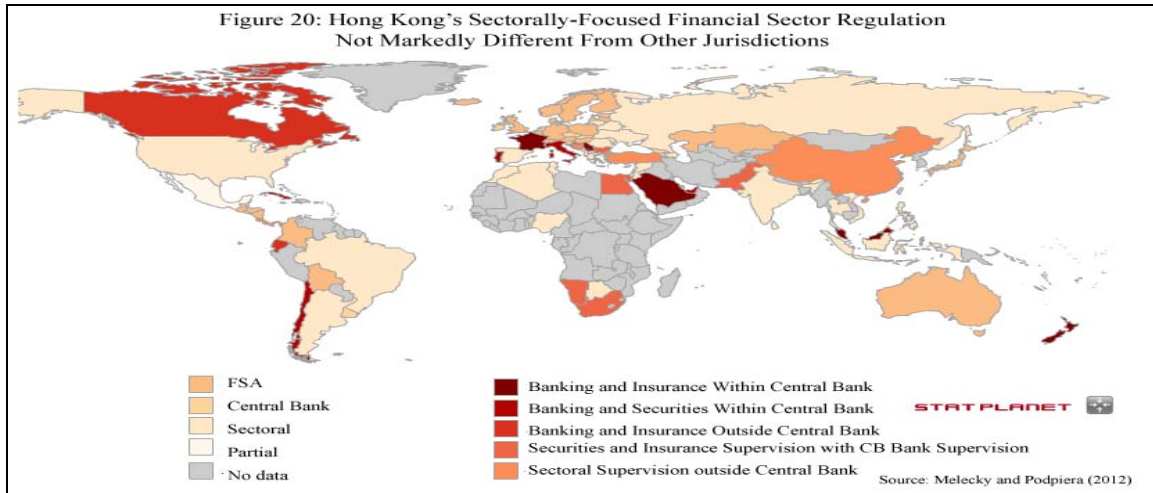
From a world-wide perspective, Hong Kong’s regulatory approach does not differ markedly from international practice. Indeed, as we have previous described, Twin Peaks regulation represents the exception rather than the rule. Figure 20 shows Hong Kong’s financial sector arrangements in comparative perspective. Hong Kong’s mixed approach – with the HKMA taking an institutional (cross-sectoral) approach while the SFC takes a sectoral approach – certainly represents the norm, rather than the exception. As we have previously described, roughly 50% of countries have integrated their financial sector supervisory institutional arrangements – with sectoral-based supervision

¹¹⁰ For a history, see Douglas Arner, Berry Hsu and Antonio Da Roza, *Financial Regulation in Hong Kong: Time for a Change*, 5 ASIAN J. OF COMP. L. 1, 2010.

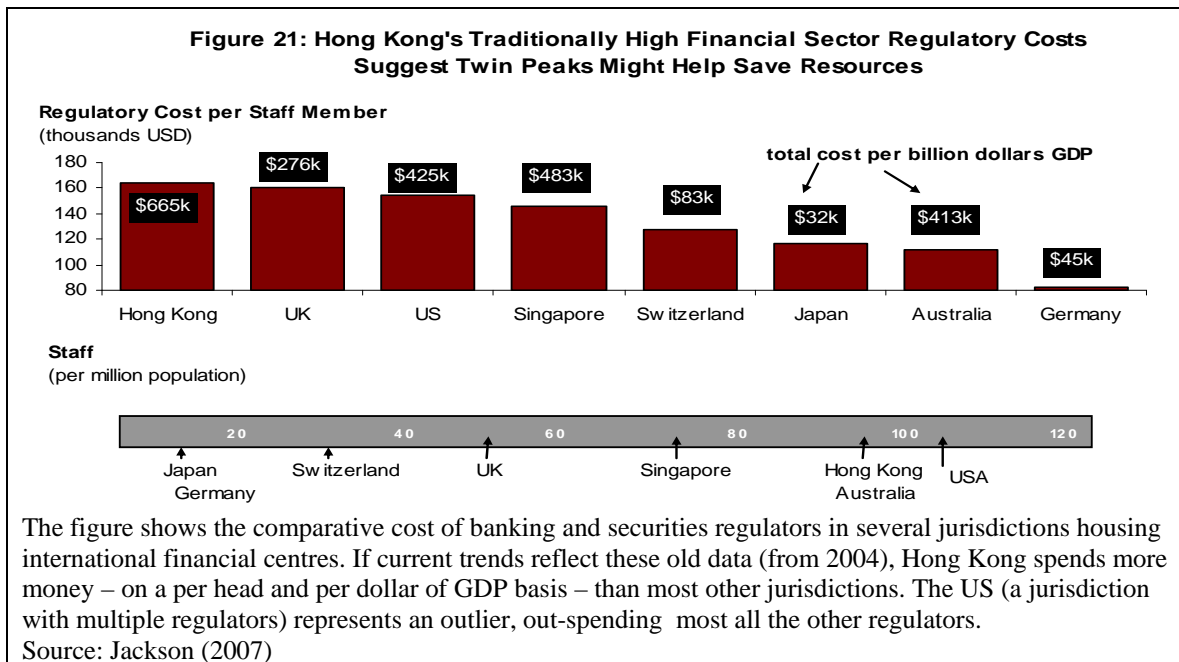
¹¹¹ For a cross-country description of these regulatory structures, see Group of Thirty, *The Structure of Financial Supervision: Approaches and Challenges in a Global Marketplace*, 2008, available [online](#).

¹¹² The practitioner literature is too large and fragmented to provide an account of every time someone in the industry complains about overlapping and confusing competencies between the SFC and HKMA. For an academic discussion, see Artie Ng, *Regulatory risk and strategic controls of financial institutions: institutional dynamics in an emerged global financial centre*, Conference at Cardiff Business School, 2012, available [online](#).

falling to 34% of countries world-wide. At first glance, Hong Kong’s regulators should not worry too much about the current regulatory structure.



Yet, the cost of the status quo may suggest that the time has come to change Hong Kong’s financial sector regulatory approach. Figure 21 shows the costs of financial sector regulation in Hong Kong – compared with costs in other financial centres.¹¹³ Hong Kong has some of the highest financial sector regulatory costs in the world. The archipelago financial regulators’ costs – per billion dollars of GDP – exceed all other jurisdictions. Costs per staff also come in higher than in other jurisdictions and its financial regulators employ far more staff (per million persons) than Japan, Germany and Switzerland. Very high regulatory costs point to inefficiencies in Hong Kong’s financial sector regulation.



¹¹³ Howell Jackson, *Variation in the Intensity of Financial Regulation: Preliminary Evidence and Potential Implications*, 24 YALE J. ON REG. 253, 2007

The current process-based (rather than outcomes-based) approach to financial sector regulation in Hong Kong may contribute to such high costs. As a result, Hong Kong’s financial law has become increasingly complex and confusing. Consider the long titles (and objectives) of the Hong Kong Banking Ordinance and the Securities and Futures Ordinance. Figure 22 shows the objectives of each Act as mentioned in the long version of each title. All titles focus on financial services processes rather than outcomes.

Figure 22a: Hong Kong’s Two Major Financial Laws Focus Mostly on Processes Rather than Outcomes

Banking Ordinance	type of objective
to regulate banking business and the business of taking deposits	process-based
to make provision for the supervision of authorized institutions so as to provide a measure of protection to depositors;	process-based
to promote the general stability and effective working of the banking system;	process-based
to make provision for the supervision of money brokers;	process-based
Securities and Futures Ordinance	
consolidate and amend the law relating to financial products, the securities and futures market and the securities and futures industry	process-based
the regulation of activities and other matters connected with financial products, the securities and futures market and the securities and futures industry,	process-based
the protection of investors	results-based

Both Acts make reference to “provid[ing] for matters incidental thereto or connected therewith.” We do not analyse the Insurance Companies Ordinance due to upcoming changes in the institutional structure of Hong Kong’s insurance regulator. As we describe later, many rules actually adopt a principles-based, objectives-led and risk-oriented approach.

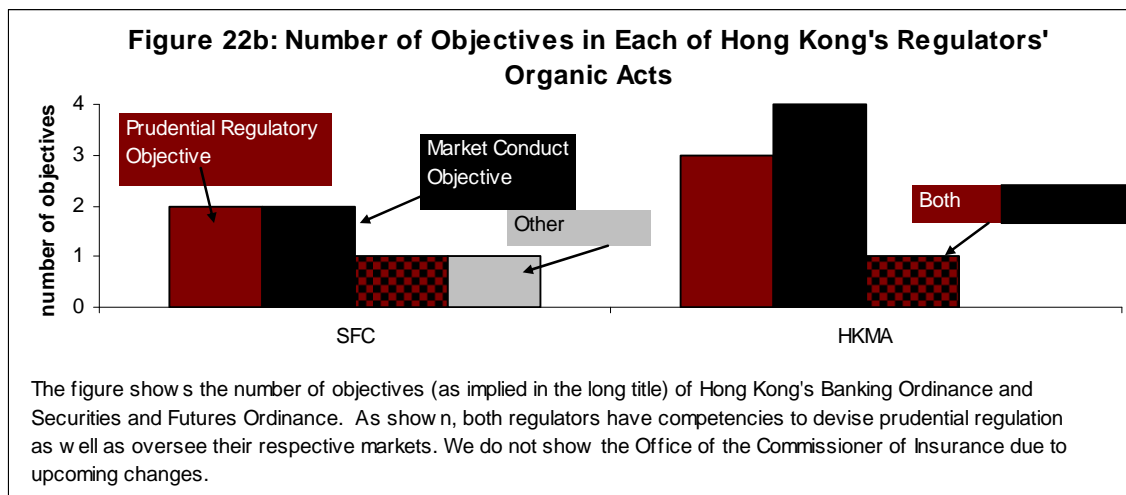
Source: Banking Ordinance and Securities and Futures Ordinance.

The current lay-out of Hong Kong’s financial sector supervisory legislation mixes prudential and market conduct objectives – creating the need for inter-agency cooperation on both objectives. Figure 22b shows the number of implicit objectives contained in the long title of the Banking Ordinance and the Securities and Futures Ordinance. The Banking Ordinance gives a fairly even mix of prudential regulatory and market conduct surveillance objectives to the HKMA. The Securities and Futures Ordinance does the same for the SFC. As a result, when the Financial Secretary’s Office wants to promulgate new prudential regulation in an area, both the HKMA and SFC must work in their respective spheres. “Inter-agency cooperation” ensues – in a process whose specifics are rarely reported to the public.¹¹⁴ In practice, such cooperation consists of the HKMA ensuring implementation of prudential regulatory measures and market conduct measures by banks and money changers. The SFC does the same for broker-dealers and other securities mongers. In theory, the Financial Secretary’s Office co-ordinates and oversees the function of both agencies.¹¹⁵ In practice, the Financial Secretary’s Office – like its

¹¹⁴ For a discussion about the lack of transparency in agreements made by Hong Kong’s regulators (both between themselves and with third-party regulators), see Arner et al., *Assessing Hong Kong as an International Financial Centre*, 2014, available [online](#).

¹¹⁵ Hong Kong’s Financial Secretary directly or indirectly determines most financial sector policy. The HKMA is directly subordinate to the Financial Secretary’s Office. The SFC, while a statutorily independent public body, still has numerous obligations and accountabilities to the Financial Secretary’s Office (as

counterparts world-wide – have neither the resources nor expertise to deal with the multiple and technical tasks these agencies must deal with daily.¹¹⁶



Implementation of recent changes proposed by the Financial Stability Board shows how regulation by objectives – with work on prudential rulemaking by one agency and market conduct by another – would greatly simplify Hong Kong's financial sector reform. Figure 23 shows several areas where Hong Kong's regulators have been working to adopt the Financial Stability Board's recommendations. Clearly in areas of overlapping jurisdiction, a Twin Peaks regulatory approach would help simplify such work. Without well-defined objectives for the regulators, we can not assess the extent to which the adoption of the measures in the figure help the Government achieve its goals.

defined in a splatter of provisions across the Securities and Futures Ordinance). The Financial Secretary also exerts moral suasion over the SFC. See Financial Secretary's Office, *Role*, available [online](#). See also *Securities and Futures Ordinance*, Chap. 571, at arts. 24(6), 28(1), 35(2), 36(2), and others, available online.

¹¹⁶ As previously mentioned, two committees and one council help oversee inter-agency issues. However, as these committees simply bring representatives from the regulators together, they do not create a permanent structure for dealing with system-wide issues. Because Hong Kong's government does not provide public information on their function (other than a telegraphic terms of reference), we have no way of assessing their likely effectiveness.

Figure 23: An Objectives-Based Twin Peaks Regulatory Structure Would Make Implementing Financial Stability Board Recommendations Easier to Understand and Assess

Rulemaking Area	Progress	TP good?
Capital, Leverage, Liquidity and Pro-cyclicality		
Adoption of Basel 3	Liquidity and capitalisation represent risks to both SFC and HKMA, with inadequate capitalisation and liquidity of either banks and/or broker-dealers posing a threat to financial stability.	X
OTC Derivatives		
Reporting of OTC derivative transactions to trade repositories	Mainly of concern to SFC, though banks need to engage in swap markets, futures and forwards to protect against certain kinds of risks. Silo regulators can not make new regulations and assess compliance with such reporting like a unified regulator.	X
Capital requirements for OTC transactions	Does capital come from borrowed funds? What risk adjustments have been applied? A seemingly obvious area for SFC work involves numerous banking aspects of relevance to the HKMA. Simple co-ordination can not detect the deep linkages implied by our questions.	X
Other subsidiary rulemaking	Subsidiary legislation (such as detailed rules for mandatory clearing and reporting/trading requirements) being jointly developed by the HKMA and SFC. Current speed of adoption behind other G20 jurisdictions – partly due to need to coordinate between different regulators?	X
Resolving Crises Involving Systematically Important Financial Institutions		
Cross-border co-operation agreements	SFC has already entered into cooperative arrangements and cross-border MoUs to exchange information and participate in investigatory assistance. But what will happen when both the SFC and HKMA have to deal with their first potential systemic important default?	
Recovery and resolution involving SIFIs	Recovery and resolution planning as important for broker-dealers as with banks. HKMA takes lead on this area – despite importance to capital markets as well.	X
Hong Kong's own SIFIs	SFC intends to participate with IOSCO to develop methodologies to identify firms that carry out potentially systemically important activities.	X
Stress testing	HKMA and SFC conduct regular stress testing on financial institutions. Are two separate teams really better than one?	X

“TP good” refers to whether a Twin Peaks regulatory structure would have simplified work on regulation in the area shown in the figure.

Note: the following represents a partial review of Hong Kong’s regulators’ adoption of provisions contained in various FSB guidance documents. Much of this information will likely be out of date by the time the reader reviews it. Please consult the primary sources – namely the SFC and HKMA websites as well as Thompson Reuters *Compliance Complete* -- of more information.

Source: Arner and Gibson (forthcoming) and Thompson Reuters *Compliance Complete*.

Figure 23 (continued): Recent Developments in Hong Kong’s Adoption of Financial Stability Board (FSB) Recommendations

Credit Rating Agencies		
Regulatory oversight of credit agencies	Recent amendments to the Securities and Futures Ordinance provide for increased oversight by the SFC. But assessing risk (particularly systemic risk) represents the HKMA’s core competence.	X
Use of credit agency ratings	HKMA promulgating Basel III’s requirements that banks form independent risk assessments and not rely solely on credit agency ratings. Yet who judges the quality of these ratings? And helps improve them? A specialised regulator may provide a superior interlocutor.	X
Hedge Funds		
Licensing and Reporting	SFC requires licensing of hedge fund managers – but they often use large amounts of borrowed capital (making their function of interest to the HKMA). A Twin Peaks regulator would be able to monitor the various angles of hedge fund activity.	X

“TP good” refers to whether a Twin Peaks regulatory structure would have simplified work on regulation in the area shown in the figure.

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Source: Arner and Gibson (forthcoming) and Thompson Reuters *Compliance Complete*.

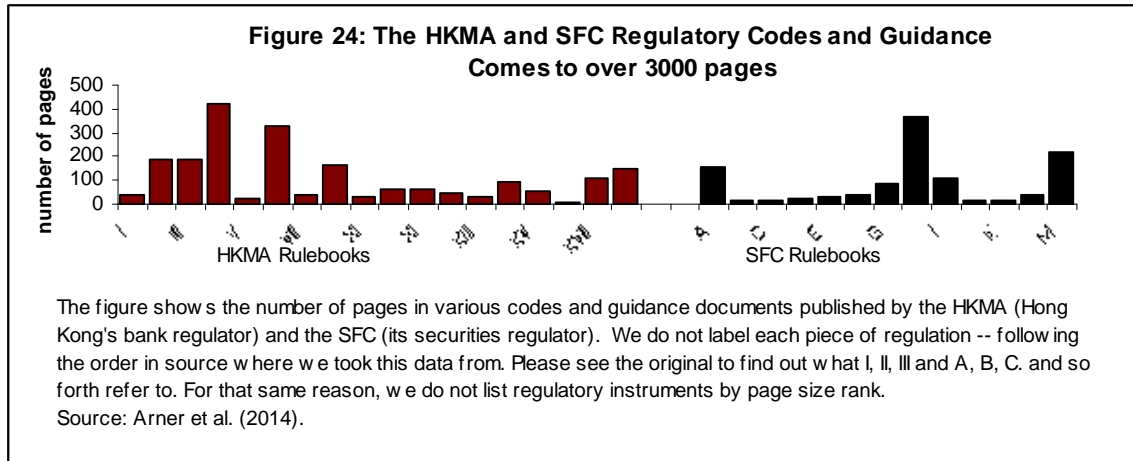
The mere quantity of Hong Kong’s financial regulations also suggest that objectives-based legislation help simplify Hong Kong’s regulatory regime.¹¹⁷ Figures 24 show the size of various regulatory instruments promulgated by the HKMA and the SFC. The SFC’s various Codes contain roughly 1,130 pages and over 4,000 provisions.¹¹⁸ The reader spending 5 minutes per page would need over 11 working days to read all the codes. The HKMA’s guidance and other rulemaking contains over 1,960 pages. Many of the codes or guidance documents by either agency contain few (if any) objectives – leaving the reader to figure out what the rulemakers’ intent and goal consists of in promulgating the Code.¹¹⁹ Having well-defined objectives in the SFC’s organic legislation (the Securities and Futures Ordinance) and subsidiary objectives in each Code would make lawmakers’ intent and desired outcomes clearer.¹²⁰

¹¹⁷ The bulk of Hong Kong’s regulations, as measured by a simple page count, comes in at far less than similar regulations in the US or EU. However, given the size of Hong Kong’s market – and its purported first-place rank as the economically freest jurisdiction – a simple comparison with the US or EU may conceal far more than it reveals.

¹¹⁸ Arner and co-authors provide a detailed description of the methodology used to create these page counts and an explicit description of the codes and guidances assessed. See Arner et al., *Assessing Hong Kong as an International Financial Centre*, 2014, available [online](#).

¹¹⁹ In general, SFC codes and regulations provide more explicit descriptions or the purpose any particular code or rule than the HKMA. If the two agencies eventually merge into a Prudential Regulatory Authority, the SFC’s competencies in principles-based rulemaking and explaining the intent of regulation will likely make an important contribution to the merged agency.

¹²⁰ As we describe elsewhere, section 4 of the the Securities and Futures Ordinance does contain at least some objectives.



Adopting an objectives-based approach to financial regulation – particularly around a Twin Peaks model – would reduce such complexity (and probably promote the effectiveness of Hong Kong’s financial sector regulation) in several ways. First, both the Banking Ordinance and Securities and Futures Ordinance – like many similar laws in countries world-wide -- represent the accretion of changes over the years. In that time, the core philosophy of regulating banks, companies, and securities exchanges has changed significantly.¹²¹ A complete and systemic rethink of Hong Kong’s financial law would allow lawmakers to think holistically about the risks they have previously identified (and we have previously described).¹²² Second, such an approach would allow for the rationalisation of existing regulatory instruments. In some cases, this would involve “pruning” the expanding body of regulations which has yet to undergo the type of review conducted in other jurisdictions.¹²³ Third, even the process of preparing the HKMA and SFC for such a reform will bring up issues and weaknesses that current reviews do not address.¹²⁴ Fourth, and possibly most importantly, a Twin Peaks structure ensure Hong Kong’s regulators provide a strategic and well-defined blueprint for current and future

¹²¹ For readers interested in tracking changes in Hong Kong’s banking laws (as proof that these philosophies and objectives change over time), see Stephen Chan, BUTTERWORTHS HONG KONG BANKING LAW HANDBOOK, 3rd Edition, 2012.

¹²² Hong Kong’s financial press has consistently reported on (and commented on) the ad hoc nature of these reforms. For one example, see Linklaters, *A New World? Hong Kong’s response to G20*, FinanceAsia 4 Sept., 2013, available [online](#).

¹²³ The recent debate on regulation versus deregulation of the financial sector has missed the main point that all sides agree on. Financial regulations require regular review to ensure they address the risks and returns they seek to regulate when the financial industry’s structure changes. We do not in any way want to argue for deregulation. Instead, we argue for right-regulating. Even a cursory glance at the HKMA and SFC’s regulatory instruments suggests that the time has come to give them a complete review. For a review of recent trends and issues, see Mads Andenas and Iris Chiu, THE FOUNDATIONS AND FUTURE OF FINANCIAL REGULATION: GOVERNANCE FOR RESPONSIBILITY, 2013.

¹²⁴ The SFC in particular undergoes various types of performance reviews. However, these reviews most focus on compliance and ignore the larger issues around the SFC’s fulfilment of its broader mandate and role in Hong Kong’s financial sector. For an example of a “compliance audit” type review, see Process Review Panel for the SFC, *2012-2013 Report*, 2013, available [online](#). If the Carst report represents the Government’s best effort at a blue-sky review of the HKMA, then the Lehman Minibond report represents the closest thing to such a review of the SFC’s work. See SFC, *Issues raised by the Lehman Minibonds crisis: Report to the Financial Secretary*, 2008, available [online](#).

regulatory reform. The Hong Kong government has not undertaken a serious analysis of the crisis and the regulators' response to it.¹²⁵ Political and administrative work studying whether to adopt objectives-based legislation leading to the adoption of a Twin Peaks financial regulatory structure could help provide that analysis.

What Would an Objectives-Based Financial Legislation and Regulation Look Like in Hong Kong?

The adoption of a Twin Peaks approach to financial regulation in Hong Kong would require the establishment of a Prudential Regulatory Authority and a Market Conduct Authority. In both cases, and unlike the UK case, the prudential regulator would sit outside of the central bank (in Hong Kong's case, the HKMA). We argue for such an arrangement, as to glibly quote two leading experts in this field, "supervisory responsibility tends to be assigned to the central bank in low-income countries."¹²⁶

A Structure Based on Merging the Banking and Securities Acts

If Hong Kong's policymakers decide to adopt a Twin Peaks regulatory approach, under the current system, they could propose either one or two new bills aimed at putting the institutional arrangements in place. Under a one-bill scheme (similar to the UK and South Africa), a consolidated piece of legislation would outline the competencies of both a Prudential Regulation Authority Bill and a Hong Kong Financial Conduct Authority. Under a two bill scheme, one legislative act (ordinance) could cover prudential regulation and the other one could define the second of the Twin Peaks -- covering market conduct.¹²⁷ In either case, as shown in Figure 25, most of the substantive provisions (not dealing with the design and organisational features of the regulators themselves) could result from simply rearranging sections of the existing Banking Ordinance and Securities and Futures Ordinance. The figure omits provisions related to the organisation and function of the HKMA and SFC. As we have shown previously, the competencies assigned to the HKMA and SFC do not necessarily cover all the elements of prudential regulatory required for a Twin Peaks approach in Hong Kong. Thus, new legislation would need to define additional competencies, likely those contained in regulatory instruments establishing the Financial Stability Committee, Cross-Market Surveillance Committee and the Council of Financial Regulators.

¹²⁵ The closest thing to a systemic-wide rethink of Hong Kong's financial regulation comes in the form of several submissions to the Legislative Council. The submissions consist of statements without any form of substantiation or data. For an example, see Carst, *The Future Structure of Financial Regulation in Hong Kong*, Submission to the Legislative Council CB(1)679/08-09(02), available [online](#).

¹²⁶ Barry Eichengreen and Nergiz Dincer, *Who Should Supervise? The Structure Of Bank Supervision and the Performance of the Financial System*, NBER WP 17401, available [online](#).

¹²⁷ A twin peaks approach actually consists of three pillars, the two we previously mentioned and a third pillar focused on the robustness of central payment systems and the overall function of the financial system. As these areas so clearly fall into the HKMA's competence, we do not spend time to describe this. For a fuller description of the twin peaks approach in a Hong Kong context, see Anthony Lin, *Twin peaks for Hong Kong?* Asia Risk, 2009, available [online](#).

Figure 25: Almost all Provisions in Banking Ordinance and Securities and Futures Ordinance Relate to Market Conduct



The figure shows which parts of the Banking Ordinance and Securities and Futures Ordinance could be arranged into two new pieces of legislation creating a Hong Kong Prudential Regulatory Authority and a Market Conduct Authority. We show only broad parts of each statute, rather than specific provisions in order to keep the figure short. In some circumstances, parts mix prudential regulation and market conduct in the same Part. We do not show provisions from the Insurance Companies Ordinance due to changes coming soon.

Three options exist for organising the regulation around Hong Kong’s financial regulators. First, following the Australian model, two new Acts could provide the legal basis for the establishment and operation of a Hong Kong Prudential Regulatory Authority and Market Conduct Authority.¹²⁸ The Prudential Regulatory Authority Act could define the Authority’s competencies and organisation.¹²⁹ The Market Conduct Authority Act could do similarly – albeit probably with more provisions in legislation covering sensitive issues like investigation.¹³⁰ Second, Hong Kong could follow the UK approach – defining organic competencies for the prudential regulatory authority and market conduct authority in legislation – leaving them to public rulebooks outlining their structure and methods of operation.¹³¹ Third, Hong Kong could follow the South African approach – which uses one legislative act to define the Twin Peaks regulators and their objectives. However, the South African bill, unlike the UK Twin Peaks authorising legislation, contains far more provisions actually regulating the financial sector, then the

¹²⁸ In theory, there is no reason why these need to be two separate Acts. One Act could create both organisations. If Hong Kong lawmakers would then attach the relevant provisions from the previous Ordinances (as we described above), then two separate Acts would make more sense.

¹²⁹ The Australian Prudential Regulation Authority Act contains 7 parts, dealing with preliminary matters, organisation, functions and powers, membership in the Authority, provisions governing staff members, financial and taxation matters, provisions governing secrecy, and other miscellaneous matters.

¹³⁰ The Australian Securities and Investments Commission Act includes far more substantive provisions than the Prudential Regulation Authority Act. Its sections include objects, provisions related to the organisation and structure of the Commission, provisions related to investigations and information-gathering, regulated activities, the Commission’s functions, provisions about its staffing, finance and reporting requirements, information on the structure of a Corporations and Markets Advisory Committee, a Takeovers Panel, Companies Auditors and Liquidators Disciplinary Board and provisions about the Australian financial reporting system.

¹³¹

UK counterpart.¹³² Fourth, and most in line with Hong Kong’s historical method of legislating, organic provisions about the operation of a Prudential Regulatory Authority could be combined with the relevant, existing provisions in the Banking Ordinance and the Securities and Futures Ordinance. Under this two-bill approach, each bill would likely contain a rearrangement of the provisions in the existing ordinances, without moving too many articles into codes and guidance documents.

Figure 26: Options for Twin Peaks Financial Regulation in Hong Kong

	legislative	regulatory
organic provisions	Australian PRA and ASIC Acts*	South African FSR Bill
previous statutory provisions	traditional Hong Kong approach	UK Financial Services Act

Such an approach would allow Hong Kong’s regulators time to adjust to a more explicit objectives-based rulemaking approach. Indeed, the provisions in various codes and guidance manuals already contain a mix of principles-based and prescriptive rules for Hong Kong’s financial institutions. Figure 24 shows several examples of provisions from a very brief random sample of HKMA and SFC regulations. We have explicitly marked objectives, principles and prescriptive rules based on those principles. As shown, Hong Kong’s financial sector regulators already think about regulation in terms of objectives, principles and risks to be managed. More explicit (and mostly cosmetic) labelling of these objectives and principles would help prepare Hong Kong’s regulators for a more explicit objectives-based legislative approach in the future.

Figure 27: Random Samples of HKMA and SFC Provisions Show Elision Between Principles and Prescriptions

OBJECTIVE : The board should **communicate throughout the AI a set of professional standards and values that promote ethical and responsible professional behaviour amongst the AI’s staff (including senior management and members of the board) and guide them in the discharge of their duties.**

RULE: Such professional standards and corporate values should a) be reflected in the code of conduct issued by the AI and b) should articulate acceptable and unacceptable behaviour, c) clearly disallow behaviour that could result in the AI engaging in any improper or illegal activity and d) require that business be conducted in accordance with applicable laws, regulations, and guidelines issued by the HKMA and other relevant regulatory authorities.

- HKMA Supervisory Policy Manual, Corporate Governance of Locally Incorporated Authorized Institutions, Setting corporate values and standards, Code of conduct, 2.6.1. (lettered list formatting added by authors)

PRINCIPLE: The complexity of the issues that a management company has to deal with when investing in and managing overseas properties depends on the jurisdiction(s) where the properties are located. As a general rule, as the number of properties increases, especially where properties are situated in different jurisdictions, the demand on the resources, expertise and internal control system of the management company multiplies.

RULE: Therefore, in licensing a management company as a REIT manager that invests in overseas properties, the Commission will generally: a) only allow it to manage one REIT and b) will impose such conditions as may be appropriate in the light of the unique circumstances of the management company.

- SFC Code on Real Estate Investment Trusts, Criteria for Acceptability of Management Company, 5.3A, (lettered list formatting added by authors).

¹³² See National Treasury, *Financial Sector Regulation Bill*, 2013, available [online](#).

OBJECTIVE :An electronic prospectus should be presented in such a format that access is reasonably easy for investors.

RULE: If special software is required for the viewing of the prospectus, the software should be provided for downloading before investors can gain access to any webpages for order execution. For the purpose of this paragraph, the software may also be provided through a hyperlink to a website where the software can be downloaded free of charge.

- CIS Internet Guidance Note, Offering of CIS on the Internet, 5.4.

The figure shows three randomly chosen financial sector rules from Hong Kong. We have explicitly highlighted the objective or principle invoked in the rulemaking. Such formatting makes the objective (or principle) clearer. Regulators can gather together these objectives and/or principles in order to create general guides on the objectives and principles of the Hong Kong financial regulatory system. Such guides would facilitate regulated persons' understanding of Hong Kong's financial rules.

Objectives-based legislation in Hong Kong would – in some ways – help implement the focus on objectives, principles and outcomes already contained in many SFC and HKMA rules. Imagine that the HKMA and SFC had labelled explicitly the objectives and/or principles contained in each provision of the roughly 3,000 pages of rulemaking (as we have done in the figure above). Such a labelling would allow the regulators to compile the objectives and principles into a separate document. Financial regulations in Hong Kong can therefore take two possible forms. First, codes and guidance documents (roughly organised as they currently are) can list the objective, principles (if relevant) and prescriptive rules, and links or mention of any best practice or optional guidance. Second, objectives and/or principles can be aggregated across rules and described in a separate manual. Relevant prescriptive rulebooks can appear on the regulators' websites along with “best practice,” optional guidance and far more analysis than the rules presently contain.¹³³ In that way, regulated institutions can consult the objectives and principles first – referring to prescriptive and optional guidance as necessary.

An Objectives-Based Structure

A Twin Peaks structure based on objectives – defined either at the legislative or regulatory levels – probably represents a more desirable (though probably less politically palatable) approach for Hong Kong. In South Africa's deliberations on adopting a Twin Peaks regulatory approach, its regulators focused on, and argued for particular objectives.¹³⁴ Like in other consultative documents, the approach to designing the twin peaks regulatory system consisted of identifying objectives, describing underlying principles and finally describing the regulatory approach.¹³⁵ Many commentators have

¹³³ The guidance documents often produced by the UK's Prudential Regulatory Authority's predecessor contained easy to understand colour illustrations, examples to practices by financial institutions, and other information in an engaging format. Organising regulation by explicit objectives would allow Hong Kong's regulators to produce similar, engaging materials. For an example of such guidance, see FSA, *Final guidance: Risks to customers from financial incentives*, 2013, available [online](#).

¹³⁴ See South Africa Financial Regulatory Reform Steering Committee, *Implementing a Twin Peaks Model of Financial Regulation in South Africa*, 2013, available [online](#).

¹³⁵ The UK's public consultation on its Twin Peaks regulatory approach focused very heavily on objectives – both objectives of the regulators and the broader reform itself. See Treasury, *Draft Financial Services (Banking Reform) Bill: Sound banking: delivering reform*, CM 8453, 2012, available [online](#).

argued that such institutional change directly targets mounting regulatory complexity and cost.¹³⁶ Yet, as the South Africa already shows (even before its implementation), adoption of a Twin Peaks approach can actually add complexity of the adoption of a Twin Peaks regulatory approach does not coincide with administrative and regulatory simplification.¹³⁷

An objectives-based legislation implementing a Twin Peaks approach in Hong Kong would simply consist of stating objectives already implicit present in the Banking Ordinance and Securities and Futures Ordinance. Under a unity piece of legislation – such as the Hong Kong Financial Markets Act 2015 for example – the core legislation could provide general objectives and set up the organisational framework.¹³⁸ Figure 28 shows how existing legislation may provide the objectives. We show the major parts of the Banking Ordinance, rewritten as objectives rather than subject headings. We also show (in light gray) the sections in the Ordinance which correspond to those objectives. These specific provisions could either be kept in legislation or preferably delegated to the Supervisory Policy Manual.

Figure 28: What Would the Banking Ordinance look like Rewritten as Objectives-Based Legislation?

PRELIMINARIES	PART I and s1-3
APPOINTMENTS, FUNCTIONS OF MARKET CONDUCT AUTHORITY AND POWER OF CHIEF EXECUTIVE TO GIVE DIRECTIONS	PART II
Objective 1: Ensure adequate oversight by a Banking Advisory Committee and Deposit-taking Companies Advisory Committee	BAs4-5
Objective 2: Work with Financial Securities and Chief Executive on Broader Financial Sector Issues	s10
BANKING BUSINESS AND BUSINESS OF TAKING DEPOSITS TO BE CARRIED ON BY AUTHORIZED INSTITUTIONS ONLY	Part III-XII
Objective 1: Ensure business restricted to licensed and regulated financial institutions	BAs11-31, s119, 118A-118F
Objective 2: Ensure proper control of Hong Kong based offices	BA s44-51A, 52-58
Objective 3: Work with Authorised Institutions on Effective Control	BA s52-68, s97L-101I, s117-118.
Objective 4: Ensure proper ownership, control and management of AIs	

¹³⁶ See KPMG, *Twin Peaks*, 2012, available [online](#).

¹³⁷ See FSB, *Peer Review of South Africa: Review Report*, 2013, available [online](#).

¹³⁸ Objectives-based legislation requires objectives-based thinking. UK policy documents consulting about financial sector reform strikingly take an objectives-based view of policymaking – defining each objective and, in big bold letters, identifying the objective of reform. See Treasury, *Banking reform: delivering stability and supporting a sustainable economy*, Cm 8356, 2012, available [online](#).

OWNERSHIP AND MANAGEMENT OF AUTHORIZED INSTITUTIONS

Part XIII-XIV

Objective 1: Prevent anticompetitive behaviour by Hong Kong's banks

s. 69 + CO*

Objective 2: Ensure proper qualification of controllers, executive officers and other staff

s70-s74

Objective 3: Prevent channelling and discriminatory lending to/by AI officers

s80-85

Objective 4: Ensure safe shareholding and landholding practices

s87-90

PROTECTING CUSTOMERS

Part XVI

Objective 1: Protect deposits against false advertisements and representations

s92-97A

ENSURE A SOLVENT BANKING SECTOR

Part XVIIA-Part XVII B

Objective 1: Ensure AI have enough capital

s97B-97F

Objective 2: Ensure banks stay liquid

s97G-97K, s102-106

The figure shows the way Hong Kong's legislators might reorganise the Banking Ordinance, based on the current part and section headings, around objectives. These objectives represent mere examples and should not be taken as authoritative suggestions for any particular objectives. The legal citations in light gray on the right-hand side of the figure refer to the legislative articles roughly corresponding to the achievement of the objective listed in the figure.

An objectives-based approach to rulemaking could also make the Hong Kong's financial regulation simpler and easier to implement.¹³⁹ Orienting Hong Kong's regulations around objectives and principles could make such rules easier to understand and follow.¹⁴⁰ Figure 29 shows one example of how regulators could rewrite provisions from the HKMA's Supervisory Policy Manual – and specifically the Corporate Governance module – with a focus on objectives. As previously discussed, the organisation of the HKMA's rulebooks by objectives and principles can improve the quality of guidance to Hong Kong's financial institutions by allowing employees at all levels to grasp quickly

¹³⁹ Objectives-based legislation does not always automatically equate with regulatory simplification. The UK example shows that even objectives-based Twin Peaks legislation can result in extremely complex rules. A quick look at the Prudential Regulatory Authority's Handbook and Rulebook show the complexity of the new regulations. The difficult-to-use online database the Prudential Regulatory Authority and Financial Conduct Authority chose to present their rules also does not help with third-party analysis of the UK's already complex financial regulations. *See* PRA Handbook and Rulebook – Combined View, 2014, available [online](#).

¹⁴⁰ The Prudential Regulatory Authority's Handbook lists rules in hierarchical fashion – from High Level Standards to Prudential Standards, Business Standards, Regulatory Processes and Redress Rules. The Rulebook also shows specialist sourcebooks, rules governing listing, prospectuses and disclosures – as well as provides guides to the Handbook and Regulatory Guides. Unfortunately, the online database showing these rules makes reading them extremely difficult.

the main objectives or such regulation and the underlying principle of the regulation.¹⁴¹ The HKMA (or its successor) can combine similar principles from across various provisions in order to publish guides which focus on implementing broad principles across a range of regulatory areas.¹⁴² However, by referencing an explicit legislative objective (in this case provided by Figure 28 above), lawmakers can ensure coherence and unity between the legislative objectives targeted in a new ordinance, and the objectives outlined in the rulemaking.

Figure 29: Reorganising Just One Provision from the Supervisory Policy Manual Shows How A Focus on Objectives and Principles Makes Rules Easier to Interpret

Objective: Insure that banks’ internal controls promote effective operations, provides for reliable financial reporting, safeguards assets and help to ensure compliance with relevant laws, regulations and internal policies. 3.5.2

Legislative Objective Implemented:

Protecting Customers and Ensuring an Solvent Banking Sector

Principle: operate in a safe and sound manner and to maintain an acceptable risk [level] 3.5.1.

Prescriptive rules:

1. Enforce official lines of authority and the appropriate segregation of duties, 3.5.1

2. An independent internal auditor should test internal controls and the results of these audits. 3.5.2.

3. Audits, including management’s response to the findings, should be properly documented. 3.5.2.

4. An evaluation of the adequacy of the internal control environment should take into account 3.5.3

- the appropriateness of the system of internal controls in relation to the type and level of risks posed by the nature and scope of the AI's business activities and products;
- whether the AI's organisation structure establishes adequately clear lines of authority and responsibility for monitoring compliance with policies, procedures and limits;

The figure shows provisions from the Corporate governance module of the HKMA’s Supervisory Policy Manual, with cosmetic changes making the objective and regulatory principle clearer. The provision that the text comes from is shown by the numbers to the right of the text. The “legislative objective implemented” comes from the example shown in Figure 28.

Looking at the objectives enshrined in legislation and defined in already existing regulatory provisions can help provide meso-objectives which help organise the HKMA

¹⁴¹ The Prudential Regulatory Authority provides guides for specific businesses such as Energy Market Participants, Small Friendly Societies, Oil Market Participants, Service Companies, Small Independent Financial Advisors, Small Mortgage and Insurance Intermediaries, and Mortgage Intermediaries. See Prudential Regulatory Authority, Handbook guides, 2014, available [online](#).

¹⁴² For an example of a guide for UK business describing the general principles, see Prudential Regulatory Authority, *The Prudential Regulation Authority’s approach to banking supervision*, 2013, available [online](#).

and SFC's rulebooks around objectives. Figure 30 shows what the HKMA's Supervisory Policy Manual might look like if organized by objectives. As shown by the light gray references to particular rulebooks, existing regulations lend themselves to particular objectives. As with the previous example, broad objectives in the Manual would fit with legislatively mandated objectives – providing coherence and unity across Hong Kong's financial law at all levels.

Figure 30: What Would the Supervisory Manual Look Like Under an Objectives-Based Legislative and Regulatory Regime?

Objective 1: Implement a risk-based approach to supervision and encourage financial institutions to adopt the same

Corresponds to statutory objective: Ensure AI have enough capital and Ensure banks stay liquid
Includes: rules on the risk-based approach and outsourcing (SA-1 to SA-2)

Objective 2: Ensure bank staff at all levels act in the interests of the financial institutions' stakeholders

Corresponds to statutory objective: Ensure proper ownership, control and management of AIs
Includes: statutory guidelines for corporate governance, codes of conduct and guidance notes on sound remuneration (CG1-7)

Objective 3: Help bank staff detect and manage risks adequately

Corresponds to statutory objective: Ensure proper control of Hong Kong based offices and Work with Authorised Institutions on effective control.

Includes: Risk management controls, internal audit guidance note, guidance on stress testing and so forth (IC1-7)

Objective 4: Assist financial institutions to maintain enough capital

Corresponds to statutory objective: Ensure AI have enough capital and Ensure banks stay liquid.

Includes: Use of internal models approach to calculate market risk, statutory guidance on property revaluation reserves and so forth (CA-G1-5/ CA-S1-10).

Objective 5: Ensure that Groups Approach Risk and Return Responsibly

Corresponds to statutory objective: Ensure proper ownership, control and management of AIs and Ensure safe shareholding and landholding practices.

Includes: Group-wide approach to supervision (CS-1)

Objective 6: Help financial institutions manage their loan books with everyone's best interests at heart

Corresponds to statutory objective: Protect deposits against false advertisements and representations.

Includes: Credit approval, review and records guidance, guidance on credit derivatives and guidance on specific lending activities -- trade finance, credit cards, taxis, and so forth (CR-G1-13 and CR S1-6). Also includes limits on credit exposures (CR-L1-5)

The figure shows how the HKMA might organise various statutory guidance and other rules they publish by objective. Organising rules by objectives allows regulated institutions to grasp the goal of such regulation and understand the broader regulatory principles involved. To save space, we have not included the entire manual (omitting the interest rate risk management module and everything after). We provide this for illustrative purposes only. Source: Supervisory Policy Manual

What would objectives-based legislation mean for other kinds of economic lawmaking? Lawmakers could also organise other legislation (ordinances) could also objectives –

making them clearer and easier to implement at the regulatory level. Figure 31 shows an example of the Hong Kong Money Laundering Ordinance, rewritten as objectives-based legislation.¹⁴³ The present ordinance has several parts including Requirements Relating to Customer Due Diligence and Record-keeping, Supervision and Investigations, Disciplinary Actions by Relevant Authorities, Regulation of the Operation of Money Service, and the establishment of an Anti-Money Laundering and Counter-Terrorist Financing (Financial Institutions) Review Tribunal. These titles tell little about the objectives or likely function of the act. In contrast, an objectives-based approach described what Hong Kong’s lawmakers want to achieve.

Figure 31: Example of objectives contained in Hong Kong’s Money Laundering Ordinance

Objective 1: Ensure financial institutions conduct sufficient customer due diligence and record-keeping to minimise the risk of money laundering and the financing of terrorism,

Objective 2: Ensure the relevant authorities adequately supervise compliance with provisions which with those requirements and other requirements under this Ordinance; to

Objective 3: Catch potential money service operators at risk of engaging in money laundering and the financing of terrorism or other unregulated activities,

Objective 4: Ensure that financial institutions suspecting of breaching the Ordinance get a fair hearing.

The figure shows objectives of the Hong Kong Anti-Money Laundering and Counter-Terrorist Financing (Financial Institutions) Ordinance, Chapter 615. We have copied parts from the long title directly into these objectives to ensure we keep the lawmakers’ intended objectives intact.

Naturally, objectives-based legislation should not cover all aspects of policymaking. Some lawmaking seeks only to extend the competencies of particular regulatory agencies or provide for the method of transacting certain kinds of government activity.¹⁴⁴ Yet, legislation with obvious social and/or economic risks and returns provide ideal candidates for objectives-based legislative drafting.¹⁴⁵ Most importantly, lawmakers can create and organise regulatory agencies around statutorily-given objectives – thus reducing the need for inter-agency collaboration and other kinds of “fixes.”

¹⁴³ See Anti-Money Laundering and Counter-Terrorist Financing (Financial Institutions) Ordinance, Cap 615, available [online](#).

¹⁴⁴ The Organized and Serious Crimes Ordinance, Roads (Works, Use And Compensation) Ordinance, and Man Mo Temple Ordinance represent examples of legislation where objectives-based organisation will not likely increase the effectiveness of the act.

¹⁴⁵ The Amusement Rides (Safety) Ordinance, Massage Establishments Ordinance and the Shipping And Port Control Ordinance provide examples with obvious risks and legislative objectives.

Conclusion

Objectives-based regulation could change the way lawmakers and regulators see the role of law in implementing government policies. When tackling complex risks (like security or financial stability), lawmakers passed a range of legislation with competencies and obligations assigned to a range of government agencies. Recent legal scholarship around the objectives-based Twin Peaks financial regulation challenges the usual view of legislating. Such legislating sets out social (financial) risks, defines particular statutory objectives and creates executive agencies to achieve those objectives. Such an approach promises to reduce the complex and sometimes ineffective inter-agency collaborations which bedevil public administration.

In this paper, we argued that objectives-based legislation may help solve some difficult executive agency organisational problems which have stumped legal, public administration and economics scholars. We illustrated how objectives-based legislation represents a new way of conceptualising the line between policymaking and lawmaking using Hong Kong as an example. We reviewed Hong Kong's financial sector regulatory arrangements (as enshrined in the Banking Ordinance, the Securities and Futures Ordinance and rulebooks published by the Hong Kong Monetary Authority and the Securities and Futures Commission). We showed how adopting objectives-based legislation in the city-state would require a rethink the traditional structure of financial legislation and regulatory. By using the possible adoption of an objectives-based Twin Peaks approach in Hong Kong, we hope to have provided insights into the adoption of similar legislation in other jurisdictions. Objectives-based legislation is, by no means, limited to the financial sector, or Hong Kong. By arguing for a different approach to legislative drafting, we hope to have inspired further research and practice in this burgeoning field.