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POLICY RESEARCH WORKING PAPER

The Regulation and Supervision of Domestic Financial Conglomerates

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If a conglomerate provides such financial services as banking, securities, investment management, and insurance, the various authorities responsible for each financial sector need an integrated approach to regulation and supervision.

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Summary findings

Financial conglomerates are groups of financial institutions related by ownership or control. Specific regulatory and supervisory issues arise when financial services — such as commercial and retail banking, securities underwriting and trading, investment management, and insurance underwriting — are provided by a financial conglomerate structure.

Scott provides a handbook for authorities responsible for financial conglomerate regulation and supervision, identifying key issues, spelling out regulatory and supervisory alternatives, and describing both preferred solutions and alternatives. He makes reference to the regulatory framework adopted in the European Economic Community.

Among the main tools available to the authorities are prudential regulations, accounting consolidation, and consolidated supervision. Prudential regulations for financial conglomerates preferably would be applied on a uniform and fully consolidated basis. Alternatively, existing regulations applicable to different financial sectors can be modified, in particular to mitigate the potential that intragroup transactions overstate capital or earnings. Accounting consolidation of the financial entities in a group is a prerequisite for consolidated prudential regulation and improves the transparency of the group's financial position. The authorities should use consolidated supervision to ensure that the risks from all group entities are identified and assessed.

This paper — a product of the Financial Sector Development Department — is part of a larger effort in the department to facilitate improvement in financial sector regulation and supervision in the Bank's client countries. Copies of the paper are available free from the World Bank, 1818 H Street NW, Washington, DC 20433. Please contact Karin Waelti, room G8-010, extension 37655 (38 pages). August 1994.

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**THE REGULATION AND SUPERVISION OF
DOMESTIC FINANCIAL CONGLOMERATES**

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SUMMARY

Financial conglomerates are groups of corporate entities engaged in financial services activities, such as commercial and retail banking, securities underwriting and trading, investment management, and insurance underwriting. Financial conglomerates may form part of mixed-activity conglomerates that engage in substantial commercial or industrial activities.

The principal purpose of this paper is to describe the supervisory issues that arise when financial services are provided via a conglomerate structure, and to offer practical alternatives for regulation and supervision. In addition, the recommendations set out in the paper espouse a specific supervisory philosophy that is applicable to the supervision of financial institutions generally. The paper is intended principally as a Handbook for authorities in the World Bank Group's client countries responsible for determining financial sector regulation and conducting supervision of financial institutions. It also will be of use to World Bank Group staff engaged in financial sector operations, particularly as a guide for the establishment of project objectives.

Part I of this paper provides relevant background. It views the emergence of financial conglomerates as an inevitable market development to which most countries' regulators and supervisors (collectively referred to as the "authorities" hereafter) will need to respond. It identifies three principal supervisory concerns that arise in the context of conglomerates (contagion, transparency and autonomy) and briefly describes the two basic approaches to regulation of financial institutions used by bank, securities and insurance supervisors (consolidated regulation and separate regulation). Part I concludes with an overview of the regulatory and supervisory responses to conglomerates that are being developed in multinational forums.

Part II sets out practical regulatory and supervisory alternatives for authorities confronted with financial conglomerates. Throughout Part II, key issues requiring policy decisions are identified. Preferred regulatory and supervisory solutions, as well as alternatives, are described. Part II makes extensive reference, by way of footnotes, to the regulatory framework that has been adopted by the EEC.

The four principal tools that the authorities must employ in dealing with financial conglomerates are authorization criteria, prudential regulation, accounting consolidation, and consolidated supervision. *Authorization criteria* should be used explicitly to promote

the probability that groups are operated in a sound manner, that the parties responsible for each regulated entity maintain autonomy within the group managerial structure so as to fulfill their responsibilities toward the individual institution, and that group structures be supervisable. Authorization criteria must include suitability standards applicable to principal shareholders, key directors and managers, and external auditors of financial groups. Supervisors must be granted the authority to prevent corporate affiliations or structures that preclude effective supervision.

***Prudential regulation* can be applied to conglomerates by modifying the existing regulations applicable to different types of financial institutions to take account of the group context, in particular the potential that intra-group transactions have led to an overstatement of capital and earnings. Preferably, however, prudential regulations would be applied on a uniform and fully consolidated basis, increasing their effectiveness and creating a more level playing field among institutions that promotes financial sector competition.**

***Accounting consolidation* of group financial entities is a prerequisite for the application of consolidated prudential regulation, and also serves to improve the transparency of the group's financial position as set forth in supervisory reports and public disclosures.**

***Consolidated supervision* is based, in part, on the use of sound prudential regulations and the analysis of consolidated accounts, but must embrace a wider scope to ensure an adequate assessment of the risks arising from all group entities, including the risk of contagion arising from entities that lie outside the scope of prudential regulation and accounting consolidation, such as unregulated financial entities and entities engaged principally in commercial or industrial activities.**

Changes in the regulatory framework alone will prove an insufficient response to financial conglomerates. Supervisory agencies will need to modify their supervisory policies and procedures, as well as policies relating to the recruitment, training and retention of qualified staff. The various authorities responsible for different components of the financial system will need to harmonize their activities to ensure an integrated approach to conglomerates.

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PART I

ISSUES, OPTIONS AND MULTINATIONAL RESPONSES

A. Introduction and Purpose

The term "financial conglomerate" is used in this paper to refer to a group of two or more legal entities, mainly engaged in financial services activities, that are related by ownership or control.¹ The different financial services entities within a conglomerate may be subject to different regulations and supervised by different supervisory agencies. Other entities within the group may be subject to little if any regulation, and may not be supervised. Many conglomerates involve a parent entity, which may be regulated or unregulated. Often the parent is a bank. The "parent" of other conglomerates may in fact be an individual or group of individuals.

Financial conglomerates are increasingly prevalent. Technological advances and the deregulation of financial markets have led to increased competition among institutions. In order to efficiently deliver a full range of products, financial organizations have established ownership links among different types of historically-distinct financial institutions. The emerging financial conglomerates might therefore be engaged in retail and commercial banking, securities underwriting and trading, investment management, and insurance underwriting.²

Financial conglomerates often have ownership ties to commercial and industrial firms. These linkages may be long-standing, perhaps the consequence of previous financial crises or simply the manner in which a country's financial system evolved. They may be of more recent origin, a result of deregulation, large-scale economic restructuring, or the need to attract capital to support financial market development.

¹This is a common definition. The term also can be used to describe a single legal entity engaged in a wide range of financial services activities. As a practical matter, however, even universal banks of the German, Swiss and Dutch model must conduct at least their insurance underwriting activities through subsidiaries. Thus, European universal banks comprise part of financial conglomerates as the term is used in this paper.

²A number of factors have contributed to the trend toward the formation of financial conglomerates. This paper does not discuss those factors further.

The market forces driving the formation of financial conglomerates also are propelling greater cross-border provision of financial services. International integration of financial markets has direct consequences for domestic authorities in their regulation and supervision of financial conglomerates. Specifically, in instances where domestic financial conglomerates wish to expand internationally, the authorities may be asked to adhere to international supervisory standards. Such standards were adopted in 1992 by the Basle Committee on Banking Supervision, with the endorsement of the Governors of the central banks of the Group of Ten countries.³ These standards for the supervision of international banking groups apply to bank supervisors in countries whose domestic banks wish to establish operations in the Basle Committee member countries. The standards provide that member countries may impose restrictive measures, including the denial of entry, on banks which are not subject to supervision that meets the established standards. The standards include provisions relating to group-wide supervision.⁴

A basic response to the emergence of financial conglomerates is increased integration and cooperation among the different authorities responsible for the various types of financial institutions which are operating as a group. In some countries, the authorities are taking advantage of this opportunity and are rethinking their regulatory policies. They are adopting objectives such as increased competition and the creation of a level playing field among financial services providers, and are attempting to create an environment that promotes efficiency and permits greater integration among financial services providers and financial markets.

At the same time, authorities in numerous countries are rethinking their basic approach to the supervision of financial institutions. They are relying less on rigorous rules-based methodologies, which tend to run counter to the principles of deregulation, and are focusing more on management practices. They are specifying more clearly the responsibilities of financial market participants for the sound operation of financial institutions, and are attempting to hold these parties accountable for their performance. Thus, in recent years many supervisory agencies have articulated more clearly the duties

³The Basle Committee consists of bank supervisory authorities from Belgium, Canada, France, Germany, Italy, Japan, Luxembourg, Netherlands, Sweden, Switzerland, the United Kingdom and the United States of America.

⁴The adoption of these standards was, in part, a response to the failure of Bank of Credit and Commerce International, or BCCI. They are summarized in this paper in Part I, Section D.

and responsibilities of directors and managers⁵, adopted minimum standards applicable to external auditors, and expanded public disclosure of information regarding financial institutions.

The apparent pervasiveness of the trend toward the formation of financial conglomerates suggests that the authorities increasingly will be confronted with the need to address the issues which conglomerates present. A successful response will require adaptation of the policies and procedures utilized in the regulation and supervision of individual institutions. The principal purpose of this paper is to highlight the issues raised by financial conglomerates and discuss alternatives for an appropriate regulatory and supervisory response.

⁵**In this paper, the term "director" refers to the board of individuals most directly representing the shareholders or owners of an entity, and responsible for overseeing the managers. "Managers" are the senior executives responsible for overall day-to-day operations.**

B. Principal Supervisory Concerns⁶

While the issues relevant to supervisors of individual financial institutions continue to be relevant where those entities form part of a group, the financial conglomerate context raises additional supervisory concerns, the principal of which are contagion, transparency, and autonomy. One objective of regulatory and supervisory arrangements should be to mitigate these concerns. Contagion, transparency and autonomy therefore serve as principal points of reference throughout this paper.

Contagion

Contagion refers to the situation where a regulated entity is affected by financial problems, such as insolvency or illiquidity, arising in another regulated or unregulated group member entity. It is the potential consequence of the various tangible and intangible linkages to other group companies. One key concern is the potential transfer of capital from the regulated entity, as might occur when it attempts to rescue another group member from financial difficulties. Such transfers may be evident, as in the case of loans, investments and guarantees, or may be obscured, most often through devices such as the off-market pricing of intra-group transactions. Another key concern is the potential for negative events involving another group member to trigger a liquidity crisis or substantially diminished flow of business for a regulated entity.⁷

Transparency

Transparency is a concern in relation to the financial condition of individual group members and the combined group, and to the group's corporate and managerial structure. A potential consequence of transactions between the various legal entities that comprise the group is an overstatement of the reported profits and capital of a regulated entity, as well

⁶In addition to supervisory concerns, the emergence of financial conglomerates gives rise to *anti-trust* concerns relating to the potential increase in financial sector concentration. This paper does not address itself to those concerns.

⁷A similar but distinct issue is *systemic risk*, where problems in an institution spread to unrelated entities and result in difficulties of systemic proportion. Systemic risk is a concern with respect to individual financial institutions as well as financial conglomerates. However, a financial conglomerate's involvement in a broader range of financial markets can increase the possibility of simultaneous crises in several markets, thus exacerbating systemic risk.

as the likelihood that net group capital is less than the sum of the capital of all group members. Consequently, the effectiveness of prudential requirements and supervisory indicators applicable to individual institutions may be diminished. The increased complexity often inherent in the group context raises concerns regarding the capacity of supervisors to identify and gauge the risks to which a regulated entity is exposed. An unclear corporate or managerial structure can raise concerns regarding the supervisor's ability to identify connected parties⁸, lines of authority, and financial and managerial responsibility within the group.

Autonomy

Where a regulated entity is a component of a larger business organization, a supervisory concern is the autonomy of those individuals responsible for the sound operation of the regulated entity. Supervisors need to be assured that directors and managers can be held accountable for ensuring the sound operation of the institution, responding to supervisory mandates, and ensuring compliance with law and regulatory requirements. The concern is that directors and managers of the regulated entity may lack the necessary authority vis a vis other individuals within the group. For example, directors and managers may not be in a position to commit to taking actions viewed as necessary by the supervisors. They may be compromised in their ability to make objective judgements regarding loans to connected parties. They may be compromised in their treatment of customers in transactions involving conflicts of interest between customers of the regulated entity and customers of other group entities, or between customers of the regulated entity and the other entities themselves. Supervisory concerns regarding autonomy become more acute where the controlling entities are unregulated or beyond the scope the supervisor's mandate.⁹

⁸Connected parties can include shareholders, other group entities, the directors and managers of all group entities, and perhaps other of the business interests of those directors and managers.

⁹In addition to concerns regarding director and manager autonomy, supervisors must be alert to the risks arising from the business challenges inherent in forming and managing financial conglomerates, and their potential implications for directors' and managers' ability to perform their roles adequately. The challenge of forming and managing larger, more complex organizations operating in a broader range of product and geographic markets, of integrating previously autonomous management teams, and of merging different types of business cultures can prove overwhelming, and is often a source of subsequent financial difficulties.

C. Regulatory Options

In principle, there are two fundamental regulatory alternatives for addressing financial conglomerates: *consolidated regulation*, where regulation is extended to all group members engaged in financial service activities, and *separate regulation*, where the focus of regulation is the individual regulated entity. In practice, both alternatives are difficult to implement, and supervisors typically adopt an approach that falls somewhere in between the two, even while their supervisory philosophy may remain anchored in one or the other.

Consolidated Regulation

Under consolidated regulation, contagion is taken to be such a concern as to justify the application of regulation to all group members engaged in financial services activities, even where the activity would not be regulated were it conducted outside the group. The extension of regulation group-wide might include, for example, capital adequacy requirements, large credit exposure limits¹⁰, foreign exchange position limits, shareholder and senior manager suitability standards, and required regulatory reporting and public disclosure. Transparency is enhanced by applying prudential requirements to the consolidated group, as well as to each financial institution group member, and by requiring consolidated financial reporting and public disclosure. Concerns regarding autonomy are addressed by the application of suitability standards to the principal shareholders of the group, and to the managers of all group financial institutions.

Consolidated regulation is the basis of the approach usually taken by bank supervisors, who tend to desire explicit authority over group financial entities that might affect the condition of the bank.¹¹ Thus it is common to find consolidated regulation applied to banks and their financial institution subsidiaries, and increasingly, where the parent is a financial institution or financial institution holding company, to the bank's parent entity and its financial institution subsidiaries.

There are potential disadvantages and obstacles to the implementation of consolidated

¹⁰Large credit exposure limits are designed, in part, to cap the total credit exposure of a financial institution to a single counterparty or group of economically interdependent counterparties.

¹¹A common explanation for this is that banks' role in the payments systems and the implementation of monetary policy justifies the bank supervisor's explicit authority over entities closely related to banks.

regulation. From a policy standpoint, extending regulation to otherwise unregulated financial institutions due solely to their group affiliation might be seen as burdensome and creating a competitive disadvantage.¹² From a practical standpoint, extension of regulation to entities regulated and supervised by other agencies requires coordination among the agencies, and may likely require modifications to agencies' current authorities and responsibilities.

Separate Regulation

Separate regulation attempts to minimize the potential that contagion will affect the regulated entity by insulating it from other group members. The mechanisms often employed are to require that the credit exposures of the regulated entity to other group members be supported by additional capital (often in an amount equal to the exposure itself), and/or to establish limits or other restrictions on credit exposures and other types of transactions. Because the object of regulation is defined narrowly as the individual regulated entity, the transparency of the organizational and managerial structure of the group is of less concern. Concerns regarding financial transparency are addressed by the constraints placed on transactions with other group members. Concerns regarding autonomy are addressed by the application of suitability standards to the principal shareholders and managers of the regulated entity.

Separate regulation is the approach often taken by securities and insurance supervisors. This approach is more functionally oriented, and is based on the principle that while certain activities (e.g. dealings with retail customers) are best regulated, other activities can and should be left unregulated.

In practice, it is difficult for supervisors to be comfortable with their attempts to insulate a particular entity within a group. Contagion can result from the public *perception* of an exposure, as much as from the existence of an exposure. Thus even a well-insulated regulated entity can be subject to a liquidity crisis or crippling loss of business triggered by events elsewhere within the group. Similarly, concerns regarding transparency and autonomy can only incompletely be addressed by attempting to insulate the regulated entity.

¹²Application of regulation to group members not engaged in financial activities (e.g. commercial or industrial companies) is generally viewed not only as impractical, but also as undesirable.

Regulation in Practice

Generally, financial conglomerate regulation is not based on the strict application of consolidated regulation or narrow application of separate regulation. Confronted with the practical obstacles to application of consolidated regulation, supervisors often must rely on processes designed to obtain information regarding entities outside the scope of their direct authority, and to control the potential exposure of the regulated entity to other group members, an approach similar to that employed under separate regulation. Alternatively, supervisors whose philosophy is based in separate regulation often attempt to make explicit assessments regarding potential risk exposures arising from other group members outside the scope of their direct authority. This is an approach which leans toward the group-wide application of prudential requirements inherent in consolidated regulation.

Although strictly applied consolidated regulation and narrowly applied separate regulation are not often encountered in practice, recognizing the philosophical distinctions between the two approaches can help to shed light on the different perspectives of the supervisors of different types of financial institutions. For most countries, forging an effective regulatory and supervisory framework addressing conglomerates will require that those differences be resolved, so as to facilitate agreement on a common approach.

D. Standards Adopted in Multinational Forums

The many issues involved in regulating and supervising financial conglomerates operating internationally continue to be discussed by authorities meeting in multinational forums. Two groups of countries are devoting substantial attention to this subject: the countries which comprise the European Economic Community, and the member countries of the Basle Committee on Banking Supervision. While in both instances the agreed regulatory and supervisory frameworks are still evolving, their work to date can be examined for internationally agreed principles which would be applicable to conglomerates operating domestically.

European Economic Community¹³

To create an common internal market for the provision of financial services, the approach adopted by the EEC has been to achieve only the essential harmonization necessary to secure the mutual recognition by its member states of the authorization and prudential supervision systems they employ. It has applied several principles in these efforts, and in particular its efforts to forge an agreed approach to the regulation and supervision of financial conglomerates. One such principle is that supervisors must accept the market reality of the blurring of the distinctions between historically distinct types of financial institutions and financial products. Another is that special rules for the supervision of financial conglomerates should only be applied where the regulatory problems cannot be effectively tackled through supervision of the individual regulated entities. A third is that respect should be maintained for the peculiar characteristics of the different financial sub-sectors and the legitimate differences in the way they have traditionally been regulated.¹⁴

The Commission of the European Communities reached agreements in 1992 that began to establish a framework applicable to conglomerates in which a deposit-taking bank was a member. That framework was enhanced in 1993 by agreements that dealt with

¹³This section provides a brief overview of the EEC framework. Part II of this paper makes extensive and more specific reference to the particular features of that framework.

¹⁴Presentation to the 17th Annual Conference of the International Organization of Securities Commissions by Mr. Geoffrey Fitchew, Director General, DG XV, Commission of the European Communities, October 29, 1992. These principles lay a foundation for superseding separate regulation with certain aspects of consolidated regulation, but at the same time seem to reflect a desire to minimize any infringement on existing authorities and responsibilities.

investment firms (i.e. securities companies and investment management firms). The framework distinguishes between *financial groups*, which are primarily financial services conglomerates, and *mixed-activity groups*, of which the parent is a commercial or industrial firm, but which includes one or more subsidiary banks or investment firms.¹⁵

The framework applicable to financial groups requires that supervisors conduct *consolidated supervision* of those entities within the group which are principally engaged in financial services activities, including any parent financial entity. Consolidated supervision is based, in part, on the application of consolidated regulation. Specifically, consolidated supervision is to include consolidated application of regulations relating to capital adequacy, large exposures and connected lending. Consolidated application of these regulations is based on a requirement for full accounting consolidation of all banks and/or investment firms and, at a minimum, all their financial subsidiaries.¹⁶ Consolidated supervision is further defined to require that supervisors ensure that all entities included in the scope of consolidated supervision maintain adequate internal control mechanisms so as to be able to provide any data or information relevant for the purpose of such supervision.¹⁷

For mixed-activity groups, where a parent company which is not a financial services firm or a financial holding company owns a bank or investment firm, consolidated regulation is not extended to all entities within the group, including to any insurance companies. Consolidated regulation is applied only to the bank and investment firm group member entities, and their subsidiaries, in the manner that it is applied to financial groups described above, including a requirement for full accounting sub-consolidation of those regulated entities. Exposures taken by this sub-consolidated financial group on other group members

¹⁵The Commission has yet to apply to insurance companies the requirements applicable to "financial institutions". As a result, a group where an insurance company owns a bank would be treated as a mixed-activity group under the present EEC framework.

¹⁶Which generally includes all entities of which the bank or investment firms has a 20% or greater shareholding.

¹⁷The EEC framework makes provision for an exception to application of the principle of consolidated regulation for financial groups. Under certain defined circumstances, supervisors may waive the consolidated application of regulations relating to capital adequacy and large exposures in the case of investment firms which are members of a group which does not include a bank. Thus, in limited circumstances, utilization of the principle of separate regulation is accepted. However, the EEC framework imposes on the relevant investment firm and their supervisor substantial risk monitoring requirements in respect to related institutions when this exception is utilized. Further, this exception may be eliminated, pending further harmonization. Council Directive 93/6/EEC.

are limited, in aggregate, to 20% of capital.¹⁸ Supervisors are to require the parent company and its subsidiaries to supply any information relevant for the purpose of supervising the regulated entities, and member governments are to ensure that there are no legal impediments to the flow of this information.

The EEC framework includes several additional provisions relevant to the conglomerate context. For banks and investment firms within either financial or mixed-activity groups, supervisors are to have the capacity to refuse or withdraw authorization in cases where the group structure precludes effective supervision, and member governments are to ensure that enforcement provisions may be imposed on financial holding companies and mixed-activity holding companies, or their effective managers. For individual banks, investment firms and insurance companies, supervisors are to be granted the power to disapprove senior management, as well as any shareholders owning 10% or more of the voting shares of the institution or having the power to significantly influence the institution's management. Supervisors are to establish mechanisms to ensure cooperation among the authorities responsible for different financial sectors, including the insurance industry.

The emerging EEC framework can serve as an important example of the means by which to regulate financial conglomerates, particularly once insurance companies have been brought more fully under its scope. Developments thus far suggest that application of capital adequacy requirements, large exposure limits and connected lending limits on a consolidated basis to all group financial entities will become a broadly accepted component of such regulation.

Basle Committee on Banking Supervision

The Basle Committee on Banking Supervision is comprised of the bank supervisory agencies from the Group of Ten countries. One of the committee's principal aims is to promote the enhancement and harmonization of regulation and supervision of banks operating internationally. As such, its original focus was on banking groups. However, since most banking groups are in fact financial conglomerates, the committee has broadened its focus to encompass the full range of financial activities of such groups. This effort contributed to the formation in 1993 of The Tripartite Group of Securities, Insurance and Banking Regulators.

¹⁸Excluding certain short term exposures.

The Basle Committee's approach to the supervision of international banking groups has been centered around the concept of consolidated supervision. This concept was set forth in the 1983 revised Concordat.¹⁹ The Concordat states "the principle that banking supervisory authorities cannot be fully satisfied about the soundness of individual banks unless they can examine the totality of each bank's business worldwide through the technique of consolidation." Consolidated supervision was defined as the supervisor monitoring the risk exposures and capital adequacy of the institutions for which they were responsible based on the totality of their business, wherever conducted.

In 1992, the Committee published *minimum standards* that its members agreed to apply to international banks operating in those countries.²⁰ The standards include the provision that "all international banking groups and international banks should be supervised by a home-country authority that capably performs consolidated supervision". Under the standards, consolidated supervision is defined to include three components. First, the supervisor should "receive consolidated financial and prudential information" on the group's global operations, have the reliability of this information confirmed to its satisfaction, and assess the information as it affects the bank or group.²¹ Second, the supervisor should have the capability to "prevent corporate affiliations or structures that either undermine efforts to maintain consolidated financial information or otherwise hinder effective supervision" of the bank or group. Finally, the supervisor should have the capability to prevent the bank or group "from creating foreign banking establishments in particular jurisdictions."²²

¹⁹Principles for the supervision of banks' foreign establishments, Committee on Banking Regulations and Supervisory Practices (later the Basle Committee on Banking Supervision), May, 1983.

²⁰Minimum standards for the supervision of international banking groups and their cross-border establishments, Basle Committee on Banking Supervision, June, 1992.

²¹By not specifying the method of consolidation, the Committee provides for flexibility in application of the standards by its members. It does not require the application of consolidated regulation as defined in this paper.

²²The reference to "particular jurisdictions" is thought to encompass financial centers offering nearly impenetrable secrecy, and which can be used to evade effective supervision.

PART II

PRACTICAL ALTERNATIVES FOR DEVELOPING COUNTRIES

A. Overview

Financial conglomerates are not encountered only in the world's more advanced financial markets. The authorities in many developing countries are confronted by such organizations as well. Where ownership or control linkages among different types of financial institutions already exist or can be anticipated, the authorities need to develop explicit strategies for regulation and supervision of financial conglomerates.²³

A basic goal of regulation and supervision is to promote an environment in which individual institutions and financial groups operate in a sound manner, thereby promoting *systemic financial soundness*.²⁴ In financial systems where financial conglomerates are present, attainment of this goal can be promoted by taking steps to mitigate concerns regarding contagion, transparency and autonomy.

An adequate regulatory framework will need to include group-wide capital adequacy, large exposure, connected lending, and perhaps other prudential requirements, the use of shareholder, manager, and external auditor suitability standards, and consolidated regulatory reporting and public disclosure requirements. In pursuing systemic financial soundness, the effectiveness of supervision can be at least as important as the precise nature of the regulatory framework. Individual supervisory agencies will need to adapt the policies and procedures they have utilized in the supervision of individual institutions to ensure their effectiveness in the financial conglomerate context.

Forging a regulatory and supervisory strategy to deal effectively with financial conglomerates likely will require greater integration among the regulatory and supervisory approaches traditionally utilized by bank, securities and insurance supervisors, whose

²³As described in Part I, Section A, external pressure for the development of such a strategy also may arise where domestic financial institutions attempt to expand internationally.

²⁴As used in this paper, the term systemic financial soundness is meant to reflect an environment in which the failure of financial institutions is seen as a natural consequence of market forces, but where the system itself has the capacity to accommodate such failures without adverse monetary or fiscal consequences.

objectives and methods may vary. Bank supervision tends to relate closely to national economic policy, notably monetary policy, and therefore usually involves the central bank. Bank supervisors tend to view consolidated regulation and supervision as the most effective means to accomplish their objectives. In contrast, securities and insurance supervisors often are oriented toward regulation and supervision of separate institutions, focusing more on the ability of those institutions to meet their obligations. Bank supervisors tend to take a more narrow view of what constitutes capital than do securities supervisors; insurance supervisors typically are less concerned regarding liquidity than are bank or securities supervisors; securities supervisors tend to take a more conservative approach to asset valuations than do bank and insurance supervisors. These and other differences exist due to legitimate differences in objectives and supervisory methodologies. Nonetheless, the agencies' objectives and methodologies will need to be harmonized to find a common approach to the shared challenge which financial conglomerates represent.

B. Supervisory Structure

In those countries where the authorities recently have revamped their overall approach to financial market regulation and supervision, various alternative supervisory agency structures have been employed. Some countries have opted for fewer supervisory agencies, bringing most or all financial market supervision under one agency. This approach can have the advantages of clarifying supervisory authorities and responsibilities, improving communications, permitting better coordination of supervisory activities, and leveraging resources more efficiently. Many other countries have opted to maintain multiple supervisors. One rationale for doing so is to maintain high degrees of specialization in the supervision of specific financial markets. Some countries even have moved to establish additional supervisory agencies.²⁵

In terms of the objectives of regulation and supervision, the distinction between a single agency and multiple agency approach may not be great: neither structure assures effectiveness. Attempting to modify the existing structure can give rise to struggles among the agencies over the potential rearrangement of authorities and responsibilities that hinder achievement of the objective of devising an effective means to regulate and supervise financial conglomerates. Moreover, merging existing agencies, or creating a single new agency, requires political agreement on the branch of government to which the agency should report, on whether and to what extent the agency should be responsible to the central bank, and on the extent to which it should be independent. Achieving such agreement would be outside the scope of responsibility of most supervisory agencies. On the other hand, maintenance of the status quo may prove an impediment to achieving effective supervision, particularly where the different agencies are responsible to different governments (e.g. national and regional) or different bodies within government (e.g. executive, legislative and central bank) which may not share common objectives. The existing structure may be based on the supervision of different types of institutions whose functions increasing overlap, placing in doubt the continued validity of the supervisory structure. Finally, in the face of limited human and financial resources, maintaining multiple agencies simply may no longer be affordable.

²⁵Germany has recently established a securities supervisory agency at the national level.

C. Supervisory Philosophy

The supervisory response to conglomerates needs to be assessed and formulated in the context of the ongoing efforts in many countries to upgrade basic supervisory objectives and strategies.²⁶ These new philosophies and approaches often can be characterized as more forward-looking and risk-oriented than traditional rules-based approaches. They incorporate an explicit recognition of the practical limitations on supervisory agencies attempting to "ensure" the stability and soundness of the financial system, and rely more heavily on market participants and market forces to "promote" such stability. The task of supervision is seen more as having the capacity to make qualitative assessments regarding riskiness and management quality, and less as a process of testing compliance with an extensive set of rules.

Consistent with this increasingly-adopted philosophy, supervisors need to clearly define and communicate their expectations regarding the roles and responsibilities of directors, managers and external auditors, not only in terms of individual financial institutions, but also in terms of the conglomerates of which those institutions are a component. For example, directors and managers responsible for individual institutions should be held accountable for maintaining their decision-making autonomy within a group context. Directors and managers responsible for the broader financial group should be held accountable for ensuring transparency, and for minimizing the potential for contagion by implementing sound risk management practices and by developing appropriate group-wide liquidity and capital contingency plans. External auditors should be held accountable for reporting substantive risks and concerns regarding the overall group that come to their attention in the performance of their work.

Supervisors need to be equally clear regarding their role. They must avoid falling into the "trap" of allowing their supervision to function as a substitute for sound policies and practices within the institutions they supervise. Rather, they need to focus their efforts on encouraging all relevant market participants to work toward the objective of the systemic financial soundness of the principal financial markets, and on identifying and remedying situations which threaten achievement of that objective.

²⁶In those countries not actively engaged in revamping their supervisory philosophy and approach, the imperatives created by the need to deal with conglomerates provides an opportunity to do so.

D. Financial Sector Structure

The corporate organization of conglomerates is often a consequence of existing legal provisions, capital adequacy requirements, and tax laws. Individual business decisions also are important determinants of structure.²⁷ Several different structures might arise in a given country.

Authorities need to decide whether to specifically intervene to define acceptable forms of corporate structure for financial and mixed-activity conglomerates. Alternatively, they can permit structures to be determined by the market. The key supervisory concern in this regard is transparency: supervisors must be comfortable with their understanding of the corporate and managerial structure. Structures where it is not clear which shareholders (either legal entities or individuals) and which managers exercise control over the conglomerate and its component entities, and which parties have financial responsibility for the component regulated entities²⁸, must be prohibited or discouraged. At the same time, the authorities need to be cognizant of the potential for regulation of structure to represent an impediment to competition and the prudent conduct of profitable business.

Several means exist by which to influence structure so as to promote transparency. The most flexible would be to grant supervisors the explicit power to deny structures which they view as not transparent. In principle, this authority would be exercisable at any time, and would be employed in conjunction with enforceable suitability standards applicable to significant shareholders, directors and managers. In practice, this authority most often would be relied upon by supervisors when deciding whether to grant authorization for the establishment of regulated entities, corporate acquisitions, mergers, transfers of ownership, changes in senior management and appointment of new directors.²⁹ But with the flexibility that this approach offers comes the risk that discretionary powers of this nature will be either under-utilized or abused.

Corporate transparency could be addressed more explicitly through legislation that specifies

²⁷An objective of such decisions may be to avoid regulation and minimize supervision.

²⁸Supervisors often look to parent entities or major shareholders as a source of financial support for financially troubled institutions.

²⁹See Part II, Section E.

appropriate structure. For example, some countries require the use of holding companies, whereby all financial institutions within a group must be controlled (if not wholly-owned) by a parent company, whose shareholders must be registered and are subject to disclosure requirements intended to make transparent any individual or collective holdings in excess of certain thresholds (such as 5% or 10%). Holding companies can be shell, non-operating entities, or one or more of any type of operating financial institution. The holding company structure may be a particularly appropriate solution in situations where individuals acting in concert own or control multiple financial entities in a non-transparent manner.³⁰

Structure could be influenced indirectly through prudential requirements such as those defining regulatory capital and capital adequacy requirements, and establishing investment limitations. As noted, the structures that have emerged in some countries have been determined by such rules, although the rules often were not designed with the intention of promoting transparency, and therefore may not have that consequence.

The authorities will need to make a policy decision as to whether they will accept mixed-activity groups, thereby allowing members of the conglomerate to engage in significant commercial or industrial activities. Since such structures can exacerbate supervisory concerns regarding contagion and autonomy, they must be weighed along with concerns regarding transparency in making such a decision.

If mixed-activity groups are accepted, the authorities should adopt a legal provision requiring formation of a financial institution sub-group within mixed-activity groups. The sub-group would encompass all group members engaged predominantly in financial services activities. Requiring a sub-group structure would circumscribe the relevant financial sector operations, thereby mimicking a financial conglomerate structure, which will facilitate the application of regulation and the conduct of supervision, and help create a more level playing field among financial and mixed-activity conglomerates.

Where mixed-activity groups are accepted, the authorities will need to determine acceptable structures for the ownership relationship between the financial institution sub-group and group members engaged predominantly in commercial or industrial activities. Requiring a structure whereby all group commercial and industrial entities are upstream of

³⁰This form of ownership structure is not uncommon in the developing world. It functions to obscure relationships among financial institutions (and, often, industrial or commercial groups), and is inconsistent with effective regulation and supervision.

the financial sub-group may promote transparency, and would clarify the financial responsibility of those entities for the financial sub-group. If group commercial and industrial entities are permitted to be held downstream of the financial entities, limits must be established on the portion of the financial entities' capital that can be invested in such subsidiaries.³¹

³¹See Part II, Section F, for appropriate treatment of such investments and exposures for capital adequacy purposes.

E. Authorization Requirements

Requirements for prior authorization are important tools by which to implement supervisory policies. The authorization process for the establishment of a new financial institution is the point at which supervisors should first establish an appropriate working relationship with the institution's directors, managers and external auditors, who, as part of the process, must be vetted by the authorities. Thereafter, authorization requirements can function as a series of checks during the expansion of a institution at which time supervisors can exert leverage to ensure correction of deficiencies in its operations.

In the context of conglomerates, authorization requirements should be utilized as a means to promote transparency and autonomy. Specifically, they provide supervisors a means to implement policies regarding organizational, managerial and financial transparency, and to apply suitability standards promoting the autonomy of directors, managers and external auditors. The process of granting authorization for any regulated group entity should include a group-wide assessment of conformity with these policies.

A number of different types of transactions may be subject to a requirement of prior notification and authorization. These include the establishment of new financial institutions that will incur exposures to the public, the undertaking of certain new activities (e.g. those which substantially alter the business of the institution or require specialized management experience), significant changes in ownership, major corporate transactions effecting the institution's organizational and management structure or substantially changing its business mix, and changes in senior management and external auditors. Requirements for prior notification and authorization also should be applied with respect to parent financial entities (e.g. financial holding companies).

Criteria for granting authorization should include the suitability of significant shareholders, managers and external auditors, the appropriateness and transparency of the corporate structure, the reasonableness of business and financial plans, and the existence of adequate capital.³² In assessing the suitability of significant shareholders and managers in

³²The minimum standards for authorization in the EEC require, in part, that supervisors be informed of the identities of natural and legal person shareholders with a direct or indirect holding of 10% or more of the voting rights, or the power to exercise a significant influence over management, and that supervisors be satisfied as to the suitability of such shareholders. Notification and prior approval is required whenever the direct and indirect holdings of any natural or legal person reaches or exceeds 10%, 20%, 33% or 50% of the

a conglomerate context, supervisors should consider whether the managers function, or are likely to function, in a sufficiently autonomous manner. Supervisory expectations in this respect should be communicated or reiterated to significant shareholders and managers as part of the authorization process. In instances involving a substantial expansion of the business or geographic scope of the institution or group, the ability of the board and management to successfully undertake the business challenges of the expansion should be assessed. Where the shareholders of the institution seeking authorization are other regulated financial institutions, or entities related by ownership or control to such institutions, the relevant supervisors should jointly assess whether authorization criteria have been met.

The enforcement of suitability standards regarding significant shareholders requires transparency of the ownership of regulated entities. A basic prerequisite for such transparency is the registration of ownership positions, and the prohibition on the use of bearer shares. Legal provisions should also provide for disclosure of beneficial owners when shares are held by agents acting on behalf of others. Regulated institutions should be required to periodically provide to the supervisors a list of significant shareholders and their direct and indirect holdings, and to notify the supervisors upon significant changes in the ownership structure of the institution. Existing shareholders should be required to notify the supervisors when they dispose of significant blocks of shares. While prior authorization powers with respect to parent commercial or industrial entities likely will not be formally available, the authorities should require prior notification by the regulated group members of significant transactions affecting the corporate structure of the group.

shares, and whenever the nature of the relationship between the shareholder and the institution is such that the institution would become a subsidiary. Further, supervisors are to make a determination that managers are of good repute and have sufficient professional qualifications and experience. Council Directives 89/646/EEC (banks), 92/96/EEC (life assurance companies) and 93/22/EEC (investment firms).

F. Prudential Requirements

Prudential requirements can be instrumental in alleviating concerns regarding contagion, and in promoting transparency. They may take the form of statutory provisions, regulations, norms or other types of enforceable standards. Their principal purpose is to ensure adequate capitalization and to constrain the potential riskiness of financial institutions. The key prudential requirement for any financial institution is its capital rule, which defines regulatory capital and establishes the minimum amount of such capital that must be held by the institution. Other important prudential rules establish limits on risk exposures that may be undertaken by institutions (e.g. counterparty credit exposure limits and connected lending limits). Risk limits of this nature often are fixed in terms of regulatory capital. In the context of financial conglomerates, the authorities will need to determine the means by which prudential requirements will be applied on a group-wide basis.

Capital Adequacy

Capital adequacy requirements involve a definition of which instruments constitute regulatory capital (including appropriate deductions from capital), and the specification of the amount of capital institutions should hold. The amount of capital to be held may be based on several factors, the most common being various proxies for risk (e.g. risk weights for assets based on their perceived degree of credit risk, net positions in foreign exchange, and net positions in traded securities subject to market risk), and estimates of liabilities (e.g. actuarial estimates of insurance liabilities, and historic net claims payments), but also on other factors, such as the level of the fixed operating expenses of an institution.

The adoption in 1988 by the Basle Committee on Banking Supervision of an international accord for bank capital adequacy (the so-called "risk-based capital" accord) was a significant step in more closely relating capital requirements for banks to their riskiness. This accord is mirrored in the 1989 EEC Directives regarding the "own funds" (i.e. regulatory capital) and "solvency" of banks. In 1993 the EEC adopted capital adequacy rules applicable to the securities trading and foreign exchange operations of investment firms *and* banks, which also makes applicable to investment firms certain of the own funds and solvency requirements applicable to banks, and thus creates an integrated capital adequacy requirement applicable to banks and investment firms. The EEC had previously adopted directives establishing capital requirements for life and non-life insurance

companies, but as yet they are not integrated with the requirements applicable to banks and investment firms.³³ Despite the present exclusion of insurance companies, it should be presumed that some form of group-wide application of capital adequacy requirements eventually will become an internationally accepted facet of financial conglomerate regulation and supervision.

One means to apply capital adequacy standards to financial conglomerates is to utilize the principle of consolidated regulation: a *uniform capital adequacy requirement* would be applied to all financial institutions within a conglomerate based on their consolidated accounts and risk positions. This consolidated approach would incorporate a common standard for the amount of capital required to be held against all types of risks run by different types of financial institutions, and a common definition of regulatory capital. Regulatory capital would be determined after application of full accounting consolidation techniques for all group financial entities.³⁴ Such accounting techniques will serve to eliminate the effects of intra-group transactions, and will make more transparent the net capital position of the group.³⁵

For the authorities, consolidated application of a uniform capital adequacy requirement in this manner would require that they harmonize the standards they presently utilize for defining the amount of capital to be held for different financial risks (e.g. credit risk, foreign exchange rate risk, position risk, and estimates of insurance underwriting liabilities) without regard to the type of institution conducting the activity. This effort will need to address the acceptable manner for netting offsetting risk positions in different group financial entities. The authorities would need to agree on a common definition of regulatory capital,

³³Thus, there are three EEC directives relating to capital adequacy of financial groups. One defines the own funds, or capital, of banks (Council Directive 89/299/EEC). The second establishes solvency ratios for credit risks (Council Directive 89/647/EEC). The third establishes capital charges for position (market) risk, counterparty/settlement risk, and foreign exchange risk (Council Directive 93/6/EEC). This directive also expands the definition of capital in respect to certain position risks, and makes applicable to investment firms certain provisions of the first two directives.

³⁴See Part II, Section G, for details regarding the accounting principles inherent in full consolidation.

³⁵Full accounting consolidation will not necessarily reveal, however, the distribution of the net capital among the various group member entities. The distribution of capital is important if, as is likely to be the case, there exist constraints on the transfer of capital among the entities. For this reason, effective supervision would require that the capital adequacy requirement be applied not only to the consolidated financial group, *but also to each group financial entity separately.*

as well as appropriate deductions from capital. Such agreement among the authorities might retain elements of the capital requirements traditionally employed by the different supervisors. For example, it could be agreed that certain forms of regulatory capital would be permitted to support only certain types of risks (e.g. shorter-term capital to support securities underwriting positions).

Complete harmonization of all standards may not be required. So long as any remaining differences are transparent to financial institutions, the users of published financial statements, and the supervisors themselves, certain differences in the capital standards and/or the definition of regulatory capital could be tolerated. This tolerance could extend to the accounting principles that would otherwise need to be made consistent among all types of financial institutions in order to achieve a common definition of regulatory capital (e.g. loss provisioning, income and expense recognition, asset and liability valuation, gain and loss recognition and deferral, and intangible asset inclusion and amortization).

Consolidated application of a uniform capital adequacy requirement would have the advantages of creating a level playing field for minimum capital charges between different types of financial institutions engaged in the same or similar businesses, and between financial conglomerates conformed in different structures. It would promote transparency by presenting a single financial statement for the entire financial group that eliminates the consequences of intra-group transactions, and by presenting individual financial statements for each entity prepared under the same standards. Utilizing one set of standards applicable to all financial institutions also would facilitate market comparisons of different types of financial institutions.

If consolidated application of a uniform capital adequacy requirement is not considered feasible or desirable, *alternative methods* must be adopted. The existing capital adequacy rules applicable to the various types of financial institutions will need to be modified for application in the financial conglomerate context. A likely feature of this alternative will be the absence of full accounting consolidation of all group financial entities. For this reason, the modifications to existing rules should have the objectives of avoiding the double counting of capital among regulated group entities, and the overstatement of capital within any regulated group entity, both of which can be consequences of transactions with other

group financial institutions.³⁶

A commonly utilized technique to avoid the double counting and overstatement of capital among *regulated* institutions is to deduct from an institution's regulatory capital certain of its investments and other credit exposures to other regulated group member institutions. In practice, there are at least three alternative means of defining the relevant investments or credit exposures. The first is to require the deduction of any investment that corresponds to the capital that the other group member entity is required to hold under its own capital requirement³⁷. This method, in effect, presumes that the capital in the other member entity in excess of its minimum regulatory requirement is available to meet the capital requirement of the subject regulated entity. The second method is more conservative. It requires the deduction of any investment that corresponds to the regulatory capital of the other member entity (i.e. the capital the other member entity is required to hold plus any additional regulatory capital actually held by that entity). This method presumes that the other member's capital is required to support the risks it runs, regardless of the amount of capital required under its regulatory requirement.³⁸ The third method is more conservative still. It requires the deduction of all forms of financing provided by the subject regulated entity to the other member entity, including investments. This method precludes the double counting of capital that might arise in transactions where capital is created in the regulated entity by creating a receivable due from the other entity.³⁹ Further, this method provides a higher level of comfort regarding the subject entity's insusceptibility to contagion from the other group member entity, in that the former

³⁶These objectives relate directly to the key issues of contagion and transparency. The double counting of capital within the group and the overstatement of capital within individual institutions can lead to an under-appreciation of the potential for contagion within the group, and will reduce the transparency of the group's and institutions' financial position.

³⁷Such investments normally will be funded, but also can be off-balance sheet guarantees or commitments in favor of, for example, a securities firm.

³⁸This deduction method is a component of the definition of own funds for banks and securities firms set forth in the EC Own Funds Directive. Specifically, these institutions must deduct from capital their holdings of shares and other capital instruments in other institutions (not including insurance companies) whenever the subject institution's holding of shares in the other institutions exceed 10% of the capital of the other institution. Holdings below this threshold must be aggregated, and any amount in excess of 10% of the subject institution's capital must also be deducted. The effect of this requirement is to diminish the potential for institutions to mutually inflate their capital via cross investments.

³⁹This might occur where, for example, the regulated entity finances the sale of an asset to the other group entity at an inflated value, and recognizes the "gain" as income.

can withstand the loss of its entire credit exposure to the latter and still meet its minimum capital adequacy requirement.

To fully preclude the overstatement of capital that might arise due to transactions between a regulated institution and *unregulated* group entities, the third deduction method noted above would need to be employed. If such a provision is viewed as excessively restrictive by the authorities, they must weigh the implications of existing and potential intra-group transactions in their markets in terms of the transparency of groups' and individual institutions' financial position, and should consider adopting prudential regulations applicable to such transactions, particularly to those whose effects will not be eliminated under the chosen capital adequacy methodology.⁴⁰

These alternative methods for the group-wide application of capital adequacy requirements may prove simpler to adopt than a uniform capital adequacy requirement, in that harmonization of requirements among different types of institutions would not be required. However, the alternative approaches lack most of the advantages of the fully consolidated approach. They will likely preserve disparities in the minimum capital adequacy requirements applicable to different types of financial institutions, and may produce inconsistent results when applied to groups conformed in different structures. They do not, in themselves, achieve relevant supervisory objectives regarding contagion and transparency.⁴¹ Finally, their use can contribute to the potential for *regulatory arbitrage*, where certain activities are shifted to the regulated entity subject to the least stringent

⁴⁰It follows that a key objective of potential regulation would be to minimize the extent to which intra-group transactions can lead to an overstatement of capital in comparison to the result obtained under full accounting consolidation. Appropriate regulation might include prohibitions on certain transactions and limits on others. A more flexible and market-sensitive approach would be to establish mechanisms for approval of all significant intra-group transactions by the board of directors or a committee of the board comprised of non-executive directors. Consistent with the supervisory philosophy espoused in this paper, the supervisors would make clear their expectations regarding the responsibility of the board and management to refrain from entering into transactions that result in an overstatement of capital or that are not on an arms-length basis. Similarly, supervisors could require that such transactions be reviewed by the external auditors. Supervisors also could require that sizeable transactions be reported and publicly disclosed.

⁴¹Utilizing these alternative methods for the group-wide application of capital adequacy requirements does not imply that the financial group should not be required to prepare consolidated financial statements. See Part II, Section G, for greater detail.

capital requirements for that particular activity, or to non-regulated entities.⁴²

Regardless of whether the authorities adopt a uniform capital adequacy requirement or the alternative methods, it is critical that supervisors recognize that adherence to a capital rule does not mean that a given institution or group of institutions is adequately capitalized. Capital adequacy requirements incorporate only crude measures of the riskiness of financial institutions, and there are practical limitations to increasing their accuracy (e.g. the need to avoid excessive complexity). Adequate supervision therefore requires that minimum capital adequacy requirements be coupled with subjective assessments of riskiness and management practices in the regulated entities and, to the extent possible, in the unregulated entities which are part of the group. For regulated entities, such assessments should lead to a situation where most institutions are required to hold capital in amounts greater than the minimum requirement. With respect to unregulated entities, such assessments may lead to a requirement that related regulated entities reduce their exposures to the unregulated entity, or take other actions designed to minimize the potential for contagion and to promote the transparency of its relationship with the unregulated entity. In the conglomerate context, qualitative assessments of this nature need be made on a group-wide basis by at least one of the agencies responsible for the supervision of the component financial institutions.

Large Exposures and Connected Lending Limits

In general, quantitative risk limits serve to constrain the riskiness of financial institutions and reduce the potential for a sudden shock (e.g. counterparty default) to render them insolvent. As such, risk limits can reduce potential contagion arising from institutions subject to such limits. Common examples include large credit exposure limits, connected lending limits and foreign exchange position limits.⁴³

With respect to certain risks, minimum capital adequacy requirements can serve a purpose similar to risk limits: to the extent that capital rules accurately capture the underlying risk,

⁴² While supervisors should be alert to this practice, regulatory arbitrage need not be a significant concern if each supervisor is comfortable with the regulatory framework (most particularly the capital adequacy requirement) and the supervisory practices of the other relevant supervisors, and if significant activities do not escape regulation or supervision entirely.

⁴³ In contrast, quantitative limits addressing an institution's overall exposure to interest rate risk are difficult to apply in practice, and are not often encountered.

the need for institutions to comply with the capital charges can function to constrain the level of risk they assume. In the capital adequacy requirements adopted by the EEC and proposed by the Basle Committee on Banking Supervision, for example, risks arising from positions in foreign currencies and traded securities are addressed in this manner.⁴⁴

For other risks, capital rules alone may not serve to sufficiently constrain risk. The most notable example is credit risk. The Basle and EEC capital adequacy requirements' treatment of credit risk is geared to a diversified portfolio of exposures, and is not intended to function as a constraint on credit exposures to individual counterparties. For this reason, an explicit limit on large exposures to a individual counterparty or related group of counterparties is a key element of the EEC's consolidated supervision framework.⁴⁵ As such, it is likely that some form of group-wide application of a large exposures limit will become an accepted facet of financial conglomerate regulation and supervision.

Large exposures limits can be applied on a uniform and fully consolidated basis across the financial group in a manner similar to uniform capital adequacy requirements. This would require the establishment of a common definition⁴⁶ for what constitutes an exposure⁴⁶, what constitutes an economically-related group of counterparties⁴⁷, the base against which the

⁴⁴Individual member countries are free to utilize risk limits in conjunction with these capital requirements.

⁴⁵There are two relevant EEC directives relating to large exposures. One establishes the basic large exposures limit (Council Directive 92/121/EEC), and the other makes the limits applicable to investment firms, subject to certain modification (Council Directive 93/6/EEC). In addition to establishing a counterparty credit exposure limit, the large exposures directives limit the aggregate of all exposures in excess of 10% of capital to eight times the capital of the institution.

⁴⁶The definition should include all forms of funded exposures (e.g. loans, interest bearing securities, equities, etc.), unfunded yet committed exposures (guarantees, letters of credit, loan and underwriting commitments, etc.), and potential future exposures that might arise under existing contractual relationships, such as derivative contracts (e.g. interest rate and exchange rate swaps, etc.). In defining the amount of the exposure, it is *not* appropriate to reduce the face or nominal amount of the exposure by the counterparty credit risk weightings employed for capital adequacy purposes. Weightings *will* need to be employed, however, in the case of derivative contracts, where the exposure is not the face amount of the contract, but rather its potential replacement cost.

⁴⁷The EEC large exposures directive uses the following definition: two or more natural or legal persons who, unless it is shown otherwise, constitute a single risk because one of them, directly or indirectly, has control over the other or others; or, two or more natural or legal persons between whom there is no relationship of control, but who are to be regarded as constituting a single risk because they are so interconnected that, if one of them were to experience financial problems, the other or all of the others would be likely to encounter repayment difficulties.

limit will be established (e.g. regulatory capital), and the limit itself⁴⁸. The regulatory capital of the group would be computed based on full accounting consolidation techniques. The limit would be applied to the consolidated group and to each financial entity separately.⁴⁹

If consolidated application is not considered feasible or desirable, large exposures limits should be applied separately to individual group financial entities. To take account of the potential that capital is double counted among the individual entities, or is overstated in an entity due to transactions with other group entities, the authorities should consider using the deduction method noted above in the discussion of capital adequacy requirements to scale-back the capital base against which the limit would be applied in each entity. At the group level, this will produce a result similar to the consolidated application of the large exposures limit. At the level of the individual institution, however, utilizing this approach is less compelling than in the case of the capital adequacy requirements, and will produce anomalies among institutions.⁵⁰

The authorities will need to make a policy decision as to whether the large exposures limit applicable to connected parties (i.e. non-financial group members and other related parties) should be lower than for unrelated parties. The supervisory concern in this regard is autonomy, and the potential that directors and managers may act in a less than objective manner in making decisions on potential exposures to related parties. Adopting a separate connected party exposure limit will require definition of what constitutes a connected party, which reasonably could be more conservative than the definition of an economically-related group of counterparties.⁵¹

⁴⁸In the EEC, the basic limit is 25% of capital, subject to a transitional arrangement that provides for a limit as high as 40%.

⁴⁹As noted, this is particularly important when capital is not readily transferable among the entities.

⁵⁰Regulated institutions that hold investments in other regulated group institutions will see their counterparty exposure limits reduced relative to institutions which do not hold such investments.

⁵¹In the EEC, the 25% large exposures limit applicable to third party counterparties is reduced to 20% for aggregate intra-group exposures, subject to a transitional arrangement that provides for a limit as high as 30%. Under certain circumstances, the lower intra-group limit may be waived by the authorities. Council Directive 92/121/EEC. The relevant group is defined to include all subsidiaries of the institution, the parent entity of which the institution is a subsidiary, and other subsidiaries of that parent entity. The definition of "subsidiary" in the EEC context is not limited only to instances where a parent has a direct or indirect ownership position in another entity of greater than 50%, but also includes numerous other situations with respect to the actual exercise of control, overlapping membership on administrative, managerial or

The authorities will also need to make a policy decision as to whether further regulation of intra-group exposures is appropriate. Given supervisory concerns regarding potential contagion, the authorities may wish to establish constraints on the ability of individual regulated institutions to take on significant exposures to certain other group member entities (e.g. exposures to unregulated entities for which an adequate assessment of risk cannot be made). In such critical instances, the exposures might be made subject to prohibitions, limits, or requirements for prior supervisory approval. Where less supervisory concern exists, such transactions might be subject to a requirement for ratification by the board of directors or a committee of the board of directors comprised of non-executive directors. Additionally, all intra-group transactions could be subjected to requirements that they be concluded on an arms-length basis.

supervisory boards, and unified management, among other criteria, which are more fully described in Part II, Section G. Moreover, the supervisors are empowered to designate as a subsidiary any entity over which they deem the parent effectively exercises a dominant influence. Council Directives 83/349/EEC and 92/30/EEC.

G. Public Disclosure and Supervisory Reporting

Public disclosure and supervisory reporting requirements are key means by which to address concerns regarding transparency. Credible public disclosure also can be a means by which to reduce the potential for contagion. The common objective is to ensure that financial statements and specialized disclosures provide public users and supervisors a clear understanding of the financial condition of each individual group member entity, as well as that of the financial group as a whole.

Public disclosure relating to financial institutions may derive from several sources. The agencies responsible for the regulation and supervision of the institutions typically prescribe public disclosure designed to allow creditors and other participants in the financial markets (e.g. rating agencies) to evaluate and play a role in monitoring institutions. Where the shares or debt of the institution are traded on regulated securities markets, the rules of those markets also will prescribe certain public disclosures. Companies laws can be another sources of disclosure requirements.

Supervisory reporting requirements are designed for submission only to supervisory authorities, and are an integral component of the supervisory process. They will typically provide a greater level of detail, and address more issues, than do public disclosure requirements. Often, certain portions of the supervisory reporting requirements serve as the public disclosure requirements mandated by the supervisors.

Securities market and companies law disclosure requirements typically are based on the generally accepted accounting principles (GAAP) applicable to all firms in the country. In some countries, local GAAP establishes specific requirements applicable to financial institutions. Nonetheless, GAAP often produces results that are deemed as either misleading or insufficiently conservative by the agencies responsible for the supervision of those institutions.⁵² For purposes of supervisory disclosure requirements, these agencies prescribe supplementary accounting principles, often referred to as regulatory accounting principles (RAP), which in turn may influence the evolution of GAAP for financial institutions. Supervisory reporting requirement almost always are based on RAP.

In the context of financial conglomerates, the authorities must assess local GAAP, as well

⁵²And in some countries, clearly defined GAAP may not exist.

as existing RAP, in terms of their consequences for transparency. GAAP may produce insufficient results, and RAP, often adopted independently by different supervisory agencies, may not have remedied the shortcomings.

Local GAAP may offer insufficient treatment of loss provisioning, asset and liability valuation, recognition of income and expense, deferral of gains and losses, the inclusion and amortization of intangibles, and the treatment of off-balance sheet items such as derivatives. RAP may have been established by the authorities to address such issues. In the conglomerate context, the authorities will need to determine the extent to which to harmonize accounting principles such as these that are applicable to different types of financial institutions. Harmonization would serve to promote transparency, ensure comparability among the financial statements of different financial institutions and conglomerates, and create a more level playing field among different types of institutions, and conglomerates conformed in different structures. In practice, the adoption of completely identical principles for all financial entities may not be necessary. Rather, the authorities could harmonize the differing principles to the extent practical, and provide for adequate disclosure of remaining differences.

Local GAAP may define the scope and method for the accounting consolidation of related entities, but may not result in sufficiently conservative treatment for supervisory purposes (i.e. supervisory reporting and supervisor-mandated public disclosure). GAAP may not require consolidation of non-majority owned entities, but rather may permit equity method or historic cost treatment of such investments in other group member financial entities. The authorities therefore will likely need to define RAP that establishes more appropriate standards regarding the method and scope of consolidation of financial groups. Requiring all entities engaged principally in financial services within the group to be included in the scope of full accounting consolidation would be the most comprehensive means by which to promote conglomerate transparency. Full consolidation would require the offsetting of debts and claims between consolidated entities, the elimination of income and expenses relating to transactions between consolidated entities, and the elimination of profits and losses resulting from transactions between consolidated entities that are included in the book value of any consolidated entity's assets.⁵³

The authorities might provide for certain exceptions to the requirement that all group-related financial entities be included in the scope of such consolidation. For example,

⁵³Including sub-consolidation of the financial services entities of mixed-activity groups.

where a majority of the voting rights of a financial entity are exercised by parties not otherwise associated with the group, and where there is limited overlap among directors and no common management, authorities might permit that the group's investment be accounted for under the equity method of accounting. Exceptions of this nature might be granted on a case by case basis, and be revoked should supervisory concerns regarding contagion, transparency or autonomy arise.⁵⁴ Should the absence of the necessary accounting techniques preclude full accounting consolidation of all financial services entities within the group, RAP should provide for footnote disclosures of the effects of non-consolidated entities (e.g. the substance of transactions not eliminated in consolidation).

The authorities should establish mechanisms to promote the accuracy of financial reporting and disclosures in the conglomerate context. While the supervisors themselves may play a role, primary responsibility for accurate reporting should rest with the directors and management, and internal and external auditors. Authorities should consider requiring that all group financial entities be audited by a single external auditor. Alternatively, authorities should provide for the designation of a lead auditor with explicit responsibility for the veracity of group-wide reporting and disclosure. Authorities also should mandate the use of a uniform audit date for all group financial entities.

⁵⁴The consolidated supervision directives of the EEC applicable to banks and securities firms require the full consolidation of all financial institutions that are a "subsidiary" of a parent entity. A subsidiary is defined as an entity in which the parent: holds a majority of the voting rights; is a shareholder and has the right to appoint or remove a majority of the members of the administrative, management or supervisory board; has the right to exercise a dominant influence, by contract or provision in the articles of association, regardless of holding any voting rights or not; is a shareholder and a majority of the members of the administrative, management or supervisory board have been appointed solely as a result of the exercise of its voting rights; or is a shareholder and controls alone, pursuant to an agreement with other shareholders, a majority of the voting rights. In addition, full consolidation may be required when a parent holds 20% or more of the voting rights of an entity, and either actually exercises a dominant influence over it, or the entity is managed on a unified basis with the parent. The precise language is set forth in Council Directive 83/349/EEC.

H. Implementation

Enhancements to prudential regulations, regulatory policies, and accounting principles at best can lay a foundation for effective conglomerate supervision. Implementation falls to the responsible supervisory agencies. These agencies will need to revise their policies and procedures to incorporate conglomerate supervision. Moreover, agencies' staffing, training programs, compensation plans and use of technology will need to be reassessed. Where conglomerate supervision involves more than one supervisory agency, the agencies will need to coordinate their activities. Supervisors will need to find a means to achieve effective supervision of conglomerates while at the same time ensuring that they meet their responsibilities for their particular sector of the financial system. Where conglomerates are engaged in significant unregulated entities, the agencies will need to ensure that risks posed by those entities for the regulated entities are monitored.

Supervisory policies define an agency's expectations regarding the sound operation of financial institutions, and the manner in which the agency will exercise the authority granted to it in law. Supervisory procedures establish, in part, the process through which such policies will be implemented. The revision of policies and procedures should address the major supervisory functions, including authorizations, inspections, off-site analysis and enforcement. It is sound practice to put these policies and procedures in writing. The process of developing written policies and procedures will serve to ensure that agency staff have a common understanding of underlying objectives and principles. Written policies and procedures serve to ensure better communication, both within and outside the agency. They promote more fair and consistent supervision, and can enhance agency credibility.

Effective implementation of an agency's policies and procedures with respect to conglomerates will require a reassessment of its resources and the manner in which they are employed. Adjustments in the staffing mix may be required to support new tasks associated with conglomerate supervision. The agency's training program will need to promote the development and maintenance of the necessary skills. Compensation and benefits programs may need to be modified in order to be able to acquire and retain more highly-skilled staff. Similarly, the use of technology should be assessed and upgraded to ensure its adequacy in supporting supervisory analyses and activities (e.g. inspections), the efficient processing of supervisory reports, and the maintenance of the agency's management information systems.

Where more than one supervisory agency is involved in conglomerate supervision, explicit coordination mechanisms should be developed for routine supervisory activities such as authorizations, on-site inspections and off-site analysis. These mechanisms should provide for unencumbered communications between agencies' staff members responsible for supervision of the various component entities of conglomerates. The communications should include the agencies supervisory plans, and the results of supervisory activities (e.g. the results of financial analysis, conclusions drawn during inspections, and follow-up). The agencies need to stand ready to provide other information requested by other agencies. To facilitate information flows, the various supervisory agencies at least should ensure that one agency has been assigned responsibility for coordinating information flows with respect to each conglomerates. Agencies may wish to designate one agency to function more formally as lead supervisor, with responsibility not only for coordinating information flows, but also with specific decision-making authority regarding supervisory activities and enforcement actions.⁵⁵

Supervisory agencies need to establish early warning procedures to ensure that senior management of each agency is promptly informed of potential problems, such as a deterioration in the profitability, funding capacity or capital base of other group members. At a minimum, individual supervisory agencies should notify other agencies prior to taking enforcement actions that may impact other group members. Preferably, however, enforcement policies and procedures would be coordinated so that agencies' management can formulate an integrated response to actual or potential threats. Integrated responses are critical to achieving an acceptable balance between an agency's responsibility toward an individual regulated entity, and the need to avoid exacerbating solvency or liquidity difficulties in other group entities, particularly other regulated entities.⁵⁶

Where entities within the conglomerate are not regulated, supervisors will need to establish

⁵⁵Adequate information flows are critical to effective conglomerate supervision. The capacity of supervisors to obtain information regarding conglomerate activities, and to share information with other domestic (and foreign) supervisors, should be provided for under law. Existing legal provisions, most notably those relating to bank secrecy, should be reviewed to ensure they do not serve to constrain the flow of relevant information to and among supervisors. In addition, new legal provisions will likely need to be adopted to ensure that supervisors have the enforceable capacity to obtain information regarding unregulated group member entities, including industrial and commercial entities.

⁵⁶This might occur, for example, should an agency take unilateral action to require a regulated entity to reduce or its exposures to other group entities.

procedures to monitor the activities and finances of such group members and be prepared to respond when problems are detected that may have potential consequences for regulated entities. This responsibility poses a challenge for supervisors, in that they must gather sufficient information to be comfortable with their understanding of the risks posed by unregulated members, but avoid the potential moral hazard implicit in creating a public perception that the entity is in fact supervised. Supervisors may therefore find it most practical to require regulated entities to routinely provide necessary information regarding unregulated group members. Alternatively, the information can be obtained via the parent, or, if necessary, directly from the unregulated entity itself. Key information to be obtained is that which identifies the scope and scale of the business activities of unregulated members, as well as specific information regarding their capital base, funding composition and profitability. Information regarding the asset structure may also be important, especially regarding unregulated financial entities. Where conglomerates involve significant unregulated entities, at least one agency needs to have the clear responsibility for the conduct of group-wide monitoring.

I. Conclusion

The emergence of financial conglomerates creates both the need and the opportunity for the authorities to revamp their financial sector regulatory framework, and to reassess their approach to supervision. The latter may involve changes in the manner in which limited human and financial resources are organized and employed.

This paper has dealt extensively with the concept of "consolidation". This concept is operative on three different levels: prudential regulation, accounting and supervision. In some countries the relevant group for each purpose may be identical, but in others it will vary. The authorities need to find a means to apply prudential regulation to most or all the financial entities within the group, either by modifying existing regulations applicable to different types of financial institutions, or preferably, by adopting uniform regulations applicable equally to the relevant consolidated group, and individually to all types of institutions. An important advantage of uniform prudential regulations is that they can promote competition by establishing a more level-playing field among institutions and financial organizations. Group accounting consolidation is a prerequisite for the use of uniform prudential regulations, and serves to promote transparency by improving the information content of supervisory reports and public disclosures. The scope of consolidated supervision must be at least as great as that for prudential regulation and consolidated accounts. Often it will be applied more broadly, since it must include some form of risk assessment of all group entities, including unregulated financial institutions and entities engaged principally in commercial or industrial activities.

Authorization criteria will need to be adapted for the conglomerate context. Suitability standards for principal shareholders, key directors and managers, and external auditors will need to be applied on a group-wide basis when making decisions regarding new entrants and the expansion of existing institutions. Principal shareholders will need to be held to standards regarding their objectives and financial condition, and managers will need to be held to standards regarding their integrity and professional experience. The parties responsible for each regulated entity need to have sufficient autonomy within the group managerial structure so as to be able to fulfill their responsibilities toward the individual institution and its supervisors.

The implementation of an enhanced regulatory and supervisory framework is dependent on the effectiveness of the supervisors. To promote effectiveness, the authorities will need to

reassess the structure of the financial sector supervision function, and ensure that the responsible agencies coordinate their activities. At the agency level, supervisory policies and procedures will need to be modified. Policies affecting staffing, training, compensation, and the use of technology will need to be reassessed.

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