Supervision of Financial Conglomerates

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1. What is a financial conglomerate?
2. Why is supervision of financial conglomerates important?
4. How to supervise financial conglomerates.
5. Findings of the Financial Sector Assessment Program (FSAP) in relation to consolidated supervision.
Recent Developments in the Financial Sector Industry

Factors Fostering Conglomeration

- Search for efficiency (lower costs, reduced prices, improved innovation in products and services)
- Search for diversification of revenues and risk profiles
- Search for market power
Conglomeration among the largest 500 firms worldwide has increased both in terms of number of firms and assets held.

About 87 percent of conglomerates are led by banks.

The trend in conglomereration is global (industrialized and emerging market countries).

Mixed Groups, Financial Conglomerates and Banking Groups

- Mixed Group
  - Commercial firms
  - Industrial firms
  - Banking Institution

- Financial Conglomerate
  - Banking Institution
  - Securities Company
  - Insurance Firm

- Banking Group
  - Banking Institution
  - Financial Subsidiary

At least two types of intermediaries in the conglomerate
### Examples of Bank Led Financial Conglomerate

<table>
<thead>
<tr>
<th>Type A: Full Integration</th>
<th>Type B: Partial Integration</th>
<th>Type C: Partial Integration</th>
<th>Type D: Holding Company Structure</th>
</tr>
</thead>
<tbody>
<tr>
<td>Universal Bank</td>
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<td>Holding Company</td>
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<td>Bank and Securities</td>
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<td>Bank Securities</td>
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<td>Securities, Insurance</td>
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</tbody>
</table>

- Type A: Full Integration
- Type B: Partial Integration
- Type C: Partial Integration
- Type D: Holding Company Structure
2. Why is supervision of financial conglomerates important?
Potential Problems
Posed by Financial Conglomerate

- Double-leveraging of capital
- Loopholes and opportunities for regulatory arbitrage due to:
  - Inconsistencies in legislation across sectors
  - Different prudential rules and supervisory requirements across national jurisdictions
- Contagion from one subsidiary to the rest of the group
- Conflicts of interests
- Larger systemic risks
- “Solo supervision” alone is no longer effective
What is Financial Conglomerate Supervision?

“It is a comprehensive approach to banking supervision which seeks to evaluate the strength of an entire group, taking into account all the risks which may affect a bank, regardless of whether these risks are carried in the books of the bank or related entities.” (Bank of England, 1998).

Supervision of financial conglomerate is a complement to, not a substitute for, solo supervision.
3. International organizations’ core principles for supervision of financial conglomerates
International Organizations Involved in Supervision of Financial Conglomerates

- International Association of Insurance Supervisors (IAIS)
- International Organization of Securities Commission (IOSCO)
- Basel Committee on Banking Supervision

Joint Forum
Mandate of Joint Forum

- Conduct study of issues of common interest to banks, insurance companies, and securities firms (internal controls, outsourcing, corporate governance, etc.)
- Undertake work on risk assessments and capital (risk aggregation, operational risk, credit risk).
- Provide a forum for bank, insurance, and securities supervisors to share information on various issues.
- Conduct study of financial conglomerate and develop guidance and principles and/or identify best practices.
**Criteria to Assess Compliance with Best Practices on Supervision of Bank Led Financial Conglomerate**

### Basel Core Principles for Effective Banking Supervision

<table>
<thead>
<tr>
<th>Principle 20:</th>
<th>Principle 23</th>
<th>Principle 24</th>
<th>Principle 25:</th>
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</thead>
<tbody>
<tr>
<td>“An essential element of banking supervision is the ability of the supervisors to supervise the banking group on a consolidated basis.”</td>
<td>Requires home supervisor to practice consolidated supervision.</td>
<td>Requires home supervisor to contact and exchange information with other relevant supervisors.</td>
<td>Requires host supervisor to apply local standards to foreign banks, and have power to share information.</td>
</tr>
</tbody>
</table>

### Core Principles Methodology

Same Criteria for All Countries
Assessing Consolidated Supervision
Essential Criteria (BCP-20)

1. The supervisor is aware of the overall structure of banking organizations (i.e., the bank and its subsidiaries) or groups and has an understanding of the activities of all material parts of these groups, including those that are supervised directly by other agencies.
Assessing Consolidated Supervision

Essential Criteria (BCP-20)

2. The supervisor has a supervisory framework that evaluates the risks that non-banking activities conducted by a bank or banking group may pose to the bank or banking group.
Assessing Consolidated Supervision
Essential Criteria (BCP-20)

3. The supervisor has the legal authority to review the overall activities of a bank, whether the activities are conducted directly (including those conducted at overseas offices), or indirectly, through subsidiaries and affiliates of the bank.

4. There are no impediments to the direct or indirect supervision of all affiliates and subsidiaries of a banking organization.
Assessing Consolidated Supervision
Essential Criteria (BCP-20)

5. Laws or regulations establish, or the supervisor has the authority to impose, prudential standards on a consolidated basis for the banking organization. The supervisor uses its authority to establish prudential standards on a consolidated basis to cover such areas as capital adequacy, large exposures and lending limits.
Assessing Consolidated Supervision
Essential Criteria (BCP-20)

6. The supervisor collects consolidated financial information for each banking organization.
7. The supervisor has arrangements with functional regulators of individual business vehicles within the banking organization group, if material, to receive information on the financial condition and adequacy of risk management and controls of such business vehicles.
International Trends in Regulatory Structure

- **Multiple Supervisors (USA model)**
- **Partially Unified Supervisors (Mexican, Canadian and South African Models)**
- **Single Supervisor (UK and Singapore Models)**
## Institutional Arrangements for Financial Sector Supervision (as of 2003)

<table>
<thead>
<tr>
<th>Single Supervisor for all financial system</th>
<th>Agency supervising 2 types of fin. intern.</th>
<th>Multiple Supervisors (at least one for banks, one for securities firms and one for insurers)</th>
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<tbody>
<tr>
<td>1. Austria</td>
<td>25. Australia</td>
<td>47. Albania</td>
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<td>8. Gibraltar</td>
<td>32. Malaysia</td>
<td>54. China</td>
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<td>10. Iceland</td>
<td>34. Venezuela</td>
<td>56. Cyprus</td>
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<td>37. Mexico</td>
<td>59. France</td>
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<td>76. Tunisia</td>
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<td>77. Turkey</td>
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<td>78. USA</td>
</tr>
</tbody>
</table>
8. The supervisor has the authority to limit or circumscribe the range of activities the consolidated banking group may conduct and the overseas locations in which activities can be conducted; the supervisor uses this authority to determine that the activities are properly supervised and that the safety and soundness of the banking organization is not compromised.
Criteria to Assess the Effectiveness of Consolidated Supervision

Additional criteria

For those countries that allow corporate ownership of banking companies:

1. The supervisor has the authority to review the activities of parent companies and of companies affiliated with the parent companies, and utilizes the authority in practice to determine the safety and soundness of the bank;

2. The supervisor has the authority to take remedial actions, including ring-fencing, regarding parent companies and non-bank affiliates concerning matters that could impact the safety and soundness of the bank; and

3. The supervisor has the authority to establish and enforce fit and proper standards for owners and senior management of parent companies.
4. How to supervise financial conglomerates?
Consolidated Supervision

Key Components

1. Consolidation of Accounts
2. Consolidated Regulation (Quantitative)
   - Capital Adequacy
   - Limits to large exposures
   - Connected exposures
   - Market risks
3. Consolidated Supervision (Qualitative)
   - Overall risk management system (e.g. internal controls)
   - Changes in ownership structure
   - Ring-fencing
Scope of Consolidation of Banking Groups: Which Companies Need to be Consolidated?

CONSOLIDATION

Parent
(bank or financial firm)

Subsidiary
Subsidiary
Subsidiary
Subsidiary

Other
Other
Other
Other

NO - CONSOLIDATION

Subsidiary is not a financial institution

Parent or subsidiary have a participation of less than 20% in the ownership or capital of the firm
The examination of financial institution is conducted on a solo basis.

Each supervisor discusses its findings with its respective institution.

A lead supervisor is appointed.

The lead supervisor for financial conglomerates collects all relevant findings from other supervisors.
The lead supervisor reviews the minutes of meetings of various institution and management reports to identify potential issues.

The lead supervisor meets with individual institution’s shareholders auditors to discuss their audit results and “management letter”.

The lead supervisor summarizes the main findings to the management and BOD of the top company.
The lead supervisor coordinates with other supervisors to ensure deficiencies are addressed.

The lead supervisor communicates/shares information with other supervisors as part of ongoing monitoring of financial conglomerate.
Analysis of Results - Supervision of Financial Conglomerate

- At the completion of supervisory review, the supervisor needs to ask the following questions:
  - Has the review identified any potential systemic problems?
  - Has the review identified any emerging trend and/or issues that will have an impact on the financial conglomerate?
  - Are there any supervisory and/or regulatory gaps that needs to be addressed?
5. What are the main findings of the FSAPs in relation to consolidated supervision?
## Countries that Have Participated in the FSAP (as of December 2004)

<table>
<thead>
<tr>
<th>Region</th>
<th>Countries</th>
<th>No. of Countries</th>
</tr>
</thead>
<tbody>
<tr>
<td>Africa</td>
<td>Cameroon, Cote d Ivoire, Gabon, Ghana, Kenya, Mauritius, Mozambique, Nigeria, Senegal, South Africa, Tanzania, Uganda, Zambia</td>
<td>13</td>
</tr>
<tr>
<td>Asia</td>
<td>Bangladesh, Hong Kong, India, Japan, Korea, Philippines, Pakistan, Singapore, Sri Lanka, New Zealand,</td>
<td>10</td>
</tr>
<tr>
<td>Europe</td>
<td>Armenia, Bulgaria, Croatia, Czech Rep., Estonia, Finland, France, Georgia, Germany, Hungary, Iceland, Ireland, Kazakhstan, Kyrgyz Republic, Latvia, Lithuania, Luxemburg, Macedonia, Malta, Moldova, Netherlands, Poland, Romania, Russia, Slovak Republic, Slovenia, Sweden, Switzerland, Ukraine, United Kingdom</td>
<td>30</td>
</tr>
<tr>
<td>Americas</td>
<td>Barbados, Brazil, Canada, Chile, Colombia, Costa Rica, Dominican Republic, El Salvador, Guatemala, Honduras, Mexico, Nicaragua, Peru</td>
<td>13</td>
</tr>
<tr>
<td>Middle East</td>
<td>Algeria, Egypt, Iran, Israel, Jordan, Kuwait, Lebanon, Morocco, Oman, Tunisia, UAE, Yemen,</td>
<td>12</td>
</tr>
</tbody>
</table>

Total: 78 countries
Developing Country Compliance with Best Practices on Consolidated Supervision (BCP 20)

Based on information from 60 developing countries that have participated in the FSAP program between 1999 and 2004.
Weaknesses Observed in Countries Classified as non-Compliant or Materially non-Compliant

- **Weak legal basis for consolidated supervision**
  - Bank supervisor is not empowered to review the activity or financial reports of a bank affiliate, subsidiary or parent company in a holding company structure.
  - Banking law does not require banks to submit consolidated information.
  - Bank supervisor has only partial authority to conduct consolidated supervision (for instance, bank supervisor is empowered to collect information on a consolidated basis, but it can not impose prudential requirements on a consolidated basis).
Weaknesses Observed in Countries Classified as non-Compliant or Materially non-Compliant

- Inadequate framework and tools for assessing risks on a consolidated basis
  - There is no consolidated accounting
  - Bank supervisor has little understanding of the risks posed by non-bank activities.
  - Off-site surveillance is limited to financial statement collection and checking.
  - On-site inspections focus on compliance with laws and regulations.
  - Inadequate frequency of off-site monitoring of banking groups.
  - Lack of secondary regulation specifying rules for consolidation, as well as key prudential requirements for financial groups.
Weak institutional arrangements among supervisors

- There are no formal arrangements allowing cooperation and information-sharing among domestic supervisors (bank, securities and insurance).

- There are only ad-hoc arrangements between bank supervisor and its foreign counterparts (lack of MoUs).
Weaknesses Observed in Countries Classified as non-Compliant or Materially non-Compliant

- **Other**
  - **Ownership issues.** Lack of transparency in the ownership structure of a bank (supervisor is not required to approve changes in right of control of a bank, as stated in BCP 4).
  - **Ring-fencing.** No authority to limit or circumscribe the range of activities the banking group may conduct and the overseas location in which activities can be conducted.
  - **No authority over a bank’s parent company.** The Supervisor’s authority extends over a bank’s subsidiaries, but not over a bank’s parent company or any affiliates of the parent).
Financial conglomerates have increased rapidly in recent years.

Adequate supervision of conglomerates is important for systemic stability, given their size and scope of operations across the financial system.

Consolidated supervision is a complement, not a substitute, of solo supervision.

Consolidated supervision involves a set quantitative and qualitative parameters.

Coordination and information sharing among financial sector supervisors is crucial.
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