Financial Conglomerates Supervision

By

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I. Complexity of financial conglomerates

II. Issues in conglomerates supervision
   - Double gearing
   - Double leveraging
   - Holding Companies Supervision
   - Mixed Conglomerates Supervision

III. Conclusions
I. Complexity of financial conglomerates
“Heterogeneous financial conglomerates are conglomerates whose primary business is financial, whose regulated entities engage to a significant extent in at least two of the activities of banking, insurance and securities business and which are not subject to uniform capital adequacy requirements”

*Joint Forum on Financial Conglomerates (JF, 1999)*
We know how to supervise these ...
... but how to supervise this?
... and what about THIS ???
Challenges: Dimension & organization

⇒ Complicated legal and organizational structures

  - Difficult to understand and supervise (mix of regulated and unregulated entities)
  - Room for regulatory arbitrage (across sectors and across countries)
  - Lack of transparency

⇒ In many cases also “too-big-to-fail” (SIFIs)

  - Moral hazard
  - Regulatory capture
## Challenges: Diversity of activities and risk profiles

<table>
<thead>
<tr>
<th></th>
<th>Bank</th>
<th>Insurance</th>
<th>Securities</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Assets</strong></td>
<td>Customer loans, securities, interbank assets</td>
<td>Investment portfolio</td>
<td>Receivables secured by securities, financial instruments</td>
</tr>
<tr>
<td><strong>Liabilities</strong></td>
<td>Customer deposits, interbank liabilities</td>
<td>Technical provisions</td>
<td>Payables to customers</td>
</tr>
<tr>
<td><strong>Business time horizon</strong></td>
<td>Intermediate</td>
<td>Long (life), long or short (non life)</td>
<td>Short</td>
</tr>
<tr>
<td><strong>Main risks</strong></td>
<td>Credit risk, liquidity risk</td>
<td>Underwriting risk, investment risk</td>
<td>Market risk, liquidity risk</td>
</tr>
<tr>
<td><strong>Main risks transfer mechanisms</strong></td>
<td>Securitization, credit derivatives, OTC derivatives</td>
<td>Reinsurance</td>
<td>OTC derivatives</td>
</tr>
</tbody>
</table>
Challenges: Interconnectedness

- Corporate structures => multiple gearing of capital, excessive leveraging; risk of contagion
- Intra-group transactions => related parties exposures
- Common exposures to debtors/sectors => concentration
- Management processes => complexity; conflicts of interest
Synergies and conflicts of interest …

<table>
<thead>
<tr>
<th>Banks Require</th>
<th>Insurers Possess</th>
</tr>
</thead>
<tbody>
<tr>
<td>longer-term, stable funding (NSFR)</td>
<td>A need for long-term assets</td>
</tr>
<tr>
<td>higher quality, liquid assets (LCR)</td>
<td>High quality, liquid assets</td>
</tr>
<tr>
<td>more capital</td>
<td>capital</td>
</tr>
</tbody>
</table>

• Insurers and pension funds are increasingly being used as sources for liquid assets and as investors in banking and sovereign debt

• Insurers can hold a certain amount of illiquid assets and banking exposure, but too much is detrimental

• To have an overexposure to illiquid assets puts insurers in a very fragile financial state in case of a new financial downturn

• Internal governance becomes very important!
II. Issues in financial conglomerates supervision

• Double gearing
• Double leveraging
• Holding Company Supervision
• Mixed Conglomerates Supervision
The supervision pyramid

- **Conglomerates supervision**
  - Heterogeneous financial groups

- **Group sectoral supervision**
  - Homogeneous financial groups

- **Solo supervision**
  - (individual entities)
1. Supervisory powers and authority
2. Supervisory responsibility
3. Corporate governance
4. Capital adequacy and liquidity
5. Risk management
Assessing the capital adequacy at the conglomerate level

**Objective:** assess the group-wide capital adequacy

**Measurement techniques designed to:**

- detect and provide for double or multiple gearing

- detect and provide for excessive leverage

- consider effect of unregulated intermediate HCs
Double or multiple gearing

**double gearing**
- Where one entity holds capital issued by another in same group and issuer is allowed to count the capital in its own balance sheet
- External capital is geared up twice (parent and dependent)

**multiple gearing**
- Where the dependent in turn holds capital of a third tier entity

➤ Potential abuse - when dependents own capital of the parent, because capital stops being capital.
Illustration of multiple gearing

Samsung Group

Roundabout
Shareholdings in Samsung Group companies
2009, %

Lee family
46.0%

Everland
25.6% 13.3%

Samsung Card 26.4%

Samsung Electronics
35.3%

Samsung Life
7.2%

Source: Samsung
But also … other abusive “transfers”

Dexia

Holding Communal
(Dexia HC shareholder)

ARCO Group
(Dexia HC shareholder)

Dexia SA (Holding Company)

Dexia Bank Belgium
(fully owned bank subsidiary)

Capital injection

Loan

Loan
Double or multiple gearing

Guiding principles – capital assessment:

- assessments of group capital based on solo regulatory capital assessment can overstate the external capital of group

- only capital issued to external investors provides support to group

- assessments of group capital need to take account of intra-group holdings of regulatory capital of the affiliates
Double or multiple gearing

JF provides 3 alternative methods:

- the building block prudential approach
- the risk-based aggregation, and
- the risk-based deduction method (part of Basel)

In principle, the methods assess the group’s capital excess or deficit by summing up the capital requirements of each group entity and then subtracting intra-group holdings (See Case Study 1).
Double or multiple gearing

Possible regulatory arbitrage between sectoral rules (EU):

<table>
<thead>
<tr>
<th></th>
<th>Holdings in banks</th>
<th>Holdings in insurance companies</th>
</tr>
</thead>
<tbody>
<tr>
<td>Insurance company</td>
<td>Deduction if &gt; 20% of the held entity or, if less, in</td>
<td>Deduction if &gt; 20% of the held entity or, if less, in</td>
</tr>
<tr>
<td></td>
<td>case of <strong>durable link</strong></td>
<td>case of <strong>durable link</strong></td>
</tr>
<tr>
<td>Bank</td>
<td>Deduction if &gt; 10% of the held entity or, if less, the</td>
<td>Deduction if &gt; 20% of the held entity or, if less, in</td>
</tr>
<tr>
<td></td>
<td>total amount exceeding 10% of own funds of the holder</td>
<td>case of <strong>durable link</strong></td>
</tr>
</tbody>
</table>

The arbitrage: become an insurance holding company to avoid having to deduct the holding in a bank if holding is more than 10% and less than 20%.
Double or multiple gearing

Basel III treatment of participations:

1. **Uniform treatment** of participations across institutions

2. **Much stricter regime**
   - participations representing less than 10% of subsidiary capital, full deduction is required if the value in excess of 10% of own capital
   - participations representing more than 10% of the capital of the subsidiary full deduction is required
Double leverage (when is debt excessive?)

Where the parent issues debt and downstreams proceeds to dependant as equity/regulatory capital

• Risks:
  • Lower capital ultimately available at the conglomerate level to absorb losses (see Case Study 2)
  • Risk to bank, insurance firm, if parent has difficulty in servicing the debt (i.e. subsidiaries required to contribute dividends to overcome capital shortfalls at the parent level; in turn, financial difficulties at the holding company level may have negative implications for the subsidiary funding)
Holding companies supervision experience

- Formalized Bank and Financial Holding Company (BHC and FHC) Supervision – the US “effective” model

- Coordinator oversight model – the European model (the Capital Requirements Directive and the Financial Conglomerates Directive)

- Insurance group supervision – the “not so effective” US model

- Mixed conglomerates with insurance and other non-financial activities (Samsung)
Supervision of Holding Companies (US experience)

Bank Holding Companies Act (1956)

The principle of “umbrella supervision” = sufficient to enable the supervisor to form a view of the:

1. overall condition of the holding company (HC);
2. the potential for the holding company or its nonbank affiliates to have a material adverse impact on the subsidiary bank(s); and
3. the ability of the HC to support its bank(s) during periods of financial stress or adversity (“source of strength” doctrine).
Supervision of Holding Companies (US experience)

US requirements for bank holding companies (BHCs):

✓ **Submission of periodic financial reports** on the parent HC and the major nonbank affiliates;
✓ Receipt by the umbrella supervisor of **examination reports** prepared by the sectoral regulator of any regulated nonbank entity;
✓ **Inspections power by the umbrella supervisor** (the Federal Reserve) to **inspect** the parent company and any other nonbank affiliate;
✓ **Enforcement power** – (e.g., **cease and desist**) authority of the umbrella supervisor against the financial services HC and its affiliates.
Supervision of Holding Companies (US experience)

US requirements for BHCs II:

✓ Umbrella supervisor limits double leveraging by establishing a floor below which the capital available at the parent level to support the banking subsidiary(s) is not allowed to fall;
✓ “Non bank-like” subsidiaries, such as insurance companies or securities firms, would be “deconsolidated” and their capital deducted from the parent HC capital;
✓ Aggregate parent HC capital must be at least equal to the sum of the capital expected to be maintained in each subsidiary + the capital that is necessary to support parent risk-bearing activities.
Supervision of HCs (EU experience)

Example of possible *regulatory arbitrage* based on the group structure => certain supervisory tools are lost following acquisition in insurance sector…
Supervision of HCs (based on AIG structure)

Question: Who has the broad view???
Mixed conglomerates

Combination of **financial** and **non-financial** entities (commercial or industrial activities) within the same group:

- Complicates the determination of group-wide capital adequacy, and obscures the detection of double leveraging;
- Enables potentially harmful cross-funding;
- Introduces contagion risks from industrial or commercial activities spilling over onto regulated financial institutions;
- Creates a higher potential for general conflicts of interest;
- Makes it difficult to apply prudential and compliance rules.
Dealing with mixed-conglomerate groups

Proposed structure to enable effective supervision:

Separate financial and non-financial subgroups + “firewalls”
Dealing with mixed-conglomerate groups

Possible approaches to building “firewalls”:

- **A sliding capital approach** could be imposed at the level of the HC to increase the required capital allocated to the investment on a sliding scale
- **Passive ownership** of cross-holding equity exposures
- **Cap appointment of board members** to avoid potential conflicts of interest within inter-connected companies
- **A ladder of divestiture** could be required over a reasonable period of time for existing mixed financial – non-financial conglomerates.
III. Conclusions
Conclusions

- Financial conglomerates supervision is a process of continued discovery, assessment, and response:
  - Go beyond the formality of rules to identify and respond to risks!
  - Perform judicious exercise of judgment in interpreting situations based on substance, not form!

- Scope & depth of law/regulation: supervisory powers and tools are crucial to enable effective conglomerate supervision

- Be mindful of unintended consequences of regulations (across sectors and countries)
Questions?

Supervisor