THE SUPERVISION OF FINANCIAL CONGLOMERATES

**A REPORT BY THE
TRIPARTITE GROUP OF BANK, SECURITIES
AND INSURANCE REGULATORS**

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PREFACE

At the initiative of the Basle Committee on Banking Supervision (the Basle Committee), a Tripartite Group of bank, securities, and insurance regulators, acting in a personal capacity but drawing on their experience of supervising different types of financial institution, was formed in early 1993 to address a range of issues relating to the supervision of financial conglomerates. Some of these issues had been explored by regulators within their own industries but not hitherto from a cross-industry perspective.

The purpose of the ensuing report, which is now being published as a discussion document, is to identify problems which financial conglomerates pose for supervisors and to consider ways in which these problems might be overcome. The term "financial conglomerate" is used in the report to refer to "any group of companies under common control whose exclusive or predominant activities consist of providing significant services in at least two different financial sectors (banking, securities, insurance)". Although it is recognised that supervisory problems also arise in the case of "mixed conglomerates" offering not only financial services but also non-financial or commercial services, financial conglomerates are the primary focus of the report.

As the deregulation of domestic financial markets has progressed over the past decade in tandem with the growing internationalisation of markets, a notable development has been the emergence of corporate groups which provide a wide range of financial services, normally incorporating insurance and securities activities as well as traditional banking facilities. Such entities are increasingly becoming reality not only in the major financial centres but in many emerging markets too, and, moreover, many of them operate across a wide range of countries. The regulatory authorities have for several years recognised that the supervision of these entities poses particular problems and studies have been conducted by the bank, securities and insurance regulators to explore the issues from their own perspectives.

The present report represents the first time the issues have been addressed by three sets of supervisors, working together. The results of the work, which are summarised in an accompanying executive summary, show that considerable progress has been made in identifying broad areas of agreement between supervisors in the three disciplines. The report sets out a number of recommendations as to ways in which the supervision of financial conglomerates could be improved.

The three main areas to which the report suggests that supervisors' attention needs to be drawn are the following. First, in relation to capital adequacy (paragraphs 7 to 15 of the executive summary), the Tripartite Group has concluded that a desired group-wide perspective could be achieved either by adopting a consolidated type of supervision, as traditionally used by bank supervisors, or by a "solo-plus" approach, where the supervision of individual entities is complemented by a general qualitative assessment of the group as a whole, and, usually, by a quantitative group-wide assessment of the adequacy of capital. The qualitative approach would use information about the group companies to make a judgement about the risks which group companies pose for regulated entities and as a source for early warnings about problems elsewhere in the group. The appropriateness of consolidation or the "solo-plus" approach in a quantitative assessment may vary with the nature of the conglomerate. The report concludes that three techniques - the "building-block prudential approach" (which takes as its basis the consolidated accounts at the level of the parent company), a simple form of risk-based aggregation and risk-based deduction - are all capable of providing an accurate insight into the risks and capital coverage. A fourth possible technique, "total deduction", was also explored.

The second principal area of attention concerns the need for intensive cooperation between supervisors responsible for different entities within a conglomerate and the necessary exchange of prudential information between them (paragraph 22 of the executive summary). There is general support for the idea of appointing a lead supervisor or "convenor", who would be responsible for gathering such information as the individual supervisors require in order to have a perspective on the risks assumed by the group as a whole (including information on non-regulated entities). To this end, the report suggests it might be helpful to draw up Memoranda of Understanding or Protocols between the relevant supervisors.

The third principal issue concerns group structures (paragraph 20 of the executive summary). Experience has shown that supervision can be impeded by complex structures and the report expresses the Group's view that supervisors need powers to obtain adequate information regarding managerial and legal structure and, if necessary, to prohibit structures which impair adequate supervision.

Other issues which the report addresses include: contagion, in particular the effect of intra-group exposures (paragraphs 16-17 of the executive summary); large exposures at group level (paragraph 18); problems in applying a suitability test to shareholders and fit and proper tests to managers (paragraphs 19 and 21); rights of access to information about non-regulated entities within a conglomerate; supervisory arbitrage; and particular problems posed by mixed conglomerates engaged in both financial and non-financial activities (paragraphs 23-24).

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This report was sent to the Basle Committee, the Technical Committee of the International Organisation of Securities Commissions (IOSCO) and the International Association of Insurance Supervisors (IAIS) earlier this year. These three groups welcome the report as a valuable analysis of the issues and potential solutions to a supervisory challenge that is becoming increasingly relevant as financial markets become more integrated in the wake of progressive deregulation. Accordingly, it has been agreed that the report should be made available to supervisory colleagues in other countries, financial industry participants and the general public.

While the contents of the report have not been endorsed by the three groups, the three groups consider the report as a sound basis for further collaborative efforts.

In order to take work forward in what each regards as an important area, the Basle Committee, IOSCO and the IAIS have agreed to the establishment of a joint forum to develop practical working arrangements between the different supervisors of financial conglomerates for consideration by the three groups and their individual member authorities. The new group will be expected to propose improvements in cooperation and information exchanges between supervisors, and work towards developing the principles on which the future supervision of financial conglomerates would be based. The group will consist of a limited number of nominees from each of the three supervisory disciplines and will work under the present Chairmanship of the Tripartite Group, Mr. Tom de Swaan, Executive Director of de Nederlandsche Bank N.V.

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Executive Summary

Introduction

1. The deregulation of domestic financial markets over the past decade together with the internationalisation of financial markets has led to new ways and means of doing business in the highly competitive, integrated world economy of the 1980s and 1990s. One notable development has been the emergence of **financial conglomerates**, often with significantly large balance sheets (and off-balance-sheet positions), providing a wide range of financial services in a variety of geographic locations.

2. Over the past several years, a number of supervisory and regulatory groups within the international financial community have sought to explore the ways in which some of their concerns relating to the supervision of financial conglomerates could be addressed. Those groups have approached the subject from the perspective of a particular sector - the supervision of banks, or of securities firms, or of insurance companies. This report brings together the efforts of a Tripartite Group of bank, securities and insurance regulators, who are acting in a personal capacity but are able to draw on the experience of their respective institutions. The Tripartite Group was set up at the beginning of 1993 specifically to consider ways of improving the supervision of financial conglomerates.

Working definition

3. The Tripartite Group agreed that, for its purposes, the term "financial conglomerate" would be used to refer to "any group of companies under common control whose exclusive or predominant activities consist of providing significant services in at least two different financial sectors (banking, securities, insurance)". It was recognised that many of the problems encountered in the supervision of financial conglomerates would also arise in the case of "mixed conglomerates" offering not only financial services (perhaps restricted to just one of the three sectors mentioned above), but also non-financial or commercial services. However, the primary focus of this report is on financial conglomerates.

Present situation

4. The present situation with regard to the supervision of conglomerates was clarified through the medium of a questionnaire (Appendix II to this report analyses the responses). This provided valuable information on the types of financial conglomerates in existence and their different structural features, many of which are largely a reflection of

national laws and traditions. From the responses to the questionnaire, it was also possible to compare approaches to the overall supervision of financial conglomerates.

Identification of issues

5. Subsequently, building on previous work in other forums, the Tripartite Group identified a number of problems which financial conglomerates pose for supervisors, and discussed ways in which these problems might be overcome. Among the issues discussed were the overall approach to the supervision of financial conglomerates; the assessment of capital adequacy and ways of preventing double gearing; contagion, in particular the effect of intra-group exposures; large exposures at group level; problems in applying a suitability test to shareholders and a fitness and propriety test to managers; transparency of group structures; the exchange of prudential information between supervisors responsible for different entities within a conglomerate; rights of access to information about non-regulated entities; supervisory arbitrage; and mixed conglomerates..

Overall approach to supervision

6. The rapid growth of financial conglomerates which cut across the banking, securities and insurance sectors, raises questions as to whether the traditional approach to prudential supervision - whereby each supervisor monitors institutions in one constituency without much contact with supervisors responsible for other parts of the group - is still appropriate. Fundamentally, the Tripartite Group agreed that supervision of financial conglomerates cannot be effective if individual components of a group are supervised on a purely solo basis. The solo supervision of individual entities continues to be of primary importance, but it needs to be complemented by an assessment from a group-wide perspective.

Capital adequacy

7. Banks, insurance companies and securities firms are subject to different prudential requirements, and accordingly supervisors face a difficult problem in determining whether there is adequate capital coverage. The Tripartite Group discussed this issue in some depth and concluded that the desired group-wide perspective can be achieved either by adopting a consolidated type of supervision, or by a "solo-plus" approach to supervision.[1] For the purposes of this report, the following working definitions were agreed upon:

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1 Some members consider that a quantitative assessment of group-wide capital could be inappropriate if its usefulness in terms of improved risk assessment for a regulated entity would be less than its potential drawbacks in terms of moral hazard or real or apparent extension of a safety net to include affiliates of the regulated entity. This situation could arise, for example, if the regulated entity were very small

- **Consolidated supervision** - This supervisory approach focuses on the parent or holding company, although individual entities may (and the Tripartite Group advocates that they should) continue to be supervised on a solo basis according to the capital requirements of their respective regulators). In order to determine whether the group as a whole has adequate capital, the assets and liabilities of individual companies are consolidated; capital requirements are applied to the consolidated entity at the parent company level; and the result is compared with the parent's (or group's) capital.

- **Solo-plus supervision** - This supervisory approach focuses on individual group entities. Individual entities are supervised on a solo basis according to the capital requirements of their respective regulators. The solo supervision of individual entities is complemented by a general qualitative assessment of the group as a whole and, usually, by a quantitative group-wide assessment of the adequacy of capital. There are several ways in which this quantitative assessment can be carried out (see below).

8. Recognising the different starting points of the solo-plus and consolidated supervision approaches, the Tripartite Group discussed a range of techniques available to supervisors for making a quantitative assessment of capital adequacy in a financial conglomerate. The Group recognised the value of accounting-based consolidation (involving a comparison, on a single set of valuation principles, of total consolidated group assets and liabilities, and the application at parent level of capital adequacy rules to the consolidated figures) as an appropriate technique for assessing capital adequacy in **homogeneous groups**. This is the technique commonly used by bank supervisors in respect of banking groups; under European legislation, it is also a technique applied to groups made up of banks and securities companies.

9. As a means of applying accounting-based consolidation in respect of **heterogeneous groups**, the Tripartite Group considered a technique referred to as "**block capital adequacy**", which envisages the classification and aggregation of assets and liabilities according to the type of risk involved (rather than according to the institution to which they pertain), and the development of harmonised standards for assessing a conglomerate's capital

relative to the overall group, and there were strong legal restrictions on the relationships and nature of allowable business transactions between the regulated entity and its affiliates. In such cases, a quantitative assessment of capital adequacy for the overall group would have little value in assessing the risks for the regulated entity. If such an approach were construed as bringing the affiliates within the supervisory structure applicable to the regulated entity, the overall effect could be negative.

requirement. However, this technique was not thought to be a practical possibility for heterogeneous groups in the immediately foreseeable future.

10. Instead, the Tripartite Group concluded that three techniques - the "**building-block prudential approach**" (which takes as its basis the consolidated accounts at the level of the parent company), a simple form of **risk-based aggregation** and **risk-based deduction** - are all capable of providing an accurate insight into the risks and capital coverage. It is suggested that these three techniques might form the basis of a set of minimum ground rules for the assessment of capital adequacy in financial conglomerates and that some form of mutual recognition of their acceptability would be eminently desirable. The Group also agreed that "**total deduction**" might be recognised as a fourth technique, which deals effectively and conservatively with double gearing but one which does not in itself seek to provide a full picture of the risks being carried by the conglomerate. The type and structure of the conglomerate in question may determine which of these four techniques is most appropriate for supervisory use.

11. Detailed consideration was given to the way in which supervisors should regard a parent institution's participation of less than 100% in a financial subsidiary for the purposes of assessing group capital adequacy. It was agreed that simple minority shareholdings over which the group has neither control nor significant influence (i.e. less than 20% of the shares or voting rights owned) should not be taken into account for group capital adequacy purposes. They would normally simply be regarded as portfolio investments and would be treated by the parent's supervisor in accordance with the relevant solo rules. Only in exceptional circumstances would supervisors expect to integrate such shareholdings in an assessment of capital adequacy from a group perspective.

12. Where the group has what is deemed to be a "significant influence" (i.e. ownership of between 20% and 50% of the shares or voting rights) over a subsidiary undertaking, a pro-rata approach is advocated with regard to the inclusion of capital in the group-wide assessment. As far as subsidiary undertakings which are not wholly-owned, but over which the group has effective control (i.e. more than 50% of the shares or voting rights owned), are concerned, most members of the Tripartite Group agreed that the full extent of any deficit should be attributed to the group. However, there was less of a consensus as to the appropriate treatment for any capital surplus in such a subsidiary. Some members favoured attributing such surpluses in full to the parent group for capital adequacy purposes, while others considered a pro-rata approach to be more appropriate. A few members were inclined towards an asymmetric approach, under which any capital deficit would be attributed to the group in full but surpluses would only be attributed pro-rata.

13. The suitability and availability of capital surpluses for transfer from subsidiary to parent, and from one subsidiary to a sister company, were other issues considered by the Tripartite Group. The divergent definitions of capital from sector to sector, make it necessary for supervisors to examine both the distribution and structure of capital across a financial conglomerate in order to ensure that excess capital in one group entity, which is used to cover risks in another, is suitable for those purposes. The Group agreed that the simplest approach would be to assess the extent and nature of any excess in a dependant by reference to the capital requirements of that dependant; but to admit any excess for the purposes of the parent only to the extent that the excess capital elements are suitable according to the rules applied to the parent (or other regulated entity). The supervisors of the parent and the dependant would clearly need to liaise closely over the acceptability and admission of different forms of capital.

14. As far as availability is concerned, some members of the Tripartite Group, recognising various obstacles to the free movement of capital surpluses around a group, are in favour of applying a test before accepting that surpluses in individual group entities are available at parent/group level. Other members of the Group, however, view a financial conglomerate as a single economic unit and, from a "going concern" perspective, they are prepared to assume that capital surpluses in individual entities are available to the group as a whole. It did not prove possible to reach a consensus on this point.

15. A difficult problem occurs when a group includes substantial non-regulated entities, either at the ownership level or downstream. The Tripartite Group is of the view that, notwithstanding moral hazard, supervisors should be able to obtain prudential information about the unregulated entities in a group in order to supervise the regulated parts effectively, and to be able to conduct a group-based risk assessment. Most members of the Group take the view that unregulated entities whose activities are similar to those of regulated entities should be included in group-wide assessments of capital adequacy through the application of notional capital requirements derived from the analoguous regulated activity[2]. A small minority of the Group, on the other hand, have a preference for the establishment of qualitative standards aimed at the regulated entities (rather than notional capital requirements for the unregulated ones) wherever they appear in the group structure. Most members also advocate that unregulated holding companies at the top of the group structure and intermediate holding companies should be encompassed in the group-wide assessment of capital adequacy.

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2 In determining these notional needs, some supervisors might also refer to the requirements established by the market for firms to obtain high credit ratings and ready access to low cost funding.

Contagion

16. Contagion is recognised as one of the most important issues facing supervisors in relation to conglomerates. Psychological contagion - where problems in one part of a group are transferred to other parts by market reluctance to deal with a tainted group - is difficult for supervisors to guard against. However, contagion resulting from the existence of extensive intra-group exposures can, in principle, be contained and the Tripartite Group believes that, at the very minimum, it is essential for supervisors to be informed on a regular basis of the existence and nature of all such exposures.

Intra-group exposures

17. The Group takes the view that the potential problems of intra-group exposures are best tackled as an element of solo supervision, not least because the parent regulator's perspective is likely to be quite different from that of a subsidiary's regulator. Solo regulators should ensure that the pattern of activity and aggregate exposure between the regulated entity for which they are responsible and other group companies is not such that failure of another group company (or the mere existence of such intra-group transactions) will undermine the regulated entity. Solo supervisors also need to liaise closely with other group supervisors when uncertainties arise; they need powers to limit or prohibit intra-group exposures when necessary; and they should be particularly concerned about situations where funds are being invested by a subsidiary in securities issued by a parent, or are being deposited directly with a parent.

Large exposures at group level

18. Wide differences between the large exposure rules pertaining in the banking, securities and insurance sectors provide ample scope for regulatory arbitrage, and the differences are such that it is difficult to envisage the gaps being bridged in the foreseeable future. The Tripartite Group agreed that a combination of large exposures to the same counterparty in different parts of a conglomerate could be dangerous to the group as a whole and a group-wide perspective is therefore considered necessary. One practical way of proceeding might be to develop a system whereby the parent or lead regulator is furnished with sufficient information to enable him to assess major group-wide exposures to individual counterparties; this would provide valuable information on gross exposures. It might be possible to identify suitable "trigger points" of concern which, when reached, would trigger discussions on a case-by-case basis between the supervisors involved on the nature of any perceived problems and on any proposed action to be taken.

Fit and proper tests for managers

19. Most supervisors already have the power to check the fitness and propriety of the managers of the firms for which they are responsible. The problem facing supervisors in applying such tests is that, as the banking, insurance and securities businesses become more and more integrated, it is possible that decision-making processes will be shifted away from individually-regulated entities to the parent or holding company level of the structure, enabling managers of other (perhaps unregulated) companies in the group to exercise control over the regulated entity. Because of this, the Tripartite Group believes that, in applying the fit and proper test to managers, supervisors should be able "look through" a conglomerate's legal structure and focus on the people who are actually managing the supervised entity, regardless of exactly where they feature in the group's organigram.

Structure

20. The Tripartite Group is of the view that the way in which a conglomerate is structured is crucial to effective supervision. It believes that supervisors need powers, at both the authorisation stage and on a continuing basis, to obtain adequate information regarding managerial and legal structures, and, if necessary, to prohibit structures which impair adequate supervision. Where supervision is impaired, supervisors should be able to insist that financial conglomerates organise themselves in a way that makes adequate supervision possible.

Suitability of shareholders

21. The Tripartite Group is of the view that shareholders who have a stake in a financial conglomerate (enabling them to exert material influence on a regulated firm within it) should meet certain standards, and that supervisors should endeavour to ensure that this is the case by applying, on an objective basis, an appropriate test, both at the authorisation stage and on an ongoing basis. Responsibility for applying such a test clearly rests with the supervisors of individually regulated entities, but the Tripartite Group advocates close cooperation between supervisors and a sharing of information on shareholders in this respect.

Access to information

22. In the case of a financial conglomerate, intensive cooperation between supervisors is essential and supervisors should have the right to exchange prudential information. There was general support for the idea of appointing a lead supervisor or "convenor", who would be responsible for gathering such information as they require in order to have a perspective on the risks assumed by the group as a whole (including information on non-regulated entities). Using this data, a convenor would make an assessment of the capital adequacy of the group

and would also be responsible for ensuring that the supervisors of individual entities are made aware of any developments which might affect the financial viability of the group. In addition, when supervisory action involving more than one regulated entity is called for, the convenor would be responsible for the coordination of this action. This would not interfere with the power of the solo supervisor to obtain information regarding the group and to act individually when necessary. In all probability, the convenor would be the supervisor of the dominant operational business entity in a group. The Tripartite Group also believes that the precise role of the lead regulator or convenor, and indeed the responsibilities of all individual supervisors involved in financial conglomerate, could be defined and agreed upon effectively through the establishment of Memoranda of Understanding or Protocols between the relevant supervisors, particularly when a financial conglomerate has a complex structure. Where the relevant supervisors are located in the same country, however, more informal information sharing arrangements may be sufficient. External auditors are recognised as another valuable source of information for supervisors.

Mixed conglomerates

23. Although many of the problems associated with the supervision of financial conglomerates also arise in the case of "mixed conglomerates" (groups which are predominantly industrially or commercially oriented but contain at least one regulated financial entity), the latter also raise some rather different issues for supervisors and can demand a fundamentally different approach. For example, there are difficult issues to be tackled in ascertaining the suitability of the shareholders of the regulated entities and the fitness and propriety of the managers responsible for running the regulated businesses. Intra-group exposures are another problem area and it is essential that supervisors establish that such business is conducted at "arm's length" (i.e. at the terms prevailing in the market in general at the time). Clearly, there is scope for supervisory discretion in this area, but supervisors must be satisfied that, as a rule, intra-group business is not being conducted at rates or on terms which significantly differ from those prevailing generally[3].

24. At the heart of the problem with regard to mixed conglomerates is the difficulty for supervisors in assessing overall group capital adequacy because supervisory rules and practices cannot be extended to commercial and industrial entities in the same way as they can to non-regulated financial entities. The Tripartite Group believes that, ideally, supervisors should be able to insist on the establishment of an intermediate holding company to provide a

[3] It is recognised that, in certain circumstances, it might be perfectly reasonable to expect a parent to provide support at off-market conditions to its subsidiaries. Supervisory authorities might actually require such support on occasions.

legal separation of the regulated financial parts of a mixed conglomerate from the non-financial parts; this would enable supervision to be carried out in the same way as for other financial conglomerates.

Conclusion

25. In summary, considerable progress has been made in identifying broad areas of agreement between supervisors in the three disciplines and a number of recommendations have been made as to ways in which the supervision of financial conglomerates could be improved. However, any further progress that can be made by the Tripartite Group seems certain to be restricted by the informal nature of the group. It is hoped that this paper will provide a sound basis for any further work that may be undertaken in this regard.

I. Introduction

26. The deregulation of domestic financial markets over the past decade together with the globalisation of financial markets has led to new ways and means of doing business in the highly competitive, integrated world economy of the 1980s and 1990s. One notable development has been the emergence of the financial conglomerate, often with a significantly large balance sheet (and off balance sheet positions), providing a wide range of financial services in a variety of geographic locations.

27. Driving the structure of the financial conglomerate has been the effort to create an organisation which takes advantage of economies of scale and the synergies which exist between different financial sectors, an organisation with the ability to network a package of financial products and thus meet the requirements of a broader range of customers. By its sheer breadth, a financial conglomerate also offers a certain measure of diversification in terms of revenues and risk. The goal embodied in the emergence of financial conglomerates has been to improve the efficiency and effectiveness of a financial group by creating separate business areas for a variety of financial activities where each business can develop independently and yet where the opportunities for synergy constitute a long-term competitive benefit.

28. Many of the financial activities undertaken by financial conglomerates are subject to regulation, whether by bank, securities or insurance regulators. Often, even within a single jurisdiction, more than one regulator is involved. Moreover, because of the diverse locations in which these conglomerates operate, regulators in different countries are faced with the difficulty of having contact with and responsibility for only a part of any given conglomerate. Further complications arise where entities within a financial conglomerate undertake financial activities for which, in some countries, a licence may or may not be required, but which are not subject to any capital regulation. For example, financial activities such as leasing, reinsurance, consumer credit, bridge financing, custody operations and certain financial derivatives may be conducted outside regulated entities in many countries.

29. In view of the fact that their structures are frequently complex and their activities so wide-ranging geographically, financial conglomerates pose difficulties for regulators. If, for example, one of these conglomerates were to encounter financial problems, a large number of its customers (be they depositors, insurance policy holders, investors or other creditors) could be adversely affected on an international scale. There would also be implications for deposit and customer protection arrangements.

30. Thus, the question of how to grapple from a supervisory point of view with the growing trend in most countries towards financial conglomerates is increasingly important to bank, insurance and securities regulators and is likely to remain so for the foreseeable future. At the same time, it is clear that both within any single country and among countries there are considerable differences between insurance supervisors, bank regulators, and securities authorities in terms of their regulatory objectives, the scope of their powers, and the instruments at their disposal. These differences stem in part from the nature of the businesses they supervise, and in part from differing traditions, histories, accounting practices and legal frameworks. While these differences cannot be underestimated, there is nonetheless a common need for cooperation among supervisors if only because of the greater potential for risks inherent in financial conglomerates. In short, supervisors of all sectors across countries share a common objective as to the financial position and solvency of the institutions they oversee because the way in which these institutions interact can have implications for the financial system as a whole.

31. Over the past several years, a number of supervisory and regulatory groups within the international financial community have sought to explore the ways in which some of their concerns relating to the supervision of financial conglomerates could be addressed. Each of these groups has published a report looking at the subject from their own particular perspective. The groups include the Basle Committee on Banking Supervision,[4] the Working Group of the Conference of Insurance Supervisors of the European Economic Community,[5] the Technical Committee of the International Organisation of Securities Commissions (IOSCO),[6] the Banking Advisory Committee of the Commission of the European Communities[7] and the Insurance Committee of the Commission of the European Communities[8].

32. This report attempts to look at the subject of financial conglomerates from a joint perspective. It brings together the efforts of a Tripartite Group of bank, securities and

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4 Basle Committee on Banking Supervision, The supervision of financial conglomerates, text included in report number 8 on *International Developments in Banking Supervision*, September 1992.

5 Working Group of the Conference of Insurance Supervisors of the European Economic Community, *Financial conglomerates,* 9th April 1992.

6 International Organisations of Securities Commissions, *Principles for the supervision of financial conglomerates*, October 1992.

7 Banking Advisory Committee of the Commission of the European Communities, *Financial Conglomerates,* XV/1008/92-EN-Rev.1, 21st October 1992.

8 The Insurance Committee of the Commission of the European Communities: Financial Conglomerates XV/2009/93, 15th February 1994.

insurance regulators. This group was set up at the initiative of the Basle Committee at the beginning of 1993 to consider ways of improving the supervision of financial conglomerates. The Tripartite Group is an informal one with representatives (from each of the G-10 countries, from Luxembourg and from the EC Commission) having been invited to participate on an individual basis; broadly speaking, banking, securities and insurance are equally represented among the group's twenty-six members (see Appendix I). This report seeks to synthesise the views of the Tripartite Group with regard to the body of work that has already been published by representatives of the individual sectors; to distinguish the points of agreement; and, in so doing, to identify possible solutions to some of the problems involved in the supervision of financial conglomerates.

33. With a view to clarifying the position regarding the supervision of financial conglomerates, a specially designed questionnaire was completed by members of the Tripartite Group. Answers were provided on a country basis, involving the bank, securities and insurance supervisors in all countries represented on the group. In some cases, this meant that consultation was necessary with supervisors not directly represented. An analysis of responses to the questionnaire is attached to this report (Appendix II).

II. Description of financial conglomerates and their structures

34. Before turning to some of the specific issues involved in supervising a financial conglomerate, it is useful first to be clear as to what is meant by the term financial conglomerate and what kinds of structures a financial conglomerate may take.

(i) Definition

35. There are differing perceptions as to what exactly constitutes a financial conglomerate. To a large extent, these perceptions are dependent upon custom and practice in different countries, but they are also influenced by the existence, in some countries, of rules or laws governing, not only the ownership of banks, but also the activities in which banks can become involved. In the United States, for example, banks' involvement in securities business is generally limited to acting as principal and agent for government and certain public debt securities, as agent for sales of corporate securities, and for private placements. However, US banks underwrite and deal in securities outside the United States and through interpretations of the Glass-Steagall Act, banks have been allowed to engage in certain securities activities, and selected bank affiliates can engage domestically in corporate debt and equity underwriting and dealing. US law also prohibits banks from underwriting insurance and Federal and New York state laws prevent insurance companies owning commercial banks. There are, however, no prohibitions on the mixing of financial and commercial activities in a securities firm or insurance company conglomerate, and such mixing exists. On the other hand, in Switzerland, Italy, Germany, France, Luxembourg and the Netherlands, securities business is considered to be something of a "natural" banking activity which can be conducted within the legal entity of the bank or by a separate subsidiary within a financial conglomerate.

36. In considering the problems of supervising conglomerates, the Tripartite Group has for the purposes of its discussions drawn a distinction between "financial conglomerates" whose interests are exclusively, or predominantly, in financial activities and "mixed conglomerates" - those which are predominantly commercially or industrially oriented, but contain at least one regulated financial entity in some part of their corporate structure. The focus of this report is on the financial conglomerate, defined as "any group of companies under common control whose exclusive or predominant activities consist of providing significant services in at least two different financial sectors (banking, securities, insurance)". Such an entity is likely to combine businesses which are subject to different schemes of supervision and might also include financial activities which, in many countries, are not

conducted in an entity which is subject to solo prudential supervision (e.g. leasing, consumer credit, certain financial derivatives).

37. To date, prudential supervision of financial conglomerates has normally been based on separate supervision of each individual type of activity, i.e. by bank, insurance and securities regulators. In view of the increasing importance of financial conglomerates, however, this report discusses whether the traditional organisation, procedures and instruments of prudential supervision enable the objectives of the various supervisory authorities to be met. If they are not met, what new and additional tools should supervisors be given? Because financial conglomerates are often made up of entities coming under various jurisdictions and subject to differing supervisory regimes, cooperation among regulatory authorities both domestically and internationally will clearly be an important pre-requisite of any effort to improve the prudential supervision of financial conglomerates.

38. Although the Tripartite Group has focused its discussions on financial conglomerates, it recognises that mixed conglomerates exist widely and that in some countries outside the G-10 it is quite common for a financial institution to form part of a so-called industrial conglomerate. Moreover, some of the large European "universal" banks hold majority or minority participations in industry, engineering, travel, hotels or other non-financial activities (although, in Italy, the law incorporates a principle which separates banking from commerce). Accordingly, some time has been devoted to consideration of the more complex supervisory issues that inevitably arise in groups which are commercially or industrially oriented, but which also contain regulated financial entities; these issues are discussed in section "xiv" of the next chapter. At the same time, it is fair to say that many of the problems associated with the supervision of financial conglomerates would also arise in the case of mixed conglomerates and that most of the recommendations made in this paper could be applied both to financial conglomerates and to the financial elements of mixed conglomerates.

(ii) Structure

39. Among countries, no single structure of a financial conglomerate dominates. A financial conglomerate may have different structural features depending on national laws and traditions. More specifically, a financial conglomerate may be characterised primarily as a securities, an insurance or a banking structure. The character would be determined by the sector represented at the holding company level and/or by the type of activity that constitutes the major business of the conglomerate. Alternatively, a financial conglomerate may be comprised of businesses such that no one sector dominates the character of the entity.

40. For example, a financial conglomerate involved primarily with banking would typically be one in which the parent company is either itself a banking institution under supervision, or is a financial holding company whose most dominant subsidiary is an authorised credit institution. Smaller less important subsidiaries (of the parent and/or of the dominant subsidiary) would include securities firms and/or insurance companies. A financial conglomerate engaged primarily in insurance would typically be one in which the parent or dominant group entity is an insurance company which has a relatively small banking subsidiary (over which banking supervision can be exercised in the traditional way by the bank supervisor). There are a number of examples of financial conglomerates engaged primarily in securities in the United States , where major securities firms are owned by holding companies which are not subject to regulatory capital standards. Through the holding company and its subsidiaries, the conglomerate conducts regulated and unregulated financial and non-financial activities. The regulatory scheme is focused on the regulated securities firm with capital standards which prevent withdrawal of capital for use by the holding company or its affiliates except under severe constraints. This is bolstered by risk assessment rules (i.e. information on the activities of affiliates of the regulated firm). A financial conglomerate in which no one sector dominates would typically be one formed on the basis of a holding company with subsidiaries in the banking and/or insurance and/or securities fields.

III. Supervisory issues

41. There are a number of vexing problems involved in the oversight of financial conglomerates. Some of these problems are rooted in the traditions, legal structures, accounting practices, and histories of the various countries in which financial conglomerates do business; other problems arise because of the understandably different approaches adopted by supervisors in different disciplines. Insurance supervisors, for example, have historically been primarily concerned with the liabilities side of the balance sheet as the main source of risk, although assets are of course monitored too. Their counterparts in the banking sector regard the assets side of the balance sheet as the principal source of risk, although an examination of sources of funding is an important aspect of the supervisory process. For their part, securities supervisors require securities firms to have sufficient liquid assets to repay promptly all liabilities at any time. On the one hand, it is clear that, from the standpoint of supervision, the scope for potential problems increases due to the web of financial inter-relationships that characterise financial conglomerates, particularly when the conglomerate is comprised of entities whose activities span a number of financial markets. At the same time, however, it is also possible for supervisory problems to be reduced in a financial conglomerate due to an improvement in the spreading of risk and an increase in financial solidity.

(i) Overall approach to supervision

42. The rapid growth of financial conglomerates which cut across the banking, securities and insurance sectors, raises questions as to whether the traditional approach to prudential supervision - whereby each supervisor monitors institutions in one constituency without much contact with supervisors responsible for other parts of the group - is still appropriate. The Tripartite Group very quickly came to the unanimous view that, while the solo supervision of individually regulated entities should continue to be the foundation for effective supervision, there is a need for the various supervisors to establish a coordinated approach to supervision so that a prudential assessment can also be made from a group-wide perspective. This is essential in order to provide supervisors with a realistic insight into a group's risks and the respective capital coverage; it also enables supervisors to prevent, or at least to assess the extent of, any excessive or double gearing.

(ii) Assessment of capital adequacy

43. Because banks, insurance companies and securities firms are subject to different prudential requirements, supervisors face a fundamental problem in determining whether there is adequate capital coverage in a financial conglomerate. The Tripartite Group discussed

this issue in some depth and concluded that the desired group-wide perspective can be achieved either by adopting a consolidated type of supervision, or by a "solo-plus" approach to supervision.[9] For the purposes of this report, the following working definitions were agreed upon:

- **Consolidated supervision** - This supervisory approach focuses on the parent or holding company, although individual entities may (and the Tripartite Group advocates that they should) continue to be supervised on a solo basis according to the capital requirements of their respective regulators). In order to determine whether the group as a whole has adequate capital, the assets and liabilities of individual companies are consolidated; capital requirements are applied to the consolidated entity at the parent company level; and the result is compared with the parent's (or group's) capital.

- **Solo-plus supervision** - This supervisory approach focuses on individual group entities. Individual entities are supervised on a solo basis according to the capital requirements of their respective regulators. The solo supervision of individual entities is complemented by a general qualitative assessment of the group as a whole and, usually, by a quantitative group-wide assessment of the adequacy of capital. There are several ways in which this quantitative assessment can be carried out.

44. Because of its importance with respect to the supervision of financial conglomerates, the assessment of capital adequacy was singled out for further study and the results of that study are discussed in detail in the next chapter. However, a section dealing with the supervisory issues posed by conglomerates would not be complete without a reference to the fact that it is possible for all entities in a group to fulfil their capital requirements on an individual basis, but for the own funds of the group as a whole to be less than the sum of those requirements. Such a situation occurs where the same own funds are used simultaneously as a buffer more than once - i.e. to cover the capital requirements of the parent company as well as those of a subsidiary (and possibly also those of a subsidiary of a subsidiary). This dual or multiple use of the same capital in several members of a financial

9 Some members consider that a quantitative assessment of group-wide capital could be inappropriate if its usefulness in terms of improved risk assessment for a regulated entity would be less than its potential drawbacks in terms of moral hazard or real or apparent extension of a safety net to include affiliates of the regulated entity. This situation could arise, for example, if the regulated entity were very small relative to the overall group, and there were strong legal restrictions on the relationships and nature of allowable business transactions between the regulated entity and its affiliates. In such cases, a quantitative assessment of capital adequacy for the overall group would have little value in assessing the risks for the regulated entity. If such an approach were construed as bringing the affiliates within the supervisory structure applicable to the regulated entity, the overall effect could be negative.

conglomerate is often referred to as "double gearing" or "excessive gearing"; it can lead to the under capitalisation of the group.

45. The term "excessive gearing" can also be used to describe two other problems faced by supervisors with regard to the application of capital within a financial conglomerate. The first of these relates to the situation where a parent issues debt and downstreams the proceeds as equity; the need to remunerate the debt could be a source of financial stress to the subsidiary or to the group as a whole. "Excessive gearing" is also said to occur when a group has sufficient capital to support its regulated activities, but the size and nature of its unregulated activities is such as to make overall capital adequacy doubtful. If the parent is itself unregulated, it is particularly important that supervisors have adequate control over the release of equity capital from the authorised entity. Unregulated entities in general are a source of complication for supervisors in their endeavours to assess capital adequacy within a financial conglomerate and due consideration is given to the difficulties they raise in the ensuing chapter.

46. Another problem facing supervisors trying to ascertain the capital adequacy of a financial conglomerate is that, because of the different definitions of capital which apply across the various supervisory sectors, it is unlikely to be sufficient merely to ensure that there is adequate capital. An analysis of the distribution of that capital also seems to be necessary in order to be satisfied that risks are covered by the right sort of capital. Similarly, many supervisors believe that they need to be satisfied about the availability of that capital to the supervised entity. These aspects are also covered in detail in the next chapter.

(iii) Contagion

47. Contagion entails the risk that financial difficulties encountered by a conglomerate's individual elements could have an adverse impact on the financial stability of the group as a whole and possibly even on the markets in which the constituent parts operate. Contagion thus relates to the danger that, if certain parts of a conglomerate are experiencing financial difficulties, they may infect other healthy parts of the conglomerate as a result of which the operation of the healthy parts may be hampered or even made impossible. Regulators need to be aware of the threat of contagion, and close monitoring of the relationship between regulated entities and the rest of the companies comprising the conglomerate is of paramount importance in this respect.

48. This is probably one of the most important issues facing supervisors in relation to financial conglomerates because the increasing complexity of financial groups means that there could be a higher risk of contagion. Although conglomeration offers advantages in

terms of greater financial capacity and wider diversification of activities, there are also some disadvantages. Problems arising in one part of a conglomerate can and do infect other group companies, including regulated companies; moreover, these problems can spread even if the other companies are financially very sound.

49. The Tripartite Group has identified two distinct types of contagion. The first of these is essentially psychological, where problems associated with one part of a conglomerate are transferred to other parts merely by market reluctance to deal with a tainted group. The risk of this type of contagion is particularly acute for those institutions which depend on market confidence either for funding or for trading purposes. For example, the question for banks would be the extent to which depositors' funds would be perceived to be at risk if another member of the financial group of which it was a part encountered financial difficulties. Supervisors need to be aware of institutions likely to encounter liquidity problems if weaknesses become apparent in supervised or unsupervised entities in the same group. Whatever means a bank employs to distance itself from a troubled affiliate, there is a risk that its good name could suffer and it could feel compelled to protect itself. In the case of insurance companies, the question would relate to the extent to which payments under insurance policies (including any bonuses dependent on company investment performance) are perceived to be threatened by problems in another part of the same group. It is therefore essential that supervisors monitor the extent to which each supervised institution in a conglomerate is exposed to this type of contagion risk.

50. The second type of contagion identified by the Tripartite Group relates to the existence of intra-group exposures. The circumstances under which such exposures can create risks for a regulated entity within a financial conglomerate will depend on the size and the nature of the exposures involved as well as on the financial strength of the group of companies to which the regulated entity is exposed. Experience has shown that intra-group exposures can significantly exacerbate problems for a regulated entity once contagion spreads to it. The problems caused by intra-group exposures and ways in which supervisors might seek to alleviate these problems are discussed in more detail in the next section of this chapter.

51. It has been suggested by some that one way of counteracting contagion risk resulting from intra-group exposures would be to establish a system of firewalls preventing regulated entities within a conglomerate from helping other entities in the same conglomerate if the provision of such help resulted in the provider being in breach of its capital requirements. The capital standards applied by some securities regulators, for example, are designed to insulate firms and, if necessary, to allow them to be wound down in an orderly and timely way without loss to customers and counterparties; this approach has worked well

for securities firms in the United States. However, these firms are less likely to fail as a result of a withdrawal of credit lines because their balance sheets are highly liquid; moreover, there is no predisposition within a securities conglomerate to prop up each individual entity. Many banking groups, on the other hand, are very sensitive to market funding and experience has shown that, whenever difficulties arise in one part of a banking conglomerate, the psychology of the market is such that participants are quick to withdraw or to lower credit lines from other entities in the same group. For this reason, banking groups may be prepared to go to considerable lengths to prevent the failure of any entity bearing the banking name.

(iv) Intra-group exposures

52. Intra-group exposures take the form of an often complex web of direct and indirect claims which entities within financial conglomerates typically hold on each other. The most transparent form of intra-group exposure is a credit or a line of credit which either the parent grants to a subsidiary or one subsidiary makes available to another subsidiary. Intra-group exposures, however, can originate in a variety of other ways: for example, through (a) intra-group cross shareholdings; (b) trading operations whereby one group company deals with or on behalf of another group company; (c) central management of short-term liquidity within the conglomerate; (d) guarantees and commitments provided to or received from other companies in the group; and (e) the provision of such services as pension arrangements.

53. Intra-group exposures can have implications for both liquidity and the overall solvency of a conglomerate, connected to contagion risks. For example, if a life insurance company is placing its premiums on deposit with its own parent bank, this is not necessarily obvious to the supervisors. Such risks make it important for all regulators with responsibility for some part of a financial conglomerate to monitor carefully the intra-group exposures (both on and off-balance-sheet) of the entities they regulate; it may also be desirable for them to be aware of the level of intra-group exposures within the financial conglomerate more generally. The Tripartite Group believes it to be important for regulators to be made aware in specific terms of the purpose of any intra-group exposures, whether they are long or short-term in nature, whether they are self liquidating, and whether they are likely to be repeated or rolled over. Regulators in turn must seek to ensure that capital is increased or activities are limited if the risk which other companies pose to the regulated entity appear to be unacceptable.

54. The Tripartite Group considered the following questions:

- what types of intra-group exposures are relevant in the supervision of financial conglomerates?
- how can such exposures be detected and monitored by supervisors?

- how readily do the supervisory approaches listed earlier in this paper address these problems? Are qualitative as well as quantitative methods needed?
- what limits, if any, should be applied - and if so, how?

55. There was widespread agreement that all types of intra-group exposure are in principle relevant to the supervision of financial conglomerates. Intra-group exposures are considered to be particularly important for the following reasons:

- They determine the scope of the potential impact of contagion on individual entities and hence on the effectiveness of solo supervision;
- They affect not only the solvency, but also the liquidity and the profitability of a group;
- They can be used as a means of supervisory arbitrage or of evading capital requirements altogether.

56. What sets intra-group exposures apart from exposures to third parties in the context of a financial conglomerate is that they will not necessarily be apparent to supervisors examining a consolidated balance sheet of the group as a whole (because the intra-group exposures will be netted out). Asset and liability exposures are likely to be equally relevant in this respect since they are both capable of causing contagion. Another important difference between intra-group exposures and exposures to third parties is that the former may be created on terms or under circumstances which parties operating at arms' length would not countenance.

57. It was felt that the least obtrusive way of detecting and monitoring most intra-group exposures would be to set aside parts of routine reporting forms and routine regulatory meetings (between the regulator and the regulated entity) for an analysis of intra-group transactions. Data on the following were considered to be particularly important:

- gross commitments;
- amount, nature and residual maturity of the commitments;
- the profits and losses associated with intra-group transactions;
- confirmation that business is being conducted at market terms/conditions.

58. Where non-equity resources are upstreamed from a regulated subsidiary to the parent, it has been suggested that reporting requirements need to be complemented by capital standards which deal adequately with the resource transfer. The straightforward deduction from a subsidiary's capital of any amounts upstreamed to the parent was suggested as one way of ensuring the subsidiary's stability. Some members of the Tripartite Group viewed this as a particularly harsh penalty, but it really does no more than eliminate intra-group exposures; certain techniques for assessing capital adequacy in financial conglomerates would do this

automatically (e.g. accounting-based consolidation and the building block prudential approach - see chapter IV). Other demanding measures which supervisors might take in appropriate circumstances would be to give limited value to intra-group assets if there is any doubt about the financial status of the other group company or potential realisation problems. Alternatively, limits could be imposed on the amounts of additional intra-group exposure that a company could take on; or it could be prohibited from any further intra-group exposure.

59. Although the various techniques for assessing capital adequacy in financial conglomerates (see next chapter) take account of the equity investments and other intra-group exposures inside a group in assessing overall solvency and identifying instances of double gearing, they are essentially quantitative techniques. They do not include any analysis of intra-group non-equity commitments and of the likelihood that these could give rise to contagion. Additional qualitative techniques are considered necessary in order to assess the particular risks associated with such intra-group exposures (e.g. the recoverability of amounts due from group companies which may be in other jurisdictions).

60. The Tripartite Group takes the view that consideration of the potential problems of intra-group exposures is best tackled as an element of solo supervision, not least because the parent regulator's perspective is likely to be quite different from that of a subsidiary's regulator. From the point of view of the parent regulator, loans, guarantees and holdings of securities issued by the subsidiary add to the risk represented by the participation. This additional risk exposure is particularly relevant in the case of minority participations, where the parent's responsibility for the subsidiary and for classical exposures, such as guarantees and loans, takes on relatively more importance. From the subsidiary regulator's perspective, however, it is the risk of a resource transfer to the parent company which is of most concern. In an extreme case, the net transfer of resources from the parent to a subsidiary may be reversed if the subsidiary upstreams capital in the form of loans to the parent or the purchase of securities issued by the parent. Trading exposures could, of course, have the same effect. Parent and subsidiary regulators alike should be concerned with the purchase by a subsidiary of shares in its parent institution, and with the existence of extensive cross-holdings by sister companies within a group.

61. Insurance regulators face an additional problem in the form of intra-group transactions with reinsurance companies because the reinsurance transaction reduces the risk to the insurance company by transferring it to another part of the group. However, if the reinsurance company is not included in the group-wide risk assessment - as is the case in some jurisdictions where reinsurance is not regulated - the group's risk will be underestimated.

62. The Tripartite Group agreed that intra-group exposures are a potential source of contagion between regulated (and unregulated) entities within a financial conglomerate. Solo supervisors (at both subsidiary and parent level) need to monitor carefully the extent of such exposures, including exposures to similar but unregulated businesses (e.g. in some countries, factoring, leasing and reinsurance). Within a framework of prudent principles the exercise of regulatory judgement on a case-by-case basis is called for.

63. First and foremost, regulators need information about all types of intra-group exposure. Solo regulators should then ensure that the pattern of activity and aggregate exposure between the regulated entity for which they are responsible and other group companies is not such that failure of another group company (or the mere existence of such intra-group transactions) will undermine the regulated entity. Solo supervisors need to liaise closely with other group supervisors when uncertainties arise; they need powers to limit or prohibit intra-group exposures when necessary; and they should be particularly concerned about situations where funds are being invested by a subsidiary in securities issued by a parent, or are being deposited directly with a parent.

(v) Large exposures at group level

64. Credit institutions are typically subject to requirements which limit their exposures to an individual client or group of connected clients, normally on both a solo and a consolidated basis. In the European Union, for example, credit institutions may not incur an exposure to a client or group of connected clients[10] the value of which exceeds 25% of its own funds. In contrast, insurance undertakings typically have to comply with asset diversification rules, or risk-based capital incentives directed towards asset diversification. In Europe, insurance companies may not hold more than specified percentages of the assets covering their technical provisions in exposures to various types of counterparty, the percentages varying according to the perceived riskiness of the counterparty. In the US insurance industry, counterparty exposure in general is limited, the precise treatment depending on the weightings given to different types of asset under the risk-based capital approach. Except in the United States, the United Kingdom, Canada and Germany, however, there are no limits operating in respect of insurance companies' free assets (those not required

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10 The European Union Large Exposures Directive defines a group of connected clients as:

- 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.

to cover the technical provisions) and diversification rules applied to assets backing the technical reserves are not based on capital or own funds. In non-life companies, it is quite common for free assets to amount to as much as 50% of the assets covering the technical provisions. This means that, in theory at least, it is possible for an insurance company to invest more than 100% of its own funds in one counterparty. Securities firms generally are subject to increased capital charges if they have concentrated or illiquid positions. For example, the US Securities and Exchange Commission's (SEC) capital standard provides that, if a firm holds a particular security that exceeds 10% of its liquid capital (capital after deductions for illiquid assets, but before risk-based deductions for securities positions), it must take an additional capital charge on the excess. The SEC standard also stipulates that, if a security does not have a ready market, it receives no value for capital purposes.

65. Although these approaches are well tested from a prudential perspective in the individual sectors, they differ considerably and, from a bank supervisor's perspective, there is arguably a very strong case for the application of large exposure rules on a group-wide basis in order to prevent regulatory arbitrage taking place among banking, securities and insurance undertakings within the same group. The following questions were considered by the Tripartite Group:

- How serious a problem is this seen as being?
- Are solutions readily available within the framework of options for assessing capital adequacy?
- Is it possible for individual entities within a financial conglomerate to meet the requirements of their respective regulators with regard to large exposures, but for the overall level of exposure to an individual counterparty (or group of connected counterparties) to be a matter of concern for regulators? If so, how is the "level of concern" (the limit?) to be determined?
- To what extent are common rules needed in relation to financial conglomerates?

66. As evidenced by the more stringent rules applying to large exposures as such in the banking sector as opposed to the insurance sector, large exposures are of more concern to bank regulators than to insurance supervisors and they are a particular problem for groups involving both banks and insurance companies. As indicated above, in many cases insurance regulators' asset diversification rules are not linked to the quantum of capital, so it is in theory possible for insurance companies to have exposures exceeding their capital to a single counterparty. It is therefore conceivable that the overall exposure to a single counterparty of a group involving a bank parent and an insurance subsidiary could exceed that deemed to be prudent by the parent's regulator (even though the bank parent and the insurance subsidiary each comply with their respective solo limits/rules). Where the bank's share of the insurance

subsidiary implies a high degree of responsibility, it is suggested that the parent's regulator could not ignore such a concentration of exposure.

67. Take the simple case of a bank parent with a capital of 100, a large exposure to a third party of 25 (i.e. at the solo limit), a 75% participation in an insurance company with an overall capital of 50 and an exposure to the same counterparty of 100. Pro-rata consolidation/aggregation yields an exposure at group level of 100% of group capital, but if the bank's responsibility is considered to be higher than that reflected by its share, the counterparty exposure is larger than the group's capital. If, however, the insurance company is the parent and the bank is the subsidiary, application of the insurance regulator's diversification rules at group level would not reveal an overexposure because the bank's exposure is not part of the assets backing the technical provisions. Nevertheless, the group's overall exposure to that counterparty is the same as in the first example. The difference in the regulatory treatment is sometimes explained by the different nature of banks' and insurance companies' assets, and by the ability of insurers substantially to match assets to liabilities both as regards investment risk and timing risk. However, it is arguable that losses from the worst cases of counterparty failure can only be contained by limiting counterparty exposure to the institutions own funds.

68. The above example tends to douse one suggestion which was considered by the Tripartite Group, viz. that the large exposure rules of a parent's regulator should be applied to the group as a whole. Some members wondered whether there was any scope for applying normal insurance rules to insurance assets (or only to those assets covering technical provisions), and banking/securities rules to all other assets (i.e. the free assets). However, it would be difficult to justify one set of rules for insurance companies which were part of a conglomerate and another set for those which were not, and application of a banking risk control mechanism across the whole insurance industry would be something of a quantum leap. Moreover, although such a change would undoubtedly bring the rules in the two industries closer together, it may not be sufficient to allay the concerns of bank supervisors because technical provisions account for such a large proportion of the balance sheet, particularly in life assurance companies.

69. Another idea to emerge from the Tripartite Group's discussions was the possibility of extending the insurance industry's diversification requirements so that they applied to all assets (including free assets). This would have the merit of ensuring that large exposure rules applied to all insurance sector assets, albeit different rules from those applying in the banking sector. This is essentially a matter which insurance supervisors might wish to pursue at international level.

70. It was concluded that, although the wide difference between the rules pertaining in the banking and insurance industries provided ample scope for regulatory arbitrage, the heterogeneity of the rules was indicative of how difficult it is likely to be to reach agreement on any harmonised rules.

71. The Tripartite Group, however, agreed that a combination of large exposures to the same counterparty in different parts of a conglomerate can be dangerous to the group as a whole. Notwithstanding the discrepancies between different regulatory requirements, the Group therefore sees a need for a group-wide perspective as well as the application of individual large exposure rules to regulated entities[11]. One practical way of proceeding might be to develop a system whereby the parent or lead regulator is furnished with sufficient information to enable him to assess major group-wide exposures to individual counterparties; this would provide valuable information on gross large exposures. For example, all gross exposures to a counterparty or group of connected counterparties which amount to 10% or more of an individual entity's own funds (which would be in line with the requirements of the EU Large Exposures Directive for credit institutions) could be reported by that entity's regulator to the parent or lead regulator; alternatively, a parent (bank) regulator could require large exposure information to be collected on a consolidated or "look through" basis for the parent company and all its subsidiaries taken together. Whether such exposures were a matter of concern would depend on their actual size and distribution, and on the extent to which reductions in the value of assets would be offset by reductions in the value of liabilities. Importantly, it may also be dependent upon whether the parent or lead regulator is from the banking, securities or insurance sector although it would seem reasonable to assume (and the Tripartite Group strongly advocates) that there should be a close liaison between the parent or lead supervisor and other group supervisors. With the benefit of some research, it might be possible to identify suitable large exposure "trigger points" of concern from an individual supervisory perspective. "Trigger points", it is felt, could be of particular importance in groups where the parent is, say, an insurance company with a banking subsidiary. When these "trigger points" are reached, the supervisors involved could discuss the nature of any perceived problems and agree upon an appropriate course of action on a case-by-case basis.

72. It is acknowledged, however, that identification of appropriate "trigger points" across the range of supervisory disciplines and different types of conglomerate is a task that should not be underestimated. Moreover, a system which is dependent upon reporting has the significant drawback of imposing an additional burden on regulated entities. This burden

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11 Reinsurance companies also need to be included in the consideration of a group's large exposures. Where reinsurance companies are not directly supervised, particular account needs to be taken of their exposures within the overall group perspective.

could be reduced by using a higher "trigger point" for large exposure reporting in respect of financial conglomerates as a whole, but, at the end of the day, reports can only provide a snapshot of large exposures on a given date. Since exposures are likely to vary considerably over time, it is felt that supervisors also need to encourage financial conglomerates to put in place an internal system for tracking group exposures and limiting excessive exposures to a single counterparty. Supervisors adopting an on-site approach to supervision could use the examination process for this purpose.

(vi) Conflicts of interest

73. Conflicts of interest can arise when one unit in a conglomerate, such as a bank, lends to a non-bank parent or to another entity within the group; or where an insurer is required to place money within the group rather than investing more widely in other more appropriate assets. In these circumstances, there is a danger that the bank (or insurer) will make its lending (or investment) decisions outside the usual approval processes and that these decisions may result from, or lead to, conflicts of interest. This danger can be particularly acute in a loosely structured financial conglomerate and in conglomerates where matrix management is practised (i.e. where lines of accountability are organised on a functional basis spanning a number of different corporate entities, in contrast to a pyramid structure within each corporate entity).

74. The potential for conflicts of interest in a financial conglomerate is heightened when investors with substantial holdings in the conglomerate have contractual relationships with businesses in the group. In many financial conglomerates - although not necessarily confined to them - there is a distinct possibility that shareholders' interests may conflict with the interests of creditors, particularly those whom the supervisor has a duty to protect.

(vii) Fit and proper tests for managers

75. Most supervisors already have the power to check the fitness and propriety of the managers of the firms for which they are responsible. However, managers of other companies in the conglomerate, generally upstream from the regulated entity, may be able to exercise control, either directly or indirectly, over many aspects of the regulated firm's business. In particular, some supervisors harbour concerns that, as the banking, securities and insurance industries become more integrated, so the decision-making processes within a financial conglomerate could be shifted away from the individually regulated entities themselves to the parent or holding company at the top of the group structure. Group management at parent or holding company level can play a key role not only in devising the strategic objectives of a group but also in controlling the risks carried by the individual companies throughout a group. It would not be inconceivable for management at holding company level to influence

policy in such a way that it became difficult for a supervised entity to comply with supervisory requirements or to maintain supervisory standards.

76. The Tripartite Group has no wish to usurp the prerogative of boards of directors to make key management changes at group level. However, supervisors have a responsibility to ensure that management of supervised entities is carried out by people whom they regard as fit and proper. If management is undertaken by people who are not in fact part of the supervised entity[12], there would seem to be a strong case for giving supervisors the powers to extend application of the fit and proper test to all managers who are in a position to exert a material influence on a supervised entity within a financial conglomerate (where necessary, including managers at non-regulated holding company level). In other words, supervisors would "look through" a conglomerate's legal structure and focus on the people who are actually managing the supervised entity, regardless of exactly where they featured in the group's organigram.

(viii) Transparency of legal and managerial structure

77. Transparency refers to the clarity of the legal and managerial structure of a financial conglomerate. The Tripartite Group is of the view that the way in which a financial conglomerate is structured should be transparent, and conducive to supervision from a group perspective. If supervisors and regulators do not fully understand the legal and managerial structure of a financial conglomerate, they will be unable to assess properly either the totality of the risks the conglomerate faces or the risks which other group companies pose for the regulated firm. Moreover, supervisors need to be assured that, where necessary, the financial activities of a financial conglomerate are indeed being supervised, and that the supervisor(s) in question can be relied upon, not only to do their job effectively, but also to provide the information necessary for risk assessment from a group perspective; relevant information relating to unregulated activities also needs to be available. Where this is not the case, members of the Tripartite Group believe that the supervisor should have the power to insist that appropriate structural changes are made. If this proves to be impossible, then the Group believes that there are grounds for supervisors to refuse to grant authorisation or to consider withdrawing an existing license.

78. Because the legal and managerial structures of a conglomerate may be very different, particularly where a financial conglomerate operating internationally has adopted matrix management (under which individuals report to different senior managers on different aspects of their work), the Tripartite Group also believes it is essential that regulators are

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12 In some countries this is precluded by law, but it would be difficult for supervisors to prove.

aware of lines of accountability within a conglomerate which affect the firm they regulate, as well as the form which this accountability takes. All supervisors with responsibility for some part of a financial conglomerate should have an up-to-date organisational chart of the conglomerate and should be aware of the ownership structure of the group; they also need to be fully informed about the managerial structure of that part of the group in which their regulated entity is located.

79. The complexity of the corporate structure often reflects tax, cultural and historical considerations, as well as legal and regulatory requirements. A high degree of complexity may be inevitable in the case of large international financial conglomerates. However, this may make effective regulation extremely difficult and/or significantly increase the risk of contagion within the group. Some financial conglomerates may choose a complex structure in order to make their operations opaque and to avoid regulation at all or to impede effective ongoing regulation. The Tripartite Group is of the view that supervisors need powers, at both the authorisation stage and post-authorisation, to obtain adequate information regarding corporate structures and, if necessary, to prohibit corporate structures which impair adequate supervision. If adequate supervision is impaired, the supervisor must be able to insist that the financial conglomerate in question organises its activities in a way that makes adequate supervision possible. In this respect, the Tripartite Group notes the "minimum standards" for the supervision of international banking groups, which were published by the Basle Committee on Banking Supervision in July 1992, and the proposals put forward by the EC in the wake of the BCCI affair. Under both the "minimum standards" and the EC proposals, supervisory authorities are only able to grant authorisation to banks and securities firms that are part of a group if they are satisfied that the structure of the group permits effective supervision, including consolidation. Moreover, authorisation should be withdrawn if the undertaking becomes part of an opaque group. Supervisors may also need to be able to influence the location of the place of incorporation of a parent company and its principal operating subsidiaries, with a view to preventing a situation where the supervisor is not able to exercise effective influence over the group's operations.

(ix) Management autonomy

80. In financial conglomerates, there can also be a question as to whether the management of a supervised entity has sufficient independence and authority to be able to meet the demands of the regulators. In cases where independence and authority are lacking, it is usually because there is a conflict between the supervisor's requirements of the management and the demands placed on management either by the shareholders themselves or by the management of other more influential parts of the group. To help ensure appropriate management autonomy, it is important for supervisors to know who is exercising control over

the regulated arms of a conglomerate; in particular, supervisors should know who is responsible for compliance with legal and supervisory requirements. Furthermore, supervisors need to be informed not only of significant changes in shareholders, but also of significant management changes within the conglomerate as a whole, including those changes taking place in the unsupervised holding or parent companies which involve persons who may be able to influence the management or policies of a regulated entity.

(x) Suitability of shareholders

81. As the primary source of capital, shareholders have a legitimate concern to ensure that their capital is rewarded satisfactorily, but the potential impact of their actions on other interested parties, e.g. customers, depositors and policy-holders, needs to be recognised and understood. For this reason, the Tripartite Group is of the view that shareholders who have a stake in a financial conglomerate (enabling them to exert material influence on a regulated firm within it) should meet certain standards, and that supervisors should endeavour to ensure that this is the case by applying, on an objective basis, an appropriate test, both at the authorisation stage and on an ongoing basis. Exactly what such a test should involve, and whether (and if so how) it should differ from the "fit and proper" test applied to managers was not looked at in any detail by the Tripartite Group. However, there was agreement that the purpose of such a test was to determine a shareholder's suitability. In this respect, it would be important for supervisors to have the power to intervene and to force certain actions if a shareholder passed the test at the authorisation stage, but subsequently proved to be unsuitable. The power to insist on disinvestment, to strip the shareholder of voting rights or to restrict the exercise of those rights would seem to be appropriate, although, it is not always easy to do this where there are 100% or majority shareholders.

82. Depending on the structure of the conglomerate, there will almost certainly be a need for supervisors to liaise closely in assessing the suitability of shareholders. For example, take the case of a parent bank wanting to become the shareholder controller of an insurance company. Under the usual supervisory arrangements, it is clearly the responsibility of the insurance supervisor to assess whether the bank is suitable to be the shareholder controller of the insurance company; the insurance supervisor cannot give away this responsibility. However, the Tripartite Group believes that, in such a situation, the supervisor of the subsidiary company should recognise that the regulator of the prospective parent is likely to be best placed to provide a view on the overall standing of the parent institution in question. It therefore makes good sense to seek such a view and, indeed, to rely on it.

83. A similarly close working relationship is called for where a non-regulated holding company is the shareholder controller of sister companies operating in different supervisory

fields. The supervisors involved would each be responsible on a solo level for assessing the suitability of the non-regulated holding company as a shareholder controller. However, the Tripartite Group would expect them to share any information they had on the non-regulated holding company so that it would be unlikely that they would reach differing conclusions as to its suitability.

(xi) Rights of access to prudential information

84. A fundamental problem facing supervisors in relation to financial conglomerates concerns the fact that they may lack rights of access to prudential information on those parts of a conglomerate which they do not supervise. They may be denied an overview of the legal and management structures of a financial conglomerate, and of the transactions and positions that might have a bearing on the health of a regulated entity. As a result, it might prove difficult or impossible to identify threats to regulated entities in good time.

85. There can be no doubt that supervision is most effective when supervisors are in a position to view the conglomerate as a whole. For this to be possible, supervisors need access to prudential information not only from the entities they regulate but also from the other parts of the conglomerate, including any parent holding company. Whatever form a financial conglomerate takes, the effective supervision of groups comprising disparate entities subject to supervisors and regulators of more than one discipline and in more than one country requires a considerable emphasis on cooperation between the authorities concerned. For such cooperation to be possible, the Tripartite Group believes that, subject to confidentiality provisions and restrictions on the use of information, supervisory authorities need to have the right to share prudential information with each other - including information about intra-group exposures. There must also be a proactive willingness and determination among supervisors to share appropriate information, both nationally and internationally, either within a single category of supervisors or between categories of supervisors. In addition, supervisors may need to obtain (and share with other supervisors) prudential information on other non-regulated entities within the conglomerate to the extent that this information is of importance for the purposes of supervision. Where the linked entity is not regulated, this information will probably need to be provided by the regulated institution itself.

86. It is generally agreed that the process of cooperation would be greatly enhanced if the supervisors and regulators of the various entities in a group appoint one authority to act as lead regulator or "convenor". Where the parent company in a group is a supervised bank, securities firm or insurance company and is the dominant entity in the group, it would be sensible for the parent's supervisor to assume the role of convenor. In groups headed by a holding company, however, identification of the convenor may be less obvious. If one of the

supervised entities downstream from the holding company is more dominant than the other supervised entities downstream, then the Tripartite Group would expect the supervisor of that entity to be the convenor, but, if there is no dominant entity, it is recommended that the supervisors in question agree that one of them should act as convenor or that they should assume the role jointly.

87. What would be the precise role of the convenor? The Tripartite Group suggests that, subject to applicable confidentiality provisions and restrictions on the use of information, convenors would be responsible for gathering such information as they require in order to have a perspective on the risks assumed by the group as a whole. Using this information, they would make an assessment of the capital adequacy of the group. This would not interfere with the solo supervisor's right to obtain information regarding the group. The convenor would also be responsible for the coordination of any supervisory action that may be necessary, particularly if it is desirable that two or more authorities act simultaneously (e.g. complex supervisory actions involving more than one entity and crossing jurisdictional lines). A common objective is more likely to be achieved if all the supervisors act in harmony. Such arrangements may be particularly important if sanctions are to be applied in an effective manner. In some circumstances, it may be appropriate for the convenor to take the lead in proposing such supervisory action as is necessary in respect of the group as a whole (although this would not interfere with the power of the solo supervisor to act individually when necessary). There might also be a coordinating role for the convenor to perform with regard to the monitoring of intra-group exposures and the risk of contagion arising from them although, as mentioned earlier, the Tripartite Group's view is that the primary responsibility for this should rest with solo supervisors.

88. Where supervisors are located in the same country, informal information-sharing arrangements may be sufficient. However, in conglomerates where the major operational business entities are located in different countries, the Tripartite Group suggests that the role of the convenor, and indeed the responsibilities of all individual supervisors involved in a financial conglomerate, could be defined and agreed upon effectively through the establishment of Memoranda of Understanding or Protocol between the relevant supervisors, particularly in cases where a conglomerate has a complex structure. Recent banking legislation in the European Union has prompted bank supervisors to establish bilateral Memoranda of Understanding with their fellow European supervisors so that they know what other supervisors are expecting from them in respect of branches and subsidiaries of EU banks established in their country. Although the process of establishing Memoranda can be time-consuming and burdensome, it is felt that these documents are invaluable as a source of clarification, both of the sort of information supervisors expect to receive from each other and of exactly when they expect such communication to take place. In some instances, the

Memoranda could make it clear that communication is only necessary if certain "trigger points" are reached.

89. It is evident from the discussion which the Tripartite Group had on this aspect that there are bound to be differences of view on the intensity of the exchange of information between supervisors. Everyone was agreed that there needs to be a continuous flow of prudential information to the convenor; without the necessary information on all entities within the group, it would be impossible for the convenor to assess capital adequacy from a group-wide perspective. The prudential information can be collected from the financial conglomerate itself (thereby placing the main burden and cost on the conglomerate in question); from the supervisors of the individual entities which make up the conglomerate; or from a combination of these information channels. Obviously, if the convenor receives information which has implications for the financial viability of the group as a whole, then the supervisors responsible for other entities within the group should be made aware of it. However, if the information received by the convenor gives no cause for concern, is it necessary to pass the information on to other supervisors? This is a matter of debate. At one end of the spectrum are supervisors with an eye on resource implications, who would prefer to hear nothing from the convenor unless he identifies a problem; on the other hand, they don't want to be told about the problem when it is too late to solve it. At the other end of the spectrum are supervisors who would prefer to receive a healthy flow of information from the convenor so that they themselves can have a perspective on the group of which their regulated entity forms part. Supervisors will have their own view on this; views will also vary according to the precise size, nature and structure of the conglomerate. At the end of the day, exactly what should be exchanged is a matter for the supervisors involved and this is where the establishment of Memoranda of Understanding can assume great importance.

90. In some countries, as part of an evolving approach to group supervision, financial groups are already routinely considered on an annual basis by cross-sectoral meetings of regulators, with more frequent meetings being held in the event of a crisis situation. This is a non-statutory arrangement whereby each supervisor retains his individual supervisory responsibility but a lead supervisor is appointed for each group. Meetings are seen as an opportunity to exchange and discuss qualitative views. Some members of the Tripartite Group are attracted by the concept of cross-sectoral meetings of regulators as a means of encouraging more intensive cooperation between supervisors and the sharing of supervisory information on an international basis.

91. At the same time, however, the difficulties of organising such meetings on an international scale are recognised. So too are the challenges which convenors face in getting all the information they require about a group. Convenors may lack the authority to mandate a

group to provide the requisite information; supervisors may lack the authority or the preparedness to share information (particularly if a cross-border exchange is involved); and, in some cases, potentially important group entities may lack a supervisor. Clearly, in some countries, there are some serious jurisdictional issues to be overcome if convenors are to be able to fulfil their role effectively.

92. External auditors can be another valuable source of information for supervisors. They have considerable detailed knowledge of their clients and this knowledge, as well as the performance of their functions, enables them to identify current or prospective problems for a regulated firm or for the group of which it forms part. The Tripartite Group believes that, where external auditors have concerns about the financial or operational condition of a regulated entity (or a group to which a regulated entity belongs), they should be required to ensure that such concerns are brought to the attention of the relevant supervisor. This is already the case in a number of EC countries, and in the United States as regards securities firms. In Canada, too, external auditors are required to advise the relevant supervisor of any material deterioration in the financial condition of an institution. Any conflict between the auditors' duty of confidentiality to their clients and an obligation to communicate with the supervisors would need to be overcome by legislation.

93. From a supervisor's point of view, there are obvious advantages in having all the external audit work in a financial conglomerate performed by the same firm (or affiliated firms) of auditors,[13] thus providing an overall view of the group; in Canada, legislation already requires this where possible. Accordingly, the Tripartite Group recommends exploring with the auditing profession the principle that - notwithstanding the number of auditing firms actually involved in a financial conglomerate - one firm should be appointed to provide supervisors with such an overall view, without prejudice to the general duties of all the auditors involved to carry out their work in relation to the individual entities that make up the conglomerate and, where necessary, to draw the relevant supervisor's attention to matters which relate specifically to those individual entities..

(xii) Supervisory arbitrage

94. In this paper, the term "supervisory arbitrage" is used to refer to the shifting of certain activities or positions within a conglomerate, either to avoid a situation of relatively more strict prudential supervision by one set of supervisors compared to another, or to avoid supervision altogether (by transferring the activities or positions to a non-regulated entity).

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13 In one country represented on the Tripartite Group, the supervisory authority requires audit work to be carried out in tandem by two firms of auditors.

Clearly, more cooperation between supervisors and access to information on non-regulated entities are important prerequisites to any attempt to suppress supervisory arbitrage.

95. The Tripartite Group believes that, in practice, instances of supervisory arbitrage in relation to core activities is, in most jurisdictions, relatively rare. Nevertheless, the very fact that there is the scope for arbitrage in certain areas is of concern to supervisors and it can be argued that the only way to be certain of preventing it is to ensure that the same types of risk throughout a group are covered by capital which is identical in terms of amount and structure, irrespective of the location of the supervised company in which the risks are situated (the principle of same business, same risk, same rules). A harmonisation of banking, securities and insurance regulation would be necessary in order to achieve that and most members of the Tripartite Group do not consider such an approach to be realistic at this time. A more pragmatic (but limited) approach might be to establish an "early warning system" whereby supervisors would be required to inform each other of the establishment of any part of a conglomerate within their jurisdiction and of any significant transfer of assets, liabilities or contingent liabilities (or activities in general) between different parts of a conglomerate. This would enable supervisors to identify possible instances of regulatory arbitrage and to take appropriate action at an early stage. The problems caused by unregulated companies (such as reinsurers) in other countries probably need to be tackled in the first instance through the monitoring of intra-group transactions by solo regulators. However, methods for valuing assets and liabilities in subsidiaries (particularly those established in other jurisdictions) also need to be carefully considered by the regulator of the parent or, where the parent itself is unregulated, by the regulator of the dominant group entity.

(xiii) Moral hazard

96. Supervisors can face a situation of "moral hazard" in relation to financial conglomerates which include unregulated entities. Moral hazard may occur when supervisors need to obtain sufficient information concerning the operations of unsupervised entities - financial and non-financial entities alike - in order to satisfy themselves that their activities cannot create material damage to the supervised entities. The difficulty is that supervisors have to gather this information in such a way as to avoid giving the impression that the activities of the unregulated entities are in some way being monitored or supervised, even if only informally. Such a belief could encourage outside observers or internal management to take risks they would not otherwise have taken in relation to the unsupervised entities; if this occurs, the supervisors' actions can be said to have created a situation of "moral hazard".

(xiv) Mixed conglomerates

97. For the purposes of its discussions, the Tripartite Group defined "mixed conglomerates" as those groups which are predominantly commercially or industrially oriented, but contain at least one regulated financial entity (which is more than merely a "captive" entity doing business only on behalf of the group) in some part of their corporate structure. Typically, mixed conglomerates would be headed by a commercial or industrial company (or by an unregulated non-financial holding company) with the regulated entities embedded downstream in the group structure.

98. While legislation in some countries limits the extent to which non-financial ("commercial") and financial activities may be combined, other countries have found that such mixing provides additional support for financial activities, which is beneficial to the market and to the economy as a whole. Indeed, in some countries such links between financial and non-financial entities in the same group have existed widely and continue to exist. Where regulators have not adopted the approach of separation of financial and non-financial activities, they need to deal with potential contagion risk as best they can. The traditional approach of securities regulators, for example, is to apply qualification standards to managers and shareholders of the regulated entities and stringent capital requirements to the regulated entity; at the same time, a qualitative assessment of the risks assumed elsewhere in the group is undertaken.

99. At the heart of the problem facing regulators in respect of mixed conglomerates is the difficulty in assessing overall capital adequacy. Unlike financial conglomerates, where information on non-regulated entities can be meaningfully included in a capital assessment of the group as a whole (see next chapter), this is just not possible where commercial or industrial companies are involved. Supervisory rules and practices cannot be extended to them in the same way as they might be to non-regulated financial entities.

100. The Tripartite Group is of the view that the best way regulators can ensure that standard regulatory practices and rules are adhered to by the regulated financial entities which form part of a mixed conglomerate is to implement some form of ring-fencing procedure. The most straightforward way of doing this - short of prohibiting mixed conglomerates entirely - would seem to be to insist on a legal and organisational separation of the financial parts of a mixed conglomerate from the rest of the group. This could be achieved by the establishment of an intermediate holding company which would enable regulators to supervise the financial entities of a mixed conglomerate in much the same way as financial conglomerates. Similarly, it might be that much easier to ascertain those managers who need to satisfy their supervisors with regard to their fitness and propriety. In many cases, it might be advantageous for all financial entities to be grouped together in a financial sub-group, thus facilitating the

imposition of any restrictive measures the supervisor deemed to be necessary in order to satisfy supervisory concerns.

101. Compared with financial conglomerates, mixed conglomerates raise some rather different issues for regulators and can demand a fundamentally different approach. For example, assuming that ownership of the regulated entity by the commercial or industrial company is not precluded by legislation, then the supervisor needs to consider the reputational risk of the regulated entity being owned by the company in question - i.e. the extent to which the regulated entity is exposed to contagion risk as a result of being part of that commercial or industrial group. Such contagion risk could be psychological to the extent that the business of the regulated entity could be affected by any adverse publicity and the like related to the commercial or industrial enterprise. However, of more concern to regulators perhaps would be the risk of contagion arising as a result of financial transactions between the regulated entities and the non-regulated non-financial parts of the group. A mixed conglomerate is different from a financial conglomerate in this respect in that opportunities exist for intra-group funding of the group's own commercial and industrial activity. For this reason, it is especially important that regulators establish that management and decision-taking processes within the financial entities are independent from the non-financial activities (i.e. that business is conducted on terms prevailing in the market in general at the time). Clearly, there is scope for discretion in this area, but supervisors need to be satisfied that, as a general rule, intra-group business is not being conducted on terms which are significantly below those prevailing generally. Only in certain circumstances would such favourable treatment be justified.

102. Even where intra-group business is being conducted at "arms' length", it may also be appropriate for the regulator to assess whether the mere existence of transactions between the regulated company and the other parts of the group is likely to have adverse effects on the regulated entity. For this purpose, some information about the non-financial entities would undoubtedly be required, but it would be important for regulators not to venture into areas which are beyond their sphere of responsibility and thus risking a situation of moral hazard. Only information which is relevant to the financial health or safety and soundness of the supervised entities should be collected.

103. Moreover, a supervisor who is asked to authorise an entity which is part of a mixed conglomerate is confronted by some difficult issues with regard to the assessment of fitness and propriety. It is possible for the people who are effectively managing a regulated entity to be situated in a holding company or a fully-fledged commercial or industrial company at the top of the group structure. Where this is the case, the people concerned may not be accustomed to having companies operating in a regulatory environment; they may be

uncomfortable about dealing with regulators; and they might even be tempted to ignore usual supervisory practices. Where an individual's background is outside the financial sector, it certainly makes it more difficult for supervisors to assess whether the person in question is fit and proper to manage the regulated entity. An organisational separation of financial activities from non-financial activities in a mixed conglomerate, with the former presided over by someone with a proven track record in the financial field, would be a welcome development for supervisors of the financial entities.

IV. Capital adequacy

(i) Different approaches to the assessment of capital adequacy

104. The problems of double or excessive gearing mentioned in the previous chapter are symptomatic of a fundamental problem in relation to financial conglomerates - the assessment of capital adequacy. Bearing in mind that bank, securities and insurance supervisors all have different definitions of capital and different solvency and liquidity requirements, how is capital adequacy to be assessed in a group which brings together entities from more than one financial sector? This chapter discusses the range of techniques available to supervisors for making such an assessment: six techniques have been identified, each of which is described in the ensuing paragraphs. In doing so, the different starting points of the solo-plus and consolidated supervision approaches have been recognised; the task has been to draw on both traditions to develop prudent and practical techniques for assessing group capital and for eliminating double gearing.

105. In considering the relative merits of the following supervisory techniques, it was initially assumed that all participations by parents and subsidiaries are 100%, that capital is freely transferable within the group, that the different types of regulatory capital employed are of equal acceptability, and that all the companies concerned are in the financial regulated sector. The effects of lifting these simplifying assumptions are considered in sections (ii) to (iv) of this chapter, in particular how each of these methods deals with issues such as availability and suitability of excess capital, participations of less than 100%, and unregulated entities.

106. Of the six techniques identified at the outset, two were set aside for the purposes of the Tripartite Group's further work for the reasons given below.

(a) Accounting-based consolidation

107. Accounting-based consolidation involves the straightforward addition of group liabilities vis-à-vis third parties at group level, comparison with total consolidated group assets on a single set of valuation principles, and application at the parent level of capital adequacy rules to the consolidated figures. It regards the group as a single economic unit with all intra-group exposures netted out, and with surplus capital in individual entities assumed to be available to the group as a whole. Accounting-based consolidation would normally include unregulated financial companies which are part of the group, but would not attempt to take account of any non-financial group companies. It is the technique applied by bank supervisors in assessing overall group capital adequacy in respect of banking groups, and, in Europe, accounting-based consolidation will also generally be possible for homogeneous groups

where rules have been harmonised (although some supervisors have concerns about the masking of intra-group exposures and assumed transferability of capital in this respect). For bank regulators (and securities regulators within the European Community), consolidated supervision is, or is to become, an important element of supervision. Some of these regulators may place greater emphasis on consolidated supervision than on any solo supervision they undertake. Some of them may undertake no solo supervision at all, especially in relation to conglomerates made up entirely of homogeneous entities, as long as certain conditions are fulfilled (e.g. satisfactory distribution of capital in relation to the risks being borne by the group). From the point of view of most insurance regulators and some securities regulators, however, solo-plus supervision remains preferable, not least because they believe that, for the conglomerates for which they are responsible, consolidated supervision has certain disadvantages (e.g. the combination of disparate balance sheets to which different prudential requirements apply; the issue of availability and suitability of capital for transfer between group companies; and additional costs).

108. However, the nature of insurance liabilities, differences in valuation principles, the different correlation between asset and liability risks in insurance[14], and the definition of insurance capital requirements, led the Tripartite Group to conclude that accounting-based consolidation was not an appropriate technique at the present time for heterogeneous groups including insurers, banks and securities firms. Accordingly, while the Tripartite Group recognised that accounting-based consolidation may be appropriate and useful in the supervision of homogeneous groups, it decided to set this technique aside for the purposes of this report, which focuses on heterogeneous groups of the latter type.

(b) Block capital adequacy

109. Block capital adequacy tends to assume that all undertakings within a conglomerate are regulated financial entities. It envisages the classification and aggregation of assets and liabilities according to the type of risk involved (rather than according to the institution to which they pertain), and the development of harmonised standards for assessing a conglomerate's capital requirement in respect of the risks which are common to banks, securities firms and insurance companies (i.e. principally credit, concentration, market and foreign exchange risks). In addition to the capital requirement for these common risks would be added a requirement in respect of the risks which are specific to the individual sectors in order to produce an overall capital requirement covering all risks taken on by the group as a whole. The common types of risk would need to be covered by forms of capital acceptable to

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14 In some countries, it is common for insurance policy holders - particularly holders of life policies - to bear some of the company's investment risk. So, if there is a diminution in an insurance company's assets due, say, to a general decline in asset prices, there is also likely to be a decline in the insurance company's liabilities. Such a correlation is not normal in banking.

bank, securities and insurance regulators - i.e. a common capital standard would need to be developed. However, the risks which are specific to individual sectors could be covered by designated own funds recognised for this purpose by regulators in the appropriate sector. Capital surpluses in individual group companies would need to meet the common capital standard if they were to be used to cover risks which are specific to group entities in another financial sector. The common capital standard would also need to take account of the correlation of different types of risk that exist within a heterogeneous group. At the present time, "block capital adequacy" is a purely theoretical technique; it is not currently applied as a tool of supervision. While it had theoretical attractions for some members of the Tripartite Group in the longer term, others queried whether the availability of funds for transfer between group companies could be assumed; they also questioned whether block capital adequacy could ever produce results which are sufficiently accurate to justify the regulatory resources that such an elaborate technique would be certain to absorb. Ultimately, all members agreed that, while "block capital adequacy" was not a technique which could be ruled out entirely, it was not a practical possibility in the immediately foreseeable future. Accordingly, it is not considered in any further detail in this report.

110. Four other quantitative techniques for assessing the adequacy of capital in financial conglomerates were considered in more detail:

Building block prudential approach;
Risk-based aggregation;
Total deduction;
Risk-based deduction.

The following paragraphs describe each of these techniques in outline.

(c) "Building block" prudential approach (based on consolidated accounts/data).

111. The "building block" prudential approach takes as its starting point and basis the consolidated[15] accounts of the financial conglomerate at the level of the parent company. Such an approach would come on top of the solo supervision of individual companies and the requirements of each type of supervisor, which would remain unchanged. A financial conglomerate's prudential data would be checked by the parent company's supervisor with information given by other regulators.

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15 For the purposes of this report, it is assumed that the co-existence of different methods of valuation is not an obstacle to consolidation. This was the conclusion reached by the Federation of European Accounting Experts' Task Force on Financial Conglomerates in a report to the European Commission ("The form and content of the consolidated financial statements of financial conglomerates" - December 1993). The Tripartite Group itself has not addressed this question in any detail.

112. For prudential purposes, the consolidated balance sheet and off-balance sheet commitments would be split into four different blocks according to the supervisory regime of the individual firms involved: banks, insurance companies, securities firms and unregulated firms. Capital requirements would then be calculated by the individual regulatory authorities for the three types of regulated entity (including activities of non-regulated entities carrying out similar business to regulated entities) and added together (it is worth noting that these requirements could be different from those applicable on a solo basis because of the elimination of intra-group exposures). The aggregate amount of capital requirements would then be compared with the aggregate amount of own funds across the group (i.e. the total amount of capital recognised by the different regulators), given that each type of risk (banking, insurance, securities) should be covered by prudential own funds which are recognised as capital by the relevant supervisory authority.

113. A variant - which would deliver a very similar result - would be to deduct from the prudential capital (i.e. the own funds) of the parent company the capital requirement for its regulated subsidiaries in other financial sectors (and the notional requirement of any unregulated subsidiaries carrying out similar business). The resultant amount would be compared with the capital requirement for the parent's own activities and for subsidiary activities in the same financial sector. This might be a better way of proceeding where there is a dominant financial activity (i.e. banking, securities or insurance) and that activity is undertaken by the parent company (more often than not, this is the case). It would allow the regulator of the parent company to take responsibility for the calculation of group capital requirements and for the checking of capital adequacy across the financial conglomerate as a whole. The intention would be that this should not prejudice the responsibilities of other supervisors for individual entities on a solo basis; the legal responsibilities of each supervisor would not be affected[16].

114. Under the "building block" prudential approach, unregulated firms carrying out similar business to regulated entities (e.g. leasing, factoring and reinsurance) would be included - i.e. a notional capital requirement would be calculated in accordance with the rules of the appropriate regulatory regime[17]. Other unregulated companies would be left out of the calculation.

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16 A small minority of the Tripartite Group are, however, concerned that, if the regulator of the parent company is responsible for group capital requirements, solo regulation might tend to become less vigilant over time.

17 Some supervisors may also wish to take account of the requirements established by the market for firms to obtain high credit ratings and access to low cost funding.

115. By virtue of the fact that it is based on data relating to the group as a whole, the building block prudential approach - like accounting-based consolidation - regards the group as a single economic unit and implicitly assumes that surplus capital in individual entities is freely transferable to other group entities (irrespective of whether those entities are wholly or partly-owned - see section ii of this chapter). However, it is envisaged that there would need to be a separate check - by the regulator of the parent company - to ensure that there are no specific obstacles to such availability and that risks in the different blocks of business are covered by capital of an appropriate type and of sufficient quantity (i.e. satisfactory distribution of capital and risks across the group). The building block prudential approach also nets all intra-group exposures (on and off the balance sheet) automatically, rather than leaving such judgement to the supervisor. The use of audited data (i.e. group accounts and off-balance-sheet figures), rather than direct regulatory data, is seen by some members of the Tripartite Group as giving extra assurance to supervisors.

(d) Risk-based aggregation

116. In its simplest form, risk-based aggregation involves summing the solo capital requirements of regulated group companies and comparing the result with group capital. So, in a group comprising a parent bank with insurance and securities subsidiaries, the capital requirements of the parent bank would be summed with the capital requirements of the insurance and securities subsidiaries (as determined by their respective regulators) and capital adequacy assessed by comparing the result with the own funds of the group. Where subsidiaries are held at cost in the accounts of their parent company, a simple technique for calculating the own funds of the group is to add to the own funds of the parent the own funds of the subsidiaries and then deduct the book value of the parent's participations in the subsidiaries as shown in the accounts. An alternative technique, which can be used however subsidiaries are accounted for in their parent's books, is to identify the externally generated capital of the group. The externally generated capital of the group is found by adding to the externally generated supervisory capital of the parent the amount of any subsidiary's externally generated supervisory capital which:

- regardless of whether it "belongs" to the group, can be applied against the subsidiary's solo capital requirement (for which purpose, capital supplied to the subsidiary from the group is ignored); or
- "belongs" to the group (for example, the group share of retained reserves), has not been included in the parent's own capital (for example, because the investment in the subsidiary is held at historical cost), has not been dealt with under the preceding stipulation and is able to be transferred, directly or indirectly, to other group companies that recognise the form of capital concerned.

117. In this context, "externally generated" refers to capital not obtained from elsewhere in the group; accordingly, equity supplied by minorities, third party debt finance and retained profits arising from transactions with third parties would all qualify as externally generated group capital. The term "belongs to the group" refers to amounts which would in principle be payable to the group on the winding up or sale of the subsidiary. It thus excludes, for example, retained reserves which would be payable to a minority shareholder. The term "able to be transferred" aims to exclude amounts subject to foreign exchange controls, withholding taxes and the like. It should be noted that the strict assumptions about minority capital and transferability are not intrinsic to the general technique of risk-based aggregation and could easily be relaxed to provide a wider definition of relevant externally generated capital. In addition, the structure of the capital may be examined to ensure that banking risks are covered by capital recognised by the bank regulators, securities risks by capital recognised by the securities regulators and insurance risks by capital recognised by the insurance regulators, although this would normally be ensured by the solo supervision on which aggregation is based.

118. This form of risk-based aggregation and the building block prudential approach are indeed very similar. As in the building block prudential approach, each category of risk is treated according to the rules of the respective specialised regulator and so the application of rules stemming from another supervisory framework is avoided. The principal difference is that the building block prudential approach is based on consolidated accounts whereas risk-based aggregation uses data supplied to supervisors in the normal course of supervision; as such, it can be applied when consolidated accounts are not available[18]. A corollary of this is that the building block approach automatically nets out intra-group exposures, while aggregation does not deal specifically with such exposures (but this does not prevent them being netted out at a later stage, if necessary).

119. A more prudent form of risk-based aggregation - the concepts of which are more akin to those of the total deduction method described below - involves aggregation of the maximum regulatory capital requirement of each subsidiary in a group. The maximum regulatory capital requirement for each regulated subsidiary is deemed to be the greater of the subsidiary's actual solo regulatory capital requirement or the investment by the group in that subsidiary. The aggregated maximum regulatory capital requirement of the subsidiaries is then added to the regulatory capital requirement of the parent company itself to produce the overall group capital requirement. The lead supervisor or convenor would compare this requirement with the externally generated capital of the group (as described above).

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18 According to international accounting standards, consolidated accounts have normally to be established.

120. In the event that risk-based aggregation reveals an apparent capital shortfall, the lead supervisor/convenor would need to consult with other relevant supervisors and to gather such information as is necessary in order to come to a decision on whether remedial action was required, or whether the position could be accepted on the basis of the obviously temporary nature of the problem or for other reasons.

121. In the case of unregulated subsidiaries, the lead supervisor/convenor would normally expect to bring into the aggregation an amount representing the investment by the group in the subsidiary plus, in the unlikely event that there is a shortfall in the net assets of the subsidiary, the amount of that shortfall (amount 'A'). However, where the business of an unregulated subsidiary is very similar to a regulated business, the lead supervisor or convenor might decide to estimate a notional regulatory capital requirement for the unregulated subsidiary and, if this exceeds 'A', bring this into the aggregation instead.

(e) Total deduction method

122. The total deduction method is based on the full deduction of the book value of all investments made by the parent in subsidiaries; some supervisors also advocate the deduction of any capital shortfalls in those subsidiaries (as indicated by the capital standards of their solo supervisors) from the parent's own capital. In other words, the supervisor attributes a zero value, or in some cases a negative value, to the parent's investments. The result is then compared with the parent's solo capital requirement calculated according to the regulatory rules applicable to the parent. Supervisors using total deduction rely on the capital standards of other regulators for identifying any capital shortfalls in subsidiaries; there is no obvious way of integrating undercapitalised unregulated entities in the group-wide risk assessment.

123. As long as the parent's supervisor checks that the capital of the subsidiary at least meets regulatory norms (or, as described above, that a further deduction is made in respect of any shortfall), total deduction is equally as effective as the other techniques described in this chapter in eliminating double gearing. It is conservative, simple to apply and, importantly for some securities supervisors, it also recognises that the parent would not be obliged to bail out a subsidiary. What it does not do is produce an overall measure of risk at parent/group level, nor does it give any credit at parent/group level for surplus capital in subsidiaries. Accordingly, there is no incentive for parent institutions to ensure that their subsidiaries are any more than adequately capitalised. Instead, total deduction tends to recognise intrinsically that there may be restrictions on the ability of the parent to remove capital from a regulated subsidiary (a question addressed in more detail later in this chapter).

(f) Risk-based deduction

124. The risk-based deduction method looks at each company in turn starting from the lowest level of the group. It utilises regulatory data for the assets and liabilities of each company, but replaces the value of all investments in subsidiaries with an amount calculated as follows:

- Own funds of subsidiary assessed on the solo-plus supervisory basis relevant to that subsidiary, less
- Capital requirement of subsidiary,
- all multiplied by the relevant proportion of shares held in the subsidiary (e.g. 60% in the case of a 60% holding).

125. Where equity accounting is employed, this can be seen most simply as taking account in the parent company of the own funds of the subsidiary, reduced by the latter's capital requirement (see Example J in Appendix III). If there is a capital shortfall, then the method can either operate by attributing the whole of the shortfall to the parent or on the pro-rata basis described (for the attribution of surpluses) in paragraph 124 above.

126. This method can be further refined by excluding from item (a) any "own funds" that (i) are not attributable to the parent company or (ii) represent reserves or some other capital elements that are not freely transferable to the parent company or (iii) any withholding or other tax that might be payable in the event of transfer of resources. In addition, the value of shares in the subsidiary may be limited to the value that might be realised (net of any tax) by an arms length sale or transfer of the shares to a third party.

127. In other words, unlike the total deduction method, the parent is permitted to take account of its share of capital surpluses in subsidiaries. However, with the refinement in the preceding paragraph, this is subject to the proviso that it is able to satisfy the supervisor that the surplus capital it has taken into account is both available and suitable.

128. It is a very similar approach to the risk-based aggregation method in that there is an addition of the own funds of each subsidiary to those of the parent and both methods are based on regulatory rather than accounting data. However, the capital requirement of each subsidiary is matched directly against the own funds of that subsidiary, rather than being aggregated together against the own funds of the group. Therefore, it is feasible to ensure directly that risks in each sector (insurance, banking or securities) are covered by capital that is regarded as appropriate by the supervisor in that sector.

129. With the refinement in paragraph 126 above, the supervisor at parent/group level can assess whether the capital surpluses in the subsidiaries are fully available and suitable for

transfer to the parent or elsewhere in the group, and also whether the type of capital involved would be acceptable on transfer.

Conclusions

130. The Tripartite Group agreed that techniques (c), (d) and (f) above (building-block prudential, the simple form of risk-based aggregation and risk-based deduction) are all in principle capable of achieving the desired objectives - providing an accurate insight into the risks and capital coverage across a heterogeneous financial group; and eliminating double-gearing. Technique (e), total deduction, deals effectively and conservatively with double-gearing. What it does not do is seek to provide a full picture of the risks carried by the group. The same can be said of the more prudent variant of risk-based aggregation described in paragraph 119. In simplified circumstances (i.e. there are no unregulated entities, and equal acceptability of different types of regulatory capital, free transferability of capital within a group, and 100% ownership of all subsidiaries are assumed), the Tripartite Group also concluded that techniques (c), (d) and (f) should yield the same (or very similar) results. Examples A-C in Appendix III demonstrate this conclusion for simple specimen cases. It is suggested that these three techniques - suitably developed to deal with some of the other important issues dealt with in the remainder of this chapter - might form the basis of a set of minimum ground rules for the assessment of capital adequacy in financial conglomerates, and that some form of mutual recognition of their acceptability would be eminently desirable. Total deduction might also be recognised as an effective technique for the purposes of preventing double gearing within a financial conglomerate, but not for providing a group-wide perspective of the risks being run by a financial conglomerate.

131. In order to deal with more complex and typical cases, two important issues arise in the context of capital assessment:

- participations in dependants: availability and transferability of capital surpluses;
- capital adequacy at group level: suitability of capital for intra-group transfers;

And two other issues of a more general nature also need to be confronted:

- unregulated holding companies/unregulated dependants;
- regulatory intervention issues.

While the building-block prudential approach, risk-based aggregation and risk-based deduction provide a framework for handling these issues, they do not automatically provide policy solutions to them. The Group therefore devoted considerable time to discussion of these issues; the remainder of this chapter reflects those discussions and the conclusions reached.

(ii) Participations of less than 100%: availability of capital surpluses in partly-owned subsidiaries

132. The Tripartite Group has had detailed discussions on how supervisors should regard a parent institution's participation of less than 100% in a financial subsidiary:

- in relation to the responsibility of the parent for regulatory capital shortfalls in the dependant;
- for the purposes of valuing the participation of the parent in the dependant in the balance sheet of the parent;
- for the purposes of assessing capital adequacy on a group-wide basis, and of eliminating double gearing;

Particular issues that arise in considering these questions are:

- in the event of a capital shortfall, what is the responsibility of the parent company? Does this responsibility vary according to the level of the participation and the distribution of the balance of the share holdings (including as between other regulated financial institutions and non-regulated shareholders). If so, how?
- if there is excess capital in a dependant, to what extent can the parent attribute value to its holding for regulatory or risk-bearing purposes?
- the transferability of excess capital from a partly-owned dependant to its parent and from one dependant to a sister company (via the parent), reflecting any legal, taxation or regulatory restrictions on the distribution of surplus capital in the dependant to the parent and/or other shareholders.

133. Where the parent holds 100% of the share capital and voting rights in a subsidiary, then capital in that subsidiary not required there for regulatory purposes will in normal circumstances be available to the parent (and, hence, to other parts of the group), subject to any other requirements (e.g. legal, tax or foreign exchange control restrictions). Provided that excess capital, in addition to that required by the regulator of the subsidiary, is of a type which is acceptable to the regulator of the parent and there are no current or foreseeable restrictions on its transfer, it is not imprudent to allow such an excess to be regarded as available for the bearing of risks by the parent institution or by other entities in the group[19].

134. The position is, however, less clear-cut when external holdings exist in a dependant company. Partly-owned undertakings can be categorised in a number of ways, for example:

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19 There are certain exceptions which parent supervisors need to watch out for - notably subordinated debt, and also "profit reserves" in a life insurer - neither of which is available automatically to the parent

- Subsidiary undertakings over which **control** is established, either by the group owning **more than 50%** of the shares or the voting rights, or through a contractual or other arrangement;
- "Associated undertakings", denoting for these purposes undertakings over which the group does not have control but does have **significant influence** (i.e. in the sense of a group shareholding or share of the voting rights of **between 20% and 50%**);
- Simple minority shareholdings in undertakings over which the group has **neither control nor significant influence** (i.e. the group shareholding or share of voting rights is **less than 20%**).

135. Discussions within the Tripartite Group have focused on the question of whether full or pro-rata consideration should be given to the various levels of participation in a group-wide assessment of capital adequacy. On the one hand, how much of the risks extant in a partly-owned subsidiary should a part-owner be held responsible for in terms of capital coverage? And, on the other hand, how much of any excess capital in a partly-owned subsidiary can be attributed to a part-owner for his own gearing purposes? The Tripartite Group decided that the answers to these questions depend in part on which of the above mentioned categories a partly-owned undertaking falls into.

136. Simple minority shareholdings (less than 20%) in undertakings over which the group has neither control nor significant influence do not present a problem. There is widespread agreement that, as a general rule, these small participations, over which the group has no significant influence and which are not consolidated for accounting purposes, should be treated in accordance with the solo entity rules for assessing the capital requirements of the "parent" undertaking. Only in very exceptional circumstances, would supervisors expect to consider proportional or full integration to be appropriate.

137. Similarly, in the case of "associated undertakings", members of the Tripartite Group are agreed that they would normally expect the group's share of the undertaking's capital (and the same proportion of the undertaking's regulatory capital requirement) to be included in any group-wide assessment of capital adequacy. In other words, the pro-rata approach is generally advocated where the parent or the group has what is deemed to be a "significant" influence, subject to questions of availability and suitability discussed in the ensuing paragraphs of this section and in the next section of this chapter. However, some Tripartite Group members would wish to add a rider to the effect that if it appeared that the group subject to integration would by itself maintain the solvency of a particular "associated undertaking", then the whole of that undertaking's regulatory capital requirement should (if greater than the amount invested by the group) be included in the group-wide assessment of capital adequacy. The

proportions of the undertaking held by third parties and the identity of those shareholders may be other factors which have a bearing on the most appropriate treatment.

138. There are, however, some differences of view with regard to the treatment of subsidiary undertakings which are not wholly owned, but over which a group has effective control (either through the ownership of more than 50% of the shares or voting rights, or through a contractual or other arrangement). Some members favour the full integration of such controlling interests for the purposes of assessing capital adequacy from a group-wide perspective (i.e. the full integration of the capital and risks prevailing in the partly-owned subsidiary); others support integration on a pro-rata basis.

139. Those who argue in favour of full integration of such controlling participations with no specific safeguards being necessary make the following points:

- A "break-up" or liquidation value approach is inconsistent with the assumptions underlying the prudential framework of many supervisors. If such an approach were to be followed, for example, some bank and insurance supervisors would have to move to a mark-to-market valuation of all assets.
- From a going concern standpoint, full integration makes more sense than pro-rata integration in the assessment of capital adequacy from an overall group perspective. It recognises the majority shareholder's ability to effect the transfer of marketable assets or the granting of subordinated loans within the group (although supervisors may wish to prevent certain intra-group transactions).
- Controlling participations give the parent company a responsibility for the risks run by its subsidiary which goes further than the mere proportion of capital it has contributed and, in many cases, would extend to the totality of the risks. In the same way, a controlling participation gives the parent company a control of the own funds of a subsidiary which goes further than its contribution to its capital; indeed, it gives the parent important policy powers over the structure and restructuring of the subsidiary's own funds, subject to the legal rights of the minority shareholders.
- If there are doubts as to the availability of surplus capital in a majority-owned subsidiary for the covering of risks at parent/group level, then in reality those doubts apply both to that part of the surplus which is attributable to third parties and to that part which is attributable to the parent group.
- Full integration of controlling participations is in line with international accounting standards and, where possible, it makes sense to achieve consistency between accounting and prudential rules, especially given the certainty and guaranteed status of audited accounts. The same reasons which justify a full

accounting integration of majority subsidiaries are valid from a prudential point of view[20].

- Full integration is consistent with the internationally agreed supervisory regime for banks. Indeed, minority interests are specifically recognised as capital at group level by bank regulators in both the Basle Accord and in the EU.
- The solo supervision of individual firms within a group would ensure that, under no circumstances, are minority interests (or any other form of excess capital) in one entity used to cover a deficit in another.

140. Other members of the Tripartite Group feel that full integration is inappropriate because there is a need to examine the attributability and to check the availability of any surplus funds. These members take the view that a surplus of an undertaking's qualifying capital over its regulatory capital requirement should not be included in the regulatory capital of its parent where there is any doubt as to the undertaking's ability to transfer that surplus to other undertakings in the group. The main reason for this view is that bringing into account at group level surpluses in subsidiaries which are not attributable to the parent, or which may prove not to be transferable to it, could give an illusory feeling of confidence about a group. These members maintain that the only value of a non-transferable surplus is that it will provide a buffer against exceptional losses in the event that they arise in the subsidiary in which the surplus is located; they say that this does not, in itself, justify inclusion in group capital which, by definition, should be attributable and available to the group as a whole.

141. On the question of attributability, the real point at issue is whether capital surpluses which are attributable to third parties should be recognised as an acceptable form of capital when supervisors assess capital adequacy from a group perspective. If they are to be so recognised, the implications are that capital surpluses attributable to third parties could be used to compensate for what might otherwise be seen as a case of double gearing between a parent and another wholly-owned subsidiary. In order to be sure of preventing the group/parent from benefiting in this way, it would appear necessary for the regulator of the parent to deduct the value of the participation from the parent's own regulatory capital base or to take other comparable measures to satisfy himself regarding the distribution of capital within the group. However, supporters of full integration would take the view that the whole of the capital surplus is indeed available to the parent/group; and that, at group level, capital surpluses attributable to third parties could also be used to cover notional deficits in unregulated entities if they are fully integrated at parent/group level.

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20 The Group's understanding of general accounting principles is that only in cases where there are severe long-term restrictions, which are substantially affecting a parent's ability to exercise its rights over an undertaking, should that undertaking be excluded from consolidated accounts.

142. Protagonists of the pro-rata approach also question whether the solo supervision of individual firms within a group would in fact prevent capital surpluses attributable to third parties being used to cover notional deficits in unregulated entities. The situation they have in mind is where full integration of a parent and a partly-owned regulated subsidiary reveals a surplus stemming from the subsidiary (see Example E in Appendix III). If a second undercapitalised unregulated subsidiary is included in the group-wide perspective, full integration could still reveal a group surplus because it would be possible for the excess in the first partly-owned subsidiary to conceal the deficit in the second. This would not be the case with pro-rata integration which, by its very nature, takes into account only that part of the surplus which is attributable to the group.

143. As for the availability aspect, there are a number of circumstances in which the whole or part of a surplus may not be available to the group. Distributions of profit, dividend taxation, foreign exchange controls, withholding taxes, covenants given to suppliers of debt finance, legal restrictions, general creditors' rights, solo regulatory requirements (such as the required ratio between tier 1 and tier 2 capital and any restrictions on capital withdrawals) and the relationship with minority interests are examples of such circumstances. Moreover, in the case of capital surpluses which have been generated by the issue of subordinated debt in a subsidiary, for example (see Example H in Appendix III), it could be considered inappropriate to regard any surplus capital generated by that debt as being attributable to the group as a whole (unless the debt is also subordinated to the liabilities of the parent). It is arguable that non-transferable resources in other group companies will not help the parent company to support a troubled dependant; that they will not prevent the troubled entity being wound up; and that they will be of no use to the parent if its own capital becomes depleted (e.g. if it has to write off its investments in troubled subsidiaries).

144. Many of the impediments to the availability (i.e. the free movement) of capital surpluses can apply equally to that part of a surplus which is attributable to the parent and that part which is attributable to a minority shareholder. However, protagonists of the pro-rata approach tend to view the very fact that part of the surplus is attributable to a third party as an impediment to free movement in itself.

145. Example F in Appendix III shows that, where a partly-owned subsidiary has a capital surplus, full integration can be viewed as the least conservative of the approaches. A parent increases its stake in a partly-owned subsidiary with a capital surplus, inducing its regulator to switch from pro-rata to full integration (because it is now regarded as the controlling shareholder). Although the parent can be viewed as having taken on increased risks, the assessment of capital adequacy on a group basis shows an improved capital surplus

because full account has been taken of the subsidiary's excess capital. Protagonists of full integration, however, maintain that this is an accurate reflection of the position from a going concern perspective because the parent's increased stake in the subsidiary provides it with an overriding influence over the subsidiary's excess capital and the whole of the excess should therefore be regarded as available to the group.

146. However, full integration need not necessarily always benefit the parent. If the subsidiary in Example F were to have a capital deficit, full integration would have the effect of upstreaming the full deficit to group level, probably giving rise to a deficit at that level. In other words, it holds the controlling shareholder responsible for making good the whole of the deficit. Pro-rata integration, on the other hand, might still reveal a surplus at group level.

147. Some members of the Tripartite Group draw attention to what they regard as a significant flaw associated with full integration. They maintain that if the capital surpluses of partly-owned subsidiaries are integrated in full at group level, then it is possible to conceal instances of double gearing. The basis of this argument is that the full integration of a capital surplus at solo level in a (partly-owned) subsidiary could be used to conceal double gearing between a parent and another (wholly-owned) subsidiary (see Example D in Appendix III). Faced with evidence of double gearing between the parent and the wholly-owned subsidiary, the supervisor of the parent would invariably instruct the parent to inject more capital or to reduce its risks. However, the element of double gearing is not evident if the partly-owned subsidiary is integrated in full and action on the part of the supervisor does not appear to be justified. In these circumstances, the parent/group can be said to be benefiting - albeit indirectly - from the full extent of the capital surplus in the second subsidiary. In order to prevent this occurring, it would appear necessary for the regulator of the parent to deduct the value of the participation from the parent's own regulatory capital base or to take other comparable measures to satisfy himself regarding the distribution of capital within the group. However, supporters of full integration would take the view that the whole of the capital surplus is indeed available to the parent/group.

148. Some members of the Tripartite Group have pointed out that it is possible to combine the full integration of deficits with the pro-rata attribution of excess capital. Such an **asymmetric** approach would be consistent to the extent that it would always produce the most prudent result, rather than mechanically consistent in selecting the same approach for every situation regardless of the result achieved. It would ensure that the controlling parent at least had the means to make good a deficit in a subsidiary even if, in the event, it was not required to do so. On some occasions, the full integration of deficits would clearly overstate the extent to which the parent is ultimately liable for a subsidiary's deficit, but supporters of the asymmetric approach see this as infinitely preferable to the pro-rata approach, which

obviously understates the parent's obligations in cases where risks of contagion are prevalent. It is also suggested that it would be comparatively rare for majority shareholders to allow a subsidiary to fail just because additional funds were not forthcoming from minority shareholders. Again, the need for a group-wide perspective, and regard for supervision of a conglomerate as a single economic unit, rather than a collection of individual entities, becomes apparent. To some extent, it might be argued that supervisors should be seeking to ensure that the solvency position of a financial conglomerate is better than the sum of the capital requirements of its individual entities.

149. In summary, the logic of full integration is that the conglomerate is viewed as a single economic unit with full account being taken of all capital which is both available to cover risks and recognised by the respective regulators. The viability of the group in the long run is assumed (the "going concern" perspective) and it is expected that the controlling shareholder will inject fresh capital if and when necessary for business reasons. Full integration supplies the regulator with a picture of the group as a whole; any minority interests are part of that overall perspective and need to be included if the supervisor is to be fully informed as to the capital situated in a group. What full integration does not do automatically is to determine whether or not there is adequate distribution of the capital in relation to the risks run by the group. For its part, pro-rata integration takes cognisance of capital which is attributable to minority shareholders (to the extent that it covers risks in the entity in which it is situated), but also intrinsically recognises that such capital is not attributable to the group/parent and may not be available to cover losses elsewhere in the group. Pro-rata integration provides a perspective of the capital position of the parent company as a separate legal entity. As such, however, it does not give an accurate reflection of the situation when a subsidiary has a capital deficit and the parent's responsibility for making good that deficit exceeds its pro-rata share.

Conclusions

150. The Tripartite Group agreed that, of the three main techniques considered (building-block prudential, risk-based aggregation, risk-based deduction), the building block prudential technique was inclined towards the full integration approach to majority shareholdings, simply by virtue of its reliance on consolidated accounts. Both forms of risk-based aggregation and risk-based deduction, on the other hand, tended to point towards the pro-rata approach to majority shareholdings. That said, all three approaches are in principle capable of being adapted to accommodate either the full or pro rata integration approaches to majority shareholdings.

151. Most members of the Group agreed that in situations where a deficit occurs in a subsidiary, as a general rule the full extent of that deficit should be attributed to a parent with a controlling participation or to a parent which has provided a guarantee to the subsidiary. Only in very exceptional circumstances - where the relationship between a parent and a majority-owned subsidiary can be distinguished from other parent/subsidiary relationships and the risk of contagion is considered to be minimal - would pro-rata integration be regarded as sufficient for the purposes of assessing overall group solvency. Equally, however, it should not be implied that deficits in subsidiaries will be tolerated by supervisors other than in the very short term; by their very nature, deficits need to be remedied quickly or the subsidiary put into insolvency proceedings. In any event, it will probably be rare for group financial returns to incorporate unremedied deficits in regulated subsidiaries if solo supervision is working properly, unless the group as a whole is at risk.

152. Where capital in a partly-owned subsidiary exceeds the regulatory requirements of the solo supervisor, the Tripartite Group agreed that, in principle, it was legitimate for such excess to be used to cover risks at the parent/group level, but subject to certain conditions.

153. The Tripartite Group was however unable to agree on the conditions for the use of excess capital in this way. Some argued that, consistent with the philosophy of regarding the group as a single economic unit, all excess capital, including that attributable to minority shareholders, could legitimately be used to cover risks at parent/group level, subject only to the effective solo supervision of individual entities and a check on adequate distribution of capital and risks within the group (which solo supervision should, of course, ensure). They do not believe that a further check on the availability and transferability of the excesses is necessary because they take the view that, if the supervisors have any doubts about the free movement of capital around the group (i.e. any doubts about the ability of the group to operate as a cohesive unit), they should not allow the financial conglomerate to exist in that particular shape and form. Others argued that a pro-rata recognition - i.e. recognising only the share of the surplus attributable to group shareholders - was the more prudent approach and that, even then, any amount thus recognised must be genuinely available and transferable. Notwithstanding the influence a controlling shareholder may be able to bring to bear, supporters of the pro-rata approach do not believe that supervisors should regard capital which is attributable to minority shareholders as being available to the group as a whole.

(iii) Capital adequacy at group level: suitability of excess capital for use in subsidiary entities

154. There are important differences in the definition of capital across the various regulatory frameworks, reflecting the different types of risk involved in the wide range of

activities undertaken by the different institutions. Some types of capital are an appropriate buffer for certain types of risk, but not for others, and in the case of financial conglomerates it is therefore unlikely to be sufficient to ensure that capital at group level is at least equal to the sum of the capital requirements of the individual entities. An examination of both the type and structure of group capital appears to be necessary if supervisors are to satisfy themselves that risks are indeed covered by capital, which is not only available to the supervised entity but is also of a type they recognise - i.e. that banking risks are covered by capital recognised by bank regulators, insurance risks are covered by capital acceptable to insurance regulators and so on. If excess capital recognised by one regulator is to be taken into account by a regulator in another sector, it would appear necessary for the capital components to be eligible as capital under both supervisory regimes, and for their transferability (from one entity to the other) to be beyond question.

155. It is not the parent's ability to downstream funds to a subsidiary which is under scrutiny here, but the suitability of surpluses for transfer from subsidiary to parent or from one subsidiary to a sister company. The Tripartite Group endeavoured to identify what treatments are practicable and prudent to meet the requirements set out in the paragraph above. It concluded that there are two possible approaches:

(a) the identification of elements of capital recognised by bank/securities/insurance regulators as acceptable as "all round" capital and thus available to cover risks incurred by any entity within a financial conglomerate;

(b) a system whereby the excess capital in a dependant would be taken into account for the purposes of the parent/group only to the extent that the capital elements were suitable according to the rules of the parent.

Example G in Appendix III demonstrates the nature of the suitability problem. It shows a case where an insurance parent and a bank subsidiary each fulfil their solo capital requirements, but an analysis of the capital structure at group level reveals that banking risks are actually being covered by a type of capital recognised only by insurance regulators.

156. There was general agreement among members of the Tripartite Group that the diverging definitions of capital from sector to sector made it difficult to envisage harmonised capital rules in the foreseeable future. Development of the notion of "all-round" capital was considered attractive by some members because it would result in application of the most severe requirements in calculating own funds and the scope for supervisory arbitrage would therefore be considerably reduced. However, a methodology which ignored the existence of excess capital available for covering certain types (perhaps most types) of risk (but not all types) was considered by most members to be unduly restrictive and the second of the two approaches outlined above (option 'b') was generally favoured.

157. Under the building block prudential approach, capital items would be taken into account by the parent company and qualified at that level according to conditions ensuring the suitability of excess capital items for each other's block. In other words, the quantitative assessment of capital adequacy at group level would be supplemented by a further disaggregated assessment in order to ensure that each block of risks is covered by capital of an appropriate type. In the aggregation and risk-based deduction methods, the own funds and capital requirement would be assessed for each company in the group according to the rules applicable in the sector to which that company belongs. As an integral part of these two methods, the parent regulator would almost certainly be in liaison with regulators responsible for other entities within the group with a view to establishing whether amounts of any surplus capital which have been identified are indeed suitable to be taken into account for the parent's own purposes (i.e. that they are recognisable as capital under his own regulatory regime).

158. Again, some members of the Tripartite Group maintain that special attention needs to be paid to capital surpluses generated by the issue of subordinated debt by subsidiaries. Subordinated debt may well qualify as capital under the regulatory regimes of both the parent and its subsidiary, but, where it is issued by the subsidiary (see Example H in Appendix III), not only does it raise questions about the availability of any capital surpluses in that subsidiary (see paragraph 143), but its suitability to be regarded as capital for the group as a whole is also questionable (unless the debt is subordinated to the liabilities of the parent). It is even conceivable that an issue of subordinated debt by a subsidiary could be taken up by its parent. To help to alleviate this problem, some members would advocate that the qualitative assessment of capital needs to distinguish between subordinated debt issued by the parent and that issued by subsidiary companies in the group. However, other members of the group take the view that subordinated debt issued by a majority-owned (or wholly-owned) subsidiary should be regarded as available to the group as a whole.

Conclusions

159. The diverging definitions of capital from sector to sector make it difficult to envisage harmonised capital rules in the foreseeable future. With this in mind, the Tripartite Group agreed that the simplest way of ensuring that excess capital in a dependant is suitable to cover risks at parent/group level was a system whereby the extent and nature of any excess capital in a dependant would first be assessed by reference to the capital requirements of that dependant. The excess capital elements identified in this way would only be admitted for the purposes of the parent/group to the extent that they are suitable according to the rules of the parent (or, where the parent itself is unregulated, the dominant regulated entity). The regulators of the parent and the dependant would need to liaise closely over the acceptability and admission of different elements of capital.

(iv) Unregulated holding companies/unregulated dependants

160. A difficult problem occurs when a group includes substantial non-regulated activities, either at the ownership level or downstream. Supervision can only be directed at regulated entities and any sanction can only be imposed on them. It can be argued that it is difficult to insist on receiving information about non-regulated entities of a group, and yet not bear any responsibility for the well-being of those entities. The Tripartite Group itself was of the view that, notwithstanding moral hazard, supervisors should be able to obtain prudential information about the unregulated entities of a group in order to supervise the regulated parts effectively, and to be able to conduct a group-based risk assessment. There is however substantial opinion that any approach which might be adopted must avoid the impression that there is a supervisory function in relation to the unsupervised entity standing alone.

161. The following questions arise.

- Is it possible to distinguish between types of non-regulated entities with which supervisors should be concerned and those which can be excluded for supervisory purposes? If so, how should such a distinction be drawn? If not, is it possible to separate non-regulated entities which demand particular attention (e.g. leasing/factoring, reinsurance in some jurisdictions) from others? What view should be taken of group holding companies and intermediate holding companies?
- Should capital adequacy assessments be attempted for non-regulated group holding companies? If so, on what basis, and on the basis of which regulatory rules?
- If not, what problems nonetheless need to be addressed in respect of groups as a whole (e.g. contagion, capital leverage)? For example, should supervisors control the quality of capital in the regulated entity (e.g. the downstreaming of debt as equity by non-regulated holding companies) and, if so, how?

Treatment of unregulated entities according to the type of business carried out;

162. It is obviously risky to exclude unregulated entities from supervisory consideration, wherever they appear in the group structure. For unregulated entities whose activities are similar to regulated activities (notably - in some jurisdictions - leasing, factoring and reinsurance), it was agreed that it should be possible to include in the group-wide assessment of capital adequacy a notional requirement for the unregulated undertaking calculated by the application to its business of some or all of the capital standards (and valuation requirements for assets and liabilities) of the appropriate regulator (e.g. insurance rules would be applied to a reinsurance company, banking rules to a leasing company etc.). An alternative would be to use accounting techniques to consolidate the unregulated

undertaking with its regulated analogue and then apply the analogue regulator's capital standards to the consolidated numbers (e.g. a reinsurance company would be consolidated with an insurance company and the insurance sector's capital standards applied to the joint figures). The resultant sub-consolidated capital requirement would then be brought into the overall assessment of group capital adequacy[21].

163. In principle, any additional capital needed by the group as a result of the integration of unregulated financial entities should be situated in the parent or holding company of the group. Attention was drawn to the need to be mindful about creating inequality of competition between, say, leasing companies included in group assessment and those which were not.

164. Where there are unregulated entities - which may or may not be seen as holding companies - undertaking activities which cannot be regarded as financial activities (or little or no activity at all), it is suggested that the capital required by such entities is in fact dictated by the market. In other words, they can be virtually ignored for the purposes of assessing group capital adequacy because of the very low risk of contagion arising from non-financial companies. If, however, there are significant fixed assets in the unregulated entity, most members thought that there may be grounds for identifying a notional capital requirement, reflecting the extent to which those assets absorb capital, with the possible addition of a working capital requirement.

165. A small minority of the Tripartite Group, however, expressed a preference for the establishment of qualitative standards aimed at the regulated entities (rather than the application of notional capital requirements to unregulated entities either at the ownership level or downstream). They had in mind, for example, requiring notification of large capital withdrawals from the regulated entity, placing limitations on the withdrawal of funds in certain circumstances and obtaining information on other group companies. Instances of double gearing would be identified and these members would foresee the regulatory structure allowing appropriate measures to be taken in respect of the regulated entities.[22] That said,

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21 In the experience of some regulators, however, unregulated entities require higher capital ratios to operate competitively than their regulated counterparts; explicit or implicit availability of safety nets for various regulated entities provides a measure of funding advantage for them compared with unregulated financial companies. For example, some unregulated consumer lending companies in the United States need to maintain capital ratios of 15-20% in order to obtain funding in the commercial paper market which is vital to their business. Accordingly, in attempting to determine the capital needs of a non-regulated entity, supervisors may need to take account of the requirements established by the market for firms to obtain high credit ratings and ready access to low cost funding, as well as the comparable requirements for a regulated entity.

22 In certain circumstances, for example, it might be considered appropriate to apply a significantly higher (as compared with credit risk) risk asset weighting to the book value of the parent's participation in non-

ways of dealing with companies which undertake non-financial activities were not discussed in any great detail by the sub-group. It was recognised that, at the margin, there could be a problem in defining what were and what were not "financial activities".

Unregulated company as intermediate company in structure

166. Unregulated companies appearing as an intermediate company in the group structure may be mere holding companies or companies which are carrying out ancillary business on behalf of a bank, insurance company or securities firm. The main issue in the case of an intermediate unregulated holding company was thought to be ensuring that the structure of the group was conducive to effective supervision of the regulated entities. The technique for assessing group-wide capital adequacy must effectively eliminate the effects of such companies; it must ensure that the group calculation yields results which are the same as those one would obtain if there were no intermediate holding company. There were not thought to be any specific problems in doing this because supervisors could either adopt the look-through approach (under which, subject to tests as to availability and suitability, the solvency surpluses/deficits of the unregulated holding company itself and all companies owned by it would be taken into account), and/or they could integrate by using one of the methods described earlier in this paper, which would have the same effect. On this approach, third party debt issued by an intermediate holding company should be seen as a liability for the purposes of its (regulated) parent. The situation which supervisors should be seeking to guard against is the one where an intermediate holding company takes on debt with a view to channelling the proceeds to regulated entities elsewhere in the group (perhaps through the purchase of another group company's subordinated debt). An assessment of capital adequacy from a group-wide perspective, using either the building block prudential approach or risk-based deduction, would deal with this problem by the straightforward elimination of intra-group exposures if the holding company is included in the entities to be integrated; in risk-based aggregation, meanwhile, the emphasis on recognising only externally generated capital within the group should overcome this difficulty. At the end of the day, it comes back to ensuring that the existence of the intermediate holding company does not interfere with or circumvent the normal regulatory rules.

Unregulated holding company at top of structure

167. The most common problem in respect of holding companies at the top of a group structure is that they can conceal cases of double or excessive gearing arising from, for

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financial companies. The capital requirements for banks (and superordinate holding companies) in Switzerland apply a 500% weighting (equal to a 40% capital ratio instead of the standard 8%) to the net open position of non-consolidated participations in non-financial companies.

example, the issuing of debt and the downstreaming of the proceeds as equity. This situation is recognised as unacceptable (under EU legislation) in relation to banking and securities business, and is one which poses risks of financial strain for insurance companies. The problem for supervisors is that their regulatory powers do not as a rule extend to the unregulated holding company. There was agreement among members of the Tripartite Group that this problem should be addressed. At a minimum, it was considered necessary for supervisors to have the power to obtain information from (or about) unregulated holding companies so that, if necessary, they could make a qualitative assessment of the overall ability of the holding company to service any debt. Most members did not think it necessary to supervise the holding company itself and did not seek powers to be able to impose sanctions on it. They were of the view, however, that the relationship between the holding and the regulated entities needed to be monitored closely and, if a capital deficiency was identified, then there should be coordination between all the subsidiaries' supervisors on how to address the problem.

168. The "one-to-one rule" applied by bank supervisors in the Netherlands (as described in Appendix IV) was noted. In a nutshell, this ensures that there is as much capital in an unregulated bank holding company as there is in its subsidiaries (i.e. the holding company has to cover one-to-one the sum of the capital situated in its regulated subsidiaries). Although the supervisors can only take sanctions against the regulated entity, the one-to-one rule in reality facilitates indirect supervision of the holding company. The possibility of extending this rule to financial conglomerates appealed to some members, both as a means of eliminating double or excessive gearing flowing from an unregulated holding company and as a technique for identifying at an early stage capital pressures within a financial conglomerate. If the sum of the capital in the regulated entities of a conglomerate exceeded the capital available in the holding company, it would be for the lead regulator (where this was obvious) to coordinate supervisory action. Where the lead regulator is not obvious, (e.g. sister companies of similar size below a non-regulated holding company), the capital structure needs to be addressed in the first instance by the respective regulators independently; subsequently, the position could be considered jointly and a future modus operandi could be agreed upon.

169. Views on the precise sort of action that should be taken tend to be coloured by differences in the nature of the insurance, banking and securities businesses and by differences in the philosophy of regulators towards protection of customers. Securities supervisors, for example, require securities firms to have sufficient liquid assets to repay promptly all liabilities at any time; securities firms are therefore highly liquid and can be wound down in a timely manner. Insurance supervisors are also likely to be less worried about illiquidity risk arising from contagion than their banking counterparts (although market

volatility and the leverage effect of derivatives are causing some concerns). Moreover, bank risks are often short to medium term, while life insurance risks are generally long term. In seeking to protect the interests of life policy holders, most life insurance regulators are concerned primarily with the regulated insurer and with restrictions being placed on transfers of funds to other group companies or to shareholders. What is acceptable at the group level will depend to some extent on the mix of businesses that the group undertakes.

170. It is recommended that an exercise be conducted, selecting, say, the leading financial conglomerates in each country which are headed by a non-regulated (on a solo basis) holding company and which have subsidiaries in other jurisdictions; the idea would be to identify the lead regulator in each case. Under the EU's BCCI Directive, it was noted that supervisory authorities are only able to grant authorisation to banks, securities firms and insurance companies that are part of a group if they are satisfied that the structure of the group permits effective supervision. Supervisors needed enough information, not only to enable them to understand the structure of a financial conglomerate, but also to enable them to supervise the regulated entities effectively.

Conclusions

171. The Tripartite Group agreed that:

i. Unregulated entities whose activities are similar to those of regulated activities (e.g. leasing, factoring and reinsurance) should be included in group wide assessments of capital adequacy. Most members felt that the most effective way of doing this is to apply notional capital requirements derived from the analogous regulated activity. A small minority of the Group had a preference for establishing qualitative standards in respect of the regulated entities rather than notional requirements in respect of the unregulated ones;

ii. Intermediate holding companies need to be integrated into group capital adequacy assessments, using one of three techniques discussed in this paper (or by accounting-based consolidation if that is appropriate);

iii. As regards unregulated holding companies at the top of a financial conglomerate structure, supervisors need to include the holding company in their assessment of group-wide capital adequacy. If they fail to do so, there is a risk that financial conglomerates will structure themselves in such a way that a meaningful group-wide assessment of capital adequacy is not possible. Furthermore, supervisors need to have appropriate powers to obtain sufficient information about an unregulated holding company to enable them to make a qualitative assessment both of its overall ability to service any external debt and of any other measures that might be necessary in relation to regulated entities. If concerns become apparent, the regulator of the leading regulated entity can be expected to need to liaise with regulators of other parts of the group before supervisory action is taken;

iv. Notwithstanding the above, supervisors should not lose sight of the distinction between regulated and unregulated entities within a financial conglomerate. Supervisory powers, and the related sanctions, can only be directed at regulated entities if moral hazard is to be avoided;

v. An exercise should be carried out in which the leading financial conglomerates headed by non-regulated holding companies and which have subsidiaries in other jurisdictions should be identified for each of the major industrialised countries. The intention would be to build up a picture of the number of regulators and jurisdictions typically involved in the supervision of parts of a large financial conglomerate, and to see whether identification of the lead regulator in each case is obvious.

(v) Regulatory intervention issues

172. The Tripartite Group considered the following questions:

- If the group regulated companies meet their solo capital requirements, but leave a deficiency at group level, which part of the group should take responsibility? Is there a presumption that it should be the parent company of the group?
- If there is a capital deficiency at the solo level, is there a presumption that the deficiency should be dealt with there?
- What supervisory issues, if any, arise?

173. It was generally agreed that, where a capital deficit occurs at group level, the parent regulator (or lead regulator, where the parent itself is unregulated) is responsible for ensuring that it is corrected and that, where the deficit occurs at subsidiary level, the subsidiary regulator is responsible. If, however, the subsidiary cannot comply with its regulator's requirements, then it may be that the parent regulator would need to step in and ensure that the parent itself took responsibility. Much would depend on the size of the participation, on the existence of inter-company guarantees and on the expectations of regulators, quite apart from considerations of commercial self-interest. As to who should take regulatory action when all regulated group companies fulfil individual capital requirements, but there is considered to be excessive leverage in an unregulated holding company, the sub-group's view was that the lead regulator would need to raise questions about the capital position of the holding company, with possible implications for the regulated company's continued authorisation. It was not considered possible to prescribe answers to all issues of intervention other than to say that the supervisors involved needed to agree upon a plan of action.

V. Conclusion

174. In this paper, the Tripartite Group has endeavoured to provide international bodies in the fields of bank, insurance and securities supervision with a progress report on the trilateral discussions that have taken place over the past two years. As will have been evident, with the benefit of the work previously carried out by individual groups in this field, the Tripartite Group has been able to cover a significant amount of ground.

175. A range of problems which financial conglomerates pose for supervisors has been identified, and ways in which these problems might be alleviated have been discussed in some depth. Underpinning the Tripartite Group's response to many of these issues is a clear-cut need for more intensive cooperation between supervisors in the fields of bank, insurance and securities supervision. In parts of this paper, the Group has endeavoured to define some of the elements of this "more intensive cooperation", and to indicate how such cooperation might work in practice although it is recognised that, in some countries, there may be certain impediments to information exchange which need to be removed first.

176. Considerable progress has been made in identifying broad areas of agreement between supervisors in the various disciplines. Firstly, the group is unanimous in its view that there needs to be a group-wide perspective to the supervision of financial conglomerates if such supervision is to be effective. However, the Tripartite Group is also firmly of the view that group-wide supervision of financial conglomerates should not replace the solo supervision of individual group entities. It is essential that solo supervision continues to take place and that relevant prudential information relating to individual entities is fed into a quite separate group-wide risk assessment. The appointment of a lead regulator or convenor to facilitate this process and to undertake the necessary prudential assessment from a group-wide perspective is strongly recommended.

177. Despite difficulties associated with the different definitions of capital, different types of risk and different capital requirements being applied across the regulatory spectrum, considerable progress has also been made in identifying what the Tripartite Group regards as acceptable techniques for the assessment of capital adequacy in a financial conglomerate. It is envisaged that the lead regulator or convenor would undertake this assessment on the basis of information received either from other supervisors and/or directly from the financial conglomerate itself. In other areas, too (e.g. large exposures, intra-group exposures etc) methods of dealing with the special problems posed by financial conglomerates, and solutions which have the broad support of all members of the Tripartite Group, have been identified.

178. In a group where members are participating in an individual capacity, this is probably as much as one can expect to achieve. Without a mandate from their respective supervisory organisations, individuals cannot be expected to commit themselves to implementation of agreed recommendations, nor can they be expected to negotiate solutions, with which they might not be entirely in agreement, but which they might be prepared to support in order to reach a mutually acceptable outcome for supervisors in the banking, securities and insurance fields. The Tripartite Group hopes that its work over the past two years, which is encapsulated in this paper, will provide very firm foundations for any further work that may be undertaken in this regard.

APPENDIX I

Tripartite group of bank, securities and insurance regulators[23]

Chairman
Mr. Tom de Swaan, Executive Director, De Nederlandsche Bank N.V.

Belgium
M. Pierre Dubois, Directeur, Commission Bancaire et Financière

M. J.-M. Delporte, Président, Office de Contrôle des Assurances

Canada
Ms Heather Friesen, Director, Analysis, Life Insurance Division, Office of the Superintendent of Financial Institutions

France
M. Jean-Louis Fort, Secrétaire Général Adjoint, Commission Bancaire

M. Pierre Fleuriot, Directeur Général, Commission des Opérations de Bourse (COB)

Germany
Herr Jochen Sanio, Vizepräsident, Bundesaufsichtsamt für das Kreditwesen

Herr Helmut Müller, Vizepräsident, Bundesaufsichtsamt für das Versicherungswesen

Italy
Dott. Massimo Santoro, Direttore Principale, Vigilanza sulle Aziende di Credito, Servizio Normativa e Affari Generali, Banca d'Italia

Dott. Giuseppe Godano, Direttore, Servizio Normativa e Affari Generali di Vigilanza, Banca d'Italia

Japan
Mr. Masatoshi Okawa, Manager, Financial and Payment System Department, Bank of Japan

Mr. Akira Ariyoshi, Director for International Affairs, Banking Bureau, Ministry of Finance

Luxembourg
Mme Isabelle Goubin, Reviseur, 1er en Rang, Institut Monétaire Luxembourgeois

Netherlands
Dr. Arend J. Vermaat, Chairman, Verzekeringskamer

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23 Some of the members listed have since moved to other assignments.

Sweden
Mr. Mats Josefsson, Head of Credit Institutions Department, Financial Supervisory Authority

Mr. Jarl Symreng, Head of Insurance Market Department, Financial Supervisory Authority

Switzerland
Herr Peter Streit, Vice-Director, Federal Office of Private Insurance;

Herr Daniel Zuberbühler, Deputy Director, Swiss Federal Banking Commission

United Kingdom
Ms Jane Coakley, Head, Capital Standards Policy, Financial Regulation Division, Securities and Investments Board (SIB)

Mr. Jonathan P. Spencer, Head of Insurance Division, Department of Trade and Industry

United States
Mr. William L Rutledge, Senior Vice-President, Bank Supervision Department, Federal Reserve Bank of New York

Mr. Vincent Laurenzano, Assistant Deputy Superintendent of Insurance, Office of the Superintendent of Insurance, New York

Mr. Michael Macchiaroli, Associate Director, Division of Market Regulation, Securities and Exchange Commission

Mr. Harry Melamed, Deputy Associate Director, Division of Market Regulation, Securities and Exchange Commission

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EC Commission
M. Jean Pierre Fèvre, Director, Directorate General - Banks and Financial Institutions

Basle Committee on Banking Supervision
Mr. Frederik C. Musch, Secretary General

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Secretariat
Mr. David Fisher, Member of the Secretariat of the Basle Committee on Banking Supervision
Drs. André van Dorssen, Assistant Chief, Policy Planning Division, Banking Supervision Department, De Nederlandsche Bank N.V.

A P P E N D I X I I

Analysis of responses to a questionnaire on the supervision of financial conglomerates

This paper analyses the responses received to a questionnaire on the supervision of financial conglomerates from the twelve countries represented on the Tripartite Group of Bank, Securities and Insurance Regulators (Belgium, Canada, France, Germany, Italy, Japan, Luxembourg, Netherlands, Sweden, Switzerland, the United Kingdom and the United States).

For the purposes of this questionnaire, the term "financial conglomerate" was defined as "any group of companies under common control whose exclusive or predominant activities consist of providing significant services in at least two different financial sectors (banking/securities/insurance)". In relation to international financial conglomerates, responses covered the operation of branches as well as separately incorporated subsidiaries.

A. Present situation/current developments

1(a) Do financial conglomerates exist in your country? (i.e. are there any financial conglomerates whose main operational company is incorporated in your country?)

Financial conglomerates exist in most countries. **Japan** is something of an exception; it only recently (from 1.4.93) became legally possible for a Japanese bank to be the majority shareholder of a securities company and for a Japanese securities company to be a majority shareholder of a bank. Hitherto, however, Japanese banks have owned securities subsidiaries abroad and Japanese securities companies have owned banks abroad.

In general, financial conglomerates engage in a variety of activities both domestically and internationally. For example, **US** broker-dealers, either directly or through their subsidiaries and affiliates, engage in financial activities such as brokerage, trading, investment banking, merchant banking, asset management, insurance, futures and other derivative products. In addition, broker-dealer affiliates engage in commercial activities such as travel arrangements and travel-related publication services, information processing, real estate brokerage and commercial property management, retail activities, and producing and selling industrial equipment, consumer appliances and duplicating equipment.

In **Switzerland**, some conglomerates also carry out leasing, factoring, foreign exchange and precious metal trading, but in most cases the universal banking activity tends to be predominant. Some large universal banks hold majority or minority participations in industry, engineering, travel, hotels and other non-financial activities. In the **United Kingdom**, the majority of financial conglomerates are predominantly banking or insurance based. The same can be said of **Luxembourg** (where only two conglomerates exist), **Italy**, **Germany**, the **Netherlands**, **Belgium** and **France.** In **Switzerland**, **Italy**, **Germany**, **Luxembourg** and the **Netherlands**, securities business is considered to be something of a "natural" banking activity which can be conducted within the legal entity of the bank or by a separate subsidiary of a financial conglomerate.

In **Canada**, several large life insurance companies own subsidiaries that are banks or near-banks, while Canadian banks have acquired control of several domestic securities firms and a few have established or acquired insurance companies.

1(b) If so, has their relative importance grown during the last five years (measured in absolute numbers or in percentage market share)?

Except in **Japan** and **Luxembourg**, the importance of financial conglomerates has grown during the last five years, although growth in the **United States** has been slower than it was in the early 1980s. In **Sweden**, too, growth has been slow as it only became possible for banks and insurance companies to own shares in each other in mid-1991. In **Japan**, the relative importance of financial conglomerates is expected to grow as a result of the recent legislative reform.

In the **United Kingdom**, "Big Bang"(the ending of certain restrictive practices on the Stock Exchange) provided the impetus for financial diversification - in particular the emergence of conglomerates based on the acquisition by banks or existing banking groups of securities subsidiaries. The process of financial conglomeration has continued post "Big Bang".

In the **Netherlands**, financial conglomerates developed rapidly following the liberalisation of the so-called structural policy, which took place on 1 January 1990. Until that time, participations by banks in insurance companies and by insurance companies in banks were not allowed (except for participations for investment purposes of less than 15%).

Italian law has a principle separating banking and commerce. However, since 1990, credit institutions have been allowed to take equity participations in insurance companies, while the latter have in turn been able to take controlling interests in banks.

In the **Netherlands**, the market share of banks incorporated in financial conglomerates (balance sheet total) is about 70%, while the market share of insurers incorporated in financial conglomerates (in premium income) is about 65%. The market share of the three largest **Swiss** financial conglomerates was roughly 50% at end-1994.

In **Canada**, financial conglomerates have grown in importance over the last five years and will continue to do so in response to the 1992 revisions to financial institution legislation in Canada which allows financial institutions themselves to set up conglomerates. Previously, financial conglomerates were owned largely by upstream holding companies.

2(a) Are there legal or prudential restrictions on ownership linkages between financial companies in different sectors?

2(b) If so, please describe briefly what these restrictions are.

In a majority of countries, there are no legal restrictions on ownership linkages between financial companies in different financial sectors, although the **United States** and **Japan** are notable exceptions to the norm. Specific prudential restrictions exist widely and these vary from country to country.

In the **United States**, legal restrictions on the mixing of commercial banking with full-scale securities and insurance business prevent a financial conglomerate from providing all such services. Under Federal and New York state law, insurance companies cannot directly or indirectly own commercial banks (insurance laws vary from state to state); moreover, the Glass-Steagall Act generally restricts the ability of banks to engage directly in securities activities or to affiliate with securities firms[24] . Where the restricted securities activities cannot be carried on domestically by a bank, they may be permitted in a foreign branch or affiliate of the bank. In the US, banks are generally limited to acting as principal and agent for government securities and certain public debt securities, and to acting as agent for customer transactions in corporate securities. However, through interpretations of the Glass-Steagall Act, the US federal banking regulators have permitted banks to engage in certain securities activities in the United States, such as private placements, investment advisory services and discount brokerage, and have allowed bank affiliates to engage in corporate debt and equity underwriting and trading, subject to certain restrictions. US law also prohibits banks from affiliating with commercial firms and from underwriting insurance either directly or through a domestic affiliate.

The Anti-Monopoly Law in **Japan** prohibits establishment of a holding company whose main business is to control the business activities of other domestic companies through the holding of ownership. The law also prohibits a bank or securities company from holding more than 5% of a domestic company, and an insurance company from holding more than 10% of such a company, unless they receive prior permission from the Fair Trade Commission. Permission is strictly limited, for example, to cases of a bank becoming majority shareholder in a securities company or vice-versa.

In **Italy**, securities investment firms may not acquire controlling interests in credit institutions, in the parent company of credit groups or in insurance companies. However, the larger credit institutions may be authorised by the Bank of Italy to acquire controlling interests in insurance companies subject to restrictions related to the own funds of the credit institution. The prior authorisation of ISVAP is also required for the purchase of controlling stakes in insurance companies.

In the European Community, the First European Insurance Directives limit insurance undertakings to insurance business. In **Switzerland**, too, the Insurance Supervision Law requires insurance business to be legally separated from other activities for prudential and technical reasons; but banks may own insurance companies and, subject to the authorisation of the Federal Office for Private Insurance, insurance companies can own banks. Swiss banks' participations in non-consolidated entities - mainly non-financial companies - is indirectly restricted by stringent capital requirements. A capital ratio of 40% of the participation's net value is required, equivalent to 500% of the standard credit-risk weighting of 8% for unsecured claims against the private sector. Furthermore, banks have to deduct participations in insurance companies from the regulatory capital.

In the **Netherlands**, banking supervisory legislation requires a declaration of non-objection from the Minister of Finance (or from the Nederlandsche Bank on behalf of the Minister) for any participation by a bank of 10% or more in the share capital of another institution; and for any participation involving more than 5% of a bank's share capital. According to insurance supervisory legislation, similar declarations are required for any participation of more than 5% by an insurer (or by the holding company of an insurer) in a bank; and for participations of more than 5% by a bank in an insurance company.

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24 Recently proposed Federal legislation would eliminate or relax the restrictions on the mixing of commercial banking with full-scale securities business.

In the **United Kingdom** and in **Luxembourg**, the acquisition of qualifying shareholdings is also subject to certain "fit and proper" controls. Moreover, in the United Kingdom, the Bank of England and the Department of Trade and Industry Insurance Division consult one another informally about proposed ownership linkages between banks and insurance companies. Certain UK regulators also assess the prudential consequences of proposed acquisitions in respect of matters such as the ability of the acquirer's management to effect proper direction and control of any new subsidiary and the impact of the acquisition on the overall capital position of the group. In addition, mergers and acquisitions can be referred to the Monopolies and Mergers Commission (or, in certain cases, its EC equivalent) primarily, but not exclusively, on competition grounds.

In **Luxembourg**, the law requires the group structure to be transparent so that it is possible to identify the competent supervisory authority and to carry out effective supervision. The group structure must also facilitate consolidated supervision of the group where applicable, although this condition does not apply to insurance companies. The Luxembourg Monetary Institute and the Commissariat aux Assurances may oppose ownership linkages between credit institutions, insurance companies and investment firms on the grounds that these legal requirements have not been met. In any event, the taking of a participation in a credit institution, investment firm or insurance company is subject to the prior approval of the Luxembourg Monetary Institute and the Commissariat aux Assurances.

In **Belgium**, a law has recently come into force authorising credit institutions to acquire shareholdings in insurance companies without any quantitative limitations; they are also authorised by law to acquire shareholdings in broking companies. Similarly, legal requirements concerning the own funds of insurance companies include no restrictions on the acquisition of shareholdings. However, company shares held by insurance companies as securities to cover their technical reserves must not exceed, in total, 25% and, per caption, 5% of those reserves. In accordance with the third European Insurance Directive, new rules are being prepared under which the 5% limit per caption will remain but the 25% limit on the total will no longer apply. However, a new limit of 10% of technical reserves will be imposed on the total value of the securities which cannot be traded on a regulated market. Similar restrictions on the amount insurance companies can invest apply in **France** and in **Luxembourg**. Broking companies in Belgium, on the other hand, are forbidden from acquiring shareholdings in companies other than broking companies without the prior consent of the Banking and Finance Commission (BFC). This has only arisen once, when permission was granted for a broking company to acquire 100% of the capital of a credit institution.

In **Germany**, the Federal Insurance Supervisory Office (FISO) can prohibit participations in non-insurance companies. Where an insurance company holds a financial interest in another enterprise not subject to supervision, which, because of the nature of its business or because of the size of the participation, could endanger the insurance company, FISO is empowered to prohibit continuation of the interest or to impose specific conditions.

In **Canada**, there is a requirement that no shareholder in a major domestic bank should have more than a 10% interest with a view to ensuring that such banks are widely held. Financial institution legislation which came into force in June 1992 removed previous restrictions on ownership linkages between financial companies in different sectors. Restrictions still apply, however, on activities which Canadian financial institutions can engage in directly. (Companies generally restricted to core activities of banking, insurance, trust or securities).

3 What structures of financial conglomerates can be observed?

(i) "groups" in which companies participate in each other to a substantial degree

The most common structure of a financial conglomerate in **Belgium** is that of direct shareholdings between controlled enterprises operating in different financial sectors. Examples of this type of conglomerate also exist in **Germany, France, Italy, Sweden** and the **United Kingdom**.

(ii) "groups" with a licensed holding company above the (other) operating companies

The larger **US** financial conglomerates generally operate within a holding company structure. The owner may be a regulated bank holding company, an unregulated holding company, an insurance company, or a commercial firm.

In the majority of financial conglomerates in **Germany**, the main operational company is not a holding company, but is a licensed operating company (usually a bank). In **Canada**, too, the top company in the "tree" is often a bank or life insurance firm. In the **Netherlands**, a large licensed bank owns a large insurance company; and one holding company, which has a banking license, owns a large operating bank with a small insurance subsidiary. Banking subsidiaries of insurance companies in the **Netherlands** are nearly always owned by the holding company of the insurer.

Groups with a licensed holding company above the other operating companies can also be found in **Italy** (though only among credit groups), **Sweden, Belgium** and the **United Kingdom**.

In **Switzerland,** most financial conglomerates still have the traditional European group structure with the original parent bank or insurance company at the head. There are no "groups" with a licensed holding company above the other operating companies as there is no licensing requirement for holding companies. The same holds true for the two financial conglomerates in **Luxembourg**, where the parent companies are among the large players in the banking sector.

(iii) "groups" with a non-licensed holding company above the operating companies

The two largest financial conglomerates in the **Netherlands** are structured in this way and there are notable examples in **Switzerland** where non-licensed holding companies feature in the structure above the other operating companies. Conglomerates with this type of structure exist in the **United Kingdom, Canada, the United States, Sweden** and **Belgium**; and also in **Italy** and **Germany**, where they are more common in insurance based groups.

(iv) "groups" in which companies are highly integrated

There are examples of highly integrated groups in **Switzerland**. A high degree of integration can also be observed in banking groups in **Italy** and in a few cases in **Belgium**. In the **Netherlands**, it is not possible to integrate banking and insurance activities in a single legal entity. However, large conglomerates there are nevertheless integrating their banking and insurance activities with a view to achieving more synergy, and a few small banking subsidiaries are integrated to a large extent in larger insurance companies.

(v) other structures; if so, please give a brief description

In **Germany,** there are a number of mixed conglomerates, where a bank has major participations in other financial conglomerates as well as in industrial companies. The explanation for this lies in the fact that, historically, banks, as major creditors, have taken participations in industrial companies which have got themselves into economic difficulties.

Overall, most financial conglomerates tend to establish separate companies to specialise in specific financial activities or to set themselves up in different countries. Frequently, group structures reflect differences in regulatory requirements between countries (i.e. regulatory arbitrage). The structure of groups in the **United Kingdom** also seems to be driven by factors such as taxation, facilitation of dividend payments and management incentives. Often, day-to-day management there is undertaken without reference to the legal structures and is instead based on sectoral analysis reflecting the various types of commercial activity undertaken by the group.

4(a) Do mixed conglomerates (i.e. economic groups of companies encompassing financial and non-financial companies) exist in your country?

Mixed conglomerates exist to a limited extent in most countries. In **Belgium** and in **Canada**, however, they are said to play a major role in the economic life of the country.

In **Switzerland**, the most obvious example is CS Holding with its main activities in the financial sector, but substantial participations in the non-financial sector (Electrowatt: energy, engineering, industry; and Fides: trust business, management consultancy etc).

The non-financial activities of **UK**-based financial conglomerates tend to be a minor part of their overall business and they are often service based (e.g. leisure companies or estate agencies, many of which carry on investment business as appointed representatives of life offices in selling mortgage related endowment policies). Few, if any, UK-based financial conglomerates are involved in manufacturing. Some UK-based non-financial conglomerates have diversified into financial services.

In the **United States**, a non-financial firm can own a broker-dealer; and mixed conglomerates can also exist in the insurance industry, where the head of the conglomerate is often a public non-financial operating company. However, federal banking laws generally prohibit commercial firms from owning a US commercial bank or bank holding company, although they may be able to acquire a foreign bank or savings association. For their part, banks and bank holding companies cannot own or acquire commercial companies that are not engaged in activities which are "closely related" or "incidental" to banking.

In the **Netherlands**, a few insurance companies are part of mainly non-financial conglomerates; in **Japan**, there are a few financial companies which are owned by non-financial companies.

In **Italy**, when a bank is involved, the non-financial component of a mixed conglomerate must be no more than 15% of the balance sheet assets of the entire conglomerate. It is quite common for industrial groups in Italy to contain sub-conglomerates of financial and insurance companies.

Mixed conglomerates in **France** also encompass financial and industrial companies. Insurance companies there have very little in the way of shareholdings in non-financial companies, but examples can be found of banking activity being undertaken alongside car manufacturing or the operation of retail department stores within a mixed conglomerate.

4(b) If so, has their relative importance grown during the last five years?

The relative importance of mixed conglomerates has not grown during the past five years. On the contrary, most banking groups in **Switzerland** seem to be concentrating their activities in the financial sector because their participations in companies with non-financial activities attract a very high capital adequacy requirement (see question 2b above). Participations in industrial or commercial companies are held by banks in both Switzerland and **Germany** either on a long term basis due to historical links, or temporarily to restructure bad loans and/or rescue important firms in the public interest. New strategic investments in non-financial firms are rare; there has in fact been some disinvestment by mixed conglomerates in the financial sector.

5(a) Are financial companies - operating either as independent firms or as part of a conglomerate structure - allowed to sell each other's products?

Practices vary considerably in the twelve countries.

In the **Netherlands** and in **Sweden**, there are no limitations on the sale of each other's products by financial companies operating either as independent firms or as part of a conglomerate.

At the other end of the spectrum, in **Japan**, financial companies in different financial sectors are not allowed to sell each other's products, although securities companies can sell bank debentures and both banks and securities firms are allowed to sell certain financial instruments (e.g. government bonds).

In the **United States**, the types of securities and insurance products that banks may sell are restricted and the federal banking laws prohibit banks from tying credit extensions to other services. There are also various restrictions governing relationships between banks and their affiliates that are engaged in certain types of securities activities. However, dually-licensed employees of both an insurance company and a broker-dealer can sell both insurance and securities products.

In the **United Kingdom**, financial companies - operating either as independent firms or as part of a conglomerate structure - are allowed to sell each other's products. However, in the retail market, a distinction is made between firms acting as "tied agents" of the product provider(s) and firms acting as independent intermediaries (independent financial advisers - IFAs). As a tied agent, a financial firm can only sell the products of the provider(s) to which it is tied (which can be a group member). For life insurance, a tied agent can only be tied to a single company or group; for non-life, the agent can have up to six ties. Independent intermediaries must offer advice by considering a range of products from different providers across the market. In the distribution of life insurance, the major financial groups have tended to shift from IFA status to tied agents status.

In **Canada**, insurance agents may be licensed to sell the products of more than one company; they may also obtain a license as a mutual fund distributor. However, while a bank may own an insurance company, the bank may not act as an insurance agent, market insurance products through its branches or provide space in any of its Canadian branches to insurers or their agents. In addition, there are rules governing the bank's ability to promote insurance products; these largely address competitive concerns rather than prudential concerns.

Licensed banks in **Switzerland** can sell as many financial products as they wish, provided they have adequate organisation and expertise. Insurance companies there are allowed to sell certificates of investment funds, but cannot carry out deposit-taking.

In **Italy,** banks may sell securities products and the sale of standardised insurance policies may also be effected directly by a bank or through an agent or broker. Securities investment firms may sell all types of financial instruments (including insurance policies), with the exception of typical banking products.

In **Belgium**, legal and regulatory restrictions limit the possibilities for broking companies to act as agents of banks and the marketing of insurance products through broking companies is also quite rare. On the other hand, there are no legal restrictions on agreements between insurance companies and banks for the reciprocal marketing of each other's products, and numerous such agreements currently exist or are being developed.

In **Luxembourg**, banks and investment firms are not allowed to do insurance business on their own account but can do so through a subsidiary. Regulatory approval is required in order to set up or take a participation in an insurance company. Insurance companies themselves are not allowed to engage in banking activities on their own account, but can take a participation in a bank or investment firm provided that the legal authorisation requirements are met. There too, a number of agreements have been reached in recent years allowing insurance companies to distribute their products through the banking network. Securities business is conducted mainly through banks which, with the prior approval of the Luxembourg Monetary Institute, may take equity stakes in investment firms. On the other hand, investment firms themselves are not allowed to engage in banking activities (except investment), but may take a participation in a bank provided that the legal authorisation requirements are met.

In **France**, only firms with a banking license are allowed to sell banking products. However, banks may sell non-banking products such as insurance as long as such operations remain of limited importance in relation to the institution's normal business (i.e. less than 10% of net banking income) and they do not hinder, restrict or distort competition on the market concerned. In the case of insurance/bank conglomerates, it is quite common for employees of insurance companies to sell policies in the offices of the bank to which their company is affiliated.

In **Germany**, too, insurance companies are not allowed to sell banking products. Nevertheless, in the last five years, the importance of cross-selling has increased considerably there. However, this is not limited to financial conglomerates because there are a number of cooperations between banks and insurance companies which are neither based on cross-ownership nor on joint group membership.

5(b) If so, to what extent does this occur?

In the **Netherlands**, almost all banks act as intermediaries for insurance companies, while there are insurance intermediaries or insurance companies which sell savings products of the banks of the financial conglomerate of which they are part.

In **Sweden,** in practice, only life insurance products are sold through the banks and it is quite unusual for insurance companies to offer banking services.

In **Luxembourg**, the distribution of insurance products through banking networks is still limited. Insurance companies do not sell the products of banks and investment firms.

In the **United States**, where a financial conglomerate contains both an insurance and a securities group, it is quite common for dually-licensed employees of both the insurance company and the broker-dealer to sell insurance and securities products.

In **Belgium**, some banks already sell a range of insurance products (life and non-life), mainly to retail customers; while some insurance company agents sell investment and credit instruments offered by the banks to which their insurance companies are affiliated through cooperation agreements.

In **France** and in **Germany,** the importance of the cross-selling of banking and insurance products is also growing, while, in the **United Kingdom**, many banking-dominated conglomerates now own life offices and recommend their products. Cross-selling activity is also on the increase in **Switzerland** although it is not yet important there.

In **Japan**, a sizeable portion of bank debentures is sold through securities companies.

6(a) Do you have in your country financial conglomerates with (regulated) parts in other G-10 countries?

Most countries have financial conglomerates with regulated parts in other G-10 countries.

In the **Netherlands** and **France**, most conglomerates operate internationally, often on a substantial scale.

In **Switzerland**, there are about a dozen international financial conglomerates with a domestically incorporated parent, but there are also around 150 foreign dominated banks operating in Switzerland through locally incorporated subsidiaries of foreign banking groups or foreign securities firms. The big Swiss banking groups operate in all major financial centres of the world; they carry out most universal banking activities, but generally concentrate on the wholesale side of the business. Depending upon local legislation, activities are carried out through branches or through specialised subsidiaries; securities and derivatives business tends to be conducted through subsidiaries. In recent years, the main internal growth of these groups has taken place outside Switzerland. Swiss-based insurance groups, offering insurance and other financial services through subsidiaries or branches, have also been established in several G-10 countries.

In the **United Kingdom**, there are an estimated 60 UK-based financial conglomerates with regulated parts in other G-10 countries. The main international operations of financial conglomerates represented in the United Kingdom are in the world's major financial centres in the United States, Japan and Western Europe, although the insurance dominated conglomerates are more widely spread. In addition, a large number of financial conglomerates based in other G-10 countries have operations in the United Kingdom.

US banks, broker-dealers and insurance companies do business in other G-10 countries through the establishment of branch offices, through their subsidiaries and affiliates or by the establishment of joint ventures.

Exceptions to the norm are **Belgium** and **Luxembourg**. The presence of Belgian financial conglomerates is limited, except in Luxembourg; while the Grand Duchy's own two financial conglomerates are not represented in other G-10 countries.

6(b) Do you have in your country financial conglomerates with substantial intra-group exposures? What kind of exposures are they (e.g. trading, guarantees, etc)?

Many financial conglomerates in the **United Kingdom** generate substantial intra-group exposures. These include, but are not limited to:-

- trading exposures (both between group companies located in the United Kingdom and between UK and overseas group companies, reflecting global trading);
- exposures arising through the central management of short-term liquidity in many banking dominated groups and in some financial conglomerates where banking is not the predominant activity;
- provision of longer term finance;
- equity investments in subsidiaries and associated group companies;
- exposures arising from the provision of services (e.g. cost of overheads or of group pension arrangements);
- guarantees given to or received from other group companies.

The UK supervisors' response to intra-group exposures is twofold. First, there are legal restrictions in both company law and in supervisory law which are of general application; and second, supervisory practice is designed to ensure transparency. Certain information on intra-group transactions has to be provided automatically to supervisors, and supervisors also have powers to seek more information , and to intervene as necessary.

In the **United States**, intra-group exposure within a financial conglomerate can result from activities such as the extension of credit, equity investments, trading exposures, financing and guarantees. US laws impose capital and collateral restrictions on banks' transactions with their affiliates. Moreover, the banking regulators regularly monitor and control intra-group exposures. In the case of broker-dealers, the SEC's net capital rule limits intra-group exposure. The broker-dealer holding company risk assessment programme enables the SEC to monitor the risks posed to broker-dealers by other entities within a financial conglomerate. As far as US insurance companies are concerned, intra-group exposures, off-balance sheet transactions and guarantees have to be disclosed in an annual statement that is filed with state insurance departments. Intra-group exposures have become something of a concern within the US insurance industry, mainly because of the risk of contagion.

In **Canada**, rules applicable to transactions with related parties have been effective in minimising intra-group exposures. Loans are generally prohibited and sales of assets are subject to regulatory review to establish that they are carried out at market rates. Parent-subsidiary relationships are an exception; here it is common for there to be guarantees or support agreements.

In **Switzerland**, intra-group exposures of licensed banks are limited by large exposure limits in the same way as exposures to third parties. However, Swiss banking subsidiaries of foreign banks are authorised to exceed those limits vis-a vis other banks and adequately supervised securities firms of the same conglomerate provided the excess exposure is covered by pledged deposits with the Swiss subsidiary. Most intra-group exposures in the banking sector are loans or financial derivatives contracts, rather than guarantees. In the insurance sector, substantial exposures between group members may occur when reciprocal reinsurance is involved.

In **Belgium**, intra-group exposures are limited to 25% of the own funds of the credit institution involved (but this does not apply to the risks incurred by credit institutions on their subsidiaries or on a parent institution which is an OECD-incorporated credit institution, subject to consolidated supervision). Intra-group exposures which are not concluded at arm's length have to be deducted from the credit institution's own funds. There are no specific regulations on intra-group exposures of insurance companies, other than the general restriction on securities that cover technical reserves, and the general principles of security, profitability, liquidity and diversification, which must also be complied with.

In **Luxembourg**, too, banks' intra-group exposures are limited (currently to 30% of own funds). This limit will be reduced to 20% with effect from 1st January 1999. The situation with regard to intra-group exposures of insurance companies is the same as in Belgium

In the **Netherlands**, there are occasional subordinated loans between banks and insurers; while, in **Sweden**, intra-group exposures exist in the form of loans and security guarantees.

In **France**, banks lending more than 5% of own funds to shareholders who own more than 10% of the group's capital must notify the Commission Bancaire, while the constant supervision of insurance companies enables the supervisory authority to examine existing links and the risks they may cause.

In **Italy**, substantial intra-group exposures do not exist between firms which are part of credit groups and other parts of conglomerates as they are strictly limited by the prudential regulations stipulated in the EC Directive on large exposures. In the case of financial conglomerates that cannot be described as credit groups, when insurance companies are involved, substantial intra-group exposures can sometimes be found in the form of loans or guarantees from the insurance company to other members of the group.

In **Germany**, the main intra-group exposures of banks are loans to non-financial parts of the group. Exposure between banks and insurance companies arises from trading activities, while the insurance companies themselves also have loans outstanding to other parts of their group.

B. Supervision of Financial Conglomerates

1(a) Which national bodies are the principal regulators/supervisors of financial and mixed conglomerates?

In the **Netherlands**, the principal regulators/supervisors of financial and mixed conglomerates are:- The Ministry of Finance - legislation; Nederlandsche Bank - supervision of banks; Verzekeringskamer (Insurance Board) - supervision of insurance companies; Stichting Toezicht effectenverkeer (Securities Board of the Netherlands) - supervision of securities business, stock exchange.

In **Switzerland**, banking activities (including securities transactions) and collective investment funds are subject to prudential supervision on a consolidated basis by the Federal Banking Commission. When the new Federal Law on securities firms and exchanges comes into force in 1996, non-bank securities brokers/dealers, who are currently only regulated on a cantonal basis, will also be subject to federal prudential supervision by the Federal Banking Commission. Insurance activities are supervised by the Federal Office for Private Insurance.

In the **United States**, banks and their subsidiaries are subject to consolidated supervision and examination by their primary federal banking authority (i.e. the Office of the Comptroller of the Currency in the case of a national bank; the Board of Governors of the Federal Reserve System (FRS) in the case of a state chartered bank that is a member of the FRS; and the Federal Deposit Insurance Corporation (FDIC) in the case of a state-chartered bank that is not a member of the FRS and is insured by the FDIC. State chartered banks are also subject to regulation and examination by state banking authorities. Bank holding companies and their subsidiaries are subject to consolidated supervision and examination by the Federal Reserve Board. The Securities Exchange Act of 1934 provides for the regulation of US securities markets and the broker-dealers that participate in those markets. Regardless of their corporate nature, domestic and foreign non-bank firms effecting securities transactions utilising the US jurisdictional means are required to register with the SEC as broker-dealers (US banks including most branches and agencies of foreign banks that are doing business in the United States, and are supervised and examined by US federal or state banking supervisory authorities, are excluded from the definition of "broker" or "dealer" in the Securities Exchange Act). There are no national bodies that regulate the insurance industry in the United States; instead, the industry is regulated by the insurance commissioners of the 50 states. Regulation of insurance companies within financial conglomerates is carried out by insurance commissioners according to the state in which a company is incorporated and domiciled. The insurance commissioner also has regulatory authority over companies that are authorised to do business in his/her jurisdiction.

In **Canada**, the principal regulator of financial institutions is the federal Office of the Superintendent of Financial Institutions (OSFI), which was formed in 1987 from the amalgamation of the former Department of Insurance and the Office of the Inspector General of Banks. The OSFI has sole responsibility for the supervision of banks. Supervisory responsibility for insurance companies and trust and loan companies is shared between the OSFI and the provincial authorities with the OSFI responsible for solvency of federally incorporated companies and foreign insurers operating in Canada on a branch basis; and the provinces responsible for matters of contract and licensing of agents, and for the solvency of provincially incorporated companies. The provinces have sole responsibility for the supervision of securities firms.

In the **United Kingdom**, the principal regulators/supervisors of financial and mixed conglomerates are:- The Bank of England - deposit-taking institutions authorised under the Banking Act 1987; the Building Societies Commission - deposit-taking institutions authorised under the Building Societies Act 1986; the Department of Trade and Industry Insurance Division - companies authorised under the Insurance Companies Act 1982 to carry on insurance business; the Securities and Investments Board - a small number of institutions authorised under the Financial Services Act 1986 to carry on investment business; self-regulating organisations (SROs) recognised by the SIB - the vast majority of firms authorised to carry on investment business.

In **France**, the Minister of Economy is responsible for legislation; the Comite de la Reglementation bancaire elaborates the banking legislation; the Commission Bancaire supervises banks; the Comite des Etablissements de Credit assesses the quality of bank shareholders at the authorisation stage; the Conseil des Bourses de Valeurs and Commission des Operations de Bourse have joint responsibility for the supervision of securities firms; and there is an insurance supervision authority.

In **Italy**, the Bank of Italy is the supervisory authority for credit groups (i.e. banks and securities investment firms), although the Companies and Stock Exchange Commission (Consob) have some powers over individual intermediaries as regards information requirements, and securities dealing. Insurance companies are supervised by the insurance supervisory authority, ISVAP.

In **Germany**, the Federal Banking Supervisory Office (FBSO) is responsible for the supervision of banks, and the Federal Insurance Supervisory Office (FISO) for the supervision of insurance companies.

In **Belgium**, the Banking and Finance Commission supervises banks and financial conglomerates as defined by the EC-directive 92/30; the Office de Controle des Assurances is responsible for the supervision of insurance companies; and the Caisse d'íntervention des societes de bourse/Interventiefonds van de beursvennootschappen (CIF) supervises broking companies.

In **Luxembourg**, the Luxembourg Monetary Institute supervises banks on a solo and consolidated basis, but consolidated supervision does not extend to insurance subsidiaries; the Luxembourg Monetary Institute is also in charge of the supervision of investment firms. The Commissariat aux Assurances supervises insurance companies.

In **Japan**, the Ministry of Finance is responsible for implementation of the Banking Law, Securities and Exchange Law and Insurance Business Law, while the Bank of Japan conducts on-site examinations at banks and securities companies for whom it maintains accounts.

In **Sweden**, since the 1991 merger of the former Bank Inspection Board and the Insurance Authority, the Financial Supervisory Authority has been responsible for supervision of the whole credit market.

1(b) How is the supervision put into effect?

In the **Netherlands**, in consultation with the Minister of Finance, the Nederlandsche Bank and the Verzekeringskamer reached an agreement in the form of a Protocol concerning the supervision of financial conglomerates. The main principle of the Protocol is that the Nederlandsche Bank supervises the banks and the Verzekeringskamer supervises the insurers which form part of financial conglomerates. The fact that conditions can be attached to the granting of a declaration of non-objection makes it possible to implement the provisions of the Protocol. The holding company is not as such subject to supervision unless it is an authorised institution. However, the Nederlandsche Bank and the Verzekeringskamer must be supplied annually (and in the near future every six months) with financial information from financial holding companies regarding their solvency position and intra-group financing. A revision to the Protocol took place in 1994 which, together with amendments to supervisory legislation, makes it possible for the supervisory authorities to subject the management of an unauthorised holding company to a fit and proper test; to assess their banking or insurance expertise; and to summon them to account for their policy. Supervisory authorities and the Minister of Finance are also able to decline requests for a declaration of non-objection in the case of conglomerates whose organisation and control structure is considered insufficiently transparent and is thus an obstruction to adequate supervision.

In **Belgium**, the banking and insurance supervisors have also concluded a protocol on the coordination of their respective supervisory tasks in November 1992. This does not give any of the authorities concerned a leading responsibility for the supervision of groups which include both insurance companies and credit institutions; but it does provide rules for the exchange of information and for cooperation between the two authorities.

In **Switzerland**, the Federal Banking Commission relies to a great extent on the examination work and audit reports of external auditors, which have to be licensed for bank audits by the Banking Commission. In fact, the whole supervisory system for banks rests on two pillars: The Banking Commission which, as a government agency, has all the enforcement powers and supervises the bank audit firms; and the bank audit firms themselves who have to carry out the field work and provide the requisite information to the Commission. External auditors are therefore the essential supervisory tool for assessing the risks of financial conglomerates in the Swiss system. The licensed bank audit firm can require from the regulated entity all information about other (regulated or non-regulated, domestic or foreign) group companies which it needs for the consolidated audit and reporting. It has full access to the reports of internal group auditors and external auditors of group companies, communicates directly with these other auditors and is also empowered to carry out audits itself in group companies. Very often, all entities of a financial conglomerate are audited by the same audit firm or group of associated audit firms. Prudential supervision of non-bank securities broker/dealers under the new Federal Securities Law will follow the same principles. The Federal Office for Private Insurance carries out its supervisory tasks mainly by means of on-site inspections and on the basis of reports which companies have to submit each year; these reports contain detailed information on all aspects of the companies' business.

In **Sweden**, the Supervisory Authority relies on reports highlighting risk exposure, reports from appointed auditors and on-the-spot examinations of special functions in order to carry out its supervisory responsibilities.

In the **United States**, banks, bank holding companies and their subsidiaries are subject to applicable laws, regulations and standards, including consolidated capital adequacy standards; standards and approval with respect to ownership of, and acquisitions by, holding companies; standards regarding the types of transactions that are permitted or prohibited between affiliates; and standards regarding individuals who can participate on bank holding company boards of directors. The bank or bank holding company's regulator has the power to require changes in the activities and structure of a conglomerate, to limit expansion or diversification, and to remove bank officials. Registered broker-dealers are also subject to holding company risk assessment requirements and to business conduct and capital adequacy standards under the Securities Exchange Act, and to the rules of the self-regulatory organisation with respect to the business of acting as a broker-dealer in securities. In the insurance world, most states have similar laws governing such areas as capital, reserves, holding companies and reinsurance.

In the **United Kingdom**, the supervisory authorities use a variety of methods to put supervision into effect. The main focus of supervision applied by the supervisory authorities is on the supervision of solo group companies, but this is supplemented by various forms of consolidated/group supervision. For example, the Bank of England and the Building Societies Commission apply consolidated supervision in accordance with the relevant directives, while the Securities and Investment Board and the Self Regulating Organisations (SROs) apply a more qualitative approach. The Bank of England, the Department of Trade and Industry Insurance Division, the Securities and Investments Board and the four SROs supplement the supervision of solo regulated group companies with group-based information which is exchanged at regular college of supervisors' meetings.

In **France**, the supervisory authorities are able to request information from, or to conduct investigations into, parts of a conglomerate for which they are not directly responsible.

In **Canada**, considerable progress has been made towards coordinated supervision of financial conglomerates through the sharing of information and, in certain cases, the conducting of joint inspections of companies regulated by different jurisdictions within Canada. Groups often include players that are subject to regulation by different levels of government, making it necessary for coordination of supervision to cope with differences between political jurisdictions as well as differences in incorporating statutes.

In **Germany**, to the extent that parts of a group carry out banking or insurance business they are subject to the supervision of FBSO or FISO. However, neither supervisory authority has the legal power to extend its supervision to entities which are not banks or insurance companies; in consequence, the supervision of financial conglomerates is limited to regulated entities.

In **Luxembourg**, the Luxembourg Monetary Institute supervises the banking and investment parts of a group; consolidated supervision extends to the financial institutions of a conglomerate. The Luxembourg Monetary Institute may require group-based information from other regulated and non-regulated entities. The Commissariat aux Assurances supervises exclusively the insurance companies in a group on a solo basis.

In **Japan**, the Ministry of Finance has the legal power to request information from, or to conduct investigations into, subsidiaries of banks and securities companies. The Bank of Japan, as a part of its on-site examinations, is able to obtain information on subsidiaries for which the Bank is not directly responsible.

2(a) Where more than one supervisory authority is responsible for (some part of) a conglomerate, how are supervisory responsibilities allocated?

In the **United Kingdom**, supervisory responsibilities for a financial conglomerate are allocated by statute. Group companies within a conglomerate are subject to functional rather than institutional supervision. A banking-dominated financial conglomerate, for example, whose investment business is conducted within the banking entity itself rather than through a separately incorporated subsidiary is subject to supervision by both the Securities and Investments Board or an SRO and by the Bank of England. Insurance companies may only carry on insurance business and connected activities; an insurance company within a group will always be supervised by the Department of Trade and Industry Insurance Division. In practice, the concept of lead regulator is applied to all financial conglomerates operating in the United Kingdom with a view to maximising the effectiveness of statutory supervisory responsibilities. In general, the role of lead regulator is allocated to the supervisory authority responsible for the dominant regulated activity within a financial conglomerate.

In the **Netherlands**, in **Luxembourg** and in **Belgium**, supervisory responsibility is shared between the banking/securities supervisors and the insurance supervisors according to the nature of the business undertaken (see answer to question 1b in this section in respect of the Netherlands). However, Belgian law has recently introduced the concept of a lead supervisor for the supervision of financial groups on a consolidated basis whenever a credit institution belongs to a financial conglomerate with parts in several countries of the European Community.

In the **United States**, supervisory responsibilities are also allocated according to the nature of the activities involved. Securities activities of US banks permitted by the Glass-Steagall Act and other US laws are subject to regulation and examination by US bank regulators. However, the securities activities of separately incorporated subsidiaries and affiliates of US and foreign banks undertaking these activities, as well as those of the foreign banks themselves, are not excluded from the definition of broker and dealer under the Securities Exchange Act of 1934 and are, therefore, subject to regulation by the SEC and the self-regulatory organisations.

In **Canada**, supervisory responsibilities derive from the jurisdiction of incorporation of the various institutions. In **France**, when more than one supervisory authority is responsible for a conglomerate, supervisory responsibilities are allocated through cooperative arrangements. Typically, liaison committees have been set up, comprising the supervisors responsible for different financial activities.

In **Switzerland**, financial conglomerates comprising both banking (including securities) and insurance activities are a comparatively recent innovation and, in consequence, cooperation between the Federal Banking Commission and the Federal Office for Private Insurance has been rather loose and informal. This will change as linkages between the two sectors strengthen with the appointment of a lead regulator depending upon the predominant character of the financial conglomerate in question.

In **Germany**, there is no change to the 'natural' allocation of responsibilities in the case of financial conglomerates. The FBSO supervises the entities (and only these) which carry out banking business; the FISO supervises the entities (and only these) which carry out insurance business.

In **Italy**, when an insurance company forms part of a financial conglomerate either as a majority shareholder or as a subsidiary, it is subject to solo supervision by ISVAP. For conglomerates composed of an insurance company and a securities investment firm, prudential supervision is conducted on a solo basis by both ISVAP and the Bank of Italy.

2(b) Are you supervising any non-licensed holding companies in financial or mixed conglomerates?

In **Switzerland,** non-licensed holding companies are not supervised directly. However, regulated entities in both the banking/securities and insurance sectors are supervised in a group context, with any superordinate holding company and sister companies being included in the risk assessment. The principle that any deficiency of capital at holding company level - as measured by banking regulatory standards on a consolidated basis - must be balanced by additional capital in the main bank of the group has been confirmed in the Swiss courts, and was integrated in the Banking Ordinance in 1994.

In the **Netherlands** and in **Canada,** holding companies are not supervised unless they have a license. However, supervisory legislation (and, in the Netherlands, the Protocol between the Nederlandsche Bank and the Verzekeringskamer) make it possible for the authorities to obtain information from holding companies.

Non-licensed holding companies are often located at the head of **United Kingdom**-based, banking or insurance dominated financial conglomerates. In the absence of other regulatory authorities for such banking institutions, the Bank of England (the Bank) maintains a substantial dialogue with the non-licensed holding companies and has power to request information about them from the Banking Act authorised entity within the group. The Department of Trade and Industry Insurance Division has similar powers in respect of non-licensed holding companies of insurance dominated conglomerates. Moreover, the Bank includes non-licensed holding companies of UK-based banking dominated financial conglomerates in its consolidated supervision in accordance with the provisions of 2CSD.

In **Sweden,** the Financial Supervisory Authority also takes account of non-licensed holding companies when calculating capital ratio requirements of banks on a consolidated basis. The Authority has powers to seek information from holding companies for supervisory purposes.

In **Belgium** and **Luxembourg**, non-licensed holding companies in a financial or mixed conglomerate are not subject to solo supervision. Non-licensed holding companies are, however, taken into account in the consolidated supervision carried out by the Luxembourg Monetary Institute over banking groups. The Institute is further empowered to seek information for prudential purposes from the holding companies which are part of a mixed conglomerate.

In the **United States** and in **Germany**, while one or more of the entities controlled by a non-licensed holding company may be regulated, the non-licensed holding companies themselves are not directly subject to supervision. In **Japan**, non-licensed holding companies exist in only a few cases where non-financial companies own financial companies; they are not supervised directly.

In **France**, the Commission bancaire supervises non-licensed holding companies in financial or mixed conglomerates. Financial holding companies that do not have credit institution status are required to draw up their accounts wholly or partially in a consolidated form as concerns their banking activity, even though they are not subject to prudential regulation. The supervision of holding companies in mixed conglomerates is carried out in liaison with other relevant authorities.

In **Italy**, holding companies of credit groups are supervised by the Bank of Italy on both a solo and a consolidated basis. On the insurance side, however, non-licensed holding companies controlling one or more insurance companies are not supervised.

2(c) If not, who is supervising such non-licensed holding companies?

In most countries, non-licensed holding companies are not directly supervised. In the **Netherlands**, however, the Protocol provides for the supervisors to be supplied with information about non-licensed holding companies (see answer to question 1b in this section).

3 What can supervisory authorities do:

(i) to prevent "double gearing": dual or multiple use of the same capital in several members of a financial conglomerate, or where the parent company finances its capital subscription to a supervised subsidiary by issuing debt;

One method of preventing double gearing is to deduct the book value of participations in subsidiaries from the parents' liable funds (capital deduction). In the **United States,** double counting of capital is prevented by deducting from bank holding companies' total capital any investments in banking and finance subsidiaries whose financial statements are not consolidated for accounting or bank reporting capital purposes. In addition, on a case by case basis, investments in certain other subsidiaries are deducted from bank holding companies' consolidated total capital if the resources in those subsidiaries are not generally available to support additional leverage or to absorb losses elsewhere in the organisation. For example, capital invested in broker-dealer subsidiaries is deducted for the purposes of assessing group-wide capital adequacy (i.e. securities subsidiaries are required to comply on a stand-alone basis with capital regulations administered by the SEC). The SEC's net capital rule requires registered broker dealers to maintain sufficient liquid assets to enable firms that fall below the minimum capital requirement to liquidate in an orderly fashion without a formal proceeding. The net capital rule does not apply to non-registered affiliates of broker-dealers (including the parents), but the effects of any double leverage are minimised because the net capital rule requires, among other things, that (i) a broker-dealer that makes an unsecured loan to, or an investment in, its holding company parent, affiliates, or subsidiaries to deduct the full amount of the loan or investment when computing net capital; (ii) a broker-dealer to notify the SEC of large capital withdrawals made to benefit affiliates, subsidiaries and other persons related to the broker-dealer, and the SEC has the authority to halt certain capital withdrawals on a temporary basis in certain situations; and (iii) a broker-dealer to consolidate, in its net capital computation, the assets and liabilities of any subsidiary or affiliate that the broker-dealer guarantees, endorses, or assumes liabilities. In the US insurance industry, new risk based capital requirements have been introduced to address the issue of double gearing. When calculating an insurer's capital, the capital charge for its insurance subsidiaries is equal to the risk-based capital of those subsidiaries. The capital charge for all other operating subsidiaries of life insurers is 30% of the equity value of the subsidiary, and for non-life insurers 22.5% of the equity value of the subsidiary. In the United States, market forces limit the amount of double leverage in a financial conglomerate. In determining ratings on debt securities, one of the factors rating agencies consider is the amount of double leverage, if any, that exists in the conglomerate. Higher more favourable ratings result in, among other things, greater access to financing and a lower cost of capital than that available to lower rated issuers.

In **Canada**, the supervisory authorities have relied on a two-part approach to prevent double gearing. The capital test applicable to financial institutions requires consolidation of any subsidiary carrying on similar financial activities and "shaving" or elimination of the amount invested in an unlike financial subsidiary from the parent's capital. However, it is recognised that the consequences of either approach are not necessarily the most appropriate. In the supervision of property/casualty insurers, the required capital (including statutory margins) for the subsidiary has been deducted from the parent company's capital, enabling the parent to benefit from any excess investment in the subsidiary. Similarly, it is possible to review the regulations applicable to the subsidiary to confirm whether this excess capital is available to the parent. Under this approach, each institution is tested by its supervisory authority on a stand-alone basis. An advantage of this is that it helps resolve conflicts that arise due to different accounting and capital regimes that may be applicable to corporations of a different nature or to those domiciled in different jurisdictions.

Although in principle effective, the deduction of participations in subsidiaries may not be an accurate reflection of the true risk taken on in the subsidiaries. Another method is to deduct the solvency margins of subsidiaries from the parents' own funds, but this penalises parent companies whose subsidiaries have endowed their own funds out of profits. In these cases, the book value of the parent's participation is lower than the subsidiaries' solvency margin. In the long run, this method reduces the incentive for parent institutions to strengthen the capital bases of their subsidiaries from retained earnings.

Several variants of these deduction methods try to avoid this disadvantage. One such variant is used by the FISO in **Germany**; this involves aggregating the capital requirements of all regulated entities in a group specified by the respective supervisors in order to obtain the capital requirement at group level. Since intra-group exposures do not cancel out in the aggregation process, the deduction of solvency margins tends to be harsher than prudential consolidation. On the other hand, its application is limited to cases where the aggregating supervisor can be sure that the capital requirements specified by the subsidiaries' supervisors are adequate; this may not be the case for financial conglomerates with entities in "regulatory havens".

This disadvantage can be avoided with prudential consolidation, which is the method used in **Germany** for the consolidation of banking groups. This involves the aggregation at group level of assets and liabilities vis-a-vis external creditors and debtors (i.e. intra-group exposures cancel out). The application of capital requirements to the consolidated balance sheet prevents double gearing. Furthermore, since capital charges are applied to risk positions actually taken on in the group's entities, this method neither understates nor overstates the risks. This concept could be transposed to conglomerates with entities in different financial sectors. Assets and liabilities would have to be added as described and grouped according to the risk they represent. For each category of risk, the respective capital charges would apply. The resulting capital requirements would have to be met by the group's liable funds with a distinction made between different types of capital.

The supervisory authorities in **Belgium** also regard prudential consolidation as a means of preventing double gearing by credit institutions. Shareholdings in affiliated enterprises and in enterprises linked by a participating interest (where such enterprises are credit institutions or financial institutions which grant credit or conclude other transactions which are taken into account in the calculation of weighted risk) must be deducted from the own funds of a credit institution; so too must subordinated claims and other securities equivalent to own funds relating to the same affiliated or linked enterprises. Moreover, shareholdings in insurance companies, which are not included in the consolidation, must also be deducted from the own funds of credit institutions. On the other hand, there are no specific rules to prevent double gearing by insurance companies through their holdings in credit institutions or in other insurance companies. As far as broking companies are concerned, their fixed assets, including their shareholdings, will be deducted from own funds for the purposes of verifying minimum solvency ratios with which they will need to comply once the European Directive on the adequacy of investment firms' own funds is transposed into Belgium law.

In **France**, the supervisory authorities also rely on prudential consolidation to minimise opportunities for excessive gearing. However, their approach incorporates qualitative elements beyond strict calculation, which are particularly important if technical difficulties are experienced in consolidating certain entities of a group.

In **Italy**, double gearing is prevented by deducting unconsolidated equity participations in credit and financial institutions from the individual or consolidated own funds of the credit institution. At present, no such regulations are envisaged as regards insurance companies. There is no system for preventing double gearing in the Italian insurance industry.

In **Japan**, if the parent company is a bank, its capital adequacy ratio is calculated on a consolidated basis. If, on the other hand, the parent company is a securities company, subsidiary holdings are deducted in the calculation of the security company's capital adequacy ratio. There are no financial conglomerates with an insurance company as the parent company.

In **Sweden**, if a bank holds 50% or more of the capital or the voting rights in a financial institution (excluding insurance companies), that institution is consolidated for the purposes of supervision. Holdings of between 5% and 50% are deducted from the own funds of the bank in the solvency calculation.

In **Luxembourg**, the most efficient method for preventing double gearing is thought to be supervision on a consolidated basis. Where this is not possible due, for example, to legal impediments, deduction methods could be envisaged. The European Community Own Funds Directive requires banks to deduct from their own funds participations and other elements of own funds held in other credit institutions or financial institutions. Although the deduction of participations and other elements of own funds held in insurance companies or other non-financial institutions is not mandatory, the Second Banking Co-ordination Banking Directive does introduce limits on the taking of participations in insurance companies not subject to EEC legislation; and similar provisions are included in the Capital Adequacy Directive for investment firms. There are no specific rules to prevent double gearing by insurance companies through their holdings of participations and other elements of own funds in other insurance companies, credit institutions or financial institutions.

In the **United Kingdom**, the supervisory authorities generally apply the deduction of equity and other forms of regulatory capital downstreamed into subsidiaries and other group companies from the aggregate capital of a group. It is acknowledged that the practicalities of ensuring that capital is counted only once are not straightforward, and supervisors might take the following steps to detect (or deter institutions from attempting) double gearing:-

- Clearly define the concept of a group
- Ensure audit trail enables sources of capital to be traced; scrutinise quality of capital base;
- Gain understanding of funding strategies;
- Encourage adoption of common financial year end for all group companies.

In the United Kingdom insurance sector, a variation of the deduction method is used. A parent insurer may only take into account, for its own regulatory requirements, the relevant share of the **net assets** of its subsidiary, after deducting all the subsidiary's liabilities and its solvency margin. The parent's holding is thus valued on the basis of "look through" to the underlying assets and liabilities of the subsidiary.

In the **Netherlands**, the supervisors' Protocol includes a solvency test for financial conglomerates. Under this rule, a holding company should have an amount of capital, reserves and subordinated loans which is at least equal to the funds required by the Nederlandsche Bank and the solvency margins imposed by the Verzekeringskamer on banks and insurance companies respectively. The supervisory authorities reserve the right to take other subsidiary companies into account.

In **Switzerland,** the Banking Law indirectly prevents double gearing by applying stringent capital requirements on banks' participations in non-consolidated entities (non-financial companies or minority participations in the financial sector); a capital ratio of 40% of the participation's net value is required (equivalent to 500% of the standard risk weighting). Consolidated capital requirements based on the full consolidation method are used in the case of majority or other controlling participations in the financial sector. In addition, consolidated participations of this nature have to be deducted from the parent bank's capital on a solo basis. Likewise, subordinated claims on subsidiaries have to be deducted from the parent bank's capital. The present insurance supervision law in Switzerland does not address the problem of double-gearing, but more information will be available to supervisors upon the planned introduction of certain annual accounts requirements.

(ii) to prevent "supervisory arbitrage": the shifting of activities within a group for undesirable supervisory reasons only (e.g. to reduce capital or solvency margin requirements);

Supervisory arbitrage occurs if there are differences in the supervisory treatment of risks, transactions positions etc. The **Luxembourg and German** supervisors subscribe to the view that the only effective means of avoiding arbitrage is to eliminate the incentives - i.e. reduce or eliminate differences in supervisory treatment, and remove obstacles to the exchange of information between supervisory authorities. The strict observation of the principle "same business - same risk - same rules" would help to achieve this objective. This implies that a certain risk would be subject to the same capital requirement regardless of the type of institution in which it occurs. Participations in regulated entities could also be made subject to the prior approval of the competent supervisory authorities.

The supervisory authorities in **Canada** also believe that harmonisation of the rules applicable to different types of institution would be the most effective means of preventing supervisory arbitrage. However, given that most jurisdictions apply rules by type of institution rather than nature of business, this is acknowledged as difficult. For example, deferred annuities offered by life insurance companies are very similar to deposits offered by banks and are often advertised as deposit instruments to consumers.

The banking and securities supervisory authorities in the **United Kingdom** believe there are several measures that can be implemented in order to militate against the shifting of activities from one group company to another in order to benefit from a more lax regulatory regime:-

- Regulation by product type rather than category of institution (thus, for example, a securities house which starts to take deposits is likely to need a deposit-taking license and in effect for that purpose become a bank, and be regulated by a banking supervisor);
- Restrictions on the types of business which individual regulators are empowered to cover (so that in practice it may not be possible to persuade a regulator with a less onerous supervisory regime to cover business which would typically be dealt with by a different regulator who operates a more rigorous regime);
- Liaison between regulators as regards "borderline" activities (such as index linked "deposits") and awareness of a need for common standards.

In the UK insurance sector, the scope for such arbitrage is limited. The European Community Directives require insurance undertakings to limit their activities to insurance business and activities carried on in connection with that business. At the margins, some insurance activities are similar to banking business, but there is no evidence yet that significant distortions have arisen.

In the **Netherlands**, the Nederlandsche Bank and the Verzekeringskamer have agreed to inform each other about major transactions which may cause supervisory arbitrage between their respective regimes. In order to counteract transactions that might endanger the solvency of a bank, the Nederlandsche Bank may give a bank directions on the course of action to be pursued. The Verzekeringskamer has identical powers in respect of insurers. Furthermore, according to the Insurance Business Supervision Act, the Verzekeringskamer can restrict the right of disposal of an insurer in respect of its financial assets.

In **France** and in **Sweden**, prudential consolidation is seen as reducing the risk of supervisory arbitrage within a group since it provides regulators with a comprehensive assessment of the risks borne by the whole group as an economic entity. In Sweden, the way in which a new institution is organised is always examined and the institution is required to the advise the Authority of any changes. In **Belgium**, prudential legislation requires credit institutions to consolidate insurance companies in which they hold a participation so that compliance with large exposure rules and with the rules on the holding of equities in non-financial companies can be checked. In **Italy**, too, consolidation eliminates supervisory arbitrage among credit groups and there is no evidence of activities being shifted to avoid supervisory restrictions in the case of financial conglomerates. However, there is no consolidated supervision in the insurance sector there.

In **Switzerland**, in 1983 and 1988 Credit Suisse changed from the classical parent bank structure to two holding structures in the hope of avoiding consolidation of the US investment banking sub-group, CS First Boston, and the heavy capital charge on its non-financial participations. However, Credit Suisse was asked to apply consolidated capital requirements not only to its subsidiaries in the financial sector but also to the superordinate holding company and the financial entities controlled by the holding company. The Swiss Federal Supreme Court subsequently ruled that a bank cannot evade consolidated capital requirements through a holding structure and that the imposition of additional capital requirements in the case of Credit Suisse was correct. In the insurance sector, companies are obliged to provide consolidated annual accounts and detailed information on their participations.

In the **United States**, supervisory arbitrage generally is not an issue with banks and bank holding companies as the bank regulators supervise financial conglomerates on a consolidated basis. In addition, US laws impose capital and collateral restrictions on a bank's transactions with its affiliates and generally prohibit a bank from purchasing low quality assets from an affiliate. In the case of broker-dealers, the SEC's risk assessment programme enables it to monitor the risks posed by affiliates. As for the insurance sector, holding company laws vary from state to state, but they generally contain reporting requirements and restrictions on transactions between an insurer and its affiliates.

In **Japan**, there is no room for supervisory arbitrage. The scope of business is legally defined in each of the financial sectors and overlapping is limited.

The **United Kingdom** authorities also discuss a second form of supervisory arbitrage; this involves the shifting of activities to offshore centres in order to benefit perhaps from a more liberal regulatory system. A number of suggestions are made with a view to removing any incentive to do this:-

- Keep regulation to the minimum needed to achieve legitimate policy objectives;
- Prohibit branches of overseas banks unless satisfied with quality of consolidated home supervision;
- Insist that registered and head offices of a group are in the same country and that that country is regarded as the home country for supervisory purposes;
- Endeavour to enforce the principle of consolidated supervision;
- Address problems that inhibit consolidated supervision (e.g. secrecy laws in some centres);
- Promote initiatives to harmonise capital and other regulatory standards.

(iii) to redress non-transparent corporate structures;

The **German** supervisors believe that the most effective way to redress non-transparent corporate structures is to empower regulators to refuse or withdraw a license if the criterion of transparency is not met. The **United Kingdom** and **Luxembourg** supervisors also support this approach. Any definition of transparent and non-transparent structures would, on the one hand, have to be flexible enough to grant some discretion to the supervisor and, on the other hand, be precise enough not only to constitute a reliable basis for decisions to be made by corporates, but also to be enforceable in the courts. Luxembourg suggest that transparency is achieved when financial conglomerates are organised in such a way as to allow effective supervision of the group; to identify the authorities in charge of the supervision of the group to which the applicant bank, investment firm or regulated financial institution belongs; and to allow consolidated supervision of the group of which the bank, investment firm or other regulated financial institution is part. Since the beginning of 1993, the FBSO in **Germany** and the Minister of Finance in **Luxembourg** have had the power to refuse or withdraw a license if efficient supervision is not possible because of the shareholding structure of a bank. Similar legislation is in place in Luxembourg for investment firms and for insurance companies. From July 1994, corresponding rules will be in force for the supervision of insurance companies in Germany.

In **Italy**, the establishment and any subsequent restructuring of credit groups are evaluated by the Bank of Italy, which may refuse the authorisation if the structure of a group is such as to impede effective supervision. However, ISVAP does not have analogous powers in respect of insurance companies.

Under recent legislation and the revised Protocol, it is possible for the supervisors in the **Netherlands** to prevent non-transparent corporate structures by turning down requests for a declaration of non-objection if the structure has changed and has become non-transparent. It is also possible to withdraw such a declaration or to turn down requests for authorisation of banks or insurance companies which are part of non-transparent financial conglomerates.

In **Belgium** the supervisory authorities may object to group structures which are insufficiently transparent. The conclusion of protocols on banking autonomy between the Banking and Finance Commission and most Belgian credit institutions provide further possibilities for intervention in this respect. In **Sweden**, too, the Financial Supervisory Authority can require an institution to be restructured and ultimately has powers to withdraw authorisation if not satisfied.

In **Canada**, legislation has been considered, but none has been forthcoming. Cooperation and coordination between supervisory agencies has however been effective. When processing applications for new incorporations of financial institutions, the regulator routinely reviews the proposed structure and may require changes to the structure or undertakings regarding access to information as the circumstances require.

In **France**, the authorisation process for banks requires the Comite des Etablissements de Credit to verify the appropriateness of an enterprise's legal form and structure to the activity of a credit institution; and the applicant institution's capacity to achieve its development objectives in a manner that is compatible with the smooth running of the banking system and offers sufficient security to its customers. The Conseil des Bourses de Valeurs ensures that the legal and financial structure of a securities firm is consistent with its activities and the Commission de Controle des Assurances examines the structure of insurance companies.

In **Japan**, the establishment of holding companies for the purpose of controlling the business of other domestic companies is prohibited. In addition, the Ministry of Finance has adopted a policy of allowing the establishment of subsidiaries only when a clear business necessity for a multiple layer structure exists.

In **Switzerland**, the supervisory system is based on consolidation and the Federal Banking Commission is not therefore concerned with the transparency of corporate structures. If auditing and oversight were to become unduly burdensome or the corporate structure were to present an unacceptable risk for depositors, the Commission has the power to intervene and insist on changes.

In the **United States**, supervisors believe that, in general, they have adequate information on activities within corporate structures.

(iv) to influence at the holding company level the quality of the management?

In **Germany**, the granting of a banking license is conditional on banks' having at least two managers who fulfil the "fit and proper" criterion of the FBSO, which is empowered to demand their dismissal for prudential reasons. Moreover, since the beginning of 1993, the FBSO has the power to withdraw a license if the owner of a bank or the holder of a material participation does not meet the requirements for the sound management of a credit institution. Since July 1994, the FISO can suspend a shareholder's voting rights when the influence of the owner is likely to operate against the prudent and sound management of the insurance undertaking.

In **Switzerland,** under the present Banking Law, the fit and proper licensing requirement for bank managers and board members can be extended to persons with a more informal influence on a bank's activity. It would therefore be possible to ban unfit holding company managers from exercising any material influence on a bank. The additional licensing requirement (introduced in 1994), that large shareholders with qualified participations must ensure that their influence has no negative impact on the bank's activities, also provides for the elimination of a holding company with an unqualified management from its shareholder position in a bank. In the insurance sector, however, the supervisors' ability to influence the quality of management is restricted to the insurance companies that are subject to supervision; holding companies are not supervised.

In the **United Kingdom,** the sanctions which regulators may take against a group's authorised subsidiaries enables them to influence the quality of management at holding company level. In addition, banking and insurance supervisors have the power to vet a potential controller and to object to that person becoming a controller. The implementation of the Investment Services Directive will provide securities regulators with similar powers

In **Belgium**, direct influence on the quality of management at holding company level is made possible by supervision of the shareholding structure. The **Luxembourg** supervisors also believe that making the suitability of shareholders a prerequisite for the exercise of banking or insurance activities, and for the granting of authorisation to operate as an investment firm or other financial institution, can be an effective means of assuring management quality at holding company level. If the supervisory authorities notice that the shareholders or the managers of the parent holding company are acting to the detriment of the prudent and sound management of the credit institution, investment firm, insurance company or the regulated financial institution, they must take whatever supervisory measures are considered necessary. This might involve suspension of the voting rights attached to the shares in question or, if drastic action is called for, the withdrawal of the operating license of the regulated entity.

In the **Netherlands**, supervisory legislation and the Protocol between the Nederlandsche Bank and the Verzekeringskamer were revised in 1994 to make it possible to screen the fit and properness and, where applicable, the expertise of the managers of a holding company.

In the **United States**, bank and bank holding company regulators already have broad authority with respect to management. In the case of broker-dealers, persons who can directly or indirectly influence policies or management must meet certain standards. The SEC or an SRO can preclude people who fail to meet these standards. Holding company laws applicable to the insurance sector vary from state to state but, in New York, the management of any holding company wanting to acquire an insurance company must be subjected to an investigation before the company is allowed to proceed with the acquisition.

In **France,** the authorisation process for banks requires the Comite des Etablissements de Credit to verify the suitability and competence of the investors, the management and, where applicable, their guarantors (i.e. "fit and proper test"). The quality of shareholders and competence of management are also assessed by the insurance and securities supervisors.

In **Canada**, regulators have no direct authority over upstream holding companies. However, "fit and proper" tests can be applied in respect of managers and directors of the regulated institution.

In **Italy**, people performing the functions of administration, management or internal control in holding companies of credit groups are subject to the same competence and integrity requirements that Directive 77/780 imposes on people exercising these functions in credit institutions. Similar provisions apply to people exercising the same functions in insurance companies.

In **Sweden**, application of a fit and proper test to the owners of an institution is seen as the best way of influencing the level of management quality.

4(a) Do you supplement your solo supervision of licensed operating companies with group-based information and/or methods?

Most countries do indeed supplement their solo supervision of licensed operating companies with group-based information and/or methods. In general, supervisors of banks and securities companies tend to take more of a consolidated view than their counterparts in the insurance sector.

4(b) If so, to what extent is supervision based on a "consolidated" view or "consolidation" techniques? Please clarify such methods.

In the **United Kingdom**, the Bank of England (the Bank) supervises all UK incorporated banks (authorised institutions) on a solo basis. In addition, the Bank supervises the capital adequacy and risk concentrations of all authorised institutions on a consolidated basis in accordance with the EC Second Consolidated Supervision Directive (2CSD). In addition to consolidation downwards to subsidiaries of an authorised institution, 2CSD requires the Bank to extend its consolidation and application of capital requirements upwards to non-bank parents of banking groups (within the EC) and across to a banking company's fellow subsidiaries. The Bank also undertakes a qualitative assessment of the risks which other group companies pose for a bank. It regards consolidated supervision as a complement to, rather than a substitute for, the solo supervision of an authorised institution. The Bank's consolidation for capital adequacy purposes does not include group companies carrying on insurance business. In accordance with 2CSD, the Bank's treatment of a group's non-bank investment subsidiaries authorised under the Financial Services Act (FSA) for consolidated capital adequacy purposes is to deduct from its aggregate capital the investment in the subsidiary and any capital deficiency in any of these regulated subsidiaries. This approach is known as "deduction plus"; under it, regulatory capital surpluses are ignored. The Building Societies Commission also supervises the capital adequacy of building societies on a consolidated basis, while the Department of Trade and Industry Insurance Division (DTI) supervises all UK authorised insurance companies on a solo basis but includes, like the Bank, the monitoring of intra-group exposures. In addition, the DTI operates a similar deductive approach to calculation of the solvency margin of the parent in an insurance dominated group. The Securities and Investments Board and the self regulatory organisations do not at present undertake formal consolidated supervision. However, implementation of the Capital Adequacy Directive will confer the role of consolidating supervisor on UK securities regulators in respect of certain non-bank groups. The new approach is not expected to replace solo supervision.

In **France,** the Commission bancaire supplements solo supervision of licensed companies with prudential and accounting consolidation. In the prudential field, compulsory consolidation applies to capital adequacy and large exposures regulations. In the case of accounting, the method of consolidation depends on the degree of control exercised by the head office on its subsidiary. Some entities may be excluded from consolidation on the grounds that effective control is not exercised or that the entities in question are immaterial.

In **Switzerland**, consolidation includes all entities of a financial conglomerate in the financial sector (excluding insurance) as well as real estate companies if the common parent has a controlling interest. Consolidation applies to capital adequacy and to large exposures. The purpose of consolidation is not merely to know the risks and the financial situation of the conglomerate as a single economic entity, but, if necessary, to take corrective action at the level of the regulated bank. Formally, any supervisory measures are directed exclusively at the regulated bank as the holding company and its unregulated subsidiaries are not subject to the Banking Law; in practice, however, such measures force the conglomerate as a whole to comply with banking supervisory standards if it wishes its bank(s) to retain a license. Assets and liabilities of non-financial companies of a financial conglomerate are not consolidated, but the consolidated capital adequacy statement of the group's participations in such companies carry a very high capital ratio. A more qualitative approach is adopted towards the supervision of group liquidity and towards the maintenance of fit and proper standards throughout a group. The new Federal Law on securities and exchanges provides for the consolidated supervision of securities groups in the same way as for banking groups, while the Federal Office for Private Insurance is also considering implementation of consolidated supervision although, at present, it has not identified a method for so doing.

In **Sweden**, the Supervisory Authority also supplements its solo supervision of licensed operating companies with group-based information. Risks are assessed in relation to the consolidated capital base (but excluding insurance companies).

In the **United States**, banks and their subsidiaries are subject to consolidated supervision by their applicable banking authority. They file financial reports on a consolidated basis and supervisory standards, including capital standards, are applied to the consolidated entity. The SEC has authority to obtain information regarding certain activities of broker-dealer affiliates, subsidiaries and holding companies. Bank holding companies are subject to consolidated regulation and examination by the Federal Reserve Board. In addition, bank holding companies are required to file consolidated financial data as well as information on individual non-bank subsidiaries. Broker-dealers are required to maintain and to file, among other things, an organisation chart of the holding company structure; consolidating and consolidated financial statements for the holding company; and a broad range of other financial information. In the insurance sector, the state insurance regulator concentrates on the licensee. However, information on the affiliates of the conglomerate is available for review.

In **Canada**, capital rules for banks and insurance companies are based on a consolidated approach. Accounting consolidation principles are now available since accounting rules for all types of financial institution are now prescribed under Canadian Generally Accepted Accounting Principles.

The Bank of **Italy** supervises credit institutions, securities investment firms, leasing and factoring companies and other financial companies on both a solo and a consolidated basis. Consolidated supervision conforms with European Community Directives. The factors considered include own funds, risk asset ratios, large exposures and equity participations. Subsidiaries owned jointly with other companies are subject to pro-rata consolidation of accounts. The supervision exercised by ISVAP involves monitoring the consolidated balance sheets of groups in which the parent company is an insurance company. Intra-group transactions and equity participations in and by insurance companies are also monitored.

In **Belgium** and **Luxembourg**, following implementation of 2CSD, consolidated supervision is applied to banking groups where the parent company is a credit institution or a financial holding company. All financial institutions are included in the scope of such consolidated supervision. Where the parent is a mixed company, making quantitative consolidation inappropriate, the supply of group-based information facilitates qualitative supervision on a consolidated basis. Insurance supervisors are awaiting the transposition into Belgian law of the EC Directive on the annual accounts and consolidated accounts.

In **Germany**, the FBSO supervises groups of banks on a consolidated basis. Consolidation includes domestic and foreign subsidiaries as well as leasing and factoring companies in which the parent bank has an interest of at least 40%, or over which it can exercise a controlling influence. The FISO supplements the solo supervision of licensed insurance companies with group-based information on all transactions with other licensed and non-licensed companies in the group. There is, however, no consolidated supervision of insurance groups.

In the **Netherlands**, solo supervision is supplemented by group-based information; this system is known as "solo-plus" supervision. In the case of a financial holding company without insurance subsidiaries (and not therefore subject to the Protocol between the Nederlandsche Bank and the Verzekeringskamer), the Nederlandsche Bank requires consolidated returns every quarter or every six months in order to make an assessment of the solvency position.

In **Japan**, banks are required to submit consolidated financial statements and the capital adequacy ratio is calculated on a consolidated basis.

5(a) Do regulators in your country, whether statutory or self-regulating organisations, have the power to share prudential information with other regulators domestically and internationally?

In **France** and in **Luxembourg**, supervisory authorities may share prudential information covered by professional secrecy requirements with each other. In addition, they can pass on information needed for prudential supervision purposes to supervisory authorities in other countries as long as there is reciprocity and provided that the information is covered by professional secrecy requirements in the other country(ies). In **Belgium, Germany** and **Japan**, the supervisory authorities can also share prudential information with other regulators provided the information is needed for prudential supervision, is used only for that purpose, and is treated with strict confidentiality. In general terms, supervisory authorities in the **United Kingdom, Sweden, Canada** and **Italy** also have the power to share prudential information with other regulators, domestically and internationally.

In the **Netherlands**, new legislation provides for the exchange of prudential information between supervisory authorities both domestically and internationally.

In EC countries, 2BCD has potentially narrowed the gateways available to banking supervisors by allowing disclosure of information to regulators in countries outside the EC only if the regulators are subject to restrictions on information disclosure equivalent to the professional secrecy provisions in 2BCD itself. Once the Third Insurance Directives are in force, EC insurance regulators' ability to share information will be affected in the same way.

In the **United States**, federal bank supervisory authorities and the SEC are permitted to disclose information to both domestic and foreign supervisory authorities upon receipt of appropriate assurances of confidentiality. However, there are no provisions under the federal securities laws either prohibiting or permitting the provision of information by SROs to foreign supervisors; nevertheless, some SROs have adopted rules permitting them to provide foreign SROs with information. In the insurance sector, the National Association of Insurance Supervisors has adopted a model act to facilitate the exchange of regulatory information between supervisory authorities where that information can be kept confidential.

In **Switzerland**, although there are no specific provisions which apply domestically, the exchange of prudential information among different federal and cantonal regulators is legally permitted and works in practice. The cooperation between governmental agencies and private self-regulatory organisations is legally more uncertain, but practical solutions have been found in most cases. An amendment to the Banking Law (1994) now provides an explicit legal basis for international cooperation and exchange of information between the Federal Banking Commission and foreign bank supervisors or regulators of other financial institutions. A similar provision is to be found in the new Federal Securities and Exchange Law. The exchange of non-public information is subject to three conditions:- (i) the information may only be used for supervisory purposes; (ii) the recipient authority must be bound by professional or official secrecy; and (iii) the information may not be passed on to third parties without the prior approval of the Federal Banking Commission. In cases involving information related to individual customers, a more formal procedure applies, in which the customer concerned has a right to be heard and to appeal against any disclosure decision. The Federal Office for Private Insurance already has an explicit legal basis for information sharing with the supervisory authorities of the European Community for supervisory purposes.

5(b) What power do regulators in your country have to keep regulatory information received from another regulator confidential?

In all countries, any confidential information received from another supervisory authority is subject to statutory protection. However, in **Italy, France** and **Luxembourg**, professional secrecy cannot be used as a ground for non-disclosure in any criminal proceedings. Moreover, in Italy, information received from foreign supervisory authorities may be divulged to other Italian authorities unless the authority supplying the information forbids it. In the **United States**, the Freedom of Information Act exempts confidential information in the possession of the federal bank supervisory authorities from its disclosure requirements. However, if such information is subpoenaed by a court, by a federal or state governmental agency, by a legislative body, or by a grand jury, the US supervisory authorities may be required to disclose it. In such a case, to the extent possible, the foreign regulatory authority would be given the opportunity to assert any applicable privileges before the information is disclosed. The International Securities Enforcement Cooperation Act (ISECA) of 1990 provides an exemption from disclosure under the Freedom of Information Act for confidential information received by the SEC from foreign regulators. However, the ISECA also specifies that the SEC is not authorised to withhold information from Congress or from a court in an action commenced by the SEC or by the United States.

6 Do you have any policy objectives with respect to the structure of the financial sector (as a whole or any part of it)?

In the **United Kingdom**, the present policy objective with respect to the structure of the UK financial sector is to continue to promote an open financial sector, which is accessible to domestic and overseas based financial conglomerates providing they are fit and proper and their corporate structure is sufficiently transparent from a regulatory perspective.

In the **Netherlands**, a major policy objective of the authorities is to make it possible for Dutch financial institutions to compete in the liberalised European financial markets. With this in mind, the so-called "structural policy" was liberalised as of 1 January 1990 (see answer to question 1b in section A of this analysis), giving institutions the opportunity to strengthen their position internationally through the formation of financial conglomerates. The supervisory authorities believe it is their duty to pursue an adequate supervisory policy with regard to new risks posed by the phenomenon of financial conglomerates.

In **Germany**, regulation is based on the philosophy that there should be as much competition as possible, and only as much regulation as is necessary. For this reason, the roles of FBSO and FISO are limited to prudential aspects.

In **Sweden, France** and **Belgium**, the supervisory authorities have no policy objectives with respect to the structure of the financial sector. The same can be said of the situation in Luxembourg.

In **Switzerland**, too, there are no explicit policy objectives with respect to the structure of the financial sector. The 40% capital ratio (i.e. 500% risk-weighting) for banks' participations in the non-financial sector is mainly based on prudential grounds, but it also has the implied structural effect of discouraging the existence of truly mixed financial conglomerates. In the insurance sector, EC developments are the focus of attention, with Swiss insurance legislation being adapted to the third generation of EC insurance directives.

In **Italy,** a primary objective of insurance supervision is currently to produce a legal definition of insurance groups with a view to the development of group-based supervision.

In **Japan**, supervisory objectives include the following:- to maintain and improve the soundness and stability of the financial system; to improve the efficiency of the financial markets and promote healthy competition; and to avoid conflict of interests.

In the **United States**, the regulatory authorities each have their own policy objectives with regard to ensuring the soundness and stability of their own part of the financial sector.

In **Canada**, supervisors seek to foster a safe yet competitive environment and to ensure that Canadian institutions can be competitive abroad.

7 Is there any concern about the concentration of power within the financial sector in your jurisdiction due to the emergence of financial conglomerates?

In **Italy, France, the United Kingdom, the United States, Canada, Belgium, Luxembourg** and the **Netherlands**, there are no concerns about concentration of power. However, as the three largest Dutch banks currently have a market share in the Netherlands of about 70%, the Nederlandsche Bank is of the opinion that mergers between them are not desirable at present. In **Canada**, legislation exists for the review of significant transactions which could reduce competition. In addition, financial institution legislation requires the Minister to take into account the size of companies involved when a transfer of ownership takes place. In the **United Kingdom**, competition authorities (the Office of Fair Trading, the Monopolies and Mergers Commission and the Department of Trade and Industry) have powers to prevent a merger or acquisition taking place or to impose conditions, except where the proposed merger falls under the remit of the European Commission.. They have the lead responsibility for detecting any undue concentrations of power within the financial sector, whether or not due to the emergence of financial conglomerates.

In **Switzerland,** there is no particular concern about the concentration of power due to the emergence of financial conglomerates as such. Concentration is taking place amongst the banks themselves, with many small banks merging or being subsumed by larger banks. The main worry with regard to this restructuring is that it can take place without losses for depositors. The trio of financial conglomerates at the top end of the banking sector hold about half the market share in aggregate, but their individual powers are well-balanced and the balance would only be tipped by a further merger among them; this seems unlikely. Concentration has also been taking place in the insurance sector and the supervisory authority takes a positive view of this development as a number of small and medium-sized companies were not up to the requirements of a liberalised market.

In **Germany**, the power of financial conglomerates is not yet a political issue. However, for the supervisory authorities, the prudential ramifications of issues such as double gearing, regulatory arbitrage, transparency and contagion are of major importance.

In **Japan**, the Anti-Monopoly Law prohibits monopoly and aims to eliminate excessive concentration of power in both the financial and non-financial sectors. In addition, the Financial System Reform Act, effective from 1.4.93, stipulates arm's length rule by a parent over its subsidiaries in order to prevent the exercise of undue influence.

In **Sweden**, there are no immediate concerns, although it has been said that the convergence of banks, insurance companies and securities firms should not be allowed to have any damaging effects from a competitive viewpoint.

APPENDIX III

Capital adequacy and related issues: worked examples

Example A

An insurance company parent with 100% participations in a bank and a securities firm. It is assumed that, apart from the participations, there are no intra-group exposures (or that these have been netted out). Capital and General reserves are assumed to represent the externally generated own funds of each entity (and are recognised as such by the regulators in question).

Insurance Company A1 (Parent)

Assets		Liabilities	
Investments	2,300	Capital	400
Book value participations in:		General reserves	900
Bank B1	800	Technical provisions	2,000
Securities firm B2	200		
Total	3,300	Total	3,300

Bank B1 (Subsidiary)

Assets		Liabilities	
Loans	14,000	Capital	800
Other assets	1000	General reserves	700
		Other liabilities	13,500
Total	15,000	Total	15,000

Securities Firm B2 (Subsidiary)

Assets		Liabilities	
Investments	4,500	Capital	200
Other assets	500	General reserves	400
		Other liabilities	4,400
Total	5,000	Total	5,000

Group (Consolidated)

Assets		Liabilities	
Insurance investments	2,300	Capital	400
Bank loans	14,000	General reserves	2,000
Bank assets	1,000	Technical provisions	2,000
Securities investments	4,500	Bank liabilities	13,500
Securities assets	500	Securities liabilities	4,400
Total	22,300	Total	22,300

(i) Assume that capital requirements/solvency margins are as follows:

Insurance company A1	200
Bank B1	1,200
Securities firm B2	400

(ii) **The building-block prudential approach** would use the consolidated balance sheet as its basis. Capital requirements would be calculated for the three types of regulated entity and aggregated (200 + 1,200 + 400 = 1,800). This figure would then be compared with the prudential consolidated capital (capital 400 + general reserves 2,000 = 2,400). So the group has a solvency surplus of 600.

(iii) Under **risk-based aggregation**, the consolidating supervisor would aggregate the capital requirements for the regulated subsidiaries (these requirements being greater than the investments by the group in the subsidiaries), producing a figure of 1,600 (B1 1,200 + B2 400), which would then be added to the parent's own requirement (200) to produce the group requirement of 1,800. This figure is then compared to the externally generated capital of the group, typically the parent company's own capital (capital 400 + general reserves 900 = 1,300). This reveals a deficit of 500. However, if the general reserves of the subsidiaries are freely available and suitable for transfer (as was assumed under the building-block prudential approach), then the deficit is translated into a group surplus of 600 (-500 + 700 + 400).

(iv) Under **risk-based deduction**, the value of the participation in each subsidiary would be replaced by a figure representing the "look-through" net value of assets less tangible liabilities and less the minimum capital requirement of the subsidiary. So the book-value participation in B1 (800) would be replaced by a figure of 300 (assets 15,000 - other liabilities 13,500 - capital requirement 1,200 = 300). The write-down in the value of the participation is balanced by a similar write-down in the value of general reserves. In the case of the securities firm, the book-value figure at 200 remains the same (assets 5,000 - other liabilities 4,400 - capital requirement 400 = 200). So the revised "balance sheet" of the parent company looks as follows:

Insurance Company A1

Assets		**Liabilities**	
Investments	2,300	Capital	400
Participation in:		General reserves	400
Bank B1	300	Technical provisions	2,000
Securities firm B2	200		
Total	2,800	Total	2,800

This assumes that the parent is able to satisfy its supervisor that the solvency surplus assets in the subsidiaries are both available and suitable to be taken into account. The solvency surplus of the group can then be calculated by deducting the parent's own capital requirement (200) from its own funds (capital and general reserves).

(Capital) 400 + (Reserves) 400 - 200 = **600**

(v) So a group solvency surplus of 600 is revealed under all three supervisory approaches discussed above.

(vi) The total deduction method, however, would produce a different outcome. Under this method, the book-value of all investments in subsidiaries (plus any capital shortfalls in subsidiaries) is deducted from the parent's capital (1,300 - 800 - 200). The result (300) is then compared with the parent's solo capital requirement (200), showing a surplus of 100.

Example B

A bank parent with a 60% participation in a regulated insurance company. Again, it is assumed that, apart from the participations, there are no intra-group exposures (or that these have been netted out). Capital and General reserves are assumed to represent the own funds of each entity (and are recognised as such by the regulators in question). Subsidiaries are held at cost in the accounts of their parent company.

Bank A1 (Parent)

Assets		**Liabilities**	
Loans	10,000	Capital	400
Other assets	2,700	General reserves	1,100
Book-value participation in:		Bank liabilities	11,500
Insurance company B1	300		
Total	13,000	Total	13,000

Insurance Company B1 (60% participation)

Assets		**Liabilities**	
Investments	15,000	Capital	500
		General reserves	500
		Technical provisions	14,000
Total	15,000	Total	15,000

The shape of the **Group (consolidated)** balance sheet would depend upon whether full or pro-rata integration of the subsidiary is adopted:

(a) Full integration

Assets		**Liabilities**	
Bank loans	10,000	Capital	600
Other bank assets	2,700	General reserves	1,600
Insurance investments	15,000	Bank liabilities	11,500
		Technical provisions	14,000
Total	27,700	Total	27,700

(b) Pro-rata integration

Assets		**Liabilities**	
Bank loans	10,000	Capital	400
Other bank assets	2,700	General reserves	1,400
Insurance investments	9,000	Bank liabilities	11,500
		Technical provisions	8,400
Total	21,700	Total	21,700

Assume that capital requirements/solvency margins are as follows:

Bank A1 (Parent)	1,100
Insurance Co. B1 (Subsidiary)	600

(a) Full integration

(i) Under the **building-block prudential approach**, the capital requirements of the two types of entity would be aggregated [1,100 + 600 = 1,700] and this figure compared with the prudential consolidated group capital (600 capital + 1,600 general reserves = 2,200). Thus a solvency surplus of **500** would be revealed.

(ii) Under **risk-based aggregation** in its simplest form, the capital requirements of the parent and subsidiary would again be aggregated (1,700) and this figure compared to the own funds of the group (own funds of parent 1,500 + own funds of subsidiary 1,000 - book value of participation 300 = 2,200). Thus a solvency surplus of **500** is identified.

(iii) Under **risk-based deduction**, the value of the participation in the subsidiary would be replaced in the balance sheet of the parent by a figure representing the "look-through" net value of assets less tangible liabilities and less the minimum capital requirement of the subsidiary. If the fact that the subsidiary is not wholly owned is ignored, the book-value participation (300) would be replaced by a figure of 400 [assets 15,000 - technical provisions 14,000 - capital requirement 600 = 400]. And the revised "balance sheet" of the parent bank would look as follows (the General reserves being written up to reflect the increased value of the participation):

Bank A1

Assets		**Liabilities**	
Loans	10,000	Capital	400
Other assets	2,700	General reserves	1,200
Participation in B1	400	Bank liabilities	11,500
Total	13,100	Total	13,100

This assumes that the parent is able to satisfy its supervisor that <u>all</u> the solvency surplus assets in the partly-owned subsidiary are both available and suitable to be taken into account (as they were under the building block prudential approach and risk-based aggregation). The solvency surplus of the group can then be calculated by deducting the parent's own capital requirement from its own funds (capital and general reserves).

(Capital) 400 + (Reserves) 1,200 - 1,100 (Parent's capital requirement) = **500**

(iv) So a group solvency surplus of 500 is revealed under all three supervisory approaches if a partly owned subsidiary is <u>fully</u> integrated <u>as long as the same assumptions are made about the availability and suitability of surplus capital</u>.

(v) Under **total deduction**, the book value of the investment in the subsidiary is deducted from the parent's capital (400 + 1,100 - 300 = 1,200) and the result is compared with the parent's solo capital requirement (1,100), revealing a surplus of 100.

(b) Pro-rata integration

(i) Under the **building-block prudential approach**, the capital requirements of the two types of entity would be aggregated [1,100 + (60% of 600) = 1,460] and this figure compared with the prudential consolidated group capital (400 capital + 1,400 general reserves = 1,800). Thus a solvency surplus of **340** would be revealed.

(ii) Under **risk-based aggregation** in its simplest form, the capital requirements of the parent and subsidiary would again be aggregated (1,460) and this figure compared to the own funds of the group (own funds of parent 1,500 + 60% of subsidiary's own funds 600 - book value of participation 300 = 1,800). Thus a solvency surplus of **340** is again revealed.

(iii) Under **risk-based deduction**, the value of the participation in the subsidiary would be replaced in the balance sheet of the parent by a figure representing the "look-through" net value of assets less tangible liabilities and less the minimum capital requirement of the subsidiary. So the book-value participation in the subsidiary (300) would be replaced by a figure of 240 [assets 15,000 - technical provisions 14,000 - capital requirement 600 = 400 x 0.6 (i.e. pro rata) = 240]. So the revised "balance sheet" of the parent bank would look as follows:

Bank A1

Assets		**Liabilities**	
Loans	10,000	Capital	400
Other assets	2,700	General reserves	1,040
Participation in B1	240	Bank liabilities	11,500
Total	12,940	Total	12,940

Again, this assumes that the parent is able to satisfy its supervisor that the solvency surplus assets in the partly-owned subsidiary are both available and suitable to be taken into account. The solvency surplus of the group can then be calculated by deducting the parent's own capital requirement from its own funds (capital and general reserves).

(Capital) 400 + (Reserves) 1,040 - 1,100 (Parent's capital requirement) = **340**

(iv) So a group solvency surplus of **340** is revealed under all three supervisory approaches <u>if a pro-rata approach is adopted to integration of the partly owned subsidiary</u>.

(v) The **total deduction** method would yield the same result as under full integration (i.e. a surplus of 100) since it involves subtracting the <u>book value</u> of the participation from the parent's capital.

Example C

An unregulated holding company with two regulated wholly-owned subsidiaries (i.e. sister companies) in the banking and insurance sectors. The bank is heavily over-capitalised. Again, it is assumed that, apart from the participations, there are no intra-group exposures (or that these have been netted out). Capital and general reserves are assumed to represent the own funds of each entity (and are recognised as such by the regulators in question). Again, subsidiaries are held at cost in the accounts of their parent company.

Unregulated Holding Company A1

Assets		**Liabilities**	
Book-value participations in:		Capital	1,000
Bank B1	800		
Insurance company B2	200		
Total	1,000	Total	1,000

Bank B1 (Subsidiary)

Assets		**Liabilities**	
Loans	900	Capital	800
Other assets	400	General reserves	200
		Other liabilities	300
Total	1,300	Total	1,300

Insurance Company B2 (Subsidiary)

Assets		**Liabilities**	
Investments	7,000	Capital	200
		General reserves	200
		Technical provisions	6,600
Total	7,000	Total	7,000

Group (consolidated)

Assets		**Liabilities**	
Bank loans	900	Capital	1,000
Other bank assets	400	General reserves	400
Insurance investments	7,000	Other bank liabilities	300
		Technical provisions	6,600
Total	8,300	Total	8,300

(i) Assume that capital requirements/solvency margins are as follows:

Bank B1	100
Insurance Company B2	300

(ii) Under the **building-block prudential approach**, the capital requirements for the bank and insurance company would be aggregated (100 + 300 = 400) and this figure compared with the prudential consolidated capital (capital 1,000 + general reserves 400 = 1,400). So the group is seen to have a solvency surplus of **1,000**, most of which is situated in the bank.

(iii) Under **risk-based aggregation** in its simplest form, the capital requirements of the two subsidiaries would again be aggregated (400) and this figure compared to the own funds of the group (own funds of parent 1,000 + own funds of bank 1,000 + own funds of insurance company 400 - book value of the participations 1,000 = 1,400). Again, the group is seen to have a solvency surplus of **1,000.**

If the more prudent form of **risk-based aggregation** described in paragraphs [] of the main report is adopted, however, the consolidating supervisor aggregates either the regulatory capital requirement or the investment by the group in a subsidiary (whichever is the greater). Since the investment by the group in the bank (800) exceeds the bank's capital requirement (100), it is this which is included in the aggregation:

800 + 300 (Insurance Co.'s capital requirement) = 1,100

This figure is then compared to the own funds of the group (own funds of parent 1,000 + own funds of bank 1,000 + own funds of insurance company 400 - book value of the participations 1,000 = 1,400). A surplus of only 300 is revealed. The difference between this figure and the 1,000 surplus identified under the simpler form of risk-based aggregation (and under the building-block prudential approach) is accounted for by the fact that the group's investment in the banking subsidiary (800) was included in the aggregation instead of the bank's capital requirement (100).

(iv) Under **risk-based deduction**, the value of the participation in each subsidiary would be replaced in the balance sheet of the parent by a figure representing the "look-through" net value of assets less tangible liabilities and less the minimum capital requirement of the subsidiary. So the book-value participation in B1 (800) would be replaced by a figure of 900 (assets 1,300 - other liabilities 300 - capital requirement 100); and the book-value participation in B2 (200) would be replaced by a figure of 100 (investments 7,000 - technical provisions 6,600 - capital requirement 300). So the revised "balance sheet" of the parent holding company would look as follows:

Assets		**Liabilities**	
Participation in:		Capital	1,000
Bank B1	900		
Insurance company B2	100		
Total	1,000	Total	1,000

Under risk-based deduction, the group's solvency surplus would normally be calculated by deducting the parent's own capital requirement from its own funds. However, in this example, the unregulated parent has no capital requirement of its own and its capital of **1,000** therefore represents the group solvency surplus.

(v) So a group solvency surplus of **1,000** is revealed under the building-block prudential approach, under the simpler form of risk-based aggregation and under risk-based deduction. The more prudent form of risk-based aggregation comes to a different conclusion, essentially because the investment by the group in the banking subsidiary has been included in the aggregation instead of the bank's actual solo regulatory capital requirement.

(vi) When there is an unregulated holding company, the total deduction method is not applicable.

Example D (double-gearing with full consolidation)
PARENT

Capital	100	
Capital requirement	90	
Participation 1	40	(historic cost)
SOLO SURPLUS	10	

SUBSIDIARY 1 (100%)

Capital	40
Capital requirement	25
SOLO SURPLUS	15

GROUP

Capital	
- parent	100
- subsidiary 1	40
Capital requirement	
- parent	-90
- subsidiary 1	-25
Participation (book value)	-40
GROUP DEFICIT	-15

If the parent regulator's rules do not require the deduction of the participation's book value at solo level, both institutions (parent and subsidiary 1) comply with their respective solo requirements. The assessment of capital adequacy at group level reveals that there is an element of double-gearing, which would call for supervisory action from the parent's regulator. However, in a situation where the parent also has a 60% participation in a second subsidiary with a considerable surplus at solo level,

SUBSIDIARY 2 (60%)

Capital	100
- parent	60
- minority interest	40
Capital requirement	-25
SOLO SURPLUS	75

the Group position would be as follows:

GROUP

	Full integration		Pro rata integration
Capital			
- parent	100		100
- subsidiary 1	40		40
- subsidiary 2	100	(60 parent's share, 40 minority interests)	60
Capital requirement			
- parent	-90		-90
- subsidiary 1	-25		-25
- subsidiary 2	-25		-15
Participation 1 (book value)	-40		-40
Participation 2 (book value)	-60		-60
GROUP DEFICIT	0		-30

Full integration of the second subsidiary in the group calculation reveals no element of double-gearing. The second subsidiary's surplus compensates for the previous deficit at group level. This is because full integration regards capital elements attributable to minority interests as available to the Group as a whole.

Of course, if the second subsidiary had a capital deficit at solo level:

SUBSIDIARY 2 (60%)	
Capital	100
- parent	60
- minority interest	40
Capital requirement	-125
SOLO DEFICIT	25

then full integration would reveal a larger deficit at group level than pro-rata integration:

GROUP

	Full integration		Pro rata integration
Capital			
- parent	100		100
- subsidiary 1	40		40
- subsidiary 2	100	(60 parent's share, 40 minority interests)	60
Capital requirement			
- parent	-90		-90
- subsidiary 1	-25		-25
- subsidiary 2	-125		-75
Participation 1 (book value)	-40		-40
Participation 2 (book value)	-60		-60
GROUP DEFICIT	-100		-90

This is because full integration has the effect of placing full responsibility for making good the deficit on the controlling shareholder.

Example E (use of surplus capital in one entity to cover a deficit in another entity)
PARENT

Capital	100	
Capital requirement	75	
Participation	25	(historic cost)

SUBSIDIARY 1 (50% participation)

Capital	60
- equity	50
- reserves	10
Capital requirement	10
SOLO SURPLUS	50

GROUP

	Pro rata aggregation		Full aggregation
Capital parent	100		100
Capital subsidiary	30	(50% of 60)	60
Capital requirement			
- parent	-75		-75
- subsidiary	-5	(50% of 10)	-10
Participation	-25	(book value)	-25
GROUP SURPLUS	25		50

The surplus at group level stems exclusively from the partly-owned subsidiary. However, in the event that the parent also had a participation in an undercapitalised unregulated entity, the group position would be as follows:

UNREGULATED SUBSIDIARY 2 (100% participation)

Capital	20
- equity	10
- reserves	10
Notional capital requirement	-50
SOLO SURPLUS	-30

GROUP

	Pro rata aggregation		Full aggregation
Capital	150		180
- parent	100		100
- subsidiary 1	30	(50% of 60)	60
- subsidiary 2	20	(100% of 20)	20
Capital requirements	-130		-135
- parent	-75		-75
- subsidiary 1	-5		-10
- subsidiary 2	-50		-50
Participation 1	-25		-25
Participation 2	-10		-10
GROUP SURPLUS	-15		10

Under the full integration approach, the surplus in subsidiary 1 is regarded as available to the group as a whole and it thus more than compensates for the deficit in subsidiary 2. The pro-rata approach, on the other hand, only takes account of that part of the surplus in subsidiary 1 which is attributable to the parent and, as shown, this is not sufficient to offset the deficit in subsidiary 2.

Example F (higher risk - lower standards)

PARENT

Capital	100
Capital requirement	-50
Solo surplus	50
Participation	
(25%)	(20)
(50%)	(40)

SUBSIDIARY

Capital	80
- group	20
- external	60
Capital requirement	-20
Solo surplus	60

GROUP

	25% share pro rata integration		50% share full integration
Capital	120		180
- parent	100		100
- subsidiary	20	(25% of 80)	80
Capital requirement	-55		-70
- parent	-50		-50
- subsidiary	-5		-20
Participation	-20		-40
GROUP SURPLUS	45		70

The parent increases its share in the subsidiary from 25% to 50% which induces its regulator to apply full instead of pro rata integration because full responsibility for the subsidiary (and full availability of its surplus capital is assumed. The group surplus increases from 45 to 70 and some members would argue that this automatically increases the scope for potential double-gearing in other parts of the group. A change from pro-rata to full integration, which might be regarded as taking a more conservative view of the parent's risks now that it has increased its participation, in fact has the opposite effect.

Example G:- The purpose of this example is to show that, when definitions of banking and insurance capital differ, it is possible that, at group level, insurance risks are covered by banking capital (or vice-versa), even when the bank and the insurer that constitute the group each fulfil their solo capital requirements.

- A parent life insurance company has own funds of 500, of which 200 is paid-up share capital (<u>also recognised by banking regulators</u>);
- The remaining 300 stems from profit reserves appearing in the balance sheet and future profits, capital components which are <u>only recognised by insurance regulators</u>;
- The insurance company has a 100% participation in a bank subsidiary with a book value of 250. It therefore complies with its capital requirement of 250.
- In addition to the 250 paid-up share capital furnished by the insurance parent, the banking subsidiary has hidden reserves and reserves for general banking risk of 50 which - by definition - are not elements recognised as liable funds by insurance regulators. Its capital requirement is 300.

An undifferentiated, purely quantitative, calculation at group level identifies a balanced capital position with the sum of the capital elements equalling the capital requirements:-

Capital of Insurance Parent		Capital of Banking Subsidiary	
Profit Reserves, Future Profits	300	Paid-Up Share Capital	250
Paid-Up Share Capital	200	Hidden Reserves and Reserves for General Banking Use	50
Less Book Value of Participation	250		
Net Capital	**250**	**Net Capital**	**300**
Capital Req't	**250**	**Capital Req't**	**300**

Further analysis, however, reveals that coverage is inadequate:-

		Capital Requirements		
		Banking Risk	Insurance Risk	Excess/Deficit
		300	250	
Insurance Capital	300		250	50
Banking Capital	50	50		0
"All-round" Capital	200	200		
Excess/Deficit		**- 50**	**0**	

The capital charge for insurance risk of 250 is more than covered by the 300 units of capital recognised only by insurance regulators; there is an excess of 50 units. The capital charge for banking risk of 300 is covered by 50 units of capital recognised only by banking regulators and by 200 units of capital recognised under both supervisory regimes; but the remaining charge of 50 is effectively covered by insurance capital - i.e. by capital components which banking regulators have deemed unsuitable for covering banking risks.

Example H (subordinated debt)

PARENT

Capital	110
Capital requirement	90
Participation (historic cost)	20
SOLO SURPLUS	0

SUBSIDIARY (100% participation)

Capital	50
- equity	20
- subordinated debt	30
Capital requirement	20
SOLO SURPLUS	30

GROUP

Capital		
- parent	110	
- subsidiary	50	(100% of 50)
Capital requirements		
- parent	-90	
- subsidiary	-20	(100% of 20)
Book value of participation	-20	
GROUP SURPLUS	30	

The solvency surplus at group level stems from the subsidiary's subordinated debt. Although subordinated debt may be an acceptable form of capital under the parent's own regulatory rules, the group surplus in this example is arguably only available to the subsidiary, in which case the regulator of the parent will need to guard against the possibility that this excess is used to cover risks at group level (e.g. a notional deficit in an unregulated entity).

Example J (Risk-based deduction)

(Specimen simplified balance sheets)

Company A (parent life insurer, with a 60% holding in B)

Investments Participation in B Other assets	1000 48 100	Share capital Profit carried forward Technical provisions Other liabilities	100 28 1000 20
	1148		1148

A's solvency margin is 40 (4% of 1000). It has free reserves of 128 to cover it.

Company B (life insurer)

Investments Other assets	650 150	Share capital Profit carried forward Technical provisions Other liabilities	60 40 500 200
	800		800

B has free reserves of 100 (60 share capital plus 40 profit carried forward) to cover its solvency margin of 20 (4% of 500). The surplus of net assets over liabilities *and* solvency margin = 80. 60% share of 80 = 48, which is therefore the value of A's participation in B which is allowable for the purposes of A's balance sheet.

APPENDIX IV

The "one-to-one" rule in the Netherlands

1. The statutory basis underlying measures for countering double-gearing at banks in the Netherlands is provided for by supervisory legislation, stipulating that a declaration of no objection is required for each participation of a bank amounting to more than 10% of the capital of the other institution (bank, insurance company or another financial or non-financial institution) and for each participation of more than 5% in a bank. The declarations of no objection, to be granted by the Minister of Finance on the recommendation of the Nederlandsche Bank (the Bank), may be subject to conditions concerning for instance the periodic provision of additional information and the degree of capitalisation of the institutions with which a participation relationship exists.

2. The **conditions** attached to declarations of no objection depend on the structure of the conglomerate and are determined case by case. Notably where participations in banks by non-regulated holding companies are concerned, these conditions are a major instrument with which to counter double-gearing, as they afford the possibility of imposing requirements as to the size of the holding company's own funds (capital and reserves). In some cases, for instance, the own funds of the holding company may be required to amount to at least the total own funds of the (banking) subsidiary or subsidiaries, the participations being valued at net worth by the holding company. In the Netherlands, this approach is known as the one-to-one rule. If an institutions does not meet the conditions set, the authorities can, as a last resort, revoke the declaration of no objection granted, which means that the participation relationship between the holding company and the bank must be terminated.

3. In the case of relationships between banks and insurance companies, the Insurance Board plays a role comparable to that of the Bank. The Bank and the Insurance Board have concluded a Protocol with a view to attuning the supervision exercised by the authorities on banks and insurance companies making up part of a single conglomerate through, for instance, a joint recommendation to the Minister of Finance as to the conditions to be attached to the declarations of no objection. Here allowance is made for the fact that in the Netherlands the degree of capitalisation of non-regulated holding companies and the measures countering double-gearing generally play a smaller role in the supervision of insurance companies than of banks.

4. The following conditions may be attached to declarations of no objection:-

A. In the case of participations of **banks or financial holding companies** (more than 80% of whose balance-sheet total concerns financial activities; insurance operations are considered non-financial activities) **in banks**, the requirements provided for by the EC Directive on Consolidated Supervision are applied. This means that parent banks are subject to consolidated supervision, while financial holding companies need to meet the standards of banking supervision where, for instance, solvency in concerned.

B. In the case of a **participation of a bank in an insurance company**, the required solvency margin at the insurance company (plus any deficits) must, prior to the calculation of the parent bank's solvency ratio, be deducted from the bank's regulatory capital base (risk-based deduction). The participation in the insurance company is valued, in the bank's balance sheet, at net worth.

C. The most usual structure for banking/insurance conglomerates in the Netherlands is that of the **non-regulated holding company with banking and insurance subsidiaries**. The capital requirements to be imposed on the holding company are conditional, according to the Protocol, on the share of banking and insurance activities in its total financial activities:-

(i) in the case of primarily j(>80%) banking conglomerates, the one-to-one rule may be applied;

(ii) in the case of mixed banking/insurance conglomerates, the holding company's capital, reserves and subordinated loans (including specific components acknowledged by the supervisory authorities) are checked to see whether they amount to at least the total of the required solvency (margin) of the subsidiaries;

(iii) in the case of primarily (>80%) insurance conglomerates, the degree of capitalisation of the holding company is usually not subject to requirements.