

REPORT
for the
BIRMINGHAM SUMMIT

Prepared by the
Joint Forum on Financial Conglomerates

March 1998

Report by the Joint Forum on Financial Conglomerates

Principal developments

The Joint Forum has made significant progress in carrying out its mandate. In particular,

- the Joint Forum has developed its understanding of financial conglomerates through the completion of a detailed study of fourteen internationally active financial conglomerates;
- this study has been used to construct a framework for sharing information between supervisors and has assisted in developing principles for the supervision of financial conglomerates;
- seven papers relating to the supervision of financial conglomerates and information sharing among supervisors were completed; and
- the Basle Committee, IOSCO and the IAIS have put in train a consultative procedure, involving industry and supervisors, for the Joint Forum papers.

Introduction

1. The Joint Forum on Financial Conglomerates (the Joint Forum), under the aegis of the Basle Committee on Banking Supervision (the Basle Committee), the International Organisation of Securities Commissions (IOSCO) and the International Association of Insurance Supervisors (IAIS), has pursued its examination of supervisory issues relating to the operations of financial conglomerates. The Joint Forum is comprised of an equal number of senior bank, insurance and securities supervisors representing each supervisory constituency. Thirteen countries are represented in the Joint Forum: Australia, Belgium, Canada, France, Germany, Italy, Japan, Netherlands, Spain, Sweden, Switzerland, United Kingdom and United States. The EU Commission attends in an observer capacity. In November 1997, Mr. Alan Cameron A.M., Chairman of the Australian Securities Commission, succeeded Mr. Tom de Swaan as Chairman of the Joint Forum.

2. In accordance with its mandate, which is attached in annex, the Joint Forum has in the past year: (a) pursued practical means at domestic and international levels to facilitate the exchange of information between supervisors; (b) investigated legal and other barriers which could impede the exchange of information between supervisors; (c) examined ways to enhance supervisory coordination, including the benefits and drawbacks to establishing criteria to identify and define the responsibilities of a coordinator or coordinators where appropriate; and (d) developed principles toward the more effective supervision of regulated firms within financial conglomerates.

3. The following paragraphs provide a synopsis of the various papers completed and of the consultative process underway, and a description of additional work done in identifying impediments to information sharing amongst supervisors and of the ongoing and future work of the Joint Forum.

Completion of Supervisory Papers

4. The Joint Forum completed papers addressing different aspects of supervising regulated entities within financial conglomerates. The Joint Forum also completed work and prepared two papers addressing information sharing between supervisors of a conglomerate.

5. In December 1997, the Joint Forum recommended that the Basle Committee, IOSCO and the IAIS undertake a consultation procedure with the industry and the supervisory community in each of the banking, securities and insurance sectors. The consultative process, which is described in the next section of this report, was endorsed by each of the Basle Committee, IOSCO and the IAIS and is underway. The consultative process will give

the Joint Forum practical insights regarding the principles and guidance elaborated to date, thereby enhancing the cooperation that already exists between supervisors, particularly intra-sector. The documents submitted for comment to the banking, securities and insurance industries have been forwarded to the G-7 Group of Financial Experts.

Joint Forum papers in consultation

6. The following Joint Forum papers were included in the consultative process for the industry and the supervisory community in each sector:

- A. *Capital Adequacy Principles* paper
- B. *Supplement to the Capital Adequacy Principles* paper
- C. *Fit and Proper Principles* paper
- D. *Framework for Supervisory Information Sharing* paper
- E. *Principles for Supervisory Information Sharing* paper
- F. *Coordinator* paper
- G. *Supervisory Questionnaire*

7. The *Capital Adequacy Principles* paper outlines measurement techniques and principles to facilitate the assessment of capital adequacy on a group-wide basis for financial conglomerates. The paper recognises that the solo capital adequacy requirements of each of the banking, securities and insurance sectors are different with varying definitions of the elements of capital and varying approaches to the valuations of assets and liabilities. The measurement techniques put forward are based on existing approaches used by various supervisors and are intended to complement solo requirements. The paper does not promote a single technique for universal application. The guiding principles address particular issues that should be identified in assessing the capital adequacy of financial conglomerates on a group-wide basis and are intended to assist supervisors, in the exercise of their discretion, so that the techniques will yield broadly equivalent results within a range of acceptable outcomes. The *Supplement to the Capital Adequacy Principles* paper consists of theoretical examples constructed to illustrate and describe complex situations that can arise in practical applications of the measurement techniques. The examples are provided for general information to assist reviewers to understand the Joint Forum's thinking.

8. The *Fit and Proper Principles* paper, recognising that the qualifications of the top management of banks, securities firms and insurance enterprises are critical to the

objectives of supervision, provides guidance intended to ensure that supervisors of entities within a financial conglomerate are able to exercise their responsibilities to assess whether those entities are soundly and prudently managed. The paper encourages the application of fitness, propriety or other qualification tests to managers and directors of other entities in a conglomerate, and to key shareholders, as defined, if they exercise a material influence on the operations of regulated entities. Further, the paper promotes arrangements to facilitate consultation and the exchange of information between supervisors with respect to managers and directors of other entities in a conglomerate who have a material influence on the operations of regulated entities.

9. The *Framework for Supervisory Information Sharing* paper outlines a general framework for facilitating information-sharing between supervisors of regulated entities within internationally active financial conglomerates. The framework is based on the mapping exercises carried out by a task force created by the Joint Forum to analyse the structures and operations of fourteen financial conglomerates (the Mapping Task Force) and focuses on two dimensions which tend to have particular implications for the supervision of regulated entities within financial conglomerates namely, 1) the organisation of business activities along business lines versus along the corporate legal structure and 2) the organisation of corporate control functions on a global or centralised basis versus on a local basis. The paper describes the categorisation of financial conglomerates into four "quadrants" and outlines the principal features of each quadrant and the supervisory issues arising for each quadrant.

10. Annexed to the *Framework for Supervisory Information Sharing* paper is the *Conglomerate Questionnaire* which was developed by the Mapping Task Force and is considered a useful tool to assist supervisors in enhancing their understanding of the structure and operations of financial conglomerates. The Questionnaire can be used by supervisors on a unilateral, bilateral or multilateral basis to facilitate discussion with representatives of a conglomerate and to assist supervisors in furthering their understanding of the conglomerate's risk profile, systems of controls and organisational/management structure. Also annexed to the paper is an outline of the types of information that would be useful to supervisors in an emergency situation.

11. The *Principles for Supervisory Information Sharing* paper sets out a number of guiding principles intended to assist supervisors in enhancing information sharing arrangements that will contribute to a more effective supervisory framework for financial conglomerates. The guidance recognises that the informational needs of supervisors vary considerably depending on many factors, including the objectives and approaches of supervisors themselves and the organisation and structures of individual financial conglomerates. The paper encourages supervisors to be proactive in communicating

material issues and concerns with other supervisors and to build amongst themselves a climate of trust and cooperation that is essential for channels of communication to function efficiently.

12. The *Coordinator* paper provides guidance to supervisors for the possible identification of a coordinator or coordinators and a catalogue of possible roles and responsibilities of a coordinator or coordinators in emergency and non-emergency situations. Timely and efficient information sharing between supervisors with responsibility for different entities within a financial conglomerate may in certain circumstances be facilitated through the designation of one or more of those supervisors to play a coordination role. The paper outlines several factors that influence whether to appoint a coordinator and, if so, that impact the determination of the role and responsibilities of the coordinator. Accordingly, a catalogue of different elements of coordination is put forth to assist supervisors in designing coordination arrangements amongst themselves.

13. The *Supervisory Questionnaire* was developed and used by the Mapping Task Force to facilitate supervisors' understanding of each others' objectives and approaches and of their authority to share information. The continuing work of the Joint Forum and experience gained in using the Questionnaire, together with input from the consultative process, may result in changes to enhance its coverage. The Questionnaire can be used as a tool to assist supervisors in enhancing their understanding of each others' objectives and approaches.

Consultative Procedure

14. Each of the parent organisations released consultative documents in mid-February. As was recommended by the Joint Forum, the parent organisations transmitted the consultative package under common documentation, thereby ensuring that consistent messages were conveyed. The comment period will end on 31st July 1998. As many members of the parent organisations are not represented in the Joint Forum and thus did not participate directly in the elaboration of the Joint Forum papers, having the consultation undertaken by the parent organisations will, it is believed, achieve the objective of obtaining a broad range of practical insights and comments regarding the papers produced by the Joint Forum.

15. The releases by the parent organisations are directed to the banking, securities and insurance industries and to the supervisors in each sector. The input from both the industry and the supervisory community in each sector will assist supervisors in assessing the implications of the ongoing blurring of distinctions between the activities of regulated entities in each sector and in developing approaches to ensure efficient and comprehensive oversight arrangements for financial conglomerates. Further, the consultative process will influence the continuing work of the Joint Forum.

Impediments to supervisory information sharing

16. Statutes that facilitate information flows between supervisors and the implementation of information sharing arrangements usually contain conditions. Such conditions are needed to protect the rights and privacy of the persons providing the information and otherwise limit the risk of confidential supervisory information being misused. For example, (a) supervisors receiving confidential information should be subject to adequate confidentiality provisions, (b) information provided to other supervisors should be used only for purposes that are related to or compatible with the regulation of the financial institutions concerned, including the enforcement of laws applicable to such institutions, and (c) an information-sharing framework between supervisors may include, where legally permissible, reciprocity arrangements.

17. In the Final Report to the G-7 Heads of State and Government on Promoting Financial Stability, the G-7 Finance Ministers indicated that they were undertaking an assessment of impediments to information sharing identified by the Basle Committee, IOSCO, the IAIS and the Joint Forum. Work conducted in this area will be reported for the Summit.

18. As part of its study of information sharing among supervisors of financial conglomerates, the Joint Forum has sought to identify impediments to information sharing.

19. The impediments identified by the Joint Forum to date include, for example, (a) the lack of sufficient legal authority needed to exchange confidential supervisory information across sectoral and national boundaries, (b) legislation which only permits exchanges with specific agencies, and (c) the inability of a supervisor receiving confidential information to ensure the confidentiality and appropriate use of the information provided. A further impediment can arise in cases where a prerequisite to information sharing is the obligation to have in place a complex agreement, such as an international treaty, the negotiation of which is subject to formal and lengthy procedures. It was recognised that even where impediments can be overcome, they can result in delays in communication if sufficient flexibility is not available to supervisors.

20. It is clear that the full involvement of Ministers and Parliaments will be needed in order to remove inappropriate statutory and other impediments to information sharing and to lead to national legislative frameworks which facilitate and encourage relevant exchanges of information between supervisors domestically and internationally, intra-sectorally and cross-sectorally.

Joint Forum continuing work

21. At the time of the release of the Joint Forum papers for consultation, attention was drawn to the interest of the Joint Forum in intra-group transactions and exposures in financial conglomerates. The Joint Forum is continuing its work in this area, noting that (a) the application of corporate governance processes relating to the monitoring of intra-group transactions and exposures at conglomerates have not kept pace, in all instances, with the expansion of intra-group relationships and (b) supervisory approaches to intra-group transactions and exposures tend to be diverse and may not fully address the expansion of intra-group relationships in financial conglomerates.

22. Further, the separate issue of large exposures undertaken by entities within financial conglomerates could also present a concern. In particular, the complex and opaque structures of financial conglomerates can make it difficult to ensure that there is proper monitoring and management of large exposures by the conglomerate and can hinder effective supervision. The Joint Forum also intends to pursue work on large exposures in the coming year.

23. The Joint Forum considers that, with the consultation process on many aspects of its work now underway, it would be appropriate for it to turn to the implementation of its work. For example, the Joint Forum is undertaking an exercise to test the principles in the coordination paper in a practical setting, and to identify areas where it may be difficult to agree on whether a coordinator should be appointed, who the coordinator should be, or what role might be appropriate.

24. The ongoing work of the Joint Forum will also include practical testing of the principles and techniques it has developed on capital adequacy and continuation of its examination of barriers and potential obstacles to supervisory information sharing.

9th March 1998

Mandate for the financial conglomerates group

To draw up proposals for improving cooperation and the exchange of information between bank, securities and insurance supervisors and to work towards developing principles for the future supervision of financial conglomerates.

The group would:

- seek practical means at domestic and international levels to facilitate the exchange of information by supervisors within their own sectors, e.g. bank supervisor to bank supervisor and by supervisors in different sectors, e.g. insurance supervisors to securities supervisors or vice versa;
- investigate any barriers, legal or otherwise, that would impede the exchange of information between supervisors within their own sectors and between supervisors in different sectors;
- examine the possibility of establishing criteria to identify a "lead regulator" or "convenor" and consider the role and responsibilities of such "lead regulator" or "convenor";
- work towards developing principles for the future supervision of financial conglomerates:

It is anticipated that these principles for future supervision would parallel the issues identified in the present report:

- (1) Supervision of financial conglomerates on a group-wide perspective.
- (2) Techniques for assessing the adequacy of capital of financial conglomerates.
- (3) Supervisors' ability to check on fit and proper standards of managers and their ability to ensure that shareholders meet adequate standards.
- (4) Supervisory approach to participations of less than 100% in entities within financial conglomerates.
- (5) Supervisory approach to large exposures and to intra-group exposures within financial conglomerates.
- (6) Supervisors' ability to intervene in structures that impair effective supervision.

Topics may not necessarily be taken up or finished in the same time frame.