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**Your Ref: Comment letter on Consultative Report
- Principles for the supervision of financial conglomerates**

Dear Sir.

Thank you for giving us the opportunity to comment on your consultative report on Principles for the supervision of financial conglomerates.

The Joint Forum (BCBS, IOSCO and IAIS) is proposing principles for the supervision of financial conglomerates that provide national authorities, standard setters and supervisors with a set of internationally agreed principles regarding the effective monitoring, supervision and regulation of financial conglomerates, particularly financial conglomerates with cross-border operations and both regulated and unregulated businesses. The proposed principles build on the Joint Forum's 1999 principles,¹ and are based on a revised, broader definition of financial conglomerate. I will first make some general comments and then discuss some more detailed points.

Coordination among supervisors

I agree that much more needs to be done to improve the coordination and collaboration among supervisors. The Group-level supervisor should take ultimate responsibility for effective group-level supervision and coordination between sectoral and other relevant supervisors, coordinate the relevant and essential information to be exchanged, and ensure that gaps in supervision are avoided. Colleges of supervisors² and crisis management

¹ See Compendium of documents produced by the Joint Forum (2001), available at: www.bis.org/publ/joint02.htm

² See the college of supervisors concept for European insurance groups. The Insurance Group Directive, The Helsinki Protocol and additional guidelines are available at:

groups provide an appropriate template for promoting such coordination and collaboration among supervisors.³ The composition of the college should ideally be flexible and could also include supervisors of companies only participated (but not controlled) by the group, and significant branches.

Remuneration in financial conglomerates

I agree with the proposed principle concerning remuneration. It is necessary that financial conglomerates have and implement clear and transparent remuneration policies. These should be communicated and disclosed to all relevant stakeholders, including investors and shareholders, supervisors and internally within the companies. It is also necessary to have strong, independent governance structures and processes that will ensure that the conglomerate's remuneration policies are appropriate and are being followed.

It is clearly appropriate that variable remuneration should take account of the risks being taken on by personnel. If personnel meet performance targets by taking on excessive risk, then this endangers the conglomerate, and effectively rewards luck, which is unacceptable. I would recommend that the best-practice risk adjustment to variable remuneration should be done through a cost of capital type adjustment, for example by linking performance to a risk adjusted measure such as economic value added or RORAC.

Sanctions and whistleblowing

A fully functioning supervisory sanctioning regime must be effective, proportionate and dissuasive. These basic requirements could be met by incorporating the following three criteria within the proposed principles:

- 1) sanctions imposed must be significantly greater than potential benefits derived from a breach of legislation;
- 2) sanctions should be targeted at those parties who stand to gain from a breach of legislation, whether natural or legal persons;
- 3) sanctions imposed should normally include a public reprimand and / or be published.

<http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:1998:330:0001:0012:EN:PDF>,
https://eiopa.europa.eu/fileadmin/tx_dam/files/publications/protocols/nl194_helsinki_gbfi.pdf,
https://eiopa.europa.eu/fileadmin/tx_dam/files/consultations/consultationpapers/guidelines_coordination.pdf,
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https://eiopa.europa.eu/fileadmin/tx_dam/files/publications/standardsandmore/guidelines/CEIOPS-Guidelines-on-preparation-for-and-management-of-financial-crisis-27.03.2009.pdf

³ See also the Financial Conglomerates Directive and additional guidelines available at: <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2003:035:0001:0027:EN:PDF>,

The proposed principles also refer to whistle-blowing as part of an appropriate group-wide risk management culture. This is a good proposal. I would recommend that the Joint Forum should further encourage whistle-blowing in this arena, as a minimum by supporting the protection of actual and potential whistleblowers against retaliation by employers, and possibly through encouraging the granting of financial rewards to whistleblowers whose information leads to a successful enforcement of a sanctioning regime.⁴ A well-designed whistleblowing program would reinforce the integrity of internal compliance programs, help encourage employees to identify violations, and also to assist their companies in taking preventative as well as corrective action.

Stress testing and scenarios

The proposed principles, particularly principle 26, highlight the importance of stress and scenario testing as an ongoing risk management practice that supports a financial conglomerate's capital planning and forward-looking assessment of its risks.

Naturally stress testing should allow for shocks and variations along the following lines:

- 1) changing individual assumptions and parameters (sensitivity testing);
- 2) changing several assumptions and parameters at the same time, where the assumptions and parameters could reasonably be expected to change together (scenario testing);
- 3) changing the dependencies assumed between assumptions and parameters.

The importance of point 3 above often underestimated. We should therefore emphasise the importance of considering dependencies and correlations under stress and scenario testing, particularly as typically observed and expected dependencies may not apply in the tail conditions and events that would underlie many stress conditions and scenarios.

I would also recommend that you should specifically refer to operational risk as a potential risk factor for stress testing.⁵ Operational risk is critical as operational risk failures effectively allow other types of risk, such as credit risk and market risk to be excessive. I note that operational risk was mentioned as a risk factor for stress testing in the Basel Committee on Banking Supervision's report on Principles for sound stress testing practices and supervision.⁶

https://eiopa.europa.eu/fileadmin/tx_dam/files/aboutceiops/Recommendations.pdf

⁴ See for example SEC file No. S7-33-10, Proposed Rules for Implementing the Whistleblower Provisions of Section 21F of the Securities Exchange Act of 1934, November 2010, available at <http://www.sec.gov/rules/proposed/2010/34-63237.pdf>; European Commission consultation on Reinforcing sanctioning regimes in the financial services sector, December 2010, available at http://ec.europa.eu/internal_market/consultations/docs/2010/sanctions/COM_2010_0716_en.pdf

⁵ Operational risk is commonly defined as the risk of loss resulting from inadequate or failed internal processes, people and systems or from external events. This definition includes legal risk, but excludes strategic and reputational risk.

⁶ See page 3 in Principles for sound stress testing practices and supervision, BCBS, May 2009, available at: <http://www.bis.org/publ/bcbs155.pdf>

Fungibility of capital and diversification

Proposed principles 15 and 19 refer to limitations and impediments on the transferability of capital within the group. This assessment needs to consider the availability of capital across companies, sectors and jurisdictions within the scope of the group capital and solvency assessment. Therefore capital that can not be made both fungible and transferable should not be considered effectively available at group level. Furthermore, supervisors should ensure that diversification and correlation assumptions used in the group capital assessment are applied consistently with this.

Outsourcing

I agree with proposed principle 25 on outsourcing, however I would recommend a stronger focus on the implementation criteria regarding the supervision of outsourced functions. The service provider should commit itself to enable supervisory monitoring of its activities, which should include access to the information and the premises of the service provider. When the service provider is located cross-jurisdiction, the financial conglomerate is obliged to ensure that the supervisor (or its representative) has the appropriate access to the service provider. Particular attention should be given to chain outsourcing. This should help to remove any gaps in supervision here. I also agree that it is a general principle that no matter how much decision-making or functionality is outsourced, overall responsibility remains firmly with the financial conglomerate.

Yours faithfully

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