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March 16, 2012

Dr. Therese M. Vaughan
Chair
The Joint Forum
Bank for International Settlements (BIS)
Basel

Re: The Joint Forum – Consultative report "Principles for the supervision of financial conglomerates"

Dear Ms. Vaughan:

The Institute of International Finance is pleased to provide the following comments on the Joint Forum consultative report on Principles for the Supervision of Financial Conglomerates.

General Comments

The Institute supports the work of the Joint Forum in revising the Principles for the supervision of financial conglomerates. As stated in the IIF's report on effective supervision[1], we strongly believe that appropriate emphasis should be placed on supervisory issues which have as great a role as regulation in identifying and addressing the risks associated with conglomerates. Although important and essential reforms are currently under way in the area of financial regulation, without a strong supervisory framework such reforms will not contribute to the additional stability and resilience of the financial sector that are its ultimate goals.

It is essential that the principles **do not seek to create additional layers of regulation or supervision** in respect of international groups[2]. They should instead highlight and encourage, to the maximum extent, the coordination and mutual recognition of existing regulatory regimes, which already take into account a comprehensive risk perspective. The principles should be crafted in such way that they assist regulators in assessing whether existing local and regional regulatory frameworks achieve the objectives of effective group supervision. As an example, forthcoming Solvency II and Basel III requirements are already based on a group-wide perspective on risk which largely obviates the need for supplementary capital and liquidity requirements for financial conglomerates.

[1] Achieving Effective Supervision: An Industry Perspective; Institute of International Finance, July 2011.
[2] The comments are in line with the IIF response to the IAIS ComFrame Dialogue (see http://www.iif.com/regulatory/article+1048.php).

A requirement for the consistent assessment of the capital requirements of financial conglomerates is that **regulation in different sectors is appropriately coordinated** – a point which has been made by the IIF in its comments on the interaction of banking capital and insurance solvency requirements[3]. Banks and insurers have different core business models and regulation needs to reflect that. At the same time, banking regulation affects the activities of insurers and vice versa and both will be less effective if these spill-over effects are insufficiently recognized. It is essential that there is an appropriate coordination of regulation as it applies to firms in different sectors. This is a more appropriate goal than harmonization of regulation across sectors. We believe that such a statement should be included in the Principles and that the Joint Forum has a key role in promoting this coordination.

Given the challenges of achieving an effective oversight of financial conglomerates, the Institute believes that the principles do not place sufficient **emphasis on the mechanisms for achieving a comprehensive group-wide oversight, in particular the use of supervisory colleges**. Colleges are important not only on a cross-border setting. Even where a conglomerate is largely concentrated in one jurisdiction, it might be necessary to hold domestic college meetings in jurisdictions where the structure of supervision involves the interaction of multiple domestic regulators. The US is a particularly prominent example of this but it is a feature of many others where, for example, securities regulation is undertaken separately from that of banking and insurance. Where a conglomerate has extensive international operations, the creation and operation of effective international colleges led and managed by a group-level supervisor[4] is a high priority. Therefore, the Institute believes that significantly more emphasis should be put on developing a framework that makes colleges more efficient and effective.

The effectiveness of colleges often depends critically on the appointment of a **group-level supervisor**. The principles need to recognize this and to clearly identify those responsibilities of the group-level supervisor. There are a number of places throughout the document where 'supervisors' should be replaced with 'group-level supervisor'. Several of these are set out in Annex 1.

The IIF welcomes the statement in part IV that a supplementary assessment of capital adequacy will be necessary only if the relevant sectoral framework does not fully address the nature and scope of the financial conglomerate's risk profile for the purpose of ensuring capital adequacy on a group wide basis. In this regard the IIF strongly supports the principle that double or multiple use of the same component of capital by various entities of the same group should not be permitted by supervisors. However, the Institute is concerned about the **suggested requirement that minima and targets should always be exceeded** (e.g. implementation criterion 16.d). Whilst many firms may choose to exceed regulatory minima, making this a requirement is tantamount to establishing supplementary capital standards, something which is inappropriate where sectoral capital frameworks adequately address risk.

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[3] The Implications of Financial Regulatory Reform for the Insurance Industry; Institute of International Finance, August 2011 (http://www.iif.com/press/press+200.php).

[4] We use the term group-level supervisor throughout this document as defined in the glossary of the Joint Forum Consultative document on Principles for the supervision of financial conglomerates, p7/8.

This is something that in the IIF's view damages the concept of sectoral risk based capital frameworks.

As part of the introductory chapter 2 or 3, the Institute suggests to recognize more explicitly the linkage between **the micro-prudential supervision of financial conglomerates and the use of macro-prudential surveillance**. Supervision of financial conglomerates, however effective, cannot replace macroprudential surveillance as it does not capture all relevant risks to financial stability, such as externalities between conglomerates or systemic risk arising from the interconnectedness between conglomerates and other financial entities. Effective group supervision, however, is a prerequisite for strong macroprudential surveillance as macroprudential authorities need to rely on the assessments and reported data from a group-level supervisor regarding its supervised financial conglomerate.

In addition to the General Comments presented above, the Institute is also pleased to provide the following specific comments on the proposed Principles:

Principles

1. <u>Comprehensive group supervision</u>

The IIF supports the principles for comprehensive group wide supervision. Achieving an effective, efficient and consistent level of group-wide oversight is likely to depend on making extensive (although not exclusive) use of **supervisory colleges.** Such colleges will not replace the work of the solo supervisors of the legal entities making up the group. But they will provide a group perspective by focusing on the following tasks:

- Appointment of a group-level supervisor (this will be most likely the home supervisor) who facilitates and coordinates college activities as the central point of contact.
- Sharing of risk information (subject to appropriate confidentiality constraints and information security procedures as explained below).
- Coordination of supervisory activities with a view to enhancing the effectiveness, efficiency and consistency of supervision and to avoiding unnecessary duplication.
- Undertaking holistic assessment of the group-wide risk landscape (e.g. a coherent view of group-wide business risks, examination of the risk appetite and risk tolerance frameworks, arrangements for stress and scenario testing and how these translate into limits at the level of business units) and risk governance (e.g. the existence of an independent and effective risk management function, an independent and influential CRO and a board level risk committee).
- Assessment of risks arising from the macro-prudential perspective of surveillance.
- Taking appropriate group-focused actions to mitigate the risks identified.
- Interaction and liaison with group management.
- Planning and coordination of supervisory activities during emergency situations (crisis management).

The IIF considers it important that such tasks be included at the very least in the explanatory notes of the Principles.

Further, it is important that the draft is clearer about the role and powers of the group-level supervisor. While it is hard to see how the group-level supervisor can, in most cases, have additional formal powers, this is an important role carrying significant responsibilities which need to be agreed upon and respected by other interested supervisors. While this is the implication of explanatory comment 5.3, it could be made clearer. It is also relevant to implementation criterion 6.a. While the role and responsibilities of the group-level supervisor need to be agreed and made clear, this is a matter for discussion and agreement among the parties concerned and cannot be based on a formal legal framework.

Explanatory note 1.1 sets out that the legal framework should provide clear authority to collect information in respect of the head and the constituent entities of the financial conglomerate and the level of risk and support from the wider group. It is important in this context, and in respect of information requests more generally, that supervisors consider whether their information requirements can be met by existing information that is reported to them (or other interested supervisors/college members) before requesting any additional information from financial conglomerates.

2. Cooperation and exchange of information

Implementation criterion 2.b does not contain a reference to providing information on a 'need to know' basis. The Institute supports the free flow of information among supervisors; however, this should be subject to the discipline that the recipient has a clear need for it and therefore that supervisors should collect only necessary information. The Institute suggests the addition of a clear statement that there needs to be a balance between meeting legal obligations and respecting legitimate concerns about confidentiality within the college (e.g. sharing information only on a 'need to know' basis) whilst not allowing an undue preoccupation with confidentiality to become a barrier to the efficient and effective working of colleges. The Institute recommends that the industry and the Joint Forum work together to develop clear protocols for the secure collection and sharing of confidential or sensitive competitive data.

3. Independence and accountability

3.2 notes that supervisors should be protected from liability for acts taken in good faith. We strongly agree with this principle but it should be balanced with a right to be heard and to receive a coherent and definitive ruling, together with an explanation of the supervisor's rationale.

4. Resources

It is noted in 4.b that supervisors should be financed in a manner to permit effective supervision. Again, we strongly agree with this principle but it needs to be balanced with a requirement that supervision should be subject to broad cost benefit principles so that regulatory and supervisory requirements are not disproportionate to the benefits (in terms of risk reduction) that they afford.

6. Supervisory cooperation, coordination and information exchange

The Institute suggests making a stronger reference to colleges in principle 6 by adding content along the following lines:

- Achieving the necessary level of coordination will almost certainly involve the creation of an international college.
- The group-level supervisor will have responsibility for facilitating college activities. That means: a) acting as a primus inter pares in the collection and sharing of group-level data, developing and informing about group wide risk and capital assessments as well as coordinated regulatory programs; b) determine the structure and membership of colleges on the basis of 'variable geometry' (for example, involving flexibility concerning the geographical composition of the college and the agendas); c) hosting college meetings; d) facilitating information flows.
- The group-level supervisor should also encourage, to the maximum feasible extent, coordinated working by college members. Ideally colleges should work towards a situation in which members are willing to place reliance on the work of others. At the very least, joint working should be encouraged. This helps to create a shared understanding and perspective on risk while limiting the supervisory burden on firms.
- Roles and responsibilities have to be clear, the group-level supervisor has to be empowered to take a leading role and other supervisors clearly have to rely on the group-level supervisor's assessments.

Further, implementation criterion 6.g refers to arrangements for resolving differences. This is an important issue but at the international level it cannot involve one or more supervisors having binding resolution or arbitration powers, even in the context of a college (though it is recognized that regulation in the European Union has a legal basis which provides an exception to this). The group-level supervisor should clearly have an informal role for coordination and mediation but will have no formal powers for mediation or resolving disputes.

7. Prudential standards and coverage

It is very important that the principles do not attempt to establish global capital standards where they do not yet exist (e.g. in insurance). Rather, as mentioned above, the focus for the foreseeable future needs to be on mutual recognition of the different prudential standards across jurisdictions in relation to governance, capital adequacy, liquidity and risk management. Mutual recognition is likely to be facilitated by regular exchanges of perspectives and information between regulators across sectors, especially within supervisory colleges. Where an effective sector regime is in place or being implemented which takes an adequate group-wide perspective, there should be no need for supplementary requirements.

Implementation criterion 7.b implies that listed risks are always heightened through the existence of conglomerates. The Institute strongly disagrees with this presumption. Whilst conglomerates may often have risk profiles which differ from those of their constituent parts, in many cases aggregate risk will be reduced – for example where there are significant diversification benefits. While it is true that supervisors need to be alert to heightened risks,

the IIF recommends that the wording should be changed to reflect the fact that this will not always, or indeed usually, be the result of a conglomerate structure.

In general, principle 7 would benefit from much more clarity about how prudential standards overlap[5]. Activities which are typically subject to different regulatory and supervisory regimes (e.g. banking and insurance) may take place within the same group. In such cases, supervisors need to make sure that same activities are subject to comparable regulations to prevent regulatory arbitrage. It is therefore important that the Principle be clear about how these regimes overlap and how to resolve any potential conflicts.

8. Monitoring and supervision

The existence of a conglomerate may generate legitimate needs for additional information to be provided to supervisors (e.g. consolidated group-wide data). However, the IIF believes that the section should emphasize that requests for such information should be proportionate and result demonstrably from the fact that the existence of a conglomerate adds an additional dimension to the risk profile (even though, as noted above, there should be no presumption that the existence of a conglomerate heightens risk per se).

10. Corporate governance in financial conglomerates

The IIF agrees that clear expectations should be created regarding the corporate governance to be implemented in all financial institutions, including conglomerates. These should be consistent with the requirements outlined in individual jurisdictions.

Further, governance is intimately bound up with risk management – a point which is made in comment 10.2 and principle 23 but which should already be made in the implementation criteria of principle 10.

In addition, supervisors ought to take steps to ensure that corporate governance is effective – not just that the necessary structures exist. Regarding 10.5, the Institute would suggest that a reasonable set of governance expectations is defined across all jurisdictions.

11. Structure of the financial conglomerate

Implementation criterion 11.b may need to be qualified on the basis of proportionality. Whilst supervisors have a right to require clarity regarding the structure and operation of conglomerates, this should not be a pretext for supervisors arbitrarily insisting on radical restructuring of conglomerates. Restructuring requirements should be used as a last resort and only in the context of clear and substantiated prudential needs.

Explanatory comment 11.2 should mention that recovery and resolution programs should be aligned with the corresponding sectoral requirements. Existing standards should be evaluated and wherever appropriate supervisors defer to them. The IIF believes strongly that

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[5] As cited above, the IIF report on "The Implications of Financial Regulatory Reform for the Insurance Industry" makes a case for the need for regulatory coordination across sectors and provides further details on how prudential standards may overlap.

the need and scope for RRPs varies widely across sectors and supervisory arrangements for conglomerates should not introduce requirements that are markedly different. In particular, the case has yet to be made for comprehensive RRPs within insurance.

The Institute considers that comment 11.3 would benefit from explicitly indicating that it is important that supervisors be able to identify de facto constraints on a conglomerate's financial resources arising from trapped pools of liquidity, intra group guarantees, etc.

12. Suitability of significant owners, board members and key persons

While the IIF fully supports the need for supervisors to assess suitability of owners, Board members and other key persons, the draft Principles are not sufficiently clear on how supervisors can assess and address suitability of key shareholders in terms of skills, experience and knowledge. While prescriptive criteria are probably not warranted, the Principle could be improved with additional specificity on how supervisors can discharge this task.

Reference is made to owners, key shareholders, major shareholders and significant owners in various places in principles 10 and 12 in the context of assessing suitability. It may be possible for suitability requirements to be put in place for controlling shareholders, e.g. where supervisory notification/authorization is required. It would however be difficult to enforce suitability requirements on non-controlling shareholders where shares are traded freely on public exchanges. Consequently, references to 'owners, key shareholders, major shareholders and significant owners' should be made more specific and probably replaced with references to controlling shareholders.

The requirement in 12.c that the Board of the head of the financial conglomerate include a number of members acting independently of the wider group (including owners and staff of the wider group) is ambiguous and needs further clarification. The IIF supports the requirement that board of the head of the financial conglomerate include a number of members acting independently of the wider group. However, the exact composition of the board is a matter of individual jurisdictions and should not be prescribed by the principles on conglomerates.

13. Responsibility of the board of the head of the financial conglomerate

The Institute suggests adding a reference regarding the top board having the information it needs on a timely basis to enable it to monitor risk and risk management. Further, it is important to put the proposed Principles and discussion within the context of the broad framework devised by the Financial Stability Forum on compensation, e.g. by including an explicit reference to the FSB core principles on compensation[6].

15. Capital management

As noted above, we welcome the statement in part IV that a supplementary assessment of capital adequacy is necessary only if the relevant sectoral framework does not fully address

[6] FSB Principles for Sound Compensation Practices; Financial Stability Board; September 25, 2012.

the nature and scope of the financial conglomerate for the purpose of ensuring capital adequacy on a group wide basis.

16. Capital assessment

The introduction of a concept of materiality in the implementation of criterion 16.a is of fundamental importance. Without such concept, capital assessment judgments risk focusing on activities or entities which do not materially alter the risk profile of the group or its constituent parts. In this context, the issue arises of the criteria that need to be applied to decide on when risks are material and whether entities or activities need to be consolidated.

Further, the Institute is particularly concerned about implementation criterion 16.d: A requirement that minima and targets should always be exceeded is tantamount to supplementary capital standards which are inappropriate where sectoral frameworks adequately address risk. This is something that in the IIF's view damages the concept of sectoral risk based capital frameworks.

17. Capital assessment: consider double gearing

The IIF agrees that double gearing should be carefully considered when assessing capital adequacy. As highlighted in principle 17 paragraph a and c, prudential standards should remove the double counting within the appropriate tier of capital rather than at the total capital level, in particular for banking conglomerates holding insurance companies . This will help reduce systemic risk and safeguards insurance policyholder protection. However, the implications of potential diversification effects across entities should not be neglected when assessing capital requirements. The IIF suggests including a reference to potential diversification benefits across entities at the end of explanatory comment 17.2 or in a separate explanatory comment.

19. Capital assessment: limitations to intra-group transfers

The principle as well as the implementation criteria should specify that supervisors should support the reduction of impediments of intra-group transfers unless a compelling case can be made for the necessity of these on a case by case basis. Consideration also needs to be given to the timing aspects of the underlying cash flows. This timing aspect of cash flows could be considered in 19 by amending the criteria as follows: Supervisors should require that assessment and measurement techniques evaluate any characteristics of intra-group transfers of capital, taking into account potential impediments to executing such transfers and the timing aspects of the underlying cash flows.

20. Liquidity

This section on liquidity should include a reference to regulatory requirements for liquidity in the different sectors (e.g. the LCR and NSFR under Basel III for banks) and point out that specific liquidity regulation is not required for all sectors (e.g. insurance). While the current formulation for these is in need of revision, once properly formulated requirements are in place, compliance with these will be a key element in liquidity management assessments.

Further, implementation criteria 20.b should point out that supervisor support the reduction of unnecessary impediments of intra-group transfers.

28. Risk concentrations and intra-group transfers

The IIF considers that this is an area where additional analysis should be conducted. Given that the new risk based capital regimes take a holistic risk approach and capture these risks adequately, there is no clear justification for the need to introduce quantitative limits for risk concentration and intra-group transactions and exposures. Such quantitative limits should only be necessary if it is clearly established that the current regulatory regimes fail to do address such risks.

29. Off-balance sheet activities

The section on off-balance sheet should emphasize the need for complete clarity regarding the basis for consolidation. Supervisors need to provide clear guidelines about which activities should be consolidated and when. And in providing this, the principles should not create any additional criteria regarding consolidation.

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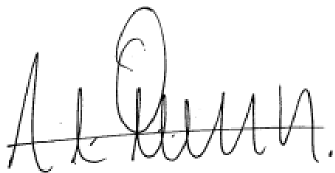
We hope this letter is useful as the Joint Forum considers the way forward in this area. We also urge the Joint Forum to provide ample opportunity for direct dialogue with the industry on this important issue. Given the complexity of conglomerates' supervision, we believe direct dialogue with the industry is essential.

The IIF stands ready to provide additional views or clarifications. We look forward to discussing these issues with the Joint Forum going forward. For further details you may reach me (aportilla@iif.com) or my colleagues Martin Weymann (mweymann@iif.com) and Samuel Schenker (sschenker@iif.com).

Best regards.

Sincerely,



Andres Portilla
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Institute of International Finance

Annex 1: Clarification of responsibilities assigned to "supervisor" and "group-level supervisor", respectively

It should be fully recognized that solo supervisors of individual entities comprising a conglomerate need to retain all powers and resources necessary to fulfill their tasks. However, also group-level supervisors have a number of responsibilities. These responsibilities and the ability to discharge them need to be more reflected in the principles even though these, for the most part, will not be embodied in formal powers.

In particular the responsibilities in the following principles should be clarified:

Principle 1: Implementation criteria
The implementation criteria should be specifically targeted at the group-level supervisor, rather than all supervisors, given that the focus should be on the activity that is supplementary to normal supervision which should be led and coordinated by the group-level supervisor.

Principle 3: Implementation criteria
3.b should be qualified so that it refers to the group supervision of financial conglomerates otherwise it states what should already be the case under national supervisory regimes.

Principle 4: Explanatory comments
The reference to supervisors having sufficient resources to carry out group-wide supervision should instead refer to the group-level supervisor.

Principle 8: Implementing criteria
The notes in 8.a rather than applying to supervisors should only apply to the group-level supervisor. Similarly the reference to supervisors in 8.d should be replaced with group-level supervisor.

Principle 11: Implementation criteria
There are a number of references to 'supervisors' for activities that should be the responsibility of the group-level supervisor. Consequently, the reference to 'supervisors' should be replaced with 'the group-level supervisor' in sections 11.b, 11.c, 11.d, 11.e and 11.f.

Principle 11: Explanatory comments
As above the references to 'supervisors' should be replaced with 'the group-level supervisor should lead consideration by supervisors ...'.

Principle 12:
The reference to 'supervisors' in 12.i and 12.ii should be replaced with 'the group-level supervisor'.