Shamshad Akhtar: Pakistan – framework for consolidated supervision

Keynote address by Dr Shamshad Akhtar, Governor of the State Bank of Pakistan, at the Annual General Meeting of the Institute of Bankers, Pakistan, Karachi, 31 October 2008.

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Financial markets have not only been growing at a rapid pace, but have also been marked by continuous change. Key structural transformation has been the evolution of large and complex global financial institutions and structures that, given their inherent size and strengths, have promoted financial engineering and innovation, exploited new avenues of financial leveraging accompanied by greater risk appetite, and infusion of information technology. Together these developments have changed the financial landscape. Over the period, various market developments along with few key legislative changes, such as repealing of the Glass Steagall Act, 1933 (which rolled back the restrictions imposed on banks for mixing their business with securities and investment banks) in the late nineties, fostered new financial structures and strategic alliances that removed the distinction between activities specific to various types of financial institutions. Though the recent global financial market turmoil has triggered questions regarding the risks associated with the emerging types of financial structures, however a more relevant debate is regarding the gaps and weaknesses in the regulatory and supervisory structures that allowed over-leveraging and the operations of several financial industry segments to operate without appropriate oversight.

Recognizing the need to evolve an appropriate oversight policy mechanism for its evolving financial structure, SBP, as a part of its overall financial sector reforms launched in July 2008, has advocated the need for legislature to empower the central bank to augment its oversight of the financial sector. In my remarks this morning I propose to outline the economic and financial benefits of financial conglomeration and the risk and supervisory challenges arising out of these complex financial structures. I propose to then share with you the legislative reforms launched by SBP in this area which have recently been approved, in principle, by the Cabinet and are to be tabled for Parliament consideration.

Rationale for consolidated supervision

Worldwide, the process of change has allowed many financial organizations, which used to engage in the primary business of banking, asset management or insurance activities on a standalone basis, to adopt more flexible structures whereby banks opened up a wide range of subsidiaries and affiliates that primarily engage in businesses other than their core business. The main economic and financial benefit which encourages the formation of such groups is the enhanced ability to achieve economies of scale and to capture synergies across complementary financial services business lines. These synergies result in improved operational efficiency and effectiveness due to lower costs, reduced prices, and improved innovation in products and services. However, at the same time the emergence of such groups has also added complex linkages and relationships among economic agents. Consequently, they have also necessitated a paradigm shift in the supervisory approaches all across the globe to assess, manage, and mitigate risks stemming from such arrangements.

Like other countries, these developments have steadily gained momentum in the Pakistani financial sector. The existing regulatory framework in Pakistan under SBP gradually became more open, flexible and allowed the banks to set up subsidiaries to operate Non-bank financial businesses. The prevalent structure under which non-bank financial services are being offered is mostly through the parent – subsidiary form of structure wherein banks are parent of their non-banking subsidiaries, or in some cases banks have Non-banking finance companies (NFBCs) as associates. Some elements of Universal banking also exist, for example banks are allowed to undertake investment banking, and leasing businesses on their own balance sheet as well. While the central bank showed flexibility in allowing these developments, the underlying legal architecture was not changed in line with the market needs and developments.

As such, the current legislation and regulatory tools are not adequate to effectively address the potential risks to the safety and soundness of the financial sector. The safety and soundness of the banking sector, being at the core of all activities of the financial sector, is critical for the general public, for the financial sector itself and for the economy as a whole. The governing law of the banking sector viz. the Banking Companies Ordinance (BCO) was introduced in 1962 and occasional changes were made in it in response to the challenges of different phases of development. The significant challenges posed by universal banking, large financial groups and holding company structures now warrant a matching legal framework to avoid any major disruptions in the economy and in the process of financial intermediation. Recognizing these challenges, SBP has sought in principle approval from the requisite forums for amendments in the BCO to enable it to supervise banks, groups and financial holding companies in line with international trends.

Besides forestalling various risks, these amendments would enable significant benefits in the form of operational efficiency, lower costs, reduced prices and innovation in products and services. Moreover, one of the Core Principles for effective banking supervision (CP-24) issued by the Basel Committee on Banking Supervision requires that a banking supervisor should be able to supervise the banking groups on a consolidated basis. Presently, Pakistan is either compliant or largely compliant with all the core principles except those dealing with consolidated supervision. The proposed amendments in the BCO would also enable Pakistan to ensure compliance with this principle.

Major risks arising from complex structures and supervisory challenges

While the increasing integration and the drive towards financial conglomeration has opened up possibilities of greater efficiency through increased economies of scale and scope, at the same time it has also generated novel risks and has consequently raised a number of supervisory concerns. A few of these risks and concerns are as follows:

- One of the foremost risks is **contagion risk** which can manifest itself in psychological as well as financial forms. Financial distress in one entity could impair the reputation of the other entities and the market participants may be reluctant to engage in business with them. The reputational problem can often lead to financial distress in the entire group, as the parent or the other group associates may have to help out the distressed entity in order to safeguard the group from reputational risk. Such other group entity could be a subsidiary of the bank, with the potential of **downstream risk**, or parent of the bank or affiliate under the control of parent i.e. **upstream risk**.
- A Bank or DFI, together with other group entities under its control, could take exposures on a single borrower, borrowing group, or sector that are beyond prudential limits. Generally, on individual basis, there are per party exposure limits. However, various entities in a group may end up with an unusually large exposure on a collective basis. Moreover, since the entities within a group may be subject to different regulations, this may lead to **regulatory arbitrage** allowing banks to take advantage of the less stringent regulatory regime applicable on some of its subsidiaries. There might be specific intra-group linkages that could nullify the impact of conventional risk mitigation techniques at the group level by simply shifting the risk from one of the group entities to another.

- Another problem is the overstatement of capital or **double gearing** whereby the capital of one entity is used to satisfy the requirements of more than one affiliate entities. This phenomenon is typical where investments are made by the parent body in its subsidiaries. Double gearing results in the overstatement of capital and can also lead to regulatory arbitrage.
- Another aspect which is often difficult to detect is of **intra group transactions**, which might not be on arms-length basis. This increases the likelihood of fraud or siphoning-off of funds.
- Liquidity risk arising from **asset liability mismatch** is also of great significance. Universal banking, since it houses diverse products with different asset liability structures and risk profiles, can be considered the most risky. In conventional banking, where universal banking is allowed, banks need to create firewalls so that no asset liability mismatches occur, and internal transfers of funds raised from one type of liability (i.e. short term deposits) are not deployed against a source which typically provides products with long term maturity (i.e. investment banking, insurance etc).
- In the absence of a formal Holding Company structure, the corporate structures at the group level are quite opaque and in various cases create ambiguities about the roles and responsibilities of the board of one entity vis-à-vis another. Similarly, interference in the managerial functions of one entity by the officials of another has also been witnessed. Increasing complexities in the ownership and managerial structure of a group can make the supervision of financial institutions in the group difficult.
- In view of the dynamic ownership structure of our banking industry, entry of foreign players in our market and investment by our banks abroad, it is necessary to take a holistic view and work towards an appropriate supervisory structure (consolidated supervision) to avoid any problem in future.

Changes sought in the legal framework and supervisory regime

These concerns and the risks associated with group relations warrant a comprehensive framework for supervision that evaluates the strength of an entire group, taking into account all the risks which may affect a bank/DFI, regardless of whether these risks are carried in the books of the bank/DFI or related entities. SBP firmly believes that the financial sector as a whole has a lot to gain through increased integration and conglomeration. However, the newly emerging phenomenon has to be properly monitored and governed under an appropriate legal framework to mitigate the potential risks. Keeping these factors in mind, three major changes are being proposed in the BCO.

Firstly, the current supervisory set up has to be changed to bring under the fold of SBP, all deposit-taking Non Bank Financial Companies (NBFCs). The major rationale for this proposal is that these NBFCs are engaged in activities which are quite incidental to banking, both on the liability as well as the asset side. Bringing such entities under SBP would lead to greater supervisory efficiency, as being the regulator of banks, its supervisory approach is well equipped for their kind of business and the resulting risk profile. In this regard, the BCO ought to bring under its folds, besides banks and DFIs, NBFCs like Investment Banks, Leasing Companies, Housing Finance Companies that are until now outside its regulatory purview.

Secondly, another change being sought is to authorize SBP to designate and regulate financial groups. Financial group for this purpose will be any group in which at least one of the entities is directly regulated by SBP. This is an extremely important step because it will enable SBP to effectively monitor the potentially dubious intra group transactions involving banks and NBFCs, and would also enable it to curtail the possible contagion risk. The proposed amendment would also enable SBP to seek information from the unregulated commercial entities and conduct limited inspection for verification of such information.

For entities in a financial group which fall under the purview of the securities regulator's supervision, the current supervisory mechanism also needs to be amended to move towards greater consolidated supervision. Under the proposed supervisory mechanism, the concept of lead and functional supervisors has been introduced. SBP would be the Lead supervisor for a financial group for consolidated supervision. Functional supervisor would be the regulatory body responsible to carry out supervision of the entity on a stand-alone basis under the relevant laws in force for the time being. In order to ensure that consolidated supervision is done effectively, and that there are minimal enforcement issues, the power to seek information, conduct onsite inspection in collaboration with the functional regulator, recommend enforcement action to the functional regulator etc. are being sought for the lead supervisor.

Thirdly, the time is ripe for the introduction of a Financial Holding Company (FHC) concept. SBP has so far facilitated the increasing integration of various segments of the financial sector through various rules and regulations, and the next logical step is the creation of enabling legal provisions for the establishment of more efficient forms of conglomerate structures such as the FHC model. The FHC model is becoming popular in different countries, e.g. USA, Hong Kong, Singapore, India etc.

The benefits of adopting a financial holding company model are as follows:

(i) One of the key advantages of the FHC form of structure is that it provides separation of business activities and investment activities of financial institutions within a group.

(ii) This structure would prevent the double gearing of bank's capital and facilitate the growth of the financial sector, as new capital injection would be required for expanding businesses.

(iii) It would be easy to establish firewalls and protect banks from risks arising out of non-banking activities. While banks will not be able to directly benefit from any profits of their non bank companies, the overall group will be strengthened.

(iv) The sponsor shareholding of banking as well as non banking companies will become transparent and help SBP in ensuring that these institutions operate at arm's length. The majority shareholding in a bank will be channeled through the FHC, and since under the proposed amendments, FHC supervision is with SBP, the shareholdings can be more closely monitored.

(v) The structure provides organic growth without increasing contagion risk as it is very unlikely that the whole group will fail.

In order to facilitate the FHC model, we are also seeking several amendments in the BCO covering its definition, licensing and supervision (which will be by SBP), capital requirement and various other aspects. In anticipation of these legal changes, SBP is also preparing supportive regulations to aid the effective development of financial conglomeration and their oversight.

In conclusion, the proposed legal and regulatory changes, discussed above, to strengthen the oversight of the financial sector, are an integral element of the Ten Year Strategy and blueprint of financial sector reforms prepared by the central bank. Concurrently, SBP has also launched wide ranging reforms including capital augmentation of banks, shift to risk-based supervisory approaches, and proper implementation of Basel II. The private sector has responded well to SBP's initiatives and a number of banks are launching work to take benefit of the emerging legal and regulatory changes to position their financial institutions better to compete in a more aggressive regional and global environment.