Principles for the Supervision of Financial Conglomerates

International Organisation of Securities Commissions

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PRINCIPLES FOR THE SUPERVISION OF FINANCIAL CONGLOMERATES

Introduction

1 This paper sets out principles which the Technical Committee believes should govern the supervision of financial conglomerates. (These principles are summarised in Annex 1). The principles are intended to provide a framework which the Technical Committee believes should guide the development of regulatory practice in this area both in individual countries and in relation to international regulatory co-operation.

2 The term 'financial conglomerate' is used to refer to any group of companies under common ownership where financial activities - whether securities business, banking, insurance or some other financial service - are undertaken on a significant scale by one or more companies in the group. Although the Technical Committee believes that the principles set out here are of relevance to the question of conglomerate supervision generally, the main concern of the Technical Committee is with groups where securities business plays a significant part. There are three different kinds of financial conglomerate where this might be the case:

i groups where securities business is the predominant activity;
ii groups where securities business is not the predominant activity, although the predominant business is financial (eg banking or insurance);

iii groups where the predominant activity is commercial or industrial.

3 The ability of securities regulators to obtain an overview of the risks involved is different in each case, as are the techniques which may need to be employed to this end. These issues are discussed in more detail later in the paper.

The need for supervision of financial conglomerates

4 Internationalisation of markets and the deregulation of national markets have, amongst other factors, encouraged the emergence of large financial conglomerates offering a full range of financial services and operating cross border in a variety of jurisdictions. While the corporate structure of financial conglomerates varies widely, it is often complex, reflecting fiscal, cultural and historical factors, as well as legal and regulatory requirements in the jurisdictions in which the conglomerate operates. Frequently, the managerial structure differs significantly from the corporate structure.

5 Many of the financial activities undertaken by a financial conglomerate will be subject to regulation and often a number of regulators from different sectors and different jurisdictions will have responsibility for some part of the group. Such entities are subject to regulatory capital requirements which reflect the entities' activities on behalf of their customers as well as concerns that firms remain financially viable and have sufficient assets to sustain market reverses. Moreover, the capital requirements of

most jurisdictions are designed to provide sufficient advance notice of an entity's problems to make possible protective or remedial activities to ensure not only the safety of the marketplace but customer funds as well.

6 But many financial conglomerates include entities which are not subject to regulation. While some of these unregulated entities may be engaged in non-financial activities, others may be conducting financial activities or have a close involvement with group companies engaged in financial activities. Leasing, consumer credit, custody operations, bridge lending, foreign exchange and swaps, for example, are *some of the* financial activities which do not require authorisation in some countries represented on the Technical Committee.

7 The appropriate supervision of financial conglomerates is an issue for securities regulators, as well as for regulators of other financial activities, because experience has shown that problems arising in one part of a financial conglomerate may infect other group companies, including regulated entities. The risk of contagion is particularly acute in the case of financial institutions, whether securities firms, banks or futures firms, which depend on market confidence either for funding or for trading purposes. The problems which a regulated firm faces when other parts of the group experience financial difficulties are likely to be exacerbated if that firm has exposures to other group companies. The regulated firm may find that amounts owed to it by other group companies can no longer be repaid on time, or that it is required

to make additional funding available to another part of the group. Many supervisors already seek to safeguard against these risks by taking special account of them in the capital requirements or other controls on the regulated entity.

8 Financial conglomerates are more likely to run into difficulties if there is insufficient capital in the group to support the risks being run. Excessive gearing* may occur as a result of the downstreaming of equity or other regulatory capital from parent to subsidiaries within the group. This risk will be greatest where there are unregulated subsidiaries which are not included in a prudential consolidation. But even where the subsidiaries are regulated, the supervisor who seeks to look at the group as a whole has, at present, and until there is international agreement on capital standards, to consider whether the capital requirements applied to those subsidiaries are appropriate to the risks they carry. The problem of excessive gearing may be exacerbated if the existence of unregulated entities in the group leads to a dilution in the quality of capital. This may occur for example, where an unregulated holding company raises short term market funding, perhaps through a commercial paper programme, which is downstreamed into operational subsidiaries, including regulated entities, in the form of equity or a long term loan.

9 Group-based supervision is an established part of bank regulation and in most jurisdictions banking supervisors have emphasised group rather than solo financial supervision. There is also at least

* This paper deliberately avoids using the term 'double-gearing', which can be used in a number of different and sometimes confusing ways.

one securities regulator that believes that instead of complementing a solo based supervision with a group-based supervision, the supervisor should regulate the group on a consolidated basis and if the regulated firms of the financial conglomerate are subject to the risk of contagion, the supervisor of the consolidated group should complement this consolidated prudential regulation with a subconsolidated or solo supervision.

10 Most securities regulators, on the other hand, have traditionally concentrated on the financial condition of regulated securities firms on a solo basis, and have taken account of the risks which the wider group poses for the regulated securities firms only in a quite general, qualitative sense, if at all. This approach reflects the fact that securities regulators do not set capital requirements at levels which would in all circumstances prevent securities firms from failing, but rather to ensure that if they fail they can be wound up in a controlled way and all liabilities can be paid without loss to customers and counterparties.

11 However, the growth of very large securities firms turning over large volumes of securities on a daily basis has meant that the collapse of such a firm could have systemic consequences. This could happen, for example, where there appear, superficially, to be sufficient liquid assets to repay all liabilities without loss to customers and counterparties, but the sheer size of the positions requiring liquidation makes it difficult to liquidate these quickly and without moving the market adversely. There could also be systemic consequences where the size of securities deliveries and

payments due from the failed securities firm could cause significant problems for counterparties if there were any delay at all in the firm's meeting its commitments and this could conceivably cause gridlock in the settlement and payment systems. The failure of such a securities firm might have a ripple effect spreading widely through the securities industry and the financial system as a whole and could trigger a general lack of confidence.

12 Even where the failure of a regulated securities firm is unlikely to have serious consequences for the securities industry and the financial system generally, the risk of contagion means that it is highly desirable for the securities regulator to have early warning of problems elsewhere in the group. Early warning of these problems will allow the securities regulator to monitor the financial condition of the regulated entity particularly carefully, to take what steps seem appropriate to reduce the exposure of the securities firm to the rest of the group and to ensure that the firm could be wound down in an orderly and timely manner if this should become necessary.

13 If regulation is to be effective, regulators must take adequate account of the risk of contagion. Securities regulators, generally, seek to safeguard the regulated entity from exposures to other group companies by ensuring that the regulated firm has sufficient capital. If risks which other group companies pose for the regulated entity appear unacceptable, for example, the securities regulator may require the firm to hold more capital or to limit its exposures to the rest of the group to ensure that the firm can be

wound down in an orderly and timely way without loss to customers and counterparties in the event that these risks crystallise into serious financial problems which spread throughout the group. Even these safeguards may not, however, prove adequate to contain contagion. Even if the regulated entity has little or no exposure to the rest of the group, market confidence in the regulated entity may nevertheless disappear, particularly if it shares the group name. Where a regulated entity is part of a heterogeneous conglomerate which includes commercial and/or industrial enterprises as well as financial activities, it may be that the only available means of minimising the risk that problems arising in the non-financial part of the group could spread to regulated financial entities is to ensure that the regulated entity is well capitalised. But it is recognised that this cannot always prevent contagion.

14 The members of the Technical Committee therefore believe that the traditional approach of securities regulators to the prudential regulation of securities firms on a solo basis should be complemented through an assessment of the risks which the rest of the financial conglomerate poses for the regulated securities firm. The extent of this assessment may need to distinguish between those securities firms whose operations give rise to systemic risk and those which do not. In the case of the latter, the securities regulator may conclude that it is sufficient to look at the group only periodically and to be aware in fairly general terms about the risks being carried elsewhere in the group. However, the greater the systemic risk inherent in a securities firm's operations the more ambitious the approach to group-based risk

assessment will need to be. In all cases, the objective of group-based risk assessment should be to enhance the regulation of the regulated firm. Every effort should be made to avoid creating any impression that hitherto unregulated entities in a financial conglomerate have been made de facto subject to regulation, or that the regulators accept any responsibility for the prudential supervision of the group as a whole where this is not, in fact, the case.

15 In view of the international nature of the activities undertaken by many financial conglomerates and the fact that these straddle different financial sectors, it may be difficult for any one regulator to obtain a full overview of the activities of a financial conglomerate. In addition, the efforts of individual regulators need to take into account the responsibilities of other regulators for specific parts of a financial conglomerate. The members of the Technical Committee acknowledge the importance of supervisory co-operation between regulators of different sectors and in different jurisdictions.

16 The Technical Committee has agreed that the following general principles should form the basis for the risk assessment of financial conglomerates and should be used, as far as possible, to guide the development of regulatory practice and regulatory co-operation in this area.

PRINCIPLES GOVERNING THE SUPERVISION OF FINANCIAL CONGLOMERATES

a Group-based risk assessment

17 *Where a regulated firm, which is part of a financial conglomerate and subject to supervision on a solo basis, is vulnerable to the risk of contagion, supervision of the regulated firm should be complemented by group-based risk assessment.*

18 There is a spectrum of possible approaches to group-based risk assessment. Prudential consolidation, which involves the application of capital requirements on a consolidated basis, lies at one end of this spectrum. Consolidation for these purposes enables a group to be viewed as a whole and regarded as a single economic unit. It is a supervisory technique rather than an accounting consolidation as required under company accounts legislation. It provides a quantitative measure of the amount of capital which is required to support the totality of risks being carried in the group companies which are included in the consolidation.

19 At the other end of the spectrum lies a much more qualitative approach. This may still involve the collection on a regular basis of relevant quantitative information about other group companies, but such information is used primarily as a basis from which to make a qualitative judgment about the degree of risk which these companies pose for the regulated entity and to provide early warning of problems elsewhere in the group which could spread to the regulated entity. Relevant information is likely

to include information about the capital, profitability and liquidity position of other group companies, the risks involved in their core activities and their intra-group exposures.

20 Where a regulator ends up on the spectrum between these two approaches is likely to depend on the nature of the financial conglomerate, the risks it carries and its significance, as well as that of the regulated entities it contains, to the financial sector. Some regulators may adopt the same approach to group-based risk assessment for all the entities they regulate. Others may end up at different points on the spectrum in relation to different financial conglomerates.

21 For banking regulators, prudential consolidation of banking groups is a fundamental part of prudential supervision. It aims to assess capital and risks on a consistent basis and to minimise the opportunity for excessive gearing and the underestimation of risks. It reduces the potential for regulatory arbitrage within a group. But even where the consolidation is technically straightforward, bank regulators usually go beyond the calculation of consolidated capital ratios to incorporate qualitative elements in their assessment of risk on a group basis. Where bank regulators encounter technical difficulties in consolidating a specific group, they may need to temper their rigorous quantitative approach with a qualitative judgment about the risks arising in the group and in some cases about the appropriate level of capital required at the consolidated level.

22 Most securities regulators are only now beginning to develop group-based risk assessment and those that have done so have

identified some form of qualitative approach as the most appropriate way of achieving their regulatory aim of ensuring that securities firms can be wound down quickly and in an orderly way. However, if there are securities firms whose collapse risks seriously harming or disrupting the markets in which they participate and the wider financial system, securities regulators may wish to move further along the spectrum towards a more quantitative approach to group-based supervision. (This is not, of course, to suggest that there are firms which are too large to be allowed to fail or that the powers of market discipline and public disclosure do not act in themselves as regulatory tools.)

23 International efforts are currently in train, both in the joint Basle/IOSCO forum and in the European Community, to develop a single, comprehensive capital adequacy methodology for banks and securities firms. However, as the joint Basle/IOSCO meeting in Geneva recognised, what is in prospect at present is partial convergence of capital adequacy standards; and any moves toward convergence with insurance regulators still remain some way off. Thus, it is likely that for some time yet, regulators will need to find some way of adapting the techniques they employ in undertaking prudential consolidation to take account of the technical difficulties which arise because securities firms, banks and, in particular, insurance companies are still for the time being subject to capital adequacy requirements which differ to some extent.

24 The need for assessing capital requirements on a consolidated basis becomes most urgent where the regulator of a financial

entity within a conglomerate concludes that the capital adequacy methodology of a regulator responsible for another part of the conglomerate fails to address certain risks adequately, or where the financial activity of other group companies is totally unregulated. If legal or other impediments prevent the flow of information necessary for prudential consolidation, one possible solution is to deduct the capital downstreamed into the subsidiary from consolidated capital. [Annex 2 provides some examples comparing the results of prudential consolidation and deduction in different circumstances.]

25 This is a common technique used by securities regulators and may be the most appropriate approach for dealing with insurance companies. It may also be appropriate in other circumstances where the subsidiary (or other group company) in question is regulated and where the consolidating regulator is content that another regulator employs an appropriate capital adequacy methodology and that the latter will inform the consolidating regulator in the event of a capital deficiency. The deduction of investments in subsidiaries or affiliates is a conservative approach because it automatically precludes the sharing of any capital surpluses. Such sharing would, in any event, be inappropriate, for example, where foreign exchange controls restrict the repatriation of funds from affiliates or where there are legal impediments to accessing an affiliate's capital.

26 Another option, where the consolidating regulator is prepared to amend the existing technique used in the prudential consolidation, is to develop a hybrid methodology which takes account of the capital requirement applied to the entity in which a

particular risk occurs and the form of capital which is permitted to support this risk on a solo basis. Such an approach might, for example, take account of the fact that a bridge loan attracts a 100% capital requirement in a securities firm, but only 8% in a bank.

27 There continue to be wide differences of view among the members of the Technical Committee about the value of some of the different available techniques which can be used to arrive at a group based risk assessment. For example, the Securities and Exchange Commission wishes to point out that the United States experience with consolidated bank holding company supervision suggests that prudential consolidation does not provide any discernible advantages. From 1985 through 1991, over 1190 US banks failed and required funds from the Federal Deposit Insurance Corporation, the entity that protects depositors of failed banks. More than 720 of these banks were subsidiaries of bank holding companies and thus subject to prudential consolidation. By way of comparison, during this same seven year period, the Securities Investor Protection Corporation, the organisation that protects customers of failed US securities firms, handled only 51 securities firm insolvencies. Securities firms in the United States have only recently become subject to holding company risk assessment requirements, and they are not subject to prudential consolidation. Moreover, from the Securities and Exchange Commission's perspective, prudential consolidation has not worked and creates unnecessarily high expectations and therefore risk along with unnecessary costs. Therefore, the SEC strongly believes that a regulatory environment with functional regulation

focusing on the regulated firm with strong capital standards and with risk assessment rules is the appropriate regulatory model to deal with group-oriented activities of financial conglomerates. Thus, if a bank and securities firm are part of a financial conglomerate, the securities firm would be supervised by the securities regulator without interference by the banking regulator. By contrast, Germany notes that it has had excellent experience of prudential consolidation with regard to banks. For years now, the German banking industry has been in a healthy state. There have been no bank failures for a long time.

28 Even if it proves possible in due course to develop and agree on a single, comprehensive capital adequacy methodology which applies to all regulated financial activities, it is highly unlikely that regulators will be able to find a way of encompassing all the risks which occur in non-financial entities, whether commercial or industrial. Although the risk of problems spreading from non-financial group companies to financial companies in the group may be less than that of problems spreading from one financial company to another, it may be impossible to rule out the risk of contagion. Some countries regard it as an option to prohibit the mixing of financial and non-financial activities in a conglomerate. Other countries have found that such mixing provides additional capital support for financial activities, which is beneficial to the market as a whole. Indeed, in some countries such links between financial and non-financial entities in the same group already exist and are widespread. Where regulators have not adopted the approach of separation they need to deal with contagion risk as

best they can. The traditional approach of securities regulators is to apply stringent capital requirements to the regulated entity complemented by a qualitative assessment of the risks being carried in the rest of the group.

b Investments in other group companies

29 *Where a regulated firm has an investment in another group company or has provided regulatory capital to another group company, these amounts should be controlled by appropriate regulations.*

30 Investments in another group company - generally, but not always, a subsidiary - are effectively locked in. This is equally true of amounts made available to another group company which form part of the latter's regulatory capital, whether in the form of a subordinated loan or an undertaking or guarantee. As such, these amounts may allow excessive gearing through the recycling of capital. For both reasons, investments in another group company and regulatory capital provided to another group company should be controlled by appropriate regulations.

31 Securities regulators control such amounts through the net liquid assets test, which provides for the deduction in full of these amounts as illiquid assets. This treatment reduces excessive gearing through the recycling of equity and other regulatory capital.

32 Banking regulators, generally, do not adopt this approach and tend to apply the same risk weight as that applied to exposures to non-affiliated companies. Instead they tend to control equity

investment in affiliated companies and the provision of other kinds of regulatory capital to such group companies through specific limits on intra-group exposures of this kind and prevent excessive gearing through prudential consolidation of group companies undertaking financial activities. However, the 1988 Basle Accord requires the deduction from capital of all investments in unconsolidated subsidiaries engaged in banking and in financial activities.

33 If a subsidiary is insolvent its parent firm may well wish to make good the resulting deficiency in its net assets, because the market believes that it stands behind its subsidiaries and not to do so would provoke a loss of market confidence in the parent. In such circumstances, securities regulators may wish to consider deducting the deficiency in the net tangible assets of the subsidiary from the capital of a regulated firm. Where banking regulators include such a subsidiary in their prudential consolidation, this will require there to be sufficient capital at group level to support the risks being run in the group overall, including the ailing subsidiary. However, where such a subsidiary is not included in the prudential consolidation, banking regulators may also wish to deduct the deficiency in its net assets from the capital of the parent bank and also at the consolidated level.

c Intra-group exposures

34 *Effective risk assessment of financial conglomerates requires careful monitoring of intra-group exposures, and where necessary limits on such exposures in the regulated entity.*

35 Intra-group exposures include, but are not limited to the following:

- trading exposures which arise where one firm deals with or on behalf of another group company in the course of normal trading operations. These exposures are normally self-liquidating, but may not be so if the financial conglomerate is experiencing financial difficulties. They may be on or off balance sheet;
- exposures arising through the central management of short-term liquidity within the conglomerate. These exposures will normally be short-term, although they may be renewed on a regular basis. They may often involve the provision of funding by the group bank. Again repayment may not be made at the due date or an enforced rollover may occur if the conglomerate experiences financial difficulties;
- equity and long term debt investments in subsidiaries, but also in some cases in other group companies, which can create a complex and opaque group structure;
- guarantees given to or received from other group companies. Guarantees given to another group company may be triggered if the financial conglomerate experiences financial difficulties. Guarantees received from another group company may become worthless if that company is experiencing financial difficulties and this may impede the normal activities of the firm which has received the guarantee;
- exposures arising from the provision of services. This may involve, for example, the cost of overheads or pension arrangements;

- exposures to shareholders. This may take the form of loans or off-balance sheet exposures such as commitments or guarantees;
- exposures arising through the placement of client money with another group company.

36 The circumstances in which intra-group exposures pose a significant risk for a regulated firm depend on the size and nature of the exposures concerned and the financial strength of the group companies to which it is exposed; these factors will vary from conglomerate to conglomerate. Experience has shown, however, that when contagion spreads to a regulated firm the existence of intra-group exposures can exacerbate the problems it encounters by, for example, significantly reducing the real liquidity of the firm. In such circumstances, it may be difficult to wind down the regulated firm in an orderly and controlled fashion.

37 These risks make it important for all regulators with responsibility for some part of a financial conglomerate to monitor carefully the intra-group exposures of the entities they regulate, and to be aware of the level of intra-group exposures within the financial conglomerate more generally. In some jurisdictions, regulators have introduced predetermined limits on the size of intra-group exposures, both to individual group companies and on an aggregate basis.

38 Although the intra-group exposures of a regulated entity may attract capital requirements appropriate to the kind of risks they represent, it is important for the regulator to be aware in more

specific terms about the purpose of these 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. This process may be facilitated by requiring regulated entities to notify the relevant regulator when they take on an intra-group exposure over a certain size, as well as to report intra-group exposures in their regular regulatory returns to their regulator.

d Structure of financial conglomerates

39 *The corporate and managerial structure of the financial conglomerate should be fully understood by the regulator and should not create undue difficulties for effective regulation. Regulators should consider whether it is feasible and practical to acquire powers to prevent the manipulation of group structures which makes effective regulation difficult.*

40 Unless regulators are aware of the corporate and managerial structure of the financial conglomerate they will be unable to assess properly the risks which other group companies pose for the regulated firm (whether they do this through prudential consolidation or qualitative risk assessment). The corporate and managerial structure of a conglomerate may be very different, particularly where a financial conglomerate operating internationally has adopted matrix management, whereby lines of accountability are organised on a functional basis spanning a number of different corporate entities rather than following a pyramid structure within each corporate entity. It is crucial for regulators to be aware of the lines of accountability within the conglomerate which affect the firm they regulate, as well as the

form which this accountability takes. All regulators with responsibility for some part of a financial conglomerate should have an up-to-date organisational chart of the conglomerate and be aware of the managerial structure of that part of the group in which their regulated entity is located.

41 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. In such circumstances, regulators may need to consider whether it is feasible to obtain the power to require a conglomerate to restructure its corporate organisation or to veto a proposed reorganisation of the corporate structure.

e Relationships with shareholders

42 *Regulators should seek as far as possible to identify shareholders with a stake in a financial conglomerate which enables them to exert material influence on a regulated firm; the regulator should seek to ensure that these shareholders meet applicable fitness standards.*

43 Dominant shareholders, as the owners of a financial conglomerate, are in principle able to exert direct and indirect influence on many aspects of the conglomerate's activities,

including those of regulated firms. Their main objective may be to secure as good a short-term return on their capital as possible, and in some circumstances this may conflict with the interests of the investors, depositors or policyholders of the regulated firms in the conglomerate. Such shareholders may also be customers of some of the companies in a conglomerate, and may exert pressure on these group companies to take decisions in relation to shareholder-customers on a non-commercial basis. For these reasons, it is important that shareholders who have a stake in a financial conglomerate which enables them to exert material influence on a regulated firm within it should meet applicable fitness standards and regulators should, as far as possible, seek to ensure that this is the case. To this end, regulators may find it useful to have a power to check the fitness and propriety of such shareholders. It may even be desirable for this power to extend beyond the authorisation stage to include the power to pre-approve prospective shareholders proposing to take a stake which would enable them to exert material influence on a regulated firm.

f Management

44 *Regulators should ensure that managers who directly or indirectly exert control on a regulated entity are subject to appropriate regulatory standards; and should seek as far as possible to be able to impose sanctions on managers who have influenced the policy and decisions of a regulated entity in ways which are inconsistent with those regulatory standards.*

45 Most regulators already have the power to check the fitness and propriety of managers of the firms they regulate. But managers of

other group 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, group management at the holding company level can play a key role in devising the strategic objectives of the group and in controlling the risks carried throughout the group: their decisions will impact on all group companies. It is possible that they could influence the policy and decisions of a regulated entity in a way which makes it difficult for the regulated entity to comply with regulatory requirements or otherwise to maintain regulatory standards.

46 Regulators need to have sufficient powers to be able to deal with this situation if it threatens to arise, or if it has arisen to ensure that it is rectified and that appropriate sanctions are applied to those concerned. One possibility is for a regulator to have power to approve all managers in a financial conglomerate who exert material influence either directly or indirectly on the regulated entity. However, if this proves to be impracticable, another possibility is to impose an obligation on board directors of the regulated entity to alert their regulator if they believe that policies or decisions taken elsewhere in the group are jeopardising the regulated entity's ability to comply with regulatory requirements or otherwise to maintain high regulatory standards.

g Supervisory co-operation

47 *Wherever possible, regulators should seek to co-operate to improve the effectiveness of the supervision of financial conglomerates. In many cases*

where more than one regulator has responsibility for some part of the financial conglomerate, it may be desirable to identify one regulator who will have primary responsibility for group-based risk assessment. This regulator is likely to emerge as lead regulator when serious concerns arise about a particular financial conglomerate. Each regulator will continue to be responsible for the solo entity in its jurisdiction and the lead regulator will have no authority to seek to take over or interfere with the exercise of that responsibility. The lead regulator's main role should be to ensure that relevant regulatory information about the conglomerate is shared promptly amongst all the regulators concerned to inform their actions.

48 Where individual regulators undertake group-based risk assessment, they should seek to improve the effectiveness of this supervision through co-operation with other regulators having responsibility for some other part of the group. The exchange of information between them is likely to provide all the regulators concerned with a better insight into the operations of the financial conglomerate and the risks which these pose for their respective regulated entities. In view of the international activities of many financial conglomerates and the fact that their operations straddle different financial sectors, it may be very difficult for one regulator to obtain a full overview of the activities of a conglomerate, without assistance from and collaboration with other regulators with responsibility for a specific part of that conglomerate.

49 It is also important that, where regulators undertake group-based risk assessment, they take into account wherever possible the

responsibilities of other regulators and the extent to which the latter already undertake group-based supervision.

50 For effective supervisory co-operation, there need to be adequate legal gateways and procedures for the sharing of confidential information, and adequate means to protect the confidentiality of such information, as recommended in the paper on this subject circulated by the Basle Committee on Banking Supervision to securities, banking and insurance regulators in April 1990. Secondly, information sharing requires there to be trust that information will be used properly and mutual respect for one another's professional competence.

51 Once information can be shared freely, it may be possible for regulators to pool their resources in relation to the supervision of a specific financial conglomerate and to rely on one another to obtain intelligence about particular aspects of the conglomerate's activities. This might involve periodic communication between regulators, but for the foreseeable future, this is more likely to involve ad hoc contact when serious concerns arise about the financial condition of a particular financial conglomerate.

52 Such co-operation might be facilitated by identifying one regulator who will act as the coordinating regulator for a specific financial conglomerate if material doubts about the group's financial condition begin to arise. In many cases, the regulators will rapidly reach agreement about the most appropriate candidate for this role. While the tasks which would be appropriate for the

lead regulator to undertake would vary from conglomerate to conglomerate, the following provide guidelines for the tasks which might be involved; compliance with these guidelines would create the infrastructure which would facilitate supervisory co-operation in times of crisis:

i production and maintenance of an up-to-date organisation chart, covering corporate structure and lines of accountability;

ii taking the lead in relation to group-based supervision by undertaking the prudential consolidation and/or producing a qualitative assessment of the risk being carried in the group as a whole. This could involve asking other regulators to provide information about the firms they regulate and the sub-group in which these firms are situated;

iii putting together a picture of intra-group exposures generally within the financial conglomerate. This might involve asking other regulators to provide information about the intra-group exposure of their regulated firms;

iv ensuring the dissemination of (i) - (iii) to other regulators, particularly in times of crisis to inform the actions of other regulators;

v acting as a clearing house for information regarding shareholders and managers;

vi providing a focal point of contact for notification of a serious concern about the financial conglomerate so that such concerns arising on the part of different regulators are brought together, evaluated on an overall basis and are passed on to other regulators with an interest in the conglomerate;

vii seeking to coordinate any regulatory action which may be necessary by more than one regulator in relation to the financial conglomerate.

viii convening as necessary meetings or international conference calls between regulators with responsibility for some part of the financial conglomerate;

ix generally promoting good communications and information flows between the regulators concerned.

h External auditors

53 *Regulators should recognise the importance of the role of the external auditors of a regulated firm and the possible contribution they may be able to make to group-based risk assessment. Auditors should be encouraged, where they have serious concerns regarding the financial or operational condition of the regulated entity or the group, to ensure that such concerns are brought to the attention of the supervisor.*

54 In some cases, supervisors require external auditors to provide opinions on whether or not the firm is in compliance with the relevant prudential requirements imposed by the supervisor. External auditors have considerable detailed knowledge of their clients and this knowledge, as well as the performance of their functions, enables them in the normal course of their work to identify serious current or prospective problems relating to the

firm or the group of which it forms a part. It is normal practice for external auditors to bring such concerns to the notice of management. In some situations the concern may be in respect of a serious breakdown in management controls or of actions on the part of senior management which may materially affect the financial or operational condition of the firm or group. In others it may be in respect of material exposures of the firm, or of group companies which may have an adverse impact on the firm. It would be helpful to the supervisor as well as the regulated firm if the auditors are able to advise the supervisor of material concerns and exposures at an early stage.

55 It is recognised that auditors may be placed in a difficult position when their duty of confidentiality to their clients conflicts with an obligation to communicate with the supervisor particularly if the concern relates to developments in the group outside the company for which they themselves are directly responsible. Their position may be safeguarded, as is the case of some jurisdictions, by providing auditors with immunity, through legislation, from any action for breach of confidentiality to which they may be exposed as a consequence of disclosing information in good faith to the supervisor which is relevant to any of his regulatory functions.

56 The appointment of a single audit firm may also help to provide an independent overall view of the group. However, it is recognised that local auditors with a specialised knowledge of a part of the group may also have a contribution to make. Where local auditors are employed, co-operation with the other auditors of the group should be encouraged.

ANNEX 1

PRINCIPLES GOVERNING THE SUPERVISION OF FINANCIAL CONGLOMERATES

a Group-based risk assessment

Where a regulated firm, which is part of a financial conglomerate and subject to supervision on a solo basis, is vulnerable to the risk of contagion, supervision of the regulated firm should be complemented by group-based risk assessment.

b Investments in other group companies

Where a regulated firm has an investment in another group company or has provided regulatory capital to another group company, these amounts should be controlled by appropriate regulations.

c Intra-group exposures

Effective risk assessment of financial conglomerates requires careful monitoring of intra-group exposures, and where necessary limits on such exposures in the regulated entity.

d Structure of financial conglomerates

The corporate and managerial structure of the financial conglomerate should be fully understood by the regulator and should not create undue difficulties for effective regulation.

Regulators should consider whether it is feasible and practical to acquire powers to prevent the manipulation of group structures which makes effective regulation difficult.

e Relationships with shareholders

Regulators should seek as far as possible to identify shareholders with a stake in a financial conglomerate which enables them to exert material influence on a regulated firm; the regulator should seek to ensure that these shareholders meet applicable fitness standards.

f Management

Regulators should ensure that managers who directly or indirectly exert control on a regulated entity are subject to appropriate regulatory standards; and should seek as far as possible to be able to impose sanctions on managers who have influenced the policy and decisions of a regulated entity in ways which are inconsistent with those regulatory standards.

g Supervisory co-operation

Wherever possible, regulators should seek to co-operate to improve the effectiveness of the supervision of financial conglomerates. In many cases where more than one regulator has responsibility for some part of the financial conglomerate, it may be desirable to identify one regulator who will have primary responsibility for group-based risk assessment. This regulator is likely to emerge as lead regulator when serious concerns arise about a particular financial conglomerate. Each regulator will continue to be responsible for the solo entity in its jurisdiction and the lead regulator will have no authority to seek to take over or interfere with the exercise of that responsibility. The lead regulator's main role should be to ensure that relevant regulatory information about the conglomerate is shared promptly amongst all the regulators concerned to inform their actions.

h External auditors

Regulators should recognise the importance of the role of the external auditors of a regulated firm and the possible contribution they may be able to make to group-based risk assessment. Auditors should be encouraged, where they have serious concerns regarding the financial or operational condition of the regulated entity or the group, to ensure that such concerns are brought to the attention of the supervisor.

ANNEX 2

COMPARISON OF FULL CONSOLIDATION AND THE DEDUCTION METHOD

This annex compares the quantitative results of prudential consolidation and capital deduction in four different cases involving a parent bank and a securities subsidiary. The parent bank is regulated, has capital of 1000 and is subject to the regulatory requirement that capital must not be less than 10% of unweighted assets (ie the maximum amount of assets on a solo basis is 10,000).

Case 1:

The securities subsidiary is unregulated and is subject to no capital requirement.

Parent		*Subsidiary*		*Group (deduction)*		*Group (consolidation)*	
100	1000		100		900	9000	1000
						7000	
9000		7000		9000			
9100		7000		9000		16000	

In this case, the parent bank meets the 10% capital requirement using the deduction method, but does not do so if the securities subsidiary is consolidated.

Case 2:

The securities subsidiary is regulated, but subject to a different (ie lower) capital requirement from the parent bank. The capital of the securities subsidiary must not be less than 7.5% of unweighted assets (ie the maximum amount of assets is 1333).

Parent		*Subsidiary*		*Group (deduction)*		*Group (consolidation)*	
100	1000	1200	100	9000	900		1000
						9000	
9000						1200	
9100		1200		9000		10200	

In this case, the parent bank meets the 10% capital requirement of the banking regulator using the deduction method, but does not do so if the securities subsidiary is consolidated, even though the latter meets its own regulator's requirement.

Case 3:

The securities subsidiary is regulated and subject to the same capital requirement as the parent bank.

Parent		*Subsidiary*		*Group (deduction)*		*Group (consolidation)*	
100	1000	1000	100	9000	900	9000	1000
9000						1000	
9100		1000		9000		10000	

In this case, the parent bank meets the 10% capital requirement of the bank regulator using the deduction method and on consolidation of the securities subsidiary. This is because the bank and its securities subsidiary are subject to the same capital requirement on a solo basis.

Case 4:

The securities subsidiary is regulated, but subject to a different (ie higher) capital requirement from the parent bank. The capital of the subsidiary must not be less than 20% of unweighted assets (ie the maximum amount of assets is 500).

Parent		*Subsidiary*		*Group (deduction)*		*Group (consolidation)*	
100	1000	500	100	9000	900	9000	1000
						500	
9000							
9100		500		9000		9500	

In this case, the parent bank meets the 10% capital requirement of the banking regulator using the deduction method and on consolidation of the securities subsidiary. On consolidation, it appears that the group as a whole has surplus capital. It will depend upon the judgment of the regulator and his assessment of the risks involved whether or not this surplus should be allowed to support additional risks which the group may decide to incur.