Risk Concentrations Principles

THE JOINT FORUM

BASEL COMMITTEE ON BANKING SUPERVISION

INTERNATIONAL ORGANIZATION OF SECURITIES COMMISSIONS

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Risk Concentrations Principles

Purpose

1. To provide to banking, securities and insurance supervisors principles for ensuring through the regulatory and supervisory process the prudent management and control of risk concentrations in financial conglomerates.

2. By combining business lines, conglomerates offer the potential for broad diversification. However, new risk concentrations may arise at the group level. In particular, different entities within the conglomerate could be exposed to the same or similar risk factors, or to apparently unrelated risk factors that may interact under some unusually stressful circumstances.

Definition and Types of Risk Concentrations

3. For purposes of this paper, a financial conglomerate is defined as a conglomerate whose primary business is financial and whose regulated entities engage to a significant extent in at least two of the banking, securities and insurance sectors. Each supervisory discipline has developed a perspective on risk concentrations in its respective industry, and this paper draws on those perspectives in establishing guiding principles for the supervision of risk concentrations in a financial conglomerate.

4. A risk concentration refers to an exposure with the potential to produce losses large enough to threaten a financial institution's health or ability to maintain its core operations. Risk concentrations can arise in a financial conglomerate's assets, liabilities or off-balance sheet items, through the execution or processing of transactions (either product or service), or through a combination of exposures across these broad categories. The potential for loss reflects the size of the position and the extent of loss given a particular adverse circumstance. Risk concentrations can take many forms, including exposures to:

(a) individual counterparties;

(b) groups of individual counterparties or related entities;

(c) counterparties in specific geographical locations;

(d) industry sectors;

(e) specific products;

(f) service providers; e.g. back office services, and

(g) natural disasters or catastrophes.

Principles

I. **Supervisors should take steps, directly or through regulated entities, to provide that conglomerates have adequate risk management processes in place to manage group-wide risk concentrations. Where necessary the supervisors should consider appropriate measures, such as reinforcing these processes with supervisory limits.**

II. **Supervisors should monitor material risk concentrations on a timely basis, as needed, through regular reporting or by other means to help form a clear understanding of the risk concentrations of the financial conglomerate.**

III. **Supervisors should encourage public disclosure of risk concentrations.**

IV. **Supervisors should liaise closely with one another to ascertain each other's concerns and coordinate as deemed appropriate any supervisory action relative to risk concentrations within the group.**

V. **Supervisors should deal effectively and appropriately with material risk concentrations that are considered to have a detrimental effect on the regulated entities, either directly or through an overall detrimental effect on the group.**

The work of the Study Group

5. The Study Group on Intra-Group Transactions and Exposures and Risk Concentrations conducted fact-finding work on the management of risk concentrations by way of two questionnaires: one dealing with supervisory practices and another with conglomerate practices. The results of these questionnaires are summarised below. The study group surveyed ten financial conglomerates on their management practices with respect to concentrations. These included six bank-led conglomerates with activities in securities and/or insurance business, two insurance-led conglomerates with banking or securities business, one securities-led conglomerate with banking activities and one mixed conglomerate involved in banking and insurance.

Review of supervisory practices

6. Supervisory attention to the nature of concentrations within financial conglomerates has paralleled the growing attention by conglomerates to possible concentrations across the three major sectors of banking, securities and insurance. Until recently, conglomerates and supervisors alike focused on concentrations almost entirely at the sector level.

7. To date, concentrations in single dimensions of risk, such as credit, country, market, liquidity and reinsurance risks, have received the most attention from supervisors at the sector level. The supervisory tools and methodologies currently in place reflect the historical concerns of supervisors in each sector and therefore vary to some extent across sectors.

8. In the insurance sector, concentrations can arise from an insurance company's assets, liabilities, and off-balance sheet exposures, including exposures to future insurance claims.[1] Supervisors use a variety of approaches to promote diversification and expect companies to have underwriting and reinsurance policies ensuring that undue concentrations are avoided. Other supervisory approaches include supervisory limits, requirements for additional technical provisions, legal restrictions on investments, restrictions on the admissibility of assets in meeting capital requirements, and review of the adequacy of the reinsurance program. Reporting is an integral part of the monitoring process by most insurance supervisors, and some supervisors require additional or more frequent reporting when insurance companies approach statutory limits. Supervisors also require insurers to have in place policies and procedures to prudently manage and control risk concentrations.

9. In the banking sector, supervisors have incorporated large exposure guidance into their national supervisory frameworks. This guidance encourages supervisors to set quantitative limits on exposures to a single counterparty or group of related counterparties, using capital as a base. In addition, some jurisdictions impose quantitative limits on investments by regulation. Generally, supervisors require banks to have in place policies and procedures to prudently manage and control risk concentrations and hold boards of directors and senior management responsible for compliance. Some bank supervisory regimes also have the ability to impose additional capital requirements or take other supervisory action if a firm has unwarranted risk concentrations.

10. In the securities sector, supervisors require firms to establish robust systems of internal control and risk management to detect and appropriately manage risk concentrations. These are supplemented by strict liquidity and credit requirements. In some jurisdictions, securities firms are subject to large exposure limits generally identical with those applied to banks. Supervisors hold boards of directors and senior management

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[1] On balance-sheet liabilities of insurance companies reflect known losses and future claims; it is recognised that once claims are made, management cannot use diversification to alter its risk concentration.

responsible for compliance with these requirements. Supervisors can impose additional capital requirements or take other action if a firm is overly exposed to a particular risk.

11. Across all three sectors, supervisors and management recognise that financial institutions face an increased risk of loss when their assets, liabilities or business activities are not diversified. Supervisors use regulation, in particular limits on large exposures, to encourage firms to control concentrations. Some supervisors have developed reporting systems to assist them in monitoring risk concentrations.

12. Supervisors in all three sectors consider that the prudent management of concentrations is integral to risk management. They expect financial institutions to have in place comprehensive systems for measuring, monitoring and managing risk concentrations. In some jurisdictions, supervisors increasingly rely on financial institutions' risk management processes to control and monitor concentrations. To that end, supervisors have issued supervisory guidance or required institutions to establish internal policies and procedures to control and monitor risk exposure in general and risk concentrations in particular.

13. Experience has led financial institutions and supervisors to broaden the concept of risk concentration over time. In recent years, financial institutions and supervisors have given increasing attention to the interaction of risks, recognising that there are circumstances where a single large transaction or set of transactions can generate unusually large losses as the market, credit and country risks interact. As a result, supervisors of regulated entities within a financial conglomerate have focused increasing attention on both concentrations arising from large single risks involving exposures across the conglomerate and concentrations arising from the interaction of risks which affect exposures in more than one sector.

Financial Conglomerates' Risk Concentration Management Practices

14. The survey of conglomerates revealed an important recent development. Some conglomerates are monitoring risk concentrations across sectors on a group-wide basis, and in some cases combining insurance with banking and securities exposures. However, the majority of the small sample of conglomerates surveyed are monitoring risk concentration only at the sector level. In the past, the focus on monitoring risk concentration has been almost entirely sectoral. As a result, risk management and internal control systems designed to monitor concentrations remain more advanced at the sector level.

15. In addition to looking for exposures to common counterparties or industries across sectors, some conglomerates are focusing on the correlation and interactions of risks in making group-wide assessments of risk concentrations, following similar developments at the sector level. For example, one insurance-based conglomerate has begun to analyse the relationship between loss potential in its property/casualty insurance business and in the lending business of its banking arm, particularly in the event of a

natural disaster. Another conglomerate has been developing a common set of risk factors to analyse risk across the entire group, which includes entities in all three sectors.

16. Generally, the measures that conglomerates put in place to control risk concentrations either at the group or sector level go beyond compliance with regulatory requirements. This is consistent with the expectations of most supervisory regimes. Financial institutions appear to recognise the potential for material losses stemming from an uncontrolled concentration, and that such losses could significantly weaken their competitive position in the international marketplace, resulting in a loss of customer, investor and/or depositor confidence.

17. At the conglomerates surveyed, the board of directors or other appropriate high level committee of the parent company[2] is usually responsible for approving the conglomerate's policies on risk management. Senior executive management develops and implements these policies. In some jurisdictions, both these functions may rest with the same body. To monitor compliance with policies, risk managers prepare reports on concentrations for a committee of senior managers who review, discuss and provide direction for reducing, mitigating or managing concentration risks. In most cases, positions in excess of established limits require approval from successively higher levels of management – the larger the position and the longer it exceeds the internal limits, the higher the approval necessary, sometimes as high as the board of directors. In many cases, the conglomerate's internal limits are set lower than the relevant regulatory limits.

18. Information and communication technology developments create the potential for firms to monitor risk at all levels, but management information systems to monitor compliance with limits on an ongoing basis currently exist only at the sector level. For example, many firms in the insurance sector now set and monitor underwriting limits by type of risk and thereby both limit the risk and ensure diversification of their exposures on a continuous basis. Systems with similar capabilities have been developed in the banking and securities sectors. In contrast, those conglomerates monitoring exposures across insurance and banking/securities activities appear to rely on a manual process, since the systems used to measure and monitor risk tend to differ substantially across the sectors.

19. Financial conglomerates are enhancing analytical techniques to identify, measure, monitor and control risk concentrations. Among the most important techniques now used at some conglomerates are stress testing and scenario analysis, often based on models. These techniques assess the impact of such adverse events as large changes in market values, declines in creditworthiness, or natural disasters on individual regulated entities or the conglomerate as a whole. Scenarios reflect historical experience or focus

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[2] Corporate governance with respect to financial institutions varies from jurisdiction to jurisdiction. In some countries, the board has the main, if not exclusive, function of supervising the executive body (senior management, general management) so as to ensure that the latter fulfils its tasks. For this reason, it is known as a supervisory board. This means that the board has no executive functions. In other countries, by contrast, the board has a broader competence in that it lays down the general framework for the management of the financial institution.

on particular vulnerabilities that the firm's risk managers identify. Stress testing also involves the systematic testing of the loss potential in a series of large changes in key risk factors. The Russian default in August 1998 reinforced the need to identify common risk factors across all elements of the firm's financial exposure. In that case, the losses experienced included repurchase agreements on Russian debt with non-Russian counterparties and credit extended to hedge funds with Russian concentrations. These were in addition to the losses on loans and other direct credit to Russian counterparties that are traditionally associated with country risk.

20. As some conglomerates have devoted greater attention to assessing the impact of correlations on risk, stress testing of correlation assumptions has become important. The 1998 disturbances in Asia and elsewhere illustrate how previously uncorrelated price movements across debt and equity markets in emerging market countries perceived to be in different economic and trading blocs could suddenly become highly correlated under stress, affecting exposures in all three sectors.

21. The developments in stress testing and scenario analysis in risk management should be encouraged and illustrate the increasing level of complexity and the growing information requirements involved in understanding how concentrations can arise. Stress testing requires comprehensive management information systems that aggregate information in a consistent and timely manner and permit positions to be analysed in a number of ways. Important elements of stress testing, however, cannot be automated, but require sound judgement. For example, judgement is required in understanding new products, analysing correlations and interpreting the results of the testing.

Analysis of Issues in the Supervision of Financial Conglomerates

22. While risk concentrations are generally seen by supervisors to be problematic, the potential for risk concentrations in a conglomerate needs to be balanced against the broad diversification benefits associated with combining business lines under the single ownership of a conglomerate. Apart from unusual, generally distressed, market conditions, cyclical effects in other markets would normally offset ebbs and flows in any one business line. In addition, a certain degree of concentration is the inevitable result of a well-articulated business strategy as well as product specialisation, the targeting of a customer base or a sound strategy of outsourcing data processing activities. The implication is that not all risk concentrations are inherently bad.

23. Nonetheless, since risk concentrations historically have been an important cause of losses in all three sectors, supervisors need to balance these benefits against the risks of concentrations at the conglomerate level. To identify some ways in which such concentrations arise, it is helpful to assess how large losses can develop in a conglomerate. Some of these are described below:

- Losses at the conglomerate level can reflect the aggregate of losses on similar types of exposures (e.g. bonds, loans and investments with the same obligor) across the sectors. These are the types of major losses which large exposure rules have traditionally tried to prevent. Losses can not only strain overall capital resources, but short-term liquidity may also be impaired if the position is very large relative to market size or market-making capacity. Positions can reach a large size relative to the market, even if the conglomerate adheres to large exposure rules at group level, because of the large capital base of some conglomerates.

- Losses at the conglomerate level could reflect risk factors that have consequences for different types of exposure in different entities. For example, a natural disaster could cause insurance losses in a conglomerate's insurance operation and credit losses in its banking operation if both offered products in the affected region.

- Losses could also reflect the interaction of risk factors. For example, the loss potential in a derivative or exchange rate contract resulting from an exchange rate depreciation may be intensified if the same price movement adversely affects the repayment ability of a counterparty or the financial stability of the counterparty's country of residence. Losses can be further compounded in a conglomerate when the same external developments generate large losses in separate, apparently unrelated sectors, such as simultaneous losses after devaluation in foreign exchange trading in the bank and emerging market bond portfolios in the securities firm.

- Losses could also reflect the breakdown of previously observed correlations, such as occurs in a flight to quality in which all risky assets decline in value, where previously many of them were measured to be uncorrelated.

Losses therefore can arise from large exposures that can be simply aggregated across sectors within the conglomerate or more complex concentrations arising from the correlation or interaction of risks.

24. Moreover, even risk concentrations confined to the sector level can have spillover effects within the conglomerate. Material problems resulting from excessive risk concentrations in one entity, either regulated or unregulated, could be transmitted to other entities in the conglomerate because the entities are linked by reputation or by intra-group transactions and exposures, or both. For example, if it is known that there are serious losses in a conglomerate's securities activities, its banking operations may suffer liquidity or market access problems through reputational effects and perceived close financial linkages between the securities and banking entities. While this potential seems most important for the transmission of liquidity risk, it can be relevant for any risk when a regulated entity has a large, concentrated exposure to the entity with the concentration in the conglomerate.

25. The possibility that large losses could threaten the ongoing business operations of a financial conglomerate clearly motivates supervisory concern that risk concentrations be identified, monitored and subject to an adequate management strategy. This concern starts at the sectoral level. But concentrations arising at the conglomerate level, whether from concentrations in the individual legal entities, from risks cutting across sectors or

from the interaction of risk concentrations within the conglomerate, could affect the efficacy of sectoral supervision. In addition, where there are very different approaches to setting limits or defining concentrations or where there are unregulated entities, the differences in requirements can produce an incentive to book positions within the conglomerate to reduce or minimise the impact of regulatory constraints. Thus, supervisors should seek to make sure that their objectives for individual regulated entities within the conglomerate are not undermined either as a result of material risk concentrations and potential losses that emerge at the conglomerate level or as a result of regulatory arbitrage.

26. The additive nature of concentrations and the risk of transmission of material problems within a conglomerate point to the value of both conglomerate management and supervisors conducting a group-wide assessment of potential concentrations. Supervisors will likely find it useful to co-operate with other supervisors of the conglomerate's regulated entities to understand material risk concentrations as part of their larger efforts to determine the overall risk profile of the conglomerate.

27. The need for a group-wide assessment of concentrations highlights the importance of supervisors access to information. Whether in a system of consolidated supervision, where a group-wide assessment may be an integral part of oversight, or in other approaches to conglomerate supervision, supervisors should have access to adequate information about risk concentrations within the conglomerate, including exposures in unregulated entities. These information needs can be satisfied by the conglomerate providing necessary information to the supervisor, by a bilateral or multilateral meeting of relevant supervisors, or by enhancing the information-gathering powers of the supervisors. In addition, sectoral supervisors may benefit from any future harmonisation in measuring risk concentrations across sectors, in exchanging information. Thus, information sharing and liaison among supervisors are important. Possible approaches to supervisory cooperation are described in the Joint Forum's *Coordinator Paper* and the *Principles for Supervisory Information Sharing Paper*.

28. As conglomerates evolve, the complexity of risk concentrations in the structure of these conglomerates is increasing, and the analytical and information demands on risk management are growing. The changing insights into the nature of risk concentrations suggest that both financial conglomerates and supervisors need to continue to advance their respective approaches to risk identification and monitoring. Thus, supervisors believe it is crucial that conglomerates have adequate systems to measure, monitor, manage and control risk concentrations as part of a broader program of risk management at the group-wide level, including scenario analysis and stress testing where appropriate. In turn, as they conduct their oversight, supervisors should understand and may make use of the methodologies and systems used by financial conglomerates.

29. In addition to risk management by conglomerates and supervisory oversight, public disclosure can contribute to sound management of risk concentrations by enhancing market discipline. Public disclosure by the conglomerate of its risk concentrations can serve two purposes. First, it can enhance market discipline by allowing other market participants to differentiate between organisations that manage risk concentrations safely and soundly and those that do not, thereby assisting supervisors in

promoting the adoption of sound risk management practices. Second, disclosure can be helpful to supervisors in understanding material concentrations in the conglomerate. While supervisors often find such disclosures are just the starting point for further questions and discussion, such disclosures may reduce the burden faced by a financial conglomerate in dealing with a number of supervisory authorities.

30. Market discipline can only be effective if disclosures are timely, reliable, relevant and sufficient. Based on a review of published financial statements by a small sample of financial conglomerates, disclosures of risk concentrations are minimal and could be considerably enhanced. At the same time, the new and extensive types of analysis conglomerates are undertaking to identify concentrations have the potential to produce a burdensome volume of information. In this respect, the prompt, detailed information on particular exposures disclosed by some conglomerates outside of the normal financial reporting cycle and in response to market concerns during the 1998 financial market turmoil were widely seen as effective and constructive. This suggests that conglomerates could both expand their periodic public disclosures of risk concentrations while continuing to focus on only the most important risks, and use timely, topical disclosures to provide additional detail as necessary.

Guiding Principles

31. Supervisory strategy with respect to risk concentrations in a conglomerate necessarily reflects the powers that supervisors have to induce financial institutions to reduce excessive concentrations and other dangerous exposures. In some cases, supervisors will have ample authority to supervise risk management throughout the conglomerate. In many cases, they will not. In all cases, supervisors should have sufficient authority to gather and safeguard information to be able to monitor material risk concentrations across sectors and to understand how such risks are managed. Supervisors at the sector level should review whether they have sufficient powers to protect the regulated entity from problematic risk concentrations, for example, through requiring reductions in exposures or higher capital at the regulated entity. Where supervisors lack sufficient powers, they should seek the additional authority they need.

I. Supervisors should take steps, directly or through regulated entities, to provide that conglomerates have adequate risk management processes in place to manage group-wide risk concentrations. Where necessary the supervisors should consider appropriate measures, such as reinforcing these processes with supervisory limits.

32. Supervisory concerns emerging from risk concentrations can be mitigated by good risk management and internal control policies, and supplemented by the holding of adequate capital. Risk concentrations need to be monitored both in the legal entity and across the different sectors of the conglomerate to provide for the protection of the regulated entities. Supervisors should take steps directly or through regulated entities to

provide that financial conglomerates have controls in place to manage their risk concentrations. For example, where the supervisor does not consider the controls adequate, supervisors should consider imposing supervisory limits.

33. A sound risk management process begins with policies and procedures approved by the board of directors or other appropriate body and active oversight by both the board and senior management. The process should include clearly assigned responsibility for the measurement and monitoring of risks and risk concentrations at the conglomerate level. The conglomerate should have in place a process to identify the conglomerate's principal risks, a comprehensive measurement system, a system of limits to manage large exposures and other risk concentrations, and processes of stress testing and scenario and correlation analysis. Comprehensive management information and reporting systems are essential to a sound risk management approach. Finally, sufficient attention should be given to non-quantifiable, as well as quantifiable, risks.

34. In addition, as financial institutions from different sectors merge and financial conglomerates evolve, the potential for new types of concentrations arises. When evaluating proposed mergers or expansions, supervisors should take into account management plans to manage material risk concentrations at a group-wide level.

II. Supervisors should monitor material risk concentrations on a timely basis, as needed, through regular reporting or by other means to help form a clear understanding of the risk concentrations of the financial conglomerate.

35. Supervisors should have access to information or should be informed on a regular basis of the nature and size of material risk concentrations. To facilitate that process, supervisors may find it useful to set limits or thresholds that serve as reporting or supervisory benchmarks. Given the dynamic nature of conglomerate organisations and the ease with which risk profiles can change, monitoring should be frequent. Risk concentrations or stress scenarios that generate large losses should be acted upon promptly through follow-up questions of the conglomerate's management.

III. Supervisors should encourage public disclosure of risk concentrations.

36. Public disclosure of risk concentrations at the group-wide level can promote market discipline. Effective public disclosures allow market participants to reward conglomerates that manage risk effectively and to penalise those which do not, thus reinforcing the messages provided by the supervisor. For market discipline to be effective, disclosures need to be timely, reliable, relevant and sufficient. Given the complexity and variety of possible risk concentrations in a financial conglomerate, enhancing disclosures includes expanding the range of the most important risk concentrations in periodic financial statements, especially in annual reports, while making timely and reliable disclosures of exposures outside the normal reporting cycle as necessary to provide greater detail in response to market concerns. A description of the conglomerate's risk management approach to concentrations would be a useful supplement to quantitative information. In addition, public disclosure can facilitate

supervisory monitoring and risk assessment and lead supervisors to explore further material issues.

37. It is not intended that disclosure of risk concentrations be done in a way that would involve the disclosure of proprietary information or information about customers that would unreasonably violate their privacy.

IV. Supervisors should liaise closely with one another to ascertain each other's concerns and coordinate as deemed appropriate any supervisory action relative to risk concentrations within the group.

38. Risk concentrations may arise from exposures in many parts of a financial conglomerate. The effective assessment, monitoring and control of such concentrations by supervisors is likely to require sectoral expertise as well as a good understanding of the techniques used by other supervisors. Supervisors need to communicate on risk concentrations found within sectors or jurisdictions, as supervision at the sector level may not detect instances of arbitrage. In addition, supervisors may need to coordinate across sectors and jurisdictions.

39. Generally, channels to permit the exchange of information within sectors have been established. The Joint Forum has set out principles for sharing information across sectors, *inter alia,* in the document entitled *Principles for Supervisory Information Sharing Paper* and in *The Coordinator Paper*. These documents, along with others in the Joint Forum package, provide principles and techniques to assist supervisors in efforts to liaise more closely and effectively with one another in the supervision of financial conglomerates.

V. Supervisors should deal effectively and appropriately with material risk concentrations that are considered to have a detrimental effect on the regulated entities, either directly or through an overall detrimental effect on the group.

40. If a financial conglomerate is exposed to risk concentrations that may affect its financial stability, supervisors should take appropriate measures with respect to regulated entities. In some cases, supervisors may elect to take preventive measures. For example, supervisors with the necessary powers may consider establishing cross-sector limits for risk concentrations. Exceeding these limits could trigger supervisory intervention directed at controlling situations affecting the viability of the regulated entities of the conglomerate. Once a problem arises, supervisory intervention almost always begins with bringing the issue to the attention of management and the board of directors and asking them to address the supervisory concern. While supervisors generally feel they have the power to seek corrective action by the entity they regulate, actions elsewhere in the

conglomerate may be necessary to effectively reduce or mitigate the concentration. Where risk concentrations cut across the regulated entities of the firm, cooperation among the relevant supervisors (as well as with the primary supervisor[3]) is important.

[3] For purposes of this document, the term “primary supervisor” ‘is generally considered to be the supervisor of the parent or the dominant regulated entity in the conglomerate, for example, in terms of balance sheet assets, revenues or solvency requirements.’ *Supervision of Financial Conglomerates,* Papers prepared by the Joint Forum on Financial Conglomerates, February 1999, page 101.