Consolidated Capital Regulation for Financial Conglomerates

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Over the past few years, financial regulators have devoted considerable attention to the development of consolidated capital rules for financial conglomerates. In this chapter, the author explores the theoretical justifications for these new requirements and explains that the case for consolidated capital oversight consists of four separate lines of argument: technical weaknesses inherent in traditional entity-level capital requirements; unique risks associated with financial conglomerates; additional diversification benefits that financial conglomerates enjoy; and recognition that financial firms increasingly employ modern risk management techniques that work on a group-wide basis. The author then reviews the specific rules for consolidated capital requirements that the Basel Committee proposed in April 2003, and argues that the Basel proposals constitute a relatively rudimentary system of consolidated capital requirements, dealing primarily with the technical weaknesses of entity level capital and making little effort to deal with more subtle issues such as unique risks of financial conglomerates, diversification benefits, and modern risk-management techniques. As the author explains, a number of significant practical considerations contribute to the relatively limited scope of the Basel Committee’s proposal, considerations that will likely prevent the development of a more comprehensive system of consolidated capital oversight for financial conglomerates in the foreseeable future.

This chapter discusses the difficulties of applying bank-focused regulation at the consolidated bank holding company level. This follows from the findings of other chapters that the approach to capital should be different for insurance, securities, and banking firms. Jackson explains how the accommodation to this reality leads Basel II to make significant exceptions to consolidation, such as requiring holding companies to deduct any investment in an insurance company. For firms with an 8% capital requirement, this would be equivalent to risk-weighting the investment at 1250%. This, in turn, may penalize financial conglomerates with banking subsidiaries.
INTRODUCTION

Over the past decade, supervision of financial conglomerates has been the focus of numerous multilateral reports and academic investigation. From this ongoing study has emerged widespread acceptance of the notions that regulatory authorities should oversee financial conglomerates on a consolidated basis and that this oversight should include consolidated capital supervision. However, no similar consensus has emerged as to how exactly this supervision should be imposed. Indeed, there exists substantial variation in existing consolidated capital regulation of financial conglomerates across national boundaries, and internal risk management procedures at financial conglomerates themselves differ radically from evolving legal standards.

My goal in this chapter is to review the regulatory justifications for imposing capital regulation on a consolidated basis and then to explore the approach that would implement a system of consolidated capital supervision under the proposed Basel Capital Accord of April 2003 (Basel II). As explained later, the Basel II proposals for consolidated capital requirements are fairly rudimentary, avoiding the more subtle aspects of conglomerate supervision and establishing only a crude system of consolidated capital oversight. In addition, the Basel II proposals grant considerable latitude to national authorities to determine how the new consolidated capital provisions are to be implemented, suggesting that variation in national rules may persist even if the new Accords are widely adopted. Nevertheless, viewed as part of broader efforts to oversee financial conglomerates, the Basel II proposals on consolidated capital supervision should, in my view, count as a modest improvement over past practices and a credible attempt to address a complex subject. The technical barriers to imposing a comprehensive and sophisticated system of consolidated capital supervision are too great to expect the framers of the Basel II revisions to have attempted much more.

JUSTIFICATIONS FOR IMPOSING CAPITAL REQUIREMENTS ON A CONSOLIDATED BASIS

Before turning to the Basel II requirements themselves, I begin with a brief discussion of a critical predicate question: Why does nearly everyone agree that capital requirements should be imposed on a consolidated basis, as opposed to traditional entity-based capital requirements? Consider the capital requirements of a U.S.-style financial conglomerate, such as Citigroup. As illustrated in figure 3.1, such a conglomerate has a number of regulated subsidiaries: depository institutions, insurance companies, and securities firms. Traditionally—and under the original Basel Accord—capital requirements were imposed solely on the regulated subsidiaries, with each sector of the financial services industry being subject to its own unique set of capital requirements. Why is this regulatory approach to capital oversight—sometimes called entity-level capital requirements—not sufficient? The
received wisdom in the literature offers numerous, not entirely consistent responses.\textsuperscript{2}

Weaknesses Inherent in Entity-Level Capital Requirements for Financial Conglomerates

Prior analyses of financial conglomerates suggest that there are three basic weaknesses in entity-level capital requirements for financial conglomerates.

First, there is the problem of "excessive leverage"—that is, the possibility that an unregulated holding company will finance the capital of its regulated subsidiaries through the issuance of debt instruments. (Joint Forum 1999; Meyers and Ballegeer 2003). With such holding-company financing, the consolidated capital of the conglomerate can be less than the sum of the capital positions of the regulated subsidiaries. The problem of excessive leverage is inherent in entity-level capital requirements because this system of capital oversight never measures the capital adequacy of holding companies. This potential for excessive leverage at the holding company level is thought to make the parent corporation likely to exploit regulated subsidiaries in times of financial stress, either by withdrawing capital from the regulated subsidiary or by forcing the subsidiary to make uneconomical transactions with related parties.\textsuperscript{3}

An analogous problem occurs if a bank or other regulated entity uses its own assets to capitalize a regulated subsidiary that is subject to its own capital requirements (see Joint Forum 1999; Jackson and Half 2002, pp. 16–7; Meyers and Ballegeer 2003). This practice, known as double gearing or, sometimes, multiple gearing, allows the regulatory capital from the upstream entity to support assets for both the upstream and the downstream entity. This problem can best be illustrated if one considers a depository institution that just meets its own capital requirements and then uses $8 million of cash to capitalize a new bank subsidiary. The bank subsidiary
then leverages up this $8 million investment of capital to make $100 million of new loans. If one just looks at each entity, both may appear to be adequately capitalized. But, taken together, the two banks have increased their assets by nearly $100 million more than the parent bank would have been allowed to do on its own, even though no new capital has been raised. Entity-level capital requirements do not typically have a mechanism for preventing parent banks from taking on additional risk in this manner.  

Unregulated affiliates present a related problem (see Jackson and Half 2002, p. 16; Kuritzkes, Schuermann, and Weiner 2003). Typically, financial conglomerates engage in some activities that are not subject to direct regulation—for example, leasing activities or consumer finance in many jurisdictions. These conglomerate activities—whether undertaken directly through holding companies or indirectly through separately incorporated unregulated affiliates—escape capital regulation if capital requirements are imposed only on regulated entities. Since some of the activities conducted in unregulated affiliates and holding companies are quite similar to activities conducted in regulated entities, there is a certain logic to bringing these affiliates under the same capital requirements. In addition, since financial difficulties in unregulated affiliates could cause problems to other parts of a financial conglomerate, there is further justification for capital oversight on a consolidated basis. Moreover, if capital regulation is not extended to unregulated affiliates, financial conglomerates face strong incentives to engage in regulatory arbitrage, escaping capital regulation by moving activities from regulated entities to unregulated affiliates.  

A principal justification for imposing consolidated capital requirements is the assumption that these three shortcomings of entity-level capital requirements—excessive holding company leverage, double gearing, and unregulated affiliates—allow financial conglomerates to evade traditional capital requirements. Applying capital standards on a consolidated basis would potentially solve all these problems. By extending them to holding companies, consolidated capital requirements address both excessive leverage and the problem of unregulated affiliates. In addition, double gearing cannot occur if downstream regulated entities are consolidated into upstream intermediaries for purposes of determining compliance with capital requirements.

Risks Unique to Financial Conglomerates

Another justification for consolidated capital requirements concerns a collection of risks that is thought to be unique to financial conglomerates. One example of these risks is the size and complexity of some financial conglomerates (see Herring and Santomero 1990; Jackson and Half 2002, pp. 18–9). Because these firms tend to be much larger and more complex than financial intermediaries with a single line of business, conglomerates are said to pose greater amounts of systemic risk to the economy and thus require higher capital reserves than ordinary intermediaries. Another unique
risk of financial conglomerates arises out of the possibility that a con-
glomerate's collective exposure to a certain risk—for example, a particular 
business or sector of the economy—may be greater than the exposure of 
each subsidiary firm; this would necessitate greater capital reserves at the 
consolidated level than at the entity level (see Jackson and Half, pp. 17–8.) 
A related concern is the "reputational" risk that an entity within a con-
glomerate structure faces when affiliates get into financial distress, a risk not 
borne by stand-alone intermediaries (see Jackson and Half 2002, p. 17). 
Finally, there is sometimes expressed a (frequently unsubstantiated) sense 
that financial conglomerates are more likely to exploit subsidiary firms than 
are the owners of independent entities and therefore require additional 
capital reserves; the idea is that by imposing capital requirements on con-
glomerates, regulators reduce the risk of such exploitation.7

While much could be said about the relative merits of these claims, these 
comments all appear with regularity in the literature about the regulation of 
financial conglomerates. A common implication of these arguments is that 
financial conglomerates that contain a collection of regulated intermediaries 
should maintain greater capital reserves than would be appropriate for a 
similar set of intermediaries operated as independent firms or for a financial 
conglomerate subject only to entity-level capital oversight.

Omission of Certain Diversification Effects in 
Entity-Level Regulation

Another advantage of consolidated capital regulation is that it takes into 
account diversification effects across the consolidated group. As explained in 
a recent article by Andrew Kuritzkes, Til Schuemann, and Scott Weiner 
(2003), the optimal capital required to support a group on a consolidated 
basis at a given level of insolvency risk may be at least 5% to 10% lower than 
the amount of capital required to support the group’s constituent firms at the 
same level of insolvency risk. The reason for this difference is that entity-level 
capital requirements cannot reflect the value of offsetting risks in other 
collective entities within the same corporate group. These intersectoral di-
versification benefits are in addition to the familiar benefits of portfolio di-
versification.8 Capital requirements assessed at the level of the consolidated 
group thus offer a theoretically more complete measure of capital needs than 
do capital requirements imposed exclusively at the level of the regulated firm.

Misalignment with Internal Risk Management Procedures

A problem related to imposing capital requirements solely on regulated en-
tities is that this traditional approach does not track the manner in which 
private enterprises themselves now engage in risk management and the al-
location of economic capital.9 Top management at the world’s largest fi-
nancial organizations is critically concerned with the overall risk profile of 
the group, not just the risk incurred within the group’s constituent entities. 
Implicit in much of the discussion of consolidated supervision is the notion
that, since capital requirements address many of the same risks that concern firm management, a similar consolidated approach should be taken to regulatory oversight, including capital regulation. Indeed, the impact of group-wide diversification effects on capital needs (described earlier) is simply one illustration of the types of insights regulatory officials might gain from emulating industry practices. For example, some of the unique risks of financial conglomerates mentioned earlier—among them, the aggregation of similar risks within different affiliates and the reputational costs of problems in one member of the group to affiliated firms—are also of concern to senior management and are already reflected in existing risk management techniques of private firms. (Other unique risks, such as concerns regarding the increased systemic risk of financial conglomerates, would not necessarily figure into management risk profiles, because the costs of systemic risks are borne by third parties.)

Conflicting Implications of the Justifications for Consolidated Capital Supervision

This quick review of the justifications for consolidated capital supervision suggests one of the reasons why there may be both consensus for imposing consolidated capital oversight and failure to reach easy agreement on how best to proceed. Experts may differ over the importance of the various justifications for consolidated capital oversight, but collectively the arguments in favor of extending capital oversight to financial conglomerates present a compelling case for some sort of consolidated capital supervision. But, if one ranks the four justifications outlined earlier on the basis of whether they suggest higher or lower capital requirements for consolidated firms, the result is instructive. The first two justifications—technical weaknesses in entity-level capital supervision and unique risks of financial conglomerates—both imply that capital standards for conglomerates should be higher than the sum of capital requirements set under entity-level capital oversight. The technical limitations of entity-level capital requirements imply that financial conglomerates can organize their activities in variety of ways that require lower levels of capitalization on a groupwide basis than consolidated capital regulation would permit. In addition, the unique risks supposedly associated with financial conglomerates suggest that the formulas used for devising capital requirements for conglomerates should be more demanding than those applicable to stand-alone regulated entities.

Diversification effects, on the other hand, point in the opposite direction. To the extent that financial conglomerates are less risky as a result of cross-sectoral diversification effects, the implication is that consolidated capital requirements for financial conglomerates should, on balance, be lower than those applicable to single-sector regulated entities or at least that the processes for determining the capital requirements for financial conglomerates should factor in these cross-sector diversification benefits. The implications of relying more heavily on private risk management technique are
Consolidated Capital Regulation

1. Excessive leverage, double gearing, and unregulated affiliates
2. Unique risks
3. Diversification effects
4. Modern risk management techniques

Figure 3.2. Justifications for Consolidated Capital Regulation.
Source: Author's compilation.

ambiguous, although most discussion of these management techniques seems to assume that conglomerate-wide risk management tends to reduce overall risks and thereby reduces optimal levels for economic and regulatory capital.

In short, the justifications for imposing consolidated capital supervision rest on conflicting assumptions regarding the effects of this reform (see figure 3.2). Some of the justifications for consolidated capital supervision imply that capital requirements for a consolidated entity should be higher than the capital requirements of its constituent parts; other justifications imply that consolidated capital requirements should be lower. As an a priori matter, therefore, it is impossible to know whether a fully developed system of consolidated capital supervision would tend to increase or decrease overall capital requirements for particular institutions or the industry in general. What is clear, a priori, is that a system of capital supervision designed to achieve all the potential benefits of consolidated oversight would be extraordinarily complex (Cumming and Hirtle 2001). As it turns out, the framers of the Basel II proposals were not nearly this ambitious.

HOW DOES BASEL II APPROACH THE PROBLEM OF CONSOLIDATED CAPITAL SUPERVISION

Perhaps the most striking point about Basel II’s approach to the problem of consolidated capital supervision is the relatively modest scope of the proposal. As I explain in more detail shortly, if one lines up the concerns that underlie the imposition of consolidated oversight of financial conglomerates with the ambitions of the Basel II proposals, the modesty of the effort is clear. The principal thrust of the proposal deals with the more technical problems of excessive leverage, double gearing, and (less completely) unregulated affiliates. The more subtle aspects of regulatory oversight of financial conglomerates are left unaddressed, though conceivably some of these might be developed in the Accord’s implementation of Pillar 2 standards for
supervisory oversight; this is where some of the additional supervisory techniques expounded in the Joint Forum’s papers on conglomerate supervision might be implemented in the future.\textsuperscript{10} Whether the modesty of the proposal’s ambitions is a flaw or a strength is an important question, to which I will return at the close of this chapter.

But first let me briefly summarize Basel II proposal’s key provisions.

Scope of Coverage

For purposes of consolidated capital supervision, the most important provision of the Basel II proposal is its scope of coverage. As illustrated in figure 3.3, reproduced from the April 2003 consultative document, the new

![Diagram](http://www.bis.org/bcbs/cp3part1.pdf)

Figure 3.3. Illustration of New Scope of the Accord. Notes: (1): Boundary of predominant banking group. The Accord is to be applied at this level on a consolidated basis, i.e., up to the holding company level (paragraph 2). (2), (3), and (4): The Accord is also to be applied at lower levels to all internationally active banks on a consolidated basis. Source: BCBS (2003), p. 5 (available at http://www.bis.org/bcbs/cp3part1.pdf).
Accords are to apply at multiple levels of financial conglomerates that include internationally active banks. For purposes of complying with the new capital requirements, all internationally active banks will be required to take account of their downstream affiliates. In addition, any parent organization that controls an internationally active bank and that is "predominantly a banking group" must also comply with the Basel Accords. Thus, for the first time, the Basel Accords would be extended to the holding company structure.\textsuperscript{11} The extension is, however, incomplete, since coverage would not reach financial groups that are not predominantly engaged in banking—that is, the consolidated capital rules do not extend to diversified financial groups.

This limitation of the scope of coverage presents an interesting design decision on the part of the framers of Basel II. On the one hand, to the extent one credits the concerns giving rise to consolidated oversight, the exception for diversified groups presents a substantial loophole. Diversified holding companies and unregulated affiliates that operate within such holding companies escape consolidated capital supervision. As a result, the problems of excessive leverage and unregulated affiliates persist in these organizational structures. On the other hand, the practical problems of applying regulatory capital standards to nonfinancial firms are great, and the ability of market mechanisms to provide adequate oversight is more plausible perhaps for fully diversified firms than for organizations that are predominantly engaged in banking. Still, the jurisdictional line here is potentially problematic, and anyone familiar with the difficulties that U.S. regulators have had in defining the business of banking over the past few decades cannot help but speculate that this jurisdictional boundary will be the focus of creative lawyering in the years ahead. In addition, it will be an area in which national authorities may have considerable latitude to articulate divergent interpretations.\textsuperscript{12}

The Basel II treatment of insurance companies under its scope of coverage rules is also noteworthy. Insurance activities are not considered to be predominantly banking activities.\textsuperscript{13} Thus, insurance companies—even ones with subsidiaries that constitute internationally active banks—would not be subject to the proposed Accord’s consolidated capital provisions at the level of the parent insurance company; however, they would presumably be applied at the level of the internationally active bank subsidiaries. The decision to exclude parent insurance companies from the Accord’s consolidated capital rules is understandable. Like diversified holding companies, insurance companies are not easily subject to the Basel II rules because the risks inherent in insurance underwriting are not fully addressed in the substantive requirements of the Basel Accords.\textsuperscript{14} Moreover, the need to apply consolidated capital provisions to insurance companies as parents is less acute because these entities are subject to their own capital requirements, which reduce the likelihood of excessive leverage in such organizational structures. Allowing different capital standards to apply to insurance company parents does, however, allow eligible financial conglomerates to engage in a form of regulatory arbitrage. They can exploit differences between Basel II capital requirements applicable to downstream internationally active banks and
insurance capital rules applicable to the parent insurance company by moving activities to the entity with the lowest capital requirements. As I explain shortly, this form of regulatory arbitrage is also possible for financial conglomerates in which insurance companies are organized as subsidiaries of internationally active banks.

Three Rules of Consolidation: Full Consolidation, Deduction of Investments, and Risk Weighting of Investments

Another important feature of the Basel II proposals concerns the manner in which it imposes consolidated capital oversight. As it turns out, the proposals permit three different methods of consolidation—full consolidation, deduction of investments, and risk weighting of investments. Only the first of these methods—full consolidation—could in theory achieve the full range of benefits theoretically associated with consolidated capital supervision. However, a series of sensible and pragmatic considerations led the framers of Basel II to allow less stringent forms of consolidation in a variety of contexts.

In full consolidation, an entity’s capital requirements are based on the fully consolidated financial statements of the entity and all of its downstream affiliates; investments in downstream entities and other intragroup transactions are eliminated, and then the substantive rules for capital requirements are applied to the balance sheet of the consolidated entity, including all the assets and liabilities of consolidated entities. The substantive capital rules are thus applied to the organization as if it were a fully integrated whole.

For the framers of Basel II, however, this ideal standard of full consolidation was not feasible in all contexts. The underlying Basel Accords themselves are designed principally for depository institutions and (as amended) can also be applied to securities firms, as they are in the European Union today. The Basel Accords are not, as noted, well suited to insurance companies or to certain other kinds of financial enterprises, much less to commercial firms. Accordingly, the Basel II proposal calls for full consolidation of only downstream banks, securities firms, and a limited number of financial affiliates other than insurance companies. Other downstream entities, most notably insurance companies, are dealt with under the deduction method whereby investments in these other entities are deducted from the parent organization’s capital. Where local laws require (as, for example, in the United States under Gramm-Leach-Bliley), downstream securities affiliates and financial affiliates may also be dealt with in this manner.  

The proposal’s approach to the issue of full consolidation reflects a pragmatic recognition that there exists today no comprehensive system of capital regulation. If, for example, insurance subsidiaries were consolidated with parent banks, the Basel II substantive rules would be ill equipped to generate appropriate capital reserves for risks peculiar to insurance companies. The deduction approach does, however, make insurance companies a bit of a stepchild to consolidated capital supervision, by permitting certain anomalies to persist. Most important, where there exist substantive differences in
the capital requirements of unconsolidated affiliates and those of the Basel Accords (which govern consolidated affiliates), possibilities for capital arbitrage will arise. ¹⁶ For example, if loans made by insurance companies continue to have lower capital requirements than loans made by depository institutions, then conglomerates will have an incentive to move their lending activities to insurance affiliates, as noted in the previous section.¹⁷ A regime of full consolidation of all affiliates would have reduced this incentive, but Basel II does not attempt this level of harmonization of capital standards.

A third approach to consolidation found within the Basel II framework is risk weighting of investments in certain subsidiaries. Under the risk-weighting approach, investments in downstream affiliates are treated like other assets under the Basel Accords; they are assigned a specific risk-weighting measure to be used to determine an entity's overall capital requirement. A risk-weighting approach is much more favorable to a regulated entity than the deduction approach, because the deduction approach essentially requires the investment to be 100% backed by regulatory capital of the regulated entity. With a risk weighting of 100%, a risk-weighted investment in a subsidiary typically would require only an 8% capital backing, and even a 150% risk weighting would require only 12% capital backing.

As explained later, the Basel II Accord permits risk weighting for certain investments in unregulated affiliates. It also, however, allows implementing countries to use risk weighting for certain insurance company subsidiaries. This authority appears to represent something of a political compromise based on the fact that, in some G-10 countries, investments by insurance companies in banks are subject to risk weighting. The framers of the Basel II Accords apparently concluded that competitive equality demands that banks in such jurisdictions also be permitted to use risk-weighted treatment for their investments in insurance companies. While one senses from the language describing this compromise that this authority was included with some reluctance, the result is that the Accord permits a degree of double gearing to persist at least for bank investments in insurance companies in jurisdictions that choose to take advantage of this exception.¹⁸

Basel II's three approaches to consolidation are summarized in figure 3.4. The purest form of consolidation—full consolidation—the Basel II proposals apply only to bank subsidiaries, as well as to securities and certain other financial subsidiaries in countries that (unlike the United States) do not have special rules that preclude consolidated capital treatment for these entities. Investments in insurance subsidiaries are generally subject to the deduction method but can be eligible for the more liberal risk-weighting approach in some circumstances.

Coverage of Unregulated Affiliates

The proposal's treatment of unregulated affiliates appears in several separate provisions and also encompasses a variety of alternative approaches. First, financial firms (other than banks, securities firms, and insurance companies)
that engage in “financial leasing, issuing credit cards, portfolio management, investment advisory, custodial and safekeeping services, and other similar activities that are ancillary to the business of banking” are generally required to be consolidated with parent banks, unless national rules require otherwise. Other affiliated entities are presumably treated as commercial enterprises. Where investments in commercial enterprises are material, these investments are deducted from the capital of parent banks; where nonmaterial, they are allowed the more lenient risk-weighted treatment, such as a 100% risk weighting under the standardized approach. Finally, for those unregulated affiliates that are held outside groups that predominantly engage in banking—that is, within diversified financial groups—the Basel II proposals do not apply.

This three-tiered approach to unregulated affiliates seems to leave considerable room for regulatory arbitrage. To the extent that the Basel II Accords present binding constraints, there will be strong incentives for conglomerates to move unregulated activities into commercial affiliates or diversified groups. One wonders how easy it will be for national authorities to determine how to categorize financial affiliates that engage in both listed and unlisted financial activities. Again, there will likely be considerable variation in the interpretation of these rules across national boundaries. Of course, for those who are skeptical as to the need for capital oversight of unrelated affiliates, the plasticity of Basel II may be a virtue. It does, however, further undermine the ability of the proposals to address the problem of unregulated affiliates.

**Recognition of Diversification Effects at the Conglomerate Level**

In light of the importance of diversification benefits in the theoretical case for consolidated capital supervision, it is perhaps surprising that the Basel II proposal’s scope of coverage provisions do not expressly address this issue.
One has to dig into the substantive rules on credit risk, market risk, and operational risk in order to ascertain the extent to which diversification benefits at the conglomerate level will be recognized under the proposal. Although the proposal is not always clear on this issue, conglomerate diversification benefits will be allowed to only a very limited degree.

In the area of credit risk, for example, neither the standard approach nor the more complex internal models make allowances for additional diversification benefits that may occur at the conglomerate level. At root, the Accord’s approach to credit risk is additive (Gordy 2002). So the credit risk portion of the capital requirement for a holding company with two banking subsidiaries will simply be the sum of the credit risk capital requirements of the subsidiary once intragroup transactions are eliminated. To be sure, the credit requirements themselves are based on some assumed level of portfolio diversification. But this assumed level of diversification does not increase when the credit risk rules are applied at the holding company level; nor is there an explicit consideration of the intersector diversification benefits that may occur within a financial conglomerate.

The market risk rules, in contrast, are designed in a manner that could theoretically recognize some of the benefits of additional portfolio diversification at the parent level. If, for example, a bank holding company had two bank subsidiaries with offsetting positions in certain kinds of securities transactions, the market risk rules applied on a consolidated basis might generate a lower capital requirement than the sum of the market risk capital requirement for the two bank subsidiaries. At least in the United States, bank holding companies are in fact permitted to recognize this intragroup diversification for purposes of the market risk rules. For purposes of calculating the market risk factor, the Federal Reserve Board allows trading activity to be measured on a consolidated basis. As a result, the market risk measure for a bank holding company in the United States can be less than the sum of the market risk measures of downstream banks at which the actual trading activity is located. Thus, market risk, in the United States, is not fully additive and recognizes some degree of conglomerate-wide diversification benefits. The Basel II proposal does not address this aspect of the market risk calculations, and it is unclear whether other jurisdictions will follow U.S. practices in this area. The Federal Reserve Board’s position is, however, likely to be influential, and, in any event, the Board’s rules govern banking organizations subject to U.S. jurisdiction.

The only component of the Basel II proposals that recognizes expressly groupwide diversification benefits is the section that covers operational risk rules. In this area, at least with respect to the Advanced Measurement Approach (AMA), the framers of Basel II have recognized that risk correlations across the corporate group can be taken into account for purposes of determining operation risk capital requirements at the group level. As result of this decision, the operational risk capital requirements for a consolidated group may be less than the sum of the operational risk requirements of the group’s subsidiary banks. So, at least in this area of
Basel II, conglomerate diversification benefits are recognized, albeit in an area that accounts for only a small fraction of total capital requirements under the Basel Accords.

Finally, the substantive Basel rules do not allow for the recognition of any diversification between or across the three building blocks of the capital requirements: credit risk, market risk, and operational risk. The three components are simply added together to determine an entity's or a group's total capital requirements.

In sum, although diversification benefits provide one of the theoretical justifications for imposing capital requirements on a consolidated basis, the Basel II proposals recognize those benefits only to a limited degree. While the operational risk rules and the market risk measure (if Federal Reserve Board policy is followed) do reflect some diversification benefits, the more important credit risk measures do not.

Other Technical Aspects of Implementation

Before presenting a tentative assessment of the Basel II proposals in this area, let me touch upon two other technical aspects of the proposal that raise interesting issues of implementation.

Regulated Entities with Surplus or Deficit Capital Positions

One conundrum for designers of consolidated capital rules is how to deal with subsidiaries that have either excess or inadequate capital. This is a particularly important problem for subsidiaries—such as insurance subsidiaries—that are generally subject to the deduction-of-investment method of consolidation. Consider, by way of illustration, a bank that has two $10 million investments in two different insurance affiliates—Insurance Co. A and Insurance Co. B (see figure 3.5). Under the Basel II proposal, investments in these subsidiaries

![Diagram](image-url)

Figure 3.5. Bank with Over- and Undercapitalized Subsidiaries. Source: Author’s compilation.
would be deducted from the parent organization’s capital for purposes of determining compliance with the proposal’s substantive rules. As ordinarily applied, these rules would call for two $10 million deductions from the parent bank’s capital. However, suppose further that Insurance Co. A actually had $2 million more capital than required. Under Basel II, the deduction for investments in that insurance affiliate would generally be reduced by that $2 million surplus on the grounds that this surplus could be used to support other activities of the group. In other words, the excess capital at the insurance company level would be allowed to count towards the parent bank’s capital. Similarly, a $1 million deficit in Insurance Co. B’s capital reserves, if not promptly corrected, would increase the amount of the deduction for the parent bank’s investment in that firm on the theory that the parent bank might shortly have to cover the shortfall.

These accounting conventions have an internal logic and, in fact, comport with the manner in which subsidiary surpluses and deficits would be treated if the downstream affiliates were fully consolidated, but they raise an interesting question about the implementation of consolidated capital supervision. To what extent should surplus capital in one part of the organization be considered to be available to support activities in the consolidated group? In the late 1980s and early 1990s, this issue was a source of considerable controversy in the United States as regulatory officials sought with only limited success to force bank holding companies to infuse additional capital in to failing affiliates (see Jackson 1994). In the absence of clear regulatory authority to order such transfers, one might question whether it is appropriate for regulatory officials to rely on managerial cooperation to transfer capital reserves to failing affiliates in times of distress. On the other hand, if the Basel II rules failed to credit consolidated groups for surplus capital held in downstream affiliates, then financial conglomerates would have strong incentives to operate these affiliates with the minimum permissible capital.

**Fractional Interests in Financial Affiliates**

A final set of intriguing rules concerns the treatment of fractional interests in financial affiliates, as opposed to wholly owned subsidiaries. The proposal includes a separate set of rules for majority interests (such as the 60% investment in Subsidiary B in figure 3.6) and also substantial minority investments (such as the 30% investment in Subsidiary C in figure 3.6). For majority investments, the key interpretive issue is how to treat minority interests in affiliates when the parent bank owns only a majority interest. If the affiliates are fully consolidated, then the minority interests are treated as capital for purposes of the consolidated group. While the Basel II proposal permits such treatment, it also allows national authorities to exclude minority interests if these investments would not be readily available to the full group. It is not clear under which circumstances minority investments would be available to a consolidated group, but, at least in theory, the Basel II
proposals seem to be imposing a standard similar to the one described earlier for surplus capital held in downstream insurance company affiliates. As the Basel II proposals penalize conglomerates for subsidiaries with capital deficits by requiring those deficits to be deducted from group capital, in a like manner a similar deduction is charged for minority interests in subsidiaries that would not be available to the consolidated group in times of crisis.  

In the case of significant minority interests in financial affiliates, the Basel II proposals permit two alternative approaches: such investments can be deducted under the deduction-of-investment method, or the subsidiaries can be consolidated on a pro rata basis. The latter option is available only if supervisory officials determine that the parent "is legally or de facto expected to support the entity on a proportionate basis only and other significant shareholders have the means and willingness to proportionately support it" (see BCBS 2003, at paragraph 9). Under both approaches, the goal seems to allow parent entities to maintain capital for only their proportionate interest in financial affiliates, provided there are not grounds to believe that the parent entity would be likely to support a greater share of the subsidiary's activities.  

The Basel II proposal's special rules for fractional interests highlight the conceptual difficulties for a regime of consolidated capital supervision when conglomerates hold less than controlling interests in affiliated organizations. Third-party investments in these affiliates are not fully available to the group while there remains the possibility that the parent organization will be called upon (or will have strong incentives) to support the affiliate in times of financial distress and that support may well go beyond the parent's pro rata share. Exactly how these competing concerns should be factored into consolidated capital rules presents difficult questions of regulatory design, a good portion of which the proposal has delegated to national authorities.
A PRELIMINARY ASSESSMENT OF THE BASEL II PROPOSALS

As suggested earlier, the ambitions of the Basel II proposal for consolidated capital supervision are quite modest. The proposals are concerned primarily with addressing the problem of excessive leverage and double gearing within groups that are predominantly engaged in banking (but not in diversified groups, which are exempt). The proposal is largely effective in these areas, although excessive leverage may still exist at the level of diversified groups that are not predominantly engaged in banking. In addition, the possibility of double gearing persists to the extent that countries permit investments in insurance subsidiaries to be accounted for under the relatively liberal risk-weighted approach. The proposal reaches, albeit in a somewhat less comprehensive way, the problem of unregulated affiliates. Internationally active banks and groups predominantly engaged in banking are subject to consolidated capital requirements for certain downstream financial affiliates. Consolidation, however, is required for only a limited range of financial affiliates and the exceptions for nonmaterial commercial affiliates and affiliates, within diversified groups may prove substantial.

The list of what the proposal does not attempt to do is much longer:

- The proposal does not eliminate the possibility of regulatory arbitrage between unconsolidated affiliates and parent banks; neither does it inhibit regulatory arbitrage between banks and subsidiaries that are consolidated under either the deduction or risk-weighting methods as long as those subsidiaries are subject to substantive capital requirements that differ from Basel II's substantive standards.

- The proposal makes almost no effort to adjust the capital requirements for financial conglomerates to their special characteristics: on the one hand, it does not increase the level of capital needed to offset the unique risks of financial conglomerates; on the other hand, it does not reduce in any substantial way the level of capital needed as a result of diversification effects, apart from the limited diversification effects for conglomerates recognized under the operational risk rules and market risk measures.

- More generally, the proposal does not incorporate any modern risk management techniques developed in the private sector, except those built into the VaR rules or the alternative credit models available to qualifying banks under other aspects of the proposal; even in these areas, the rules are implemented in a way that does not generally pick up diversification benefits at the conglomerate level.

Although the modesty of Basel II's aspirations is hardly inspiring, I wonder whether it is realistic to ask more of consolidated capital supervision. Many of the limitations of the Basel II proposal's approach to consolidated supervision are a direct result of limitations in the proposal's underlying substantive requirements. Consider, for example, the proposal's failure to address completely the problem of regulatory arbitrage. This shortcoming stems,
principally, from the fact that the proposal exempts diversified financial
groups from its coverage and also permits investments in insurance
subsidiaries and sometimes securities firms to be consolidated under the de-
duction or risk-weighted methods. These limitations invite regulatory
arbitrage by permitting financial conglomerates to move activities to affiliated
entities with more liberal capital requirements. But the only way to forestall
such regulatory arbitrage would be to impose a uniform set of capital re-
quirements on all affiliates. The substantive rules of Basel II, however, do not
provide such a comprehensive scheme of capital regulation, and as a result the
framers of the Basel II Accord had little choice but to structure the system’s
coverage rules so as to allow some degree of regulatory arbitrage.

Another theoretical weakness of the Basel II approach is its failure to take
account of diversification effects at the conglomerate level. While theoretical
literature suggests that financial conglomerates enjoy some benefits from
mingling banking, securities, and insurance activities, the Basel II rules of
consolidation do not recognize these benefits. But the Basel II substantive rules
were not written to address intersector diversification, and it is probably un-
reasonable to expect the drafters of Basel II to write in an entirely new set of
rules to deal with an issue that arises only within financial conglomerates. The
Basel II reforms are already plenty complex. Moreover, there is some rough
justice in the fact that the Basel II proposal also omits some other factors that
should in theory increase the capital requirements of financial conglomerates—
for example, the unique risks of financial conglomerates that some analysts
believe increase the likelihood of failures of regulated subsidiaries with this
organizational form. So perhaps the two omissions balance out.

Yet another arguable shortcoming of the Basel II approach to consoli-
dated capital regulation is its failure to provide any relief from capital reg-
ulation for regulated subsidiaries. If, after all, Basel II developed an effective
system of consolidated capital supervision, capital regulation at the level
of regulated subsidiaries would become redundant and could therefore be
eliminated. Again, however, limitations in the underlying substantive rules of
Basel II make such an adjustment inappropriate at this time. Consider
the problem of a bank with both over- and undercapitalized regulated
subsidiaries as illustrated in figure 3.5. If capital requirements were imposed
only on a fully consolidated basis and not at the subsidiary level, one of the
conglomerate’s subsidiaries would be allowed to operate with less than ade-
quate capital. Unless there were some obligation on the part of the parent
organization to contribute capital to subsidiaries in times of distress—a
source-of-strength requirement not written into the Basel II Accord—there
would exist the possibility of insolvency on the part of the undercapitalized
affiliate and potential risk to the financial system. Because the Basel II
substantive rules do not encompass a requirement of intragroup cross-
guarantees, the Accord’s coverage rules cannot be faulted for not relieving
regulated subsidiaries of entity-level capital requirements.

Notwithstanding the foregoing limitations of Basel II—substantial
though they are—I think there are plausible grounds for believing that the
shortcomings of the Basel II proposals will ultimately do little harm. For one thing, if one looks around the world at the regulatory systems with the most experience dealing with financial conglomerates—in particular, those of the United States and the United Kingdom—consolidated capital rules are only a part of the supervisory process for conglomerates. Both the Financial Service Authority's "Qualitative Consolidated Supervision" program and the Federal Reserve Board's "Large Complex Banking Organizations" program require the monitoring and evaluation of internal risk management techniques of conglomerate managers. Such supervisory oversight may offer a more promising way to learn from the risk management techniques of private enterprise than would an effort to develop a more sophisticated system of consolidated capital supervision.29 At a minimum, these supervisory techniques offer a check on the most obvious inadequacies of the Basel II consolidated capital rules. Moreover, even within the Basel II proposals, consolidated capital rules may not constitute the sole mechanism for policing financial conglomerates. Although not yet developed in this regard, the Pillar 2 (supervision) requirements could be fleshed out to require additional mechanisms for policing conglomerates and monitoring international risk management techniques. Indeed, much of the Joint Forum's work in this area addressed such supervisory standards, and this proposal could be grafted onto the new Basel Accords.

A further reason for equanimity with respect to the shortcomings of Basel II is the possibility that the rules may not constitute binding constraints for most firms. One of the most intriguing findings of recent studies on financial conglomerates is that current Basel requirements generally do not impose a binding constraint on major financial conglomerates. The actual capital that financial conglomerates now retain, tempered no doubt by market forces, is usually greater than the amount of capital required under Basel-based capital requirements. If true, this finding suggests that technical shortcomings of Basel II's consolidated capital rules may have little impact on the private behavior of most financial conglomerates for which the requirements are designed. Conceivably, only when capital levels of conglomerates fall beneath the requirements of internal models and market discipline—that is, in times of financial distress—will the new proposals have real bite. Thus, the costs (and benefits) of the new regime may be a good deal less significant than many commentators have assumed.

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Notes

1. See BCBS (1998). In the United States, bank holding companies have long been subject to consolidated capital requirements. In this regard, the U.S. capital
requirements have gone beyond the requirements of the original Basel Accords and anticipated the new proposals. See 12 C.F.R. § 225 App. A (2003).

2. A more complete discussion of the literature on this subject appears in Jackson and Half (2002). In this chapter, my goal is to identify the major themes underlying the case for consolidated capital supervision without delving into excessive detail.

3. To a degree, these problems could be addressed directly through the regulation of affiliated party transactions and restrictions on the withdrawal of capital, but it is possible that conglomerates are more likely to subvert these restrictions in times of financial distress than are independent financial institutions. The problem of excessive leverage is conceptually similar to some of the considerations discussed later in the section on unique risks of financial conglomerates.

4. As discussed later, there are two basic ways of implementing consolidated capital: full consolidation and deduction of investments. Either approach has the effect of eliminating any investment in covered subsidiaries from the calculation of the consolidated entity's capital, thereby solving the problem of double gearing. Under an entity-based system of capital regulation, the same result could be achieved by raising the risk weighting of investments in covered subsidiaries. With an 8% risk-weighted capital requirement, a 1250% risk weighting would be required to ensure that every dollar of investment in a covered subsidiary is backed by a dollar of capital at the parent level.

5. The decision of U.S. financial holding companies to locate over-the-counter derivatives activities in offshore affiliates is a familiar example of this phenomenon. Another form of regulatory arbitrage can occur if the capital requirements vary across different sectors of the financial services industry—for example, if the capital requirements for loans in insurance companies are different from those for loans in depository institutions. See chapter 2, “Capital Adequacy in Insurance and Reinsurance,” by Scott Harrington, and chapter 1, “Capital Regulation for Position Risk in Banks, Securities Firms, and Insurance Companies,” by Richard Herring and Til Schuermann. Such differences will encourage financial conglomerates to locate activities in the regulated entity with the lowest capital requirements.

Whether regulatory arbitrage of this sort presents a legitimate source of regulatory concern is a difficult question. On the one hand, it may seem inherently problematic for conglomerates to exploit differences in capacity requirements for the same activities in different units, and critics of regulatory arbitrage often seem to assume that private firms are exploiting supervisory errors in setting standards too low in some sectors. On the other hand, if the policy concerns are different in different contexts, then conceivably different capital requirements in different legal entities within the same conglomerate might be appropriate. If, for example, the social costs of failure for a depository institution were much higher than the costs of failure of other entities, such as insurance companies, then it might be appropriate to set capital standards lower for insurance companies than for depository institutions. Of course, were one to view the financial fate of affiliated entities as inexorably linked, then distinctions of this sort within similar financial groups could seem excessively legalistic.

6. The explanations given in the text are those commonly advanced for imposing consolidated capital rules. Implicit in these accounts is an often unstated premise that market mechanism do not provide an adequate independent restraint on inadequate capitalization at the holding company level. Zealous proponents of market discipline might well contest this premise.
7. See Jackson and Half 2002, p. 20. The empirical basis for claims of this sort are, in my view, weak (Jackson 1993, 1994).

8. The Kuritzkes-Schuermann-Weiner study suggests that the potential benefits of portfolio diversification are generally greater than the potential benefits of intersector diversification. It is, however, possible that financial conglomerates generally have more diversified portfolios than stand-alone entities, and thus some fraction of the potential benefits of portfolio diversification might properly be attributed to the conglomerate structure.

9. See illustrations of this approach to capital oversight in chapter 7, “The Use of Internal Models,” by Michel Crouhy, Dan Galai, and Robert Mark. See also Kuritzkes, Schuermann, and Weiner 2003; Cummings and Hirtle 2001.

10. Together with the International Association of Insurance Supervisors and the International Organization of Securities Commissioners, the Basel Committee on Banking Supervision formed the Joint Forum on Financial Conglomerates, in 1996, to develop supervisory standards for financial conglomerates (see Jackson and Half, pp. 23, 30). Supervisory oversight of financial conglomerates was an important component of the Joint Forum’s recommendations. (See Joint Forum on Financial Conglomerates 1999.)

11. Of course, some jurisdictions, most notably the United States, have long imposed capital requirements on many bank holding companies. See Jackson (1994, pp. 528–32).

12. Whether policymakers should be concerned about variation in national implementation of the Accords is a nice question. A chief justification for the original Basel Accords was to establish a level playing field among international banks. In the intervening years, commentators have recognized the difficulty of actually achieving uniformity. See Scott and Iwarah (1994). In the current round of Basel proposals, international uniformity is less of a selling point, because the proposals themselves allow various approaches to credit risk and other issues. However, the ability of national regulators to implement identical provisions in substantially different ways does undermine, to some degree, one of the goals of harmonized capital standards.

13. Indeed, as explained later, insurance activities are not even considered to be financial for purposes of Basel II. See BCBS 2003, paragraph 5, n. 3.


15. With the passage of the Gramm-Leach-Bliley Act, Congress determined that the capital rules applicable to U.S. bank holding companies would not extend to insurance companies and securities firms. See 12 U.S.C. § 1844(c)(3) 2003. The Basel II proposal’s exception for local law grants U.S. regulators the discretion to treat securities firms under the deduction method, thereby avoiding direct application of Basel II’s substantive rules to these firms.

16. As demonstrated in earlier papers of the Joint Forum, full consolidation and the deduction approach can reach the same results, but only if the requirements imposed on unconsolidated affiliates and consolidated affiliates are the same.

17. Conversely, if the downstream subsidiary’s capital requirements were more stringent than the upstream parent’s, the deduction approach could entail higher capital requirements than full consolidation.

18. An analogous sort of double gearing is also possible in jurisdictions that allow parent insurance companies to use the risk-weighted investment approach to investments in downstream banks.
19. The elimination of intragroup transaction does, of course, suggest that the actual credit risk capital requirement for the parent organization may be less than the sum of the credit risk capital requirements of its bank subsidiaries. This reduction does not, however, come from recognition of diversification benefits; it comes from the operation of the accounting rules of consolidation.

20. The absence of any recognition of intersectoral diversification in the credit risk models has been a source of criticism of Basel II from the financial services industry. See, for example, Letter from Jay S. Fishman, Chief Operating Officer, Financial and Risk, Citigroup, to William McDonough, Chairman, Basel Committee on Banking Supervision (May 31, 2001), available at www.bis.org/bcbs/ca/citigrou.pdf.


22. When such a differential exists, a bank holding may have a capital requirement that is less than the sum of the capital requirements of its subsidiary banks, allowing it to maintain a greater degree of leverage.

23. See BCBS 2003: “Subject to the approval of its supervisor, a bank opting for partial use may determine which parts of its operations will use an AMA on the basis of business line, legal structure, geography, or other internally determined basis.”

24. It is, apparently, still uncertain whether higher operational risk requirements will be imposed at the entity level when operational risk capital requirements are calculated for subsidiary banks. Although that result would occur if the operational risk rules were recalculated separately (and without regard to intragroup correlation of risks) for each subsidiary bank, it is possible that regulatory officials may permit conglomerates simply to allocate a portion of their operational risk capital requirements to all downstream subsidiaries, effectively granting subsidiary banks the diversification benefits of the group and making the operational risk capital requirements additive as well.

25. Application of this rule depends on national law, which would determine the extent to which such surpluses could be made available for other uses within the consolidated group.

26. Minority investments in other affiliates are subject to a different set of rules. In general, these investments are deducted by parent bank capital, but, if national laws permit, they may also be consolidated on a pro rata basis.

27. The proposal does not specifically address the treatment of insignificant investments in financial subsidiaries. The proposal does indicate that reciprocal crossholdings of bank capital should be subjected to the deduction method. See BCBS 2003, note at paragraph 10. Otherwise, however, such investments might be eligible for the risk-weighted investment approach allowed for nonmaterial investments in commercial affiliates. Such treatment would allow for a certain degree of double gearing, but the amounts involved would presumably be relatively modest.

28. Particularly in countries such as the United States, where regulatory authority is divided across sectors of the financial services industry, it would be difficult to persuade national authorities (particularly banking regulators) that their regulated firms should be required to support failing affiliates in other sectors during times of financial distress.

29. Similarly, the European Union's new conglomerate directive relies to a significant degree on supervisory oversight of financial conglomerates. See Directive 2002/87/EC on the Supplementary Supervision of Credit Institutions, Insurance

References


