Background Paper on
Evolving Trends in the Supervision of Financial Conglomerates

by

Howell E. Jackson & Cameron Half (HLS ‘02)

This background paper is divided into two parts. The first begins with a review of the emergence of financial conglomerates in the past two decades and then presents an overview of recent policy debates over the question of how these enterprises should be supervised. The second part offers a more detailed discussion of the two most significant recent international proposals to supervise financial conglomerates: the Basel Committee on Banking Supervision’s Consultative Document of January 2001 and an earlier series of papers on the Supervision of Financial Conglomerates prepared by the Joint Forum on Financial Conglomerates in February 1999.

These materials are largely descriptive and intended primarily to offer background for discussions on June 26th. Conference participants who are pressed for time should skim the first part of the paper (pp. 1-21) and read carefully the description of the Basel 2 proposals for financial conglomerates (pp. 22-28). The balance of the paper, dealing with the Joint Forum’s recommendations (pp. 29-44) can also be skimmed. It offers a more comprehensive discussion of techniques for imposing consolidated capital requirements on financial conglomerates. In addition, the Joint Forum papers outline supplemental means of supervising financial conglomerates.

I. Overview

Over the past decades, providers of financial services worldwide have increasingly expanded their operations into multiple sectors.1 Whereas once a firm could easily be categorized as a bank, a securities firm, or an insurance company, these divisions are becoming increasingly less clear.2 Not only are specific financial products less clearly differentiated into traditional business lines, but the institutions that offer them are also increasingly heterogeneous.

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1 See, e.g., Thomas J.T. Balino & Angel Ubide, The New World of Banking, IMF Finance & Development, June 1, 2000, at 41 (discussing the simultaneous processes of institutional consolidation, operational globalization, technological development, and universalization of banking that are affecting financial institutions). See generally James Maycock, Financial Conglomerates: The New Phenomenon (1986) (discussing the emergence of financial conglomerates through the mid-1980s).

2 Financial services is here used in its broadest form, to mean those services that may be performed by a bank, securities firm, or insurance company. This general definition is distinct from specific regulatory definitions of ‘financial’ that exclude insurance and/or other activities.
Driven by competitive pressures and the needs of their customers, financial organizations—whether primarily engaged in banking, securities, or insurance activities—have expanded their scope to include subsidiaries and affiliates that engage primarily in other forms of such activities. These institutional arrangements that include operations across multiple supervised financial services sectors are known as financial conglomerates.3

The growth of financial conglomerates has been spurred by the increasing deregulation of financial services in many countries. The Gramm-Leach-Bliley Financial Services Modernization Act (GLB) in 1999 in the U.S. brought the U.S. into greater parity with many other countries that have long permitted universal banking structures or other financial combinations that include operations across multiple sectors.4 As financial conglomerates have played increasingly significant roles in the financial services sectors in major industrialized countries, financial sector regulators have become increasingly concerned with the proper capital and regulatory approaches for these conglomerates.5 There is often at least a perception that in addition to whatever customer benefits might engender their formation, conglomerates also

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3 This paper adopts the definition of a financial conglomerate used by the BCBS and Joint Forum on Financial Conglomerates (and its predecessors) of “any group of companies under common control whose exclusive or predominant activities consist of providing significant services in at least two different financial sectors.” TRIPARTITE GROUP OF BANK, SECURITIES, AND INSURANCE REGULATORS, THE SUPERVISION OF FINANCIAL CONGLOMERATES ¶36 (July 1995). National definitions of financial conglomerates for supervisory purposes may vary depending on regulatory and business custom and practice. Id. at ¶35. At a formal level financial conglomerates should be distinguished from “mixed conglomerates,” commercial or industrial groups that include a financial institution as part of that structure, though these may present many of the same supervisory concerns, and as appropriate are discussed in this paper. Id. Some have sought to apply a supervisory definition, defining a financial conglomerate as an institution that is subject to supervision by multiple regulators. See L.A.A. Van den Berghe, Defining Financial Conglomerates: Combining Economics and Legal Approaches, in FINANCIAL CONGLOMERATES: NEW RULES FOR NEW PLAYERS? 1, 11 (Lutgart Van den Berghe, ed., 1995) [hereinafter NEW RULES]. However, such an approach is circular; a financial conglomerate has certain characteristics regardless of the supervisory structure under which it operates. Under a supervisory definition of a conglomerate, national definitions may vary significantly.


present new forms of financial exposure and legal risk to financial markets that existing forms of regulation and supervision may be unable to manage effectively or properly.

These questions regarding the proper supervisory structures for financial conglomerates loom particularly large in the context of the ongoing Basel 2 revisions of the 1988 Basel Capital Accords. These revisions appear almost certain to incorporate significant changes to supervisory standards for internationally active banks. While Basel 2 focuses on banking, the prominence—and growth—of major international financial conglomerates means that international banking supervisors can not effectively implement these standards without at least some attention to the role and prevalence of these conglomerates. While most financial supervisors have recognized that conglomerates deserve some form of specialized supervision, the regulatory approaches to this supervision differ greatly in their responses to some of the underlying problems of conglomerate regulation.

This paper seeks to identify key considerations in and approaches to the supervision of financial conglomerates. It first engages in a brief review of the literature on the regulation of conglomerate structures, and particularly the risks and supervisory challenges posed by the existence of financial conglomerates. It then summarizes the proposals contained in the Basel 2 consultative documents on the regulation of conglomerates and the consensus recommendations of the Joint Forum on Financial Conglomerates.7

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7 The Joint Forum is a joint working group of the Basel Committee on Banking Supervision, International Organization for Securities Commissioners, and International Association of Insurance Supervisors. See infra §II.B.
A. Formation of Conglomerates

Financial conglomerates have developed primarily over the second half of the twentieth century, and have become particularly important in recent years. The principle economic benefits from conglomerate are the ability to capture potential economies of scale and scope and to capture synergies across complementary financial services business lines.\(^9\) These economies result in improved operational efficiency and effectiveness due to lower costs, reduced prices, and improved innovation in products and services.\(^10\) Conglomerate structures may also be more stable at a group level, due to more diversified revenue and risk profiles.\(^11\) However, counterbalancing these potential gains are potential technical and allocative inefficiencies in large-scale banking organizations, and the possibility that more specialized institutions may enjoy superior operational efficiency.\(^12\) From the customer perspective, the wider range of products and improved innovation may improve the conglomerate’s competitive position vis-à-vis other providers of financial services through ‘cross-selling’ of products and services.\(^13\) This focus on economies of scale and the complementarity of operations differentiates financial conglomerates from more traditional industrial conglomerates, which diversify their operations into distinct activities with differing technologies and focus on separate markets.\(^14\)

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9 See Van den Berghe, supra note 3, at 12. See also Kazuhiko Koguchi, Financial Conglomeration, in OECD, FINANCIAL CONGLOMERATES 7 (1993) [hereinafter OECD Conglomerates].
10 See Walker, supra note 5, at 63.
11 Id.
13 See Walker, supra note 5, at 63. See also MAYCOCK, supra note 1, at 61-62 (discussing pressures to diversify and expand the range of services offered by banks).
While the empirical benefits of forming such financial conglomerate structures may be uncertain, these organizations have gained in prominence in recent years, and there appears to be a consistent trend towards increasing conglomerations in many countries. A general trend towards deregulation of the financial sector may be a contributing factor in this process. For example, the activities and permitted associations of U.S. banks have historically been tightly constrained, but these restrictions have gradually eased, and most recently GLB effected a broad liberalization of the environment. Financial institutions have responded to this deregulation by seeking to form closer associations and continuing the already ongoing process of consolidation. Some observers have even asserted that regulatory authorities have encouraged consolidation in the financial services industry in order to facilitate enhanced diversification, capitalization, and investments in banking information technology, and to lessen the supervisory burden where banking organizations are larger and more visible (and thus open to increased public scrutiny and market discipline).

Financial conglomerates are generally organized according to one of three distinct structural forms. One approach is the universal bank, in which all financial operations are conducted within a single corporate entity. Any separation of operations into separate corporate entities reflects business considerations, and not legal or regulatory limitations; conglomerates

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15 See, e.g., Vennet, supra note 12 (finding that European financial conglomerates tend to be more cost efficient than specialized banks in nontraditional banking activities; that European universal banks tend to exhibit higher levels of profit and operational efficiency; and that small banks tend to possess unexploited scale economies). See also Peter G. Klein & Marc R. Saidenberg, Diversification, Organization, and Efficiency: Evidence from Bank Holding Companies 3 (Wharton Fin. Inst. Ctr. Working Paper, Feb. 1997), available at http://wrdsnet.wharton.upenn.edu/fic/wfic/papers/97/klein.pdf (finding pre-GLB U.S. multi-bank holding companies to hold less capital and do more lending, but not to be significantly more profitable than benchmark measures); Love Me, Economist, Feb. 23, 2002, at 62 (discussing the limited success of most banks in cross-selling products to retail customers).

16 See generally Koguchi, supra note 9.


do not face any limitations on the sorts of activities that may be conducted in particular structures or how arranged within the corporate structure. The second model is the parent-subsidiary or operating subsidiary model, in which operations are conducted in and regulated as subsidiaries of another financial institution, usually (but not necessarily) a bank. While the requirement for legal separateness means that the institution may not capture the full synergies available from diversification in a conglomerate structure, the assets of a regulated parent are generally protected from problems in a subsidiary, except where creditors of the subsidiary may engage in corporate veil piercing; the affiliate’s troubles damage the reputation of the parent; a parent bank is a creditor to the subsidiary; or the parent seeks to avert a potential bankruptcy by transferring assets to the subsidiary. Finally, in a holding company model activities are conducted in legally distinct entities, each with separate management and capital but all owned by a single financial or sometimes (unregulated) non-financial institution. Difficulties in one corporate affiliate—particularly one that is unregulated—thus present a reduced threat to the solvency of regulated financial institutions, except where the creditors of an affiliate may somehow engage in corporate veil piercing; the affiliate’s troubles damage the reputation of the regulated affiliate; a regulated institution has a significant ownership in and/or financial exposure to the affiliate; or the holding company acts to prevent losses by transferring assets to the affiliate.

While the choice among these structures is often driven more by regulatory than business considerations, there are also strong commercial reasons in favor of each, including such factors

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20 *Id.* at 474.
22 See Shull & White, *supra* note 19, at 471.
as bankruptcy treatment, the impact of deposit insurance, and operational costs.\textsuperscript{23} An analysis of the choices among these structures is beyond the scope of this paper; rather we seek to investigate the approaches to supervision of those conglomerate structures that do exist in a particular financial system, not the factors that caused those structures to come into existence.\textsuperscript{24}

\textsuperscript{23} \textit{See} Santos, \textit{supra} note 21 at 48.

\textsuperscript{24} It is of course recognized that supervisory considerations may have a significant impact on the choice of corporate structure, but the permissible corporate structures in a particular regulatory environment are herein taken as given.
B. Conglomerate Supervision

The increasing tendency towards conglomeration has precipitated a new approach to regulation and supervision. Historically most countries have developed supervisory agencies that specialize in a single sector. Such sectoral (or as they are sometimes called, “solo”) supervisors may be unfamiliar or ill-equipped to monitor risks outside of their primary business area, and the difficulties of effectively dividing supervisory responsibility are multiplied when operations are combined within a single conglomerate with a network of complex and overlapping managerial and operational structures. Mixing different business lines also raises new questions in risk management: as inter-relationships within a conglomerate structure may increase the scope of some problems, improved diversification and risk-spreading may reduce the risks associated with others. These concerns lead to a generally recognized need for some form of consolidated risk management and supervision of conglomerates, independent of or as a supplement to any supervision of the individual regulated entities. At one level, such supervision brings benefits to both regulators charged with preserving the safety and soundness of financial systems as well as institutional managers themselves: supervisors act out of concerns that significant risks may be overlooked or underestimated in the absence of such a consolidated perspective, while the financial institutions themselves benefit from better assessment of the relative risks and rewards of various activities, thereby permitting a more efficient allocation of resources.

The supervision of conglomerates presents challenges for regulators on two distinct axes. The first of these is that of supervising activities in varying business lines, and accounting not

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25 See TRIPARTITE GROUP, supra note 3, at ¶42
26 Id. at ¶41.
27 Id.
only for the risks within each business but the potential impact of particular activities on the
group as a whole and its soundness and stability.\textsuperscript{29} Solo supervisors in the various sectors tend to
have highly particularized supervisory concerns and approaches, and may not be attuned to the
risks and dangers inherent in other types of regulated activities—and have little or no control
over unregulated activities. A recent study of conglomerate risks and supervision by the Joint
Forum of banking, securities, and insurance supervisors investigated these attributes, and
identified key similarities and differences in the approaches of supervisors across sectors.\textsuperscript{30}
Nevertheless, it is not clear that any significant convergence among these standards is either
necessarily forthcoming or desirable.\textsuperscript{31}

The second major challenge facing supervisors is that of multinational coordination.
Financial conglomerates frequently have operations in multiple countries, and thus may be
subject to potentially conflicting capital and other supervisory requirements across jurisdictions.
While capital requirements may differ across sectors within countries, the Basel Committee on
Banking Supervision (BCBS) has promulgated a common international capital framework for
international banks; International Association of Insurance Supervisors (IAIS) and International
Organization of Securities Commissions (IOSCO) have yet to do so, resulting in significant
inter-jurisdictional differences in capital standards for insurance companies and securities
firms.\textsuperscript{32} In response to these concerns, most supervisors appear to have reached a general
consensus that some form of specialized supervision is appropriate for financial conglomerates.
While certainly a central managerial and supervisory concern, the specific requirements and

\textsuperscript{29} The most comprehensive discussion of the justifications for and effects of supervising conglomerates in a holding
company structure is Howell E. Jackson, \textit{The Expanding Obligations of Financial Holding Companies}, 107 HARV.
L. REV. 509 (1994) [hereinafter Jackson, \textit{Holding Companies}].

\textsuperscript{30} JOINT FORUM, \textit{RISK MANAGEMENT PRACTICES AND REGULATORY CAPITAL: CROSS-SECTORAL COMPARISON} (Nov.
2001) [hereinafter Risk Management Comparison]; JOINT FORUM, \textit{CORE PRINCIPLES: CROSS-SECTORAL
COMPARISON} (Nov. 2001) [hereinafter Core Principles Comparison].

\textsuperscript{31} The possibilities for such convergence is beyond the scope of this paper.

\textsuperscript{32} Tripartite Group, \textit{supra} note 3, at ¶¶102-4.
treatment of conglomerates are also closely linked to the broader international banking supervisory regime, and the extent to which banking supervisors may seek to monitor and regulate the foreign parents of domestic financial institutions. This aspect of the topic is beyond the scope of the present paper, which focuses on the domestic supervisory structures to which conglomerate operations within a particular jurisdiction may be subject.  

The following section highlights some of the major differences in supervision between banking, securities, and insurance, and identifies the impact of these differences on attempts to develop a unified approach to the supervision of financial conglomerates. It then notes specific risks and other factors that are of concern to conglomerate supervisors and that should be considered in developing effective structures for supervising conglomerates.

1. Cross-Sectoral Differences

Though the number and importance of conglomerates has increased in recent years, the fundamental risks—and thus the concerns to which supervisors respond—associated with financial conglomerates are similar to those faced by other financial institutions. Despite this similarity of the individual operational elements within conglomerates to other financial institutions, it does not necessarily follow that existing supervisory approaches can simply be aggregated at the conglomerate level. Banking, securities, and insurance supervisors have each developed particular policies for measuring and responding to these risks, complicating attempts at imposing any sort of uniform supervisory structure on conglomerates.

Perhaps the most obvious challenge facing attempts to develop an effective supervisory structure for financial conglomerates is that the conglomerate is engaged in a range of activities

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33 The EU can not be so clearly segmented into domestic and international components due to the emphasis on creating a common internal market. See infra §IV.
that may each differ significantly in nature and risk profile. Banks, securities firms, and insurance companies all face distinctive risks in their business operations, and respond to and account for these risks in different manners.\textsuperscript{34} While many individual institutions attempt to take a consolidated enterprise-wide perspective on risk and risk management, even when assessed in the context of complex valuation models combining forms of risks is complicated by different time horizons and relationships between various background and operational parameters.\textsuperscript{35}

Reflecting these differences in the nature of the underlying risks, supervisors in each sector also apply varying definitions of permissible capital, complicating any attempts to make comparisons across sectors.\textsuperscript{36} Accounting rules are likely to vary across jurisdictions, reflecting such factors as the time horizons associated with the associated risk, differences in asset class definitions, and differential tax treatment.\textsuperscript{37} The role, definition, and purpose of allowable capital also varies. For securities firms, capital serves as a cushion against losses from market, operational, and credit risks; for banks, capital serves as a cushion principally against credit losses; and for insurance firms, it serves as the provision for paying potential claims.\textsuperscript{38} Even within a particular sector, national supervisory regimes may impose varying technical definitions of allowable losses, provisions, and timing.\textsuperscript{39} Definitions of eligible core capital also vary, incorporating different definitions of equity and qualifying capital, the treatment of reserves, and certain liabilities.\textsuperscript{40} Differences in calculation methodologies further complicate the situation, for example accounting for differences in the asset quality, liquidity, and other objectives.\textsuperscript{41}

\textsuperscript{34} For a cross-sectoral discussion of the risks facing financial services firms, see \textit{Risk Management Comparison}, \textit{supra} note 30, at 10-27.
\textsuperscript{35} See \textit{id.} at 10-27 (discussing the difficulties inherent in creating consolidated risk models).
\textsuperscript{37} See \textit{Risk Management Comparison}, \textit{supra} note 30, at 47.
\textsuperscript{38} See \textit{id.} at 47-48.
\textsuperscript{39} See \textit{id.} at 48.
\textsuperscript{40} See \textit{id.} at 49-50.
\textsuperscript{41} See \textit{id.} at 50-51.
Current capital requirements differ in their scope of application and consolidation; banking capital is generally calculated on a consolidated basis, whereas insurance is calculated on a solo basis.\footnote{See id. at 51.} Finally, application of capital requirements may vary greatly across sectors, due to a combination of market and formal and informal supervisory pressures and incentives.\footnote{See id. at 52-53.}

In parallel with these distinctions in capital, the principles applied by supervisors in each sector reflect different underlying concerns. Banking supervisors historically have perceived close linkages between banking and the overall macroeconomic environment, and thus typically emphasize overall systemic stability and soundness.\footnote{CORE PRINCIPLES COMPARISON, supra note 30, at ¶¶38, 59.} Public perception plays an important role in this process, such that even an appearance of institutional failure may cause significant adverse effects.\footnote{Id. at ¶41.} Moreover, interbank markets and payment systems create high levels of international interdependence between and among national banking systems.\footnote{Id. at ¶43.} The Basel Accords seek to provide some measure of international comparability and consistency among these standards.\footnote{Id. at ¶42.} In part due to these factors, bank regulators tend to be concerned about potential contagion from non-banking to banking activities,\footnote{Id. at ¶44.} particularly within a single conglomerate structure. Potential public-sector liabilities and/or support through a deposit insurance system may heighten these concerns.

In contrast to the approach of banking supervisors, securities supervisors tend to be concerned primarily with the firm’s liquidity, in order to respond to rapid and short-term financial flows and changing market conditions. Thus, securities supervisors emphasize\footnote{Id. at ¶41.}

\footnote{Id. at ¶43.}

\footnote{Id. at ¶42.}

\footnote{Id. at ¶44.}
background factors such as market and operating processes and trading and settlement concerns, all of which may have an adverse impact on the firm’s liquidity.

Insurance supervisors focus their efforts primarily on the possibility that disclosure of difficulties in individual companies or of regulatory action may adversely impact confidence in the sector overall. However, the systemic risks are often perceived to be relatively limited; while the collapse of an insurance firm may be catastrophic for that firm’s policyholders, the firm overall does not implicate the same systemic risk as might, for example, a bank. While prudential regulation is not irrelevant in the insurance sector, it receives far less attention than in banking; the primary concern is policyholder protection, in terms of ensuring that the policyholder receives the contracted-for level of risk protection, and that the customer is fairly treated as a consumer.

In a comparison of core sectoral supervisory principles, the Joint Forum recently found common concerns with customer protection and systemic stability across all three sectors. However, only the international core principles adopted in the banking sector by the BCBS emphasize the importance of consolidated supervision, reflecting the generally greater systemic risks associate with banking and the possible contagion effects that non-banking activities may have on banking. These problems of conglomerates are exacerbated at the international level, where one must also account for the multiplicity of supervisors and regulatory standards in each country of operation. The approach most commonly recommended for conglomerates is to form

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49 Id. at ¶51.
50 Id. at ¶48.
51 Some risk of insurer default is to be expected in any situation; the supervisory concern is that a party may be subject to a different risk of default than that anticipated ex ante.
52 Id. at ¶58.
53 Id. at ¶78-80.
an integrated relationship among supervisors, spearheaded by a single “lead regulator”—a
regulator with a mandate to spearhead international supervisory and regulatory efforts.\textsuperscript{54}

2. \textit{The Need for Specialized Conglomerate Supervision}

As suggested by the preceding section, development of an effective supervisory regime for financial conglomerates may be particularly difficult for financial supervisors. While operations across sectors may often be legally and/or functionally distinct—and subject to an independent supervisory regime—the accompanying managerial structure may not make similar distinctions.\textsuperscript{55} Even where formal legal boundaries exist, management may be best able to capture the benefits of the conglomerate structure for shareholders by operating the organization as an integrated whole, and adopting a coordinated perspective on risk management and resource allocation. For example, conglomerates may benefit by transferring risks from one corporate entity to another in which that risk may either be managed more efficiently, incurs a lower economic and/or regulatory capital charge, or results in improved diversification across a portfolio of risks.\textsuperscript{56} Supervisors may justifiably be concerned with the means by which these risk transfers occur in order to ensure from a supervisory perspective that the risks are transferred in a manner consistent with underlying regulatory concerns and motivations, and not as a means of evading or minimizing supervisory requirements without any real change in economic risk. However, a single, unified perspective on conglomerate risk and supervision may also be inconsistent with concerns regarding financial system soundness and stability, and may place

\begin{footnotesize}
\textsuperscript{54} See George A. Walker, \textit{Conglomerate Law and International Financial Market Supervision}, 17 ANN. REV. BANKING L. 287, 297-303 (1998). Other approaches include national supervision, in which purely national requirements are applied without any harmonization or attempt to coordinate the relevant regulatory provisions; informal bilateral and multilateral contacts among supervisors to coordinate and formulate regulatory standards and relationships; concluding formal bilateral and multilateral arrangements; and establishing college supervision, in which regulators approach matters collectively. \textit{Id.}

\textsuperscript{55} Such separation is characteristic of parentsubsidiary and particularly holding company structures, but not universal banking.

\textsuperscript{56} See \textit{Risk Management Comparison}, supra note 30, at 54-56 (discussing forms of and motivations for cross-sectoral risk transfers).
\end{footnotesize}
conglomerates at a competitive disadvantage in comparison to similar activities conducted outside of conglomerate structures.

In recognition of these difficulties, regulators in many countries have sought to impose some form of supplemental regulation on conglomerates that seek to protect particular subsidiaries from abuses by parent companies as well as to impose monitoring and supervisory requirements that seek to minimize the effects of risks associated with conglomerate structures, for example by limiting the ability to engage in certain transactions with affiliates and imposing additional capital requirements.57

Activities located in entities deemed to be non-financial for supervisory purposes may also not be subject to supervision or generate group capital requirements, but yet still generate risks for the conglomerate as a whole. A non-financial holding company or mixed conglomerate structure may also not be subject to an effective supervisory regime.58 Difficulties in a non-regulated affiliate may also give rise to contagion risk for other entities within the conglomerate structure.

One significant difficulty in supervising financial conglomerates—and the one that often receives the greatest attention—is that of calculating capital adequacy. As discussed above,59 banking, securities, and insurance firms are generally subject to different minimum levels and definitions of capital. Moreover, a significant potential problem within a conglomerate structure is that of double-gearing: the possibility that regulatory capital may be used to satisfy the requirements of more than one entity.60 Double-gearing typically occurs through intra-group holdings of capital, for example investments by a parent in its subsidiaries. As a result, the “net”

57 For a discussion of the history of “enhanced obligations” by holding companies in U.S. practice (pre-GLB), see generally Jackson, Holding Companies, supra note 29.
58 See TRIPARTITE GROUP, supra note 5, at ¶97.
59 See supra text accompanying notes 36-43
60 See TRIPARTITE GROUP, supra note 5, at ¶43.
solvency of the group is in fact less than the sum of the capital of the individual group components. Banking supervisors tend to be particularly concerned with problems of double-gearing, as an overstatement of group capital undermines the stability and soundness objectives of banking supervision.61

Difficulties in one subsidiary may also result in knock-on contagion effects in other components of the conglomerate structure due to interconnections and relationships among member entities even without any deliberate wrongdoing in those components.62 This contagion may take two forms: psychological, in which market participants are reluctant to deal with other parts of ‘tainted’ corporate groups, and intra-group exposures, in which the risks to which a particular entity is exposed come from other entities in the same structure.63 Conglomerates may be more likely to support member structures during periods of distress even when not legally required to do so in order to defend against such psychological contagion, and to protect the market perception and reputation of management and business prospects and to minimize the overall cost of capital for the conglomerate.64 This support may in turn adversely impact operations elsewhere within the conglomerate, and/or require a reallocation of internal resources. Intra-group exposures may have adverse effects on the liquidity or overall solvency of a conglomerate in times of crisis,65 but may not be readily apparent to an examination of even a consolidated group balance sheet.66

Conglomerates may also face difficulties from large exposures at the group level. While supervisory requirements for individual financial institutions generally limit exposures to particular clients or groups of connected clients or require some level of diversification (for

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63 See Tripartite Group, supra note 5, at ¶¶49-50.
64 Santos, supra note 21, at 47.
65 See Tripartite Group, supra note 5, at ¶¶53.
66 Id. at ¶56.
insurance companies), within a conglomerate structure individual exposures in various solo regulated entities may result in an excessively high exposure for the group as a whole. Moreover, differential limitations may permit regulatory arbitrage among solo supervisors, enabling banks to locate exposures in order to take advantage of the most liberal regulatory regime. Similarly, risks assumed by the components of a conglomerate may not be entirely independent, as for example loans to a borrower on which default may be correlated with liabilities for a group insurer.

The complex nature of conglomerate structures also facilitates the creation of opaque corporate structures that limit the ability of supervisors to comprehend and to detect intra-group, related party, and other complex transactions. While in some situations such structures may be created deliberately in order to confound regulators, in others these structures may hinder the ability of management to exercise effective control and internal monitoring of all transactions within the conglomerate structure.

The sheer size of financial conglomerates may also generate additional systemic risk. While the combination of activities into a single corporate structure does not itself generate additional systemic risk, financial conglomerates also tend to be amongst the largest financial institutions in an economy. This size is the result of the simultaneous pursuit of economies of scale and scope within sectors as well as from expanding into other sectors—the very factors that make conglomerates economically advantageous. Conglomerates may thus easily become ‘too big to fail.’ Even if a government safety net is limited to banks in its applicability, difficulties in

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67 See TRIPARTITE GROUP, supra note 5, at ¶71.
68 Id. at ¶70.
a conglomerate’s non-banking operations may adversely impact its banking activities, potentially calling on such support. Moreover, any such government support provides an implicit subsidy to banking operations, the benefits of which may “leak” to non-banking or other operations not intended to receive such protection. Thus, financial conglomerates that include a bank that benefits from deposit insurance may enjoy a competitive advantage over institutions that do not: the conglomerate can raise capital against its entire balance sheet, but a portion of this is guaranteed by government subsidies, leading to a lower overall cost of capital. Affiliates may also be able to transfer poor-quality assets to insured entities, effectively shifting the risk of loss to the government insurance provider.

The scope of financial conglomerates also raises supervisory challenges. Where a conglomerate is subject to some form of solo supervision, in which each entity or business line is supervised on an independent basis, these individual sector supervisors may each lack a coherent understanding of the conglomerate as a whole. In comparison, managers within the conglomerate are likely to have a more comprehensive understanding of the group’s overall operations. While thoroughly familiar with the risks and operations of a particular entity, supervisors may nevertheless omit key attributes of the parent structure. Similarly, one supervisor may have access to information regarding intra-group exposures or other key aspects of the group’s risk profile that is essential to effective monitoring by another, but unless accompanied by a functioning information sharing regime this may never come to light. Such informational asymmetries among supervisors may facilitate supervisory arbitrage, the process

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72 See Lemieux, supra note 69, at 165 (1999).
73 Id. at 165-66.
74 See TRIPARTITE GROUP, supra note 5, at ¶85.
of shifting activities or positions within the conglomerate in order to take advantage of a more favorable supervisory environment.\textsuperscript{75}

Conglomerates also face the possibility that managers may seek to exploit and prey upon the resources of subsidiaries and affiliates, for example offering biased advice to clients that has the effect of directing additional business to related parties even when such activities are not in the client’s best interests; uneconomical asset transfers; and tying arrangements for certain services.\textsuperscript{76} Conglomerate structures arguably present increased opportunities for engaging in such behavior and increase the difficulties inherent in monitoring and preventing these abuses.

\textbf{C. Conglomerate Regulation and Supervision: Comparative Practice}

The differences in risks and supervisory objectives that may exist even within a single financial conglomerate as discussed in the preceding section highlight the practical difficulties associated with implementing some form of “consolidated supervision” of conglomerates that seeks to provide a more complete comprehension of the risks that they pose. Unlike simple accounting consolidation, for supervisory purposes it is not altogether clear what should be consolidated, or how, or what constitutes the dominant concern to which supervision is supposed to respond. Supervisors internationally have taken a range of approaches in formulating an effective response to these concerns.

\textsuperscript{75} Id. at ¶94.

\textsuperscript{76} Eric J. Gouvin, Of Hungry Wolves and Horizontal Conflicts: Rethinking the Justifications for Bank Holding Company Liability, 1999 U. ILL. L. REV. 949, 966. As a recent and highly-public example, major lenders to Enron (including Citigroup and J.P. Morgan Chase) have been accused of concealing information they may have obtained as lenders to Enron in order to promote sales of securities, structured finance products, and derivatives. See, e.g., Jathon Sapsford, Citigroup’s Enron Sales Draw Suit, WALL ST. J., Feb. 1, 2002, at C1 (discussing a lawsuit filed against Citigroup by a purchaser of Enron convertible bonds); John R. Emshwiller et al., How Wall Street Greased Enron’s Money Engine, WALL ST. J., Jan. 14, 2002, at C1 (discussing the range of cross-sectoral financial services provided to Enron by major financial institutions).
The following discussion takes as given that some measure of additional supervision for conglomerates is appropriate, accepting the collected wisdom of the Joint Forum and the historical evolution of banking supervisory practices. The question for financial supervisors then is that of crafting the best structure and approach for these supervisory efforts: a methodology that both recognizes and responds to the risks posed by conglomerates, but that also does not introduce competitive distortions (either pro or anti-conglomerate) and create opportunities for regulatory arbitrage within conglomerate structures.
II. International Approaches to Conglomerate Supervision

Just as it has with banking capital requirements and supervisory standards more generally, the BCBS has recognized the benefits of worldwide implementation of generally comparable, sound supervisory standards for financial conglomerates. Together with International Association of Insurance Supervisors (IAIS) and International Organization of Securities Commissioners (IOSCO), the BCBS formed the Joint Forum on Financial Conglomerates (Joint Forum), a working group that has researched and promulgated supervisory standards for financial conglomerates. This work has been particularly influential, and is specifically referenced in both European Union and U.K. supervisory standards. In 1992 the BCBS issued a set of minimum standards for the supervision of banking groups as an amendment to the Basel Capital Accords, and more generally has recognized the role of universal banking and the convergence among financial services. Building on this work of both the BCBS alone and the Joint Forum, the Revised Basel Capital Accords (Basel 2) will also incorporate provisions on capital requirements for conglomerates.

In this section of the paper, we summarize the manner in which Basel 2 proposes to impose the imposition of capital standards to financial conglomerates. We then turn to the Joint Forum’s more extensive treatment of supervision of financial conglomerates. The Joint Forum’s work in this area has particular relevance to Basel 2, because it both amplifies the technical difficulties of applying capital standards on a consolidated basis and also presents a number of supplementary approaches to the supervision of financial conglomerates that may ultimately be incorporated into the as-yet undeveloped application of Basel 2’s Pillar II (supervision) to conglomerate supervision.

A. The BCBS and Financial Conglomerates

Basel 2 addresses the issue of capital requirements for financial conglomerates in the opening pages of its January 2001 proposal – the section titled “Scope of Application.” Basel 2 generally calls for consolidated supervision of internationally active banking groups. However, consistent with its origins as banking capital requirements, Basel 2 only addresses the capital components of the Joint Forum’s recommendations, which are described in the following section. While Pillars II (supervision) and III (market regulation) are both relevant in the supervision of financial conglomerates, Basel 2 does not incorporate any conglomerate-specific provisions or recommendations in these areas.
1. Scope of Application of Basel 2 Accord

Basel 2’s primary provision with respect to conglomerates is capital consolidation. The dominant concern motivating this consolidation is the possibility of double gearing.\textsuperscript{78} The Accord recommends inclusion, “on a fully consolidated basis, holding companies that are parents of banking groups to ensure that it captures risks within the whole banking group.”\textsuperscript{79} Capital should also be calculated on a fully consolidated basis for all internationally active banks “at every tier within a banking group.”\textsuperscript{80} Supervisors are also to ensure that capital is “readily available” to depositors,\textsuperscript{81} meaning that subsidiary banks should also be adequately capitalized on a stand-alone basis.

Basel 2 can thus be viewed as applying in a series of concentric boxes on a consolidated basis to each internationally active bank and its respective subsidiary banks at each successive level of a banking group. (See accompanying illustration taken from the BCBS January 2001 Consultative Document.) A qualifying bank will itself be assessed [noted as (4) in illustration], as well as its parent bank and each bank at a higher level within the banking organization [noted as (2) in accompanying illustration]. Holding company parents also may be subject to an independent capital requirement [noted as (1) in illustration], turning such a holding company into a de facto bank for consolidated capital regulation purposes. Where an internationally active bank has controlling interests in domestic banks or securities firms, these subsidiary institutions will be consolidated into that bank for determining capital adequacy [noted as (3) in illustration].

An important limitation on the scope of Basel 2’s proposed application is application

\textsuperscript{78} BASEL COMMITTEE ON BANKING SUPERVISION, CONSULTATIVE DOCUMENT: THE NEW BASEL CAPITAL ACCORD ¶1 (Jan. 2001) [hereinafter Basel 2].
\textsuperscript{79} Id. at ¶2.
\textsuperscript{80} Id. at ¶3.
\textsuperscript{81} Id. at ¶4.
only to “groups that engage predominantly in banking activities.” A diversified organization with a controlling interest in a banking group would not be subject to the consolidated capital provisions of the Accord, if the diversified group were not itself “engage[d] predominantly in banking activities” (See accompanying illustration). The consultative document does not offer a detailed definition of what it means to be “engage[d] predominantly in banking activities,” presumably leaving the issue to interpretation by national authorities.

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82 Id. at ¶2.
ILLUSTRATION OF NEW SCOPE OF APPLICATION OF THE ACCORD
(from page 5 of the January 2001 Accord)

(1) Diversified Financial Group

(2) Holding Company

(3) Internationally Active Bank

(4) Internationally Active Bank

Domestic Bank

Securities Firm

(1): Boundary of predominantly banking group. The Accord is to be applied at this level on a consolidated basis, i.e., up to the holding company level.

(2), (3), and (4): The Accord is also to be applied at lower levels to all internationally active banks on a consolidated basis.
2. **Rules of Capital Consolidation**

In principle, Basel 2 calls for capital consolidation to be imposed “to the greatest extent possible.” The actual proposal, however, allows for numerous exceptions. Full consolidation is mandated only for “majority-owned or controlled banking entities, securities entities (where subject to broadly similar regulation or where securities activities are deemed to be banking activities) and other financial entities” (other than insurance entities). However, even this mandate is subject to exceptions, for example, where interests are held on a temporary basis or where the subsidiaries are subject to different regulation and/or deconsolidation is required under local law. (These latter two exceptions presumably encompass U.S. regulation post-Gramm-Leach-Bliley which limit the authority of the Federal Reserve Board to establish capital requirements for securities affiliates of financial holding companies). One of the most important exceptions to full capital consolidation concerns insurance entities. In recognition of the differences in calculating capital requirements for banks and insurance companies, investments in insurance company are expressly excluded from the rules of consolidation under Basel 2. In addition, national authorities have latitude to exclude minority investments in consolidated subsidiaries when such minority interests are not readily available to other group entities.

Much of the technical details of this aspect of Basel 2 deals with the treatment of de-consolidated affiliates, such as insurance companies or other financial affiliates that qualify for some exception to the proposal’s full consolidation requirement. Investments in non-consolidated majority-owned securities and financial affiliates are deducted from capital, and any equity and other regulatory capital investments in those entities deducted and assets

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83 As a terminological difference, U.S. regulators consider insurance to be financial in nature. Under Basel 2, financial entities do not include insurance, but encompass “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.” See *id.* ¶ 5 n.4.

84 See *id.* at ¶6.
deconsolidated. The deconsolidated entity must, however, independently meet any applicable regulatory capital requirements. Investments in minority and other non-controlled financial entities are also deducted from capital, or where appropriate based on national accounting and/or regulatory practice may be consolidated on a pro rata basis. (Is this sentence awkward?)

Insurance subsidiaries are treated separately from other financial subsidiaries. In general, insurance investments are to be deducted outright. However, if an insurance subsidiary has capital in excess of its own regulatory requirements, the surplus capital in a majority-owned or controlled insurance subsidiary may be recognized on a group-wide basis, as permitted according to national regulatory requirements. Thus, under Basel 2, a parent bank need only deduct the lesser of its investment in a subsidiary insurance firm and that firm’s regulatory capital requirements. Under Basel 2, bank supervisors have an obligation to ensure that such insurance subsidiaries are themselves adequately capitalized in order to limit risks of future losses accruing to the parent bank, and if capital shortfalls at the insurance subsidiary level are not promptly corrected, the shortfall may have to be deducted from the parent bank’s capital.

Commercial investments—investments in non-financial, non-insurance subsidiaries and affiliates—are to be evaluated on a sliding materiality scale, based on the amount of those investments compared to the level of the firm’s capital. When commercial investments in the aggregate exceed 60% of bank capital or when an individual commercial investment exceeds 15% of bank capital, the investments are deducted, while lesser levels of investment are risk-weighted at a minimum of 100% under the standardized approach.

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85 Basel 2, supra note 78 at ¶8.
86 Id. at ¶14.
87 Id. at ¶9. The Basel 2 proposals recognize as a pragmatic matter many countries may adopt some form of risk aggregation, but urges disclosure of such positions and urges a shift towards the common Basel 2 position. See id at ¶10-11.
88 Id. at ¶12.
89 Id.
90 Id. at ¶16. Banks using IRB approach are to apply an equivalent treatment. Id. at ¶17.
B. Joint Forum

While the BCBS has recognized the importance of developing effective supervisory standards for financial conglomerates, it has been principally concerned with the supervision of the banking sector. The lead on developing supervisory standards for conglomerates has been taken by the Joint Forum on Financial Conglomerates. The Joint Forum was established in 1996 under the auspices of the BCBS, International Organization of Securities Commissioners (IOSCO), and International Association of Insurance Supervisors (IAIS). It continues the work conducted by its immediate predecessor, the Tripartite Group of Bank, Securities, and Insurance Regulators, and draws on work begun by the IOSCO Technical Committee. The Joint Forum’s February 1999 compilation on the supervision of financial conglomerates sought to provide guidance specifically with respect to “diversified financial firms with complex organizational and management structures whose large scale activities cross national borders and sectoral boundaries.” This document includes four papers presenting the Joint Forum’s conclusions covering capital adequacy, principles for assessing the sound and prudent management of conglomerates, framework for and principles for supervisory information sharing, and guidelines for identifying coordinating supervisors. This document constitutes the most recent ‘collected wisdom’ of financial services regulators on the supervision of conglomerates. The following section reviews the principle conclusions of these papers.

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91 For a general introduction to the work and background of the Joint Forum, see JOINT FORUM ON FINANCIAL CONGLOMERATES, SUPERVISION OF FINANCIAL CONGLOMERATES 1 (Feb. 1999) [hereinafter Joint Forum 1999].
92 See generally TRIPARTITE GROUP OF BANK, SECURITIES, AND INSURANCE REGULATORS, SUPERVISION OF FINANCIAL CONGLOMERATES (July 1995).
94 The most recent releases by the Joint Forum are JOINT FORUM, RISK MANAGEMENT PRACTICES AND REGULATORY CAPITAL: CROSS-SECTORAL COMPARISON 10-27 (Nov. 2001) and JOINT FORUM, CORE PRINCIPLES: CROSS-SECTORAL COMPARISON (Nov. 2001).
95 JOINT FORUM 1999, supra note 91, at 2.
96 Id. at 2-3 (summarizing component papers of Joint Forum 1999).
particularly with respect to capital adequacy and regulatory structures, and then discusses these principles in the context of the difficulties of developing effective conglomerate supervision.

1. **Capital Adequacy**

The Capital Adequacy Principles paper in the Joint Forum’s 1999 report disclaims any intention to impose specific techniques for imposing capital adequacy rules on each sector, instead seeking to propose techniques that complement other approaches to capital adequacy. The Joint Forum has proposed techniques that facilitate the assessment of capital adequacy on a group-wide basis for financial conglomerates and identification of double or multiple gearing, in which the same capital is “used simultaneously as a buffer against risk in two or more legal entities.”

The Joint Forum proposes five guiding principles for the assessment of capital adequacy within financial conglomerates:

1. Detecting and providing for double or multiple-gearing;
2. Detecting and providing for downstreaming as equity the proceeds of debt issued by a parent, resulting in excessive leverage;
3. Detecting and providing for the effects of multiple or excessive gearing through unregulated intermediate holding companies that have participations in financial dependents or affiliates;
4. Addressing the risks accepted by unregulated entities within a conglomerate that are conducting activities similar to those of regulated entities;
5. Ensuring prudentially sound treatment of minority and majority interests in regulated dependents.\(^{98}\)

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\(^{98}\) *Id.* at ¶2.
Three of these principles expressly mention problems of double gearing and excessive leverage, while the other two focus on the risks associated with the combination of regulated and unregulated entities within the conglomerate. Supervision in accordance with these principles is to be in addition to existing solo capital adequacy requirements and supervisory efforts. These principles are to be applied quite broadly: to any institution that participates in two or more of banking, securities, and insurance without being subject to uniform capital adequacy requirements, regardless of an observance of a particular corporate structure.

The first three principles call for general monitoring of and provisions against such multiple gearing. Supervisors should monitor upstream and downstream holdings of capital within the organizational structure, as well as both intra-conglomerate cross-holdings; failing to eliminate these structures results in double counting of capital. While excess leverage from downstreaming the proceeds of a parent debt issue is not seen as inherently unsafe or unsound, the parent’s obligations can in some circumstances result in undue stress on the regulated subsidiary, particularly where the top-level holding company is itself unregulated. Unregulated intermediate holding companies with financial dependents and affiliates may also facilitate excessive gearing, and thus should be treated as if consolidated in the relevant sector.

The fourth principle addresses the possible mix of regulated and unregulated entities within a conglomerate. This is one aspect of regulatory arbitrage, the possibility that similar activities may be conducted by both regulated and unregulated structures, and that a conglomerate may thus alter its regulatory burden merely by the location of certain activities...
within the corporate structure.\textsuperscript{104} Such unregulated entities are divided into financial and non-financial. For the former, supervisors are encouraged to apply a “comparable or ‘notional’ capital proxy,” applying the capital requirements of “the most analogous regulated industry.”\textsuperscript{105} Unregulated non-financial entities are generally excluded from group-level assessments, except where regulated entities have provided explicit support to the unregulated entity;\textsuperscript{106} the overall approach recommended is to look-through the formal structure to the overall level and quality of assets in the unregulated companies.\textsuperscript{107}

The final principle addresses the issue of investments in regulated dependents, as well as non-regulated financial dependents subject to comparable capital treatment as regulated dependants. These interests are evaluated according to a tiered structure. Participations of less than 20% that do not confer control or significant influence are to be treated in accordance with solo supervisory requirements for investments in similar companies.\textsuperscript{108} Shared control or situations of “significant influence and exposure to risk, but falling short of control” results in a pro-rata allocation of any excess capital to the parent.\textsuperscript{109} Finally, participations that confer effective control are to be fully consolidated.\textsuperscript{110} These provisions also seek to address capital distribution within the heterogeneous group, considering factors such as the legal and regulatory possibility of actually transferring capital between entities. Any capital deficits in solo supervised dependents are fully attributed to the group level capital assessment if the parent is likely to be called upon to support the dependent without assistance from other external

\textsuperscript{104} \textit{Id.} at ¶26.
\textsuperscript{105} \textit{Id.} at ¶26.
\textsuperscript{106} \textit{Id.} at ¶27.
\textsuperscript{107} \textit{Id.} at ¶28.
\textsuperscript{108} \textit{Id.} at ¶30.
\textsuperscript{109} \textit{Id.} at ¶31. The threshold level of effective control for these purposes is generally between 20% and 50%, though this test may be met at lower levels of ownership in the presence of rights to board membership, large exposures, or co-ordination of business plans and development. \textit{Id.} at ¶32.
\textsuperscript{110} \textit{Id.} at ¶32-33.
participants. Total deduction is appropriate where it is not possible to value the capital in a regulated dependent.\footnote{Id. at ¶37.}

The Joint Forum prescribes three methods for the measurement of the group capital of financial conglomerates.\footnote{Id. at 13.} The preferred technique—the building block technique—is to compare the consolidated capital of the conglomerate itself to the sum of the solo capital requirements for individual group members in a particular block (banking, securities, insurance, or unregulated), thereby treating the conglomerate as a single economic unit on a consolidated basis.\footnote{Annex 2 provides a helpful summary and examples of these measurement techniques. See id. at 19-38.} Block ‘affiliation’ for these purposes is determined based on the supervisory regime for each individual operating firm. Any deficit in a particular block is evaluated in the context of the transferability of capital from other blocks. Capital for the ‘unregulated’ block is assessed in accordance with assigned notional or proxy capital requirements.\footnote{Capital Adequacy Principles, supra note 97, at 15.} For conglomerates that are dominated by the activities of a regulated parent, the Joint Forum also approves of a “modified building block approach,”\footnote{See supra text accompanying notes 104-107 (discussing notional capital requirements).} in which the capital requirements of dependents in other sectors and any notional capital requirements are deducted from the parent’s capital requirements, and the result compared to the capital requirements for the parent’s own activities.\footnote{Capital Adequacy Principles, supra note 97, at 15.} While reaching the same final outcome, this approach obviates the need to calculate separate block capital requirements (as the parent’s block dominates).

Figure II.1 illustrates the application of the building block approach to a conglomerate that consists of a parent bank with insurance, 60%-owned securities, and unregulated subsidiaries. The example assumes no intra-group accounts; were any such accounts present,
they would be subtracted prior to application of the building block approach. The example also assumes complete transferability of surplus capital. Examples with both full and pro-rata consolidation of the securities subsidiary are shown.

**Figure II.1**

<table>
<thead>
<tr>
<th></th>
<th>Bank (Parent)</th>
<th>Insurance</th>
<th>Securities (60%)</th>
<th>Unregulated</th>
<th>Group Aggregate</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Full Consolidation</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Regulatory/Proxy Capital Requirement</td>
<td>32</td>
<td>10</td>
<td>17</td>
<td>10</td>
<td>69</td>
</tr>
<tr>
<td>Actual (Solo) Capital</td>
<td>40</td>
<td>12</td>
<td>22</td>
<td>7</td>
<td>81</td>
</tr>
<tr>
<td>Surplus (Deficit)</td>
<td>8</td>
<td>2</td>
<td>5</td>
<td>(3)</td>
<td>12</td>
</tr>
<tr>
<td><strong>Pro Rata Consolidation</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Regulatory/Proxy Capital Requirement</td>
<td>32</td>
<td>10</td>
<td>10.2</td>
<td>10</td>
<td>62.2</td>
</tr>
<tr>
<td>Actual (Solo) Capital</td>
<td>40</td>
<td>12</td>
<td>13.2</td>
<td>7</td>
<td>72.2</td>
</tr>
<tr>
<td>Surplus (Deficit)</td>
<td>8</td>
<td>2</td>
<td>3</td>
<td>-3</td>
<td>10</td>
</tr>
</tbody>
</table>

The second method is risk-based aggregation, appropriate where capital is determined based on unconsolidated accounts. Supervisors applying this methodology add the capital of each entity less intra-group capital holdings and compare that result to the solo capital requirements of each entity in the group. This method is generally most appropriate where it may not be possible to eliminate intra-group exposures, and is based on unconsolidated financial statements.119

Figure II.2 illustrates the application of the risk-based aggregation approach to a conglomerate that consists of a parent bank with insurance, 60%-owned securities, and

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unregulated subsidiaries. Downstreamed capital constitutes 10 to the insurance subsidiary, 12 to the securities subsidiary, and 5 to unregulated entities. This example assumes that only unconsolidated financial statements are available, and that intra-group exposures can not readily be netted out, but that any surplus capital is freely transferable. Examples with both full and pro-rata consolidation of the securities subsidiary are shown.

Figure II.2\textsuperscript{120}

<table>
<thead>
<tr>
<th></th>
<th>Insurance</th>
<th>Securities (60%)</th>
<th>Unregulated</th>
<th>Unconsolidated Bank Parent</th>
<th>Elimination of Downstreamed Capital</th>
<th>Group Aggregate</th>
</tr>
</thead>
<tbody>
<tr>
<td>Full Consolidation</td>
<td>Regulatory/Proxy Capital Requirement</td>
<td>10</td>
<td>17</td>
<td>10</td>
<td>32</td>
<td>69</td>
</tr>
<tr>
<td></td>
<td>Actual (Solo) Capital</td>
<td>12</td>
<td>22</td>
<td>7</td>
<td>67</td>
<td>-27</td>
</tr>
<tr>
<td></td>
<td>Surplus (Deficit)</td>
<td>2</td>
<td>5</td>
<td>(3)</td>
<td>35</td>
<td>-27</td>
</tr>
<tr>
<td>Pro Rata Consolidation</td>
<td>Regulatory/Proxy Capital Requirement</td>
<td>10</td>
<td>10.2</td>
<td>10</td>
<td>32</td>
<td>62.2</td>
</tr>
<tr>
<td></td>
<td>Actual (Solo) Capital</td>
<td>12</td>
<td>13.2</td>
<td>7</td>
<td>67</td>
<td>-27</td>
</tr>
<tr>
<td></td>
<td>Surplus (Deficit)</td>
<td>2</td>
<td>3</td>
<td>-3</td>
<td>35</td>
<td>-27</td>
</tr>
</tbody>
</table>

The third method is risk-based deduction, which emphasizes the amount and transferability of capital to the parent or other members of the group. The parent capital is reduced by the amount of investments in dependants, and increased or decreased by any solo capital surplus or deficit of individual dependants.\textsuperscript{121} In all situations, the Joint Forum advocates

\textsuperscript{120} Example based on JOINT FORUM 1999, supra note 91, at 21.
\textsuperscript{121} Capital Adequacy Principles, supra note 97, at 17.
a full deduction of the investments made in dependents in those situations in which regulatory capital surpluses are not available to support the parent’s capital or debt service.\textsuperscript{122}

Figure II.3 illustrates the application of risk-based deduction to a conglomerate that consists of a parent bank with insurance, 60\%-owned securities, and unregulated subsidiaries. Downstreamed capital constitutes 10 to the insurance subsidiary, 12 to the securities subsidiary, and 5 to unregulated entities. The example assumes pro-rata integration of the securities subsidiary; to adjust for full consolidation, one would simply add the full capital surplus of the securities operation.

**Figure II.3\textsuperscript{123}**

<table>
<thead>
<tr>
<th>Parent Capital</th>
<th>67</th>
</tr>
</thead>
<tbody>
<tr>
<td>Deduct Capital Investments in Dependents</td>
<td></td>
</tr>
<tr>
<td>Insurance</td>
<td>(10)</td>
</tr>
<tr>
<td>Securities</td>
<td>(12)</td>
</tr>
<tr>
<td>Unregulated</td>
<td>(5)</td>
</tr>
<tr>
<td>Substitute Dependents Surplus/Deficit</td>
<td></td>
</tr>
<tr>
<td>Insurance</td>
<td>2</td>
</tr>
<tr>
<td>Securities (60% pro-rata)</td>
<td>3</td>
</tr>
<tr>
<td>Unregulated</td>
<td>(3)</td>
</tr>
<tr>
<td>Adjusted Parent Capital</td>
<td>42</td>
</tr>
<tr>
<td>Less Parent Solo Capital Requirement</td>
<td>32</td>
</tr>
<tr>
<td>Total Group Surplus</td>
<td>10</td>
</tr>
</tbody>
</table>

While a detailed analysis of the relative benefits of each of these techniques is beyond the scope of the present paper, as illustrated in the preceding simplified examples these methodologies are intended to result in generally equivalent results regardless of the

\textsuperscript{122} Id. at 17-18.

\textsuperscript{123} Example based on JOINT FORUM 1999, supra note 91, at 22-23.
conglomerate’s organizational structure. The endorsement of the building block technique is particularly noteworthy, as it seeks to achieve a result that is independent of a particular corporate structure. While some capital arbitrage may be possible based on the allocation of certain business activities to affiliates that fall within a particular block, the formal structure is otherwise irrelevant for capital purposes. Moreover, it is important to keep in mind that capital adequacy is distinct from comprehensive risk assessment and measurement; at best, capital is a response to perceived market failures such as the subsidy of deposit insurance and poor monitoring by bank creditors (depositors), not a true measurement of the amount of economic or systemic risk inherent in a banking organization.

124 Capital Adequacy Principles, supra note 97, at ¶46.
5. *Fit and Proper Principles*

The Joint Forum also identifies the importance of sound management within the conglomerate structure. While assessment of the qualifications of the management of regulated entities is often a component of the supervision of banks and other regulated financial institutions, the Joint Forum has sought to ensure that similar scrutiny is applied at the conglomerate level, particularly for non-regulated entities that are upstream from regulated entities in a conglomerate structure; managers at this level are capable of influencing the business operations of the regulated entity and of impacting the allocation and control of risks across the entire group, including both multisectoral regulated and non-regulated entities.\(^{127}\)

Differences in supervisory standards across regulated business lines may lead to similar effects. However, supervisors do not generally have jurisdiction to apply these principles outside of their area of responsibility—or at all with respect to unregulated entities—and standards of professional secrecy may limit the sharing of relevant information among regulators.\(^{128}\)

In response to these concerns, the Joint Forum has promulgated seven guiding principles for supervision in this area:\(^{129}\)

1. Qualification tests should be applied to managers and directors of entities in a conglomerate structure that may exercise a material or controlling influence on the operations of regulated entities;

2. Large shareholders and those capable of exerting a material influence on regulated entities should meet qualification tests;

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\(^{128}\) *Id. at* ¶¶11-12.

\(^{129}\) “Qualification tests” is used in the following summary to refer to the range of managerial fitness, propriety, and qualification tests that may be imposed by supervisors.
3. Qualification tests should be applied both at the initial authorization stage and on the occurrence of specified events;

4. Qualification tests should be met on a continuous basis;

5. Supervisors should consult with each other where managers or directors who may have a material effect on the operations of the conglomerate and these individuals are or were previously managers or directors of another regulated entity within the conglomerate;

6. Supervisors should consult with each where managers or directors who may have a material effect on the operations of a regulated entity are or were previously managers or directors of an unregulated entity within the conglomerate; and

7. Supervisors should communicate with the supervisors of other entities within the conglomerate when managers, directors, or key shareholders do not meet qualification tests.\(^{130}\)

As discussed below, effective implementation of these principles requires efficient and effective informational flows, both among regulators within a jurisdiction and across jurisdictions as well as based on notice from regulated entities to relevant supervisors.\(^{131}\)

\(^{130}\) *Fit and Proper Principles Paper* \(^{¶}13-14\), in *JOINT FORUM 1999, supra* note 91, at 40.

\(^{131}\) *Id.* at \(^{¶}17-18\).
7. Information Sharing

One of the challenges associated with the supervision of financial conglomerates is the role of multiple supervisory bodies, both cross-sectorally as well as internationally. In particular, the arrangement of business activities in comparison to the formal legal structure (i.e. global business lines versus business activities contained within specific legal entities) and the assignment of corporate control on a centralized or local basis may greatly affect the information available to supervisors in their assessments—indeed of the activities of the conglomerate. In recognition of these problems, the Joint Forum has placed a strong emphasis on effective information sharing and in identifying types of information that may be relevant to supervisors in particular situations, but that may not be immediately available from examination of a conglomerate’s activities in a single sector or within a single country.

A Joint Forum Task Force that examined the structure and operations of large financial conglomerates found that the structural and operational choices within a particular conglomerate had a significant impact on the appropriate approach and concerns for effective supervision by a particular supervisor. Moreover, varying understandings of the structure and operations of a particular conglomerate by supervisors may lead to critical regulatory gaps or failings, as operations. To account for these formal distinctions, the Joint Forum recommends exchanges of information among supervisors both with respect to individual conglomerates as well as more general supervisory techniques and approaches, with the ultimate goal of enabling the relevant

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133 See generally Framework for Information Sharing, supra note 132, at ¶¶15-36.

134 Id. at ¶¶35-36. See also id. at ¶¶37-62 (discussing approaches to supervisory information sharing in the event of creation of a new conglomerate, authorization of a new activity or activity in a new supervisory jurisdiction, changes to conglomerate structure, and ongoing supervision).
supervisors to establish a full understanding of the structure, strategy, and risk profile of the conglomerate.135

To aid in the process of assessing a conglomerate and in formulating an effective supervisory strategy, the Joint Forum recommends the use of a conglomerate supervisory questionnaire as a supplement to other supervisory methods.136 This questionnaire is designed to elicit information on the conglomerate’s organizational structure, corporate governance, and management oversight structures; its risk management practices; and on the overall corporate audit and control environment.137 The Joint Forum also recognizes that emergency situations may require specialized types of information that often can not be determined ex ante, and that having in place effective systems for exchanging information is essential in allowing supervisors to develop rapid and effective responses. In anticipation of these requirements, the Joint Forum has sought to identify types of information that are likely to be relevant in crafting effective crisis responses, such that supervisors will be better prepared to make and receive requests from other supervisors.

The Joint Forum recommends a number of guiding principles in order to facilitate information sharing:

1. Sufficient information should be available to each supervisor to effectively supervise the regulated entities within the conglomerate, reflecting both the legal and regulatory regime and the supervisor’s objectives and approaches;

2. Supervisors should raise with other supervisors—and respond to such requests in a timely manner—material issues and concerns;

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135 *Id.* at ¶62.
136 *Id.* at 63.
137 *See generally id.* at 75-81.
3. Material and potentially adverse emerging issues and developments should be communicated to the primary supervisor in a timely manner;

4. The primary supervisor should share information affecting relevant regulated entities with other supervisors; and

5. Supervisors should establish and maintain contact with other supervisors and establish mutual cooperation and trust.\footnote{138}

These principles are intended to embody and provide guidelines for the implementation of the concerns reflected in the Framework for Supervisory Information Sharing.\footnote{139} The Joint Forum also endorses principles on information sharing promulgated by the G-7 Finance Ministers;\footnote{140} in many respects these duplicate the Joint Forum’s own principles and the structure established in the Framework.


\footnote{139} See supra §II.B.2.

\footnote{140} These principles are: authorization to share and gather information; cross-sector information sharing; information on systems and controls; information about individuals; information sharing between exchanges; confidentiality; rejection of formal agreements and written requests; reciprocity; passing on information that furthers supervisory purposes; and removal of laws preventing supervisory information exchange. See Information Sharing Principles, supra note 138, at 112-113.
5. **Coordination**

In addition to high-levels of communication and information sharing among regulators, the Joint Forum also recommends the designation of a single supervisor to facilitate timely and efficient information sharing—a coordinator,\(^{141}\) or as it is sometimes known, lead regulator. Instead of prescribing a specific role or function for the coordinator, the Joint Forum recommends a context-specific approach that considers a range of factors, including supervisory objectives and approaches, structural legal requirements affecting conglomerates, group organizational structures, the risk profile and structure of the conglomerates, the availability of information from the conglomerate to individual supervisors, the available forms of information sharing, supervisory resources, and the overall regulatory burden imposed.\(^{142}\) In certain situations, appointment of a coordinator may even not be appropriate.\(^{143}\) To aid regulators in assessing the need for and role of a coordinator, the Joint Forum has recommended seven guiding principles:

1. Coordination arrangements should provide for certain information to be available in emergency and non-emergency situations;
2. The appointment and identification of a coordinator should be at the discretion of the relevant supervisors;
3. Supervisors should agree amongst themselves on the role and responsibilities of a coordinator;
4. Arrangements for information flows between the coordinator and other supervisors should be clarified in advance;

\(^{141}\) *Coordinator Paper* ¶2, in *Joint Forum 1999*, supra note 91, at 115.

\(^{142}\) *Id.* at ¶¶4-9. For a discussion of information sharing in the context of conglomerate supervision, see *supra* §II.B.3.

\(^{143}\) *Id.* at ¶5.
5. The coordinator should not constrain the ability of other supervisors to carry out their responsibilities;

6. Identification of and allocation of responsibilities to a coordinator should be predicated on the expectation that doing so would enable supervisors better to carry out the supervision of regulated entities within the conglomerate; and

7. Identification and assumption of responsibilities by a coordinator should not create a presumption that responsibility has shifted to the coordinator.144

Identification of the relevant supervisor according to these principles should be “apparent,”145 though the Joint Forum also suggests several possible approaches. These include the supervisor of the regulated parent entity; the supervisor of the dominant regulated entity within the conglomerate, even where it differs from that of the parent; the supervisor of a parent-level supervised holding company; and, where the parent is unsupervised, the dominant regulated entity within the conglomerate.146

144 See id. at ¶¶10-21.
145 Id. at ¶13.
146 Id. at 123.
7. *Summary and Analysis*

The most comprehensive component of the Joint Forum’s recommendations are the capital provisions, and particularly the emphasis on double-gearing. However, the inclusion of Fit and Proper, Information Sharing, and Coordination principles demonstrates a recognition that the risks of conglomerates are not addressed by capital standards alone, and that effective supervision must be customized to account for the particular corporate and operational structure of a particular conglomerate. Inclusion of these principles is essential in order to develop a supervisory regime that is capable of accounting for the wide range of variation in conglomerate structures. While these principles are largely lacking in specific details and provisions regarding implementation, effective operationalization is also likely to vary depending on the background supervisory regime; the principles merely identify important elements in developing an effective supervisory regime.