



*Risk and regulation  
of financial groups and conglomerates*

Convergence of financial sectors

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Edit Horváth – Anikó Szombati





# RISKS AND REGULATION OF FINANCIAL GROUPS AND CONGLOMERATES

*Convergence of financial sectors*

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## *1. Introduction*

One of the most important characteristics of recent years has been the increasingly closer contact among financial intermediaries on the financial markets. This has involved partly the strengthening of cross-border connections, partly the fading away of borders among financial sectors, as well as the emergence of financial conglomerates incorporating different types of financial service providers. The development of information technology and the process of deregulation taking place on the financial markets push actors clearly in this direction. From the viewpoint of satisfying customer needs, the expansion of international companies is the most important factor in motivating financial institutions to enter the international market. Large, international financial service providers rarely remain within the framework of one sector. By establishing financial conglomerates they aim to satisfy all the financial needs of both corporate and retail customers at one and the same point .

The growth of financial conglomerates has been very spectacular in the past ten years. In parallel with fusions, mostly within the country and characteristically within the sector, independent and well functioning institutions become under the control of large international financial service providers in order to exploit potential synergic advantages. This has been beneficial not only from the viewpoint of increasing financial strength but by coordinating activities of different sectors financial innovation has accelerated, too.

Institutions safeguarding the stability of the financial system have to monitor the complex products and processes thus created and – in parallel with the innovations or only a little bit behind them - find appropriate regulatory responses to the arising challenges. From among financial market tendencies the convergence of market players, thus the higher risk of “contagion”, the complexity of conglomerates and the scale of their activity, and the efforts to make use of regulatory arbitrage represent the most important problems which regulators have to solve.

All this has to be undertaken in an environment where borders among nations and in relation to the activities of financial institutions are disappearing. Consequently, one of the most important challenges is to create the basis of cooperation of supervisory institutions, which are still organized on a national basis, and to ensure com-



plete supervision of market players. In the course of this work the diversity of the supervisory structure, which is traditionally based on the type of activity, might be a problem. The need to enhance efficiency in the protection of investors' interest over and above sectors can be emphasized due to the diversity of realization and motivation of either intra-group transactions or market transactions among independent actors.

This study aims to review forms of cooperation already existing and to demonstrate regulatory reactions on the level of codification prevailing in some economic regions. The paper pays special attention to the activity of the inter-sectoral coordinating forum set up under the aegis of BIS with the purpose of regulating conglomerates, the European Council's draft directive based mostly on the Basle recommendations, and tries to evaluate the preparedness of regulators in Hungary. In the first part of the study the phenomenon of financial convergence will be thoroughly investigated. We overview the most important forms of realization, giving a detailed description of their methodology and regulatory problems caused by them.

Then follows a detailed analysis of financial conglomerates. First, the factors behind their emergence and the source of problems will be examined. After theoretical explanations two cases will be presented, where supervisory institutions were unable to overcome the problem of complexity of the given institutions, which regrettably caused the disappearance of depositors' money and led to several unlawful acts.

The next part – as a lesson of the case studies – overviews the resulting regulatory resolutions. First we briefly overview the 2001 year-end findings in relation to the differences in the regulatory environment set up by the independent regulators of the three sectors. Then we summarize principles and proposals generated by the inter-sectoral conciliation forum to regulate financial conglomerates, serving as guidelines for the majority of national regulatory institutions.

Subsequently, the paper overviews the actual, constitutional regulatory framework already accepted. It outlines legal regulatory responses of the United States and Australia concerning the challenges of the regulation of conglomerates. The most detailed descriptions are the parts on the European Council directives relating to consolidated supervision, the post-BCCI Directive and the directive drafted on

Financial Conglomerates. It overviews considerations and arguments behind the setting up of the regulatory structure, and regarding most important segments details of the regulation are outlined, too. The structure of the chapter helps to follow the chronological development of regulation on the basis of market incentives and regulatory considerations, which give an explanation for the evaluation of the present and planned regulation.

In the last part of the paper the regulation of financial groups in Hungary is detailed. Consolidated supervision of financial groups existing in Hungary is at the present covered only by the Act on Credit Institutions and in the regulations of the Trading book. However, the requirements specified in these regulations are not in accordance either with EU regulations in force as of the nineties, or with the special risks of financial groups. Nevertheless, legal harmonization is mandatory for Hungary in this field, thus the modification of present rules will be inevitable in the near future.

## 2. *Financial convergence*

Banking, insurance and security trading,<sup>1</sup> the three, relatively segregated **financial fields**, abandoning their former institutional separation and in accordance with positive regulatory changes, **have become more and more close to each other** in increasingly varied forms. Furthermore, this is not only an **institutional development**, regarding only ownership relations; products and services offered by other sectors have started to turn up in the **activities of individual institutions**, too. First of all banks had to face the competition of savings constructions offered by the two other sectors, very similar to their deposit products. However, the investment services of universal banks indicate that competitors expand the borders of their activity, too. This trend is summarized in the literature as **financial convergence**.

The **higher** the **organizational integration** of the activity of different sectors, the **stronger** is the convergence in the territory given, since the possibility to coordinate activities continuously is here the highest. In this sense convergence is maximal if the organizations created realize all three financial activities under common control. From among institutions representing varied sectors, so-called **financial conglomerates** that operate their member companies representing particular sectors in a holding form have outstanding importance due to their worldwide presence. On the **lower level of convergence** organizationally independent institutions, being aware of their mutual interests, cooperate in some form or other, which might involve a joint appearance vis-à-vis clients, but can be business contact, too.

From the **point of view of regulation**, cooperation among sectors requires increasing attention from the perspective of the real area of **risks and responsibility**, and connected with that the continuous presence of **solvency**. Hereunder the study introduces those forms of convergence, which do not yet mean, or only partially mean, an organizational relationship. Subsequently only financial conglomerates will be investigated.

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<sup>1</sup> There are several rankings that categorize financial activities. The present study uses the above ranking – segregating banking, insurance and investment services activities by sectors. The main reason for this is that these are the sectors which are mentioned by name in the definition of financial conglomerates in the focus of the study.

## ***2.1. Risk transfer mechanisms***

From among the forms of financial institutions' convergence the reallocation of risks is the connecting point, which - although hardly to be followed up in an organizational sense - gives new elements to the former risk exposure of institutions. Efficient management and risk management of comparable portfolio elements involves more or less the same task for financial institutions acting in different sectors. The major difference is in the place and the way of undertaking risks. Financial service providers – on assuming **credit, insurance, market or operational risks** – have to make decisions about the future management of risks. Concerning the structure of their balance sheet, capital supply and strategy, they may decide to **keep, hedge** with opposite positions, or **transfer** risks to another institution against some fee.

Differences in the regulation of various sectors have an important role in decision-making, especially those which relate to the extent of capital coverage of risks. If there is a well functioning and effective risk-measuring system in place, institutions are able to distinguish properly between the **regulatory capital requirement** of the given type of risk and **the economic capital, which is needed to cover the real risk**. If there is a considerable difference in favour of the former, the institution might feel encouraged to apply active risk management techniques. This might involve, among other things, the sharing of risks with other institutions. Assessing the real extent of risks, or calculating the **attainable yield** on risky assets is inevitable on the side of the recipient, too. The parallel investigation of these two factors – besides the **willingness of assuming risks** – is the major criteria behind the decision to take over risks. Above and beyond comparing yields and risks differences in accounting, taxation and legal rules might be taken into consideration as well. From among risks arising in particular sectors financial instruments and methods were developed to transfer and sell risks first of all in the credit and insurance market and operational field. Credit risks are transferred mostly via **securitisation** to the capital market and following that they very often end up in the balance sheet of insurers. The transaction is concluded sometimes through **direct sale**. The appearance of insurance risks in the capital market also often takes place through securitisation, generally in the form of issuance of bonds connected to natural dis-

asters. Generally, the final product of these transactions will be an element of a portfolio, the **underlying** of which **buyers do not have an overview**, thus they have no opportunity to influence the characteristics of the risks. In taking over market risks there are no designated sectors or players, generally it involves a maturity transformation. Each sector might be equally interested in transferring operational risks; those who assume the risks are mostly insurance undertakings with direct contracts or, with the help of securitisation, actors of the capital market.

### 2.1.1. Transfer of credit risks

**Risk management regulations** relating to banks are extremely strict regarding credit risks. In order to cover expected losses banks have to build **provisions** and for unexpected risks they have to present at least 8 per cent **capital compared to their risk weighted assets**. Beyond that there are **limits on concentration**, which motivate institutions to diversify their portfolios.

A strict regulatory framework containing quantitative requirements motivates credit institutions to manage their credit portfolio in a way that their regulatory capital requirement should come as close as possible to their real risks measured by them. The most frequent case of the realization of these considerations is, when **credits of high quality clients** are sold to members in sectors with less stringent regulations. This is beneficial for insurance undertakings because they acquire investments with higher than risk-free yields, whereas they do not have to make lending decisions, which require special knowledge. And banks may cut back their portfolio of assets with 100 per cent risk weight.<sup>2</sup> **Direct sale of client loans** might be a way out, even if the limit of large exposures is nearly reached. Banks appreciate their contacts with clients built up over a long time and based on mutual confidence sometimes more than the impulse to reject clients due to certain capacity or administrative barriers. In such cases it is a regular business to sell client loans for syndicates or individual investors while retaining revenues from commissions and other fees.

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<sup>2</sup> This incentive is expected to be eliminated by 2006, with the introduction of the new Basle capital adequacy ratios. There will be a possibility to render 20 or 14 per cent risk weight depending on the method chosen - to the best qualifying corporate debts, which obviously cuts back the 8 per cent capital requirement to a similar extent.

There are similar considerations behind the **securitisation of debt portfolios** when banks sell their loans collected to the liquid capital market. Behind asset-backed securities (ABS) issues of banks there are generally portfolios of homogenous debt categories (mortgage and car loans, credit cards), which from the investors' point of view represent alternatives with different risks and simultaneously different yields. Although the willingness to assume risks is by far not equal among market players, a significant part of the insurance undertakings is willing to buy ABS papers belonging to the lower segment of the investment category (with A or BBB rating). Their aim is to take advantage of the interest differential compared to bonds with the same rating. The other form of insurance sector participation is the financial guarantee undertaken for ABS papers with high investment rating (AAA or AA), or sureties via monolines.<sup>3</sup>

Similarly to the ABS papers investment banks and other investment service providers issue securities, which are covered by corporate bonds and debts purchased on the secondary market. These so-called **collateralised debt obligations (CDO)** are also becoming increasingly important in the portfolio of insurance companies. Structured financial forms representing usually high quality debt allow spreads on corporate bond yields in the same investment category to be skimmed off. Furthermore, they have the favourable feature that they enable use to be made of the benefits of diversification, since portfolios diversified among sectors and geographical regions have lower individual risks. Portfolios represent different risk categories, among which one can select according to risk appetite. That is the reason why insurance undertakings are open for these and other investments made through leverage, since this is the method whereby they are able to meet **explicitly the implicit expectations of investors** regarding **attainable yields** over and above government paper yields.

Banks make use of the role undertaken by insurers and other institutional investors when articulating their risk-managing attitude. Often they conclude insurance contracts against political risks in the case of loans granted in less developed or developing countries, thus shifting systemic risk of their loans to the insurers.

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<sup>3</sup> These are alliances of insurer companies with sufficient capital supply on their own, which provide guarantee of timely payment for huge, high quality debt portfolios. Since they are highly leveraged, they have to satisfy strict capital adequacy requirements and rating agencies also scrutinize their activity.

A group of **credit derivatives** is a proper measure for shifting over the total credit risk. These types of derivatives offer coverage against a certain fee for the declaration of the default of the client. The most widely used type is the **credit default swap** (CDS). With this instrument investors agree to exchange a bank's claim for a certain amount of money following the occurrence of a predetermined event (which is mostly the declaration of default). On aggregating similar contracts they may create CDS portfolios. In this case, too, however, only high quality debts are taken into consideration. The next group of credit derivatives is **total return swaps** (TRS), which compensate the decline of interest collected below a certain level or the deterioration of the debtor's rating under a previously determined level.

The volume of debts sold through credit derivatives has been increasing since 1999, when the first survey by the British Bankers' Association was made, and it was higher than USD 1 trillion in 2001.<sup>4</sup>

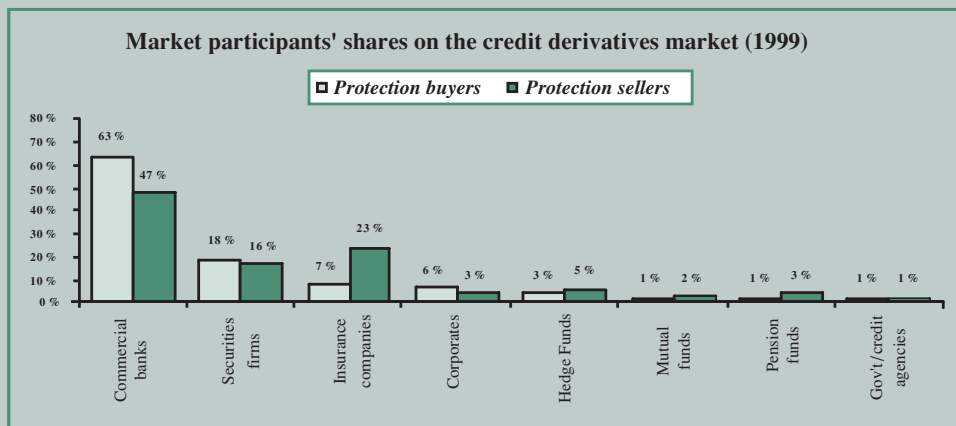
Another, relatively less popular form of insurance company involvement in credit risks involves so-called **contingent capital**. This is a type of insurance whereby the insurer agrees to raise capital in a bank following a credit risk-related trigger, for example, if the annual credit losses of the bank rise above a certain value, through purchasing equity or in the form of subscribing subordinated debt. Since the bank can use this capital in the future as coverage of other risks, this form of insurance is less frequent.

The common feature of the above-mentioned methods is that by using them credit institutions are able to **shape their capital position flexibly**. In a growing economy, when improvement in the capital position and decline in risks is expected, a preliminary capital surplus may arise. Instruments developed to transfer credit risks offer the possibility of making use of these surplus liabilities. And if the capital position is deteriorating, banks may seek remedy for the problem on the sellers' side in a flexible way. Thus, as a positive externality of risk transfer mechanism, management of the income and capital position of banks will be easier, which presumably decreases the cyclical fluctuation of these variables.

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<sup>4</sup> OECD (2002).

Chart 1.



Source: OECD (2002)

Primary source: British Bankers' Association

### 2.1.2. Transfer of insurance risks to the capital markets

Risks traditionally taken by insurance undertakings are non-financial risks arising from accidental or not foreseeable events, which those insured have shifted over to insurers against payment of a certain fee. The management of these risks is traditionally made through the reinsurance contracts of insurers. These contracts, however, will be re-negotiated each year, which means that conditions change according to the prevailing premium level. If the capital of re-insurers preliminary declines due to disbursements following large catastrophes and they have to raise prices, insurers may sign contracts with them year by year at these prices only.

As an alternative, insurance undertakings have also appeared on the suppliers' side of the risk transfer market. In this market they are able to cover their risks for several years at predetermined prices **independent of the cyclical price changes**, without being exposed to the high partner risk of reinsurers.

One of the most frequent forms of alternative risk transfer involves **appearance on the capital market in the form of securitisation**. The point of the technique is that bonds are issued in connection with new types of risks, for example weather or



catastrophes, the buyers of which get proportionally lower interest or principal redemption because of the compensation liability, if the insured event actually occurs. These bonds target banks, pension funds and other mutual funds, for whom insurance-based investments are especially favourable because they represent a risk profile which is hardly in correlation with the traditional portfolio, which might result in a considerable increase in risk-adjusted yields. The disadvantages of the capital market solutions are, however, high transaction costs and low value of individual contracts, which means they offer a real alternative only if the price of re-insurance becomes considerably higher. The next problem is that there are only partly reliable mathematical models available for risks represented by these securities, as a consequence of which these bonds' rating is below investment category. As we have seen before, **transferring risks can have an important role in the balancing of the capital position of insurers, too.** They use their surplus capital the more, and to an increasing extent, to assume credit risks, and if their capital adequacy falls below a critical level, they can counterbalance it on the alternative risk transfer markets.

### 2.1.3. Transfer of market risks

Due to the unevenness of cash flows and the inherent risks of investment assets owned, none of the three sectors can be regarded as the main transferor or recipient of market risks. As a general principle, institutions want to minimize the risks of **unforeseeable interest rate or exchange rate changes.** One of the accepted ways of that is the use of **derivatives** related to market instruments. In order to eliminate interest rate risks **bonds with an embedded option** (callable or puttable) might be issued connected to predetermined interest levels. Insurers may neutralize the liquidity risk of exercising the options built into their products **by buying or issuing similar callable or puttable bonds**, which are flexible in maturity. Mostly in the case of pension funds it happens that they conclude **swaption** deals to ensure guaranteed yields in the long run. In these cases by calling the option an interest rate swap starts: the fund pays a predetermined floating yield, against which it gets a fixed yield, which is preferably near to the yield promised.<sup>5</sup>

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<sup>5</sup> This instrument is an appropriate method for covering foreign exchange risks as well, with the modification that swap takes place on an occurring predetermined foreign exchange rate, instead of on a predetermined interest rate level.

Participants, however, can create completely hedged positions only very rarely, since the special products in the portfolios and their maturity is different from that of the instruments traded. Consequently, a certain level of basis risk – as a concomitant of most derivative transactions – still falls on the institutions. Long-term **OTC derivatives**, on the other hand, as an alternative against standard products traded in large volumes, generate **high-level partner risks**.

#### 2.1.4. Transfer of operational risks

**Operational risk** is a special type of risk inherent in the activity of financial institutions, in the case of which **there is no chance of closing the position quickly and free of costs** – unlike in the previous cases. Consequently, **all sectors are interested in lessening the damaging effects of these types of risk** which are handled as inherent features, which can not be eliminated completely and which are not to be diversified within the institution. As a solution for handling these risks, **setting aside a certain amount of capital**,<sup>6</sup> **the insuring and placing of them in the capital market** are offered – just like in the previous cases.

**Insurance contracted on operational risks** is a relatively cost-effective method, which shifts damaging consequences to an external party in exchange for paying a fixed amount. Contracts like this are also regarded as a positive factor by credit rating agencies in their analysis. The most important product known in this field is the Financial Institutions Operational Risk Insurance (FIORI), elaborated by Swiss Re for the institutions of the financial sector, which refunds about 68 per cent of the damages arising from operational risks known until now. As a **disadvantage** of the insurance construction it is often cited that it **covers only risk to be expressed in numbers**, and the speed of refunding after the damage is uncertain. The insurer might also dispute the legal basis of the refunding, and, above all, **the limited capacity of insurers** might also be an obstacle. Moreover, it can be a problem that the coverage provided by insurers may not compensate damages caused by long-

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<sup>6</sup> This might happen on a voluntary basis, too. The inauguration of the Basle recommendation, however, might cause a turnaround in this field by defining the volume of the capital expected by regulators.

term reputation effects. On the side of the recipient of the services the separated development of **insurance and capital strategies** might be a problem in realizing the actual extent of the coverage.

The **selling of operational risks on the capital market** is not yet a frequent solution. The most important reason for this is the **lack of the unified market**, due to the uncertainties in pricing. Insurers on the supply side could encourage commencing of trade the most, by quoting prices they could ensure the required liquidity.

### 2.1.5. Risks from the point of view of regulation

Subsequent to assuming risks there might be more factors behind its re-allocation and selling. One of them is the **use of efficient risk managing methods, but the use of diversification effects and the differences in the regulations should be regarded as well**. The higher the difference between the real danger of risks and capital requirements expected as coverage, the greater the push for different capital adequacy requirements of individual sectors to rearrange portfolios. In particular, unregulated insurance risks assumed by banks and the capital requirement of insurers' investments – over and above diversification requirement – and the need to consolidate the limits with similar content should to be mentioned from among unsolved problems in cross-sectoral regulation.

From the viewpoint of systemic stability, the efficient allocation of risks on its own does not threaten the financial system. On the side of regulators, increasing risk awareness is to be understood as a positive development. Nevertheless, the drastic increase in volumes traded in the risk transfer markets in recent years raises doubts about whether investors made a comprehensive analysis of risks prior to concluding their deals. In any case, regulators have to consider the so-called **learning curve risk**, since, due to considerable differences between the environment of banking and insurance, which is manifested in the legal regulations, the two sectors can close up more rapidly than the understanding of each other's risks.

Ways of realization of risk transfer might be quite different regarding the extent of coverage, too. The core activity of **insurers** is precisely the commitment without

individual coverage in connection with predetermined incidental events. If, however, this involves the **taking over** of an ever growing volume of **credit portfolios**, the lack of coverage and the impossibility of tracing commitments may generate even a systemic risk if the insurance event occurs. This is especially true for monolines, the insurance associations which undertake credit risk of low risk profile portfolios in large volumes. Their commitments are usually based on the **ratings of rating agencies**, but the most important disciplinary force in assuming risks is also the evaluation of the credit rating agencies on the stance of the institution. The external rating, often the sole evaluation approach, however, means another risk factor as the transmission is growing between those who know the real position of the debtors and those who bear the credit risk.

Another problem regarding the safety of the financial system is the **growing mutual dependence** between the two institutions on both sides of the risk transfer **due to long-term transactions**. The seller has to follow continuously the position of the debtor. The buyer, however, has to stand for the debtor in case of default. Often banks continuously investigate the capital position of their partner insurers in order to be convinced of their efficiency.<sup>7</sup>

**Regulatory authorities** have to be in the position to handle new financial instruments and investment forms. Due to **sharpening market competition** and **high yield promises** to investors, the increasing risk awareness of market actors is often accompanied by a growing propensity to assume risks. Institutions responsible for systemic risk have to be in a position to follow the **flow of risks**, and to be aware of who is **bearing ultimately the non-expected risks** turning up in the three sectors. They must also be aware that the **concentration of risks** does not reach a critical level. As a result of cross-sectoral harmonization a regulatory structure is to be developed, where similar types of risks are treated in the same way, i.e. **capital adequacy regulations** are not different from each other. This is the only way to achieve an adequate level of capital coverage against non-expected risks turning up in any of the sectors.

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<sup>7</sup> Besides efficiency, however, insurers also have to have a willingness to pay, in order to avoid the suffering of banks in the case of the debtor's default. Following the fall of Enron in December 2001, insurers refused payment, referring to the fact that J.P. Morgan Chase Bank lent credits to the company knowing that it would not be able to refund the debt. (The Economist, January 26 2002) The occurrences of insurance events of this type are serious touchstones of the viability of credit risk insurance constructions.

## *2.2. Cross-sectoral investments*

The complete institutional separation of financial service providers can be eliminated in many ways. Mergers and fusions are possible milestones in the development of conglomerates. Tight business contacts with total institutional separation – for example buying, insuring or transforming risks through different derivatives – is a probable method of the manifestation of financial convergence. Moreover, there are also partial acquisitions and investments among institutions acting in different financial sectors.

Behind cross-sectoral investments there are generally **strategic considerations**, since organizations often look for possibilities in **using more complex marketing channels** or products to ensure their development. Finding a strategic partner is the most obvious way to widen the scope of services offered, instead of implementing an expensive product development. Agreements legitimated with investments or partial cross-ownerships might be different regarding the depth of the cooperation. The first step in the cooperation is the use of **cross-selling channels**. The so-called **packaging** needs a tighter integration, when standard products sold in both sectors in large volumes (i.e. banking and insurance) will be offered combined with each other in one place. By intensifying this contact **new, comprehensive financial products** could also be developed. On a higher level of financial intermediators' progressive integration, possible **synergic effects** could be used more intensively. This might be evident first of all in **declining costs**, but it can be manifested in a considerable decline in risks due to **diversification**.

The intensification of cooperation can be hindered in several ways. The most frequent ones, however, are the **limits in the scope of activity** set by regulators (see later on in detail). These might involve provisions encouraging the maintenance of the separate legal entity status of the institution – for example through differences in the calculation of the capital requirement – but they can be manifested in actual prohibitions, too.

### 3. Financial conglomerates

An increasing number of institutions try to overcome the problem of the ever growing range of products in the financial markets and the increasing pressure to exploit advantages of efficiency by integrating financial services to the largest degree possible. The vanishing of borderlines between the three big sectors and institutions representing them in the last ten years has resulted in the establishment of financial conglomerates acting as dominant players in the market.

The specialty of the conglomerates is that several organizations with significantly different activity will come under common leadership. In the institutions of financial conglomerates at least two of the banking, security-trading or insurance activities are represented, whereas the whole of the conglomerate's operation is explicitly connected with these financial sectors. However, there are also conglomerates where non-financial activity is dominant (for example in trade or car manufacturing).<sup>8</sup>

**The definition of a financial conglomerate** is by no means coherent due to the differences in individual countries in both financial structure and the techniques of regulation. Since the possible scope of activity of banks is just as different in individual geographical regions as the definition of insurance activities, or the connection of banking and security trading activities, there is no precise and consistent definition. The Tripartite Group, the conciliation group set up by the regulators of the three financial sectors defined a conglomerate as follows:

*A group of companies under common leadership, the exclusive or dominant activity of which incorporates at least two of the services provided by the three financial sectors (banking, investment services and insurance).*<sup>9</sup>

#### 3.1.1. Factors behind the establishment of conglomerates

The most frequently cited consideration behind the setting up of conglomerates is the exploitation of **cost benefits**. Service providers in different sectors can sell each other's products to their existing clientele while cutting back administrative, marketing and operational costs. In a different interpretation: in a consolidated organization,

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<sup>8</sup> The actual category of these can differ by countries.

<sup>9</sup> Tripartite Group of Banking, Securities and Insurance Regulators (1995).

at a given level of fixed costs, the efficiency of selling is increasing, whereas the scale of products offered is growing. It may have quite important benefits that, with the merger of influential service providers in different sectors, **diversification** among products and regions **may result in a significant decline in risks**. **Legal, cultural and taxation considerations, the extent of market concentration** and the specialties in the development of the financial intermediation system of a given country are involved with these benefits, too. Finally, deregulation in the previous period and cross-border activities resulting from the formation of the unified European market can be mentioned among the factors motivating the establishment of conglomerates.

### 3.1.2. Forms realized in practice

The financial conglomerate is not a new organizational form. Already **twenty years ago** in the United States there was a wave of conglomeration in the retail financial sector with the purpose of **establishing financial supermarkets**. At that time the legal regulation in force prohibited the setting up of universal banks, thus an activity involving a wide range of financial services could be started only with the establishment of conglomerates. It was then that Sears acquired Dean Witter and Coldwell Banker, American Express bought Shearson, Bank of America purchased Schwab, and Prudential obtained Bache. Enthusiasm, however, faded quite quickly, and the concept of specialization and quality service came in the foreground again in the early eighties.

Globalisation and the development of technology, however, gave an impetus again to bringing about international holding companies. Considerations of increasing the efficiency of an organization's operation, which constituted the clear motivation behind the establishment of conglomerates in the past ten years, were realized in practice first of all through **acquisitions** made by big institutions with high capital strength. The expansions of the Hollander ING Group, the German insurer, Allianz or Deutsche Bank are examples of this.

The growing interaction within companies in different sectors – in parallel with positive changes in regulation, or probably with a special licence prior to that – resulted in many cases in **mergers**. Generally, this was accompanied by the rise of stock exchange prices, which inspired company managers to establish ever bigger and

more complex organizations – with the motivation manifested in equity options in the background. From among cross-sectoral mergers the most widely cited example is the establishment of Citigroup by the merger of Citibank and Travelers Group in 1998. Occasionally, generally in countries with less developed financial markets, it happens that a dominating institution – in most cases a bank – takes up activity in another sector through **founding a company**. In Hungary the OTP Group makes use of this technique.

### ***3.2. Challenges for regulation***

Financial conglomerates represent a new structural element in the financial intermediation system with their magnitudes and volumes of transactions, which represents an unprecedented challenge for the regulatory authorities. The magnitude of their cross-border activity intertwining economic systems is considerably beyond of that of previous institutions acting within the borders of a country. The economic strength based on that and the legislative influence is also much more dominant than it was earlier. The high volume in itself deserves special regulatory attention. In addition, the diverging activity of these organizations often involves potential dangers due to the complexity of the connection network, which would not appear in the case of separated institutions. The leaders of conglomerates, however, often conclude transactions that aim at circumventing prudential regulations. Below we first investigate problems arising due to the complexity of organizations. Then follow contagion effects, which can be triggered by market developments but they may happen through intra-group transactions, too, if risk sources are not separated efficiently. Later, we introduce briefly the characteristic forms of deliberate violation of prudential regulations.

#### **3.2.1. Complexity**

**Systemic stability effect.** The activity of conglomerates dominating the financial system might cause a serious danger to the stability of the financial system of the country where it operates. The high level of aggregation and the coordination and risk management of widespread activity generates a growing operational risk, which increases the instability of institutions even in the case of prudent operation.



**Increasing probability of moral hazard.** The extent itself, however, might be the source of moral hazard, too, since extreme risks and activities assumed under the principle of “too big to fail” are the consequences of a virtually enlarged scope of activity due to the opaqueness of operation. An additional manifestation of moral hazard occurs when an extreme extent of risks are shifted to the banking division within the conglomerate, with the presumption that ultimately the risks of banks might be shifted over to the deposit insurance system or the central bank.

### 3.2.2. The danger of contagion

**Risk concentration in the traditional sense.** In the case of member companies operating in parallel with each other in various sectors, the problem of assuming **large exposures** is an especially important one. Investigation of this problem must be concluded in several dimensions. When investigating credit or market risks, the concentrated claim against one client or sector means an extreme exposure. This is risk concentration in the traditional sense, which is to be avoided by creating quantitative limits inspiring diversification.

**Risks concentration due to the presence in more sectors.** In the case of financial conglomerates, however, the occurrence of one certain event may influence diverging risk factors of different sectors in a similar way. The most obvious example of this is the consequence of natural disasters, which – besides the losses suffered by insurers – may also cause difficulty in the banking sector due to insolvent debtors. The interaction of risk factors in different sectors might be apparent following certain money market events, for example devaluations, when deterioration of the repayment capacity of banking clients is accompanied by the loss of value in securities portfolios. The changing mood of investors due to negative developments in one or the other developing country<sup>10</sup> may result a collective flight from instruments previously regarded as uncorrelated, which might badly shake financial institutions operating in the country given.

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<sup>10</sup> This phenomenon is called “flight to quality”.

**Risks concentration enforced by the market.** In the case of conglomerates, the risk concentration effects of one sector spread over automatically to the members operating in other sectors. This occurs partly via intra-group transactions on the one hand, and the **reputation effect** enforced by third partners on the other. If, for example, there are severe losses in the brokerage or insurance division of the conglomerate, that may cause liquidity problems in the partner bank, especially, if clients reasonably suppose a tight business relationship between the two institutions.

**Risk profile transforming effects of intra-group transactions.** From among the factors motivating the establishment of conglomerates the most important ones are cuts in costs through intra-group transactions, benefits in the fields of risk management, and efficient allocation of liabilities and capital available. Regarding their form of manifestation they are the following:

- Cross shareholdings
- Trading operations among group companies
- Central management of short-term liquidity within the conglomerate
- Providing loans, guarantees or commitments within the group
- Provision of management services against fee
- Risk transfer via reinsurance
- Allocation of client claims or commitments among group members

The existence of intra-group transactions on its own does not represent a challenge for regulators, since these have a decisive role in achieving the above-mentioned efficiency targets. Nevertheless, the complex organizational structure and the big volume of intra-group transactions might cause a **contagion effect**, in the course of which the financial difficulties of one member of the conglomerate, without efficient firewalls, may spread over to a properly operating member, too.

### 3.2.3. Regulatory arbitrage

**Regulatory arbitrage via intra-group transactions.** The instruments introduced above are appropriate for realizing the phenomenon known as regulatory arbitrage, which means the reorientation of the activity of regulated institutions to members,

which are not, or hardly regulated. Being aware of this, regulators have to be able to follow continuously internal transactions in order to be convinced of the fact that these do not cause any harm either to the clients' or the member institutions' interest. Transactions are harmful if they

- serve capital or revenue transfers from regulated member companies in order to avoid prudential regulation
- are on terms which parties operating at arm's length would not allow (i.e. differences in prices, fees, commissions against market terms) and which may put the regulated company in an unfavourable situation
- can adversely affect the solvency, liquidity or profitability of individual member companies
- involve regulatory arbitrage, which aims at circumventing capital adequacy or other requirements.

**Multiple gearing within the group.** From among techniques connected with the capital adequacy of conglomerates the most widely used is double or multiple gearing. With this technique more than one member company denotes the same capital element as a capital coverage available for covering risks. The core interest of regulating authorities is to prevent this action, since the real capital situation of the conglomerate, i.e. its risk-absorbing capacity, will be worse than indicated by the aggregated individual capital adequacy.

**Indicating credit as capital.** It may cause similar problems if the parent institution acquires funds by rising loans, which it allocates into the subsidiary company as capital. This is the so-called **excessive leverage**, which may cause refunding problems if unexpected risks occur. The same problem can occur if subordinated capital elements raised by the parent company are transferred to the subsidiary as primary capital elements.

### ***3.3. Failures of regulation (case studies)***

#### **3.3.1. Presentation of inadequacies in international cooperation apropos the BCCI case**

The Bank of Credit and Commerce International S.A. (BCCI) was presumably established by its founders right from the beginning with the purpose of circumventing all regulatory control. By creating an organizational structure divided among several countries, operating even within the holding in a very complex structure, consisting of parent companies and subsidiaries, a mesh of bank-in-bank transactions, and both open and secret deals among each other, the founders were successful in bringing about a situation whereby neither any state supervision nor any auditor had an overview of the complexity of the organization's activity. By splitting its organizational structure, book keeping, supervision and auditing, the BCCI group got tangled in a series of activities forbidden by legal rules, among them money laundering, bribery, illegal immigration, support of terrorism, management of prostitution, tax evasion and a host of illegal financial activities – all this in 73 countries, among them the United States and Great Britain, as a multinational holding, for more than 20 years.

##### ***3.3.1.1. Organizational structure***

BCCI holding and one of its subsidiaries operating as a bank were registered in Luxembourg in the early seventies. However, none of the parties executed a banking activity in this country. The other registered office of BCCI was in the Grand Caymans, famous for easy bank establishment and relaxed rules of control. The international transactions of BCCI were made in the London office, which was only a head office. Consequently, the scope of investigation of the Bank of England's prudential supervision vis-à-vis a head office was quite limited. In principle, compulsory auditory reports should have called attention to the violation of financial and accountancy discipline and other illegitimacies. With the decision that BCCI divided its auditors between the offices in Luxembourg and the Grand Caymans, it managed to avoid having any complete overview of its activities.

### *3.3.1.2. Responsibility of regulators*

BCCI managed to infiltrate the financial market of each country it targeted, including the United States and Great Britain. As a first step, it created Commerce and Credit American Holding (CCAH), which as an independent institution got a licence from the Federal Reserve three years later to buy the bank Financial General Bankshares (FGB). Since the Federal Reserve wanted to prevent BCCI collecting deposits in the United States, it compelled CCAH to make a statement that BCCI did not exert any influence on its activity. The statement, however, offered the possibility for BCCI to supply information for the shareholders of CCAH in the capacity of an investment service provider and thus to continue to influence the operation of the holding. Later, BCCI opened branches in several federal states – which was a legal opportunity. In parallel with that, however, it continued with secret bank acquisitions, mostly through nominees, and there was no regulatory counteraction to this. The ultimate goal of the strategy was to merge these branches and banks, which was realized under the name of First American Bank in 1986. The Comptroller of the Currency got knowledge of the acquiring influence of BCCI through nominees and not existing persons in the management of Bank of America and the National Bank of Georgia, though this information was not passed to the Federal Reserve. The Federal Reserve initiated a comprehensive investigation only on 3 January 1991, when it got a clear picture about the extent and ways of BCCI's series of frauds. Nevertheless, it did not commence the closing down of the multinational bank. For the sake of US depositors and the internal market it obtained a USD 190 million contribution from BCCI's principal shareholders in the United Arab Emirates, which was the genuine domicile of the holding, to raise capital in First American and to avoid failure.

It has to be stated that the secret banking operations and accomplishment of acquisitions of BCCI in the United States were enabled by the lack of fundamental cooperation among banking supervision regulatory authorities such as the Federal Reserve, Federal Deposit Insurance Corporation and the Office of the Comptroller of the Currency.

The lack of international contacts among supervisory authorities and their conflicting interests is reflected in the behaviour of the Bank of England, too. The

British supervisory authority tried to hinder the expansion of BCCI in the United Kingdom from the end of the seventies, due to the dubious reputation of the holding. Although in 1988-89 it obtained exact information about BCCI's activities in connection with financing terrorism and money laundering, it did not make any significant move. The first such move was made in early 1990, when Price Waterhouse reported on the considerable loan losses of BCCI, its questionable banking activities, on the suspicion of fraud and the extent of expected losses due to all that. Subsequently, the Bank of England did not initiate the liquidation of BCCI; on the contrary, it decided to restructure and back up the holding. Making use of the stipulations regarding bank secrecy and confidential handling of information, it did not reveal the real position of the holding to investors and other regulators, and it drafted a restructuring programme. Pursuant to this programme the government of the Emirates would have consolidated BCCI, Price Waterhouse would have countersigned the books for one more year, and the Bank of England would have agreed that the holding would be divided into three parts with head offices in London, Hong Kong and Abu Dhabi. The plan was obstructed by an accusatory measure of the New York district attorney in June 1991.

### *3.3.1.3. The failure*

The New York district attorney commenced an investigation into the transactions of BCCI in 1989, first of all on the laundering of money originating from the drug trade. One impact of the questions put by the district attorney was that Price Waterhouse UK, the auditor of BCCI in Britain, initiated a comprehensive investigation, and this investigation accelerated the inspection of the Federal Reserve regarding identification of the owners of First American. This investigation and the accusation set forth impeded realization of the reorganization programme of the Bank of England, since a procedure like that would have resulted in a run against the worldwide network of the bank. Additionally, the evidence that BCCI had pursued illegal activity would have involved a huge loss of reputation for the Bank of England, if it turned out that the latter had participated in the reorganization of BCCI.

The actions of supervisory authorities accelerated in 1991, when the Luxembourg, the Grand Caymans, the British, and US authorities all took measures to draw the

transactions of the bank under supervisory control and to liquidate it on 5 July. With the collapse of the worldwide network millions of depositors suffered losses, and although the wide-ranging investigation brought a lot of things to the surface, the management escaped being called to account due to the resistance of the authorities in Abu Dhabi.

#### *3.3.1.4. Lessons*

The activity and failure of BCCI was a widely discussed topic among both European and US regulators. The transactions, connections, large volume money laundering and other illegal activities of BCCI, and the fact that it could engage in these for more than twenty years induced the creators of prudential regulatory frameworks to undertake serious self-investigation all over the world. Within one year following the failure of the bank, rules regulating foreign banks and bank holdings were supplemented both in the United States and in the EU. The legal rules in the US<sup>11</sup> stipulate as a precondition of the issuance of an operational license the consolidated supervision of the foreign owners of banks according to domicile, and they enable local regulators to obtain access to all relevant information. With this, even the possibility of covering up illegal activities by relying on bank secrecy was eliminated. Moreover, in order to avoid other anomalies, the financial, monitoring and operational conditions of domestic and foreign banks were harmonized.

The expansion of BCCI in the United States went on mostly through **shareholders nominees**. Thus, BCCI obtained voting shares in US banks while avoiding the strict regulations of the FED. This called the attention to the fact that the transparency offered by ownership rules was not satisfactory. Since that time, above a certain order of magnitude owners have to show up even in person to inform regulators about their identity. In addition, important steps were made to make the real transparency of an institution's operation, its management, decision-making structure and responsibility apparent.

The most important lesson of the BCCI case is the lack of international cooperation of the regulatory authorities. Since national supervisory authorities were primarily interested in the protection of depositors in their own country, when con-

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<sup>11</sup> A separate chapter, the review of the Post-BCCI Directive deals with the EU rules.

solidating the domestic branches of BCCI they failed to inform banking supervisors in other countries. Thus, on the one hand, they deprived themselves of the others' information, and they postponed liquidation on the other, with the consequence that the money of a lot more depositors got stuck in BCCI. The result was that 60-90 per cent of the **deposit portfolio estimated at USD 20 billion disappeared**. The careless restructuring effort of the Bank of England meant that the major part of the incriminating documentation ended up in Abu Dhabi, the destination of the managers, who were able to avoid being called to account.

### 3.3.2. The failure of Baring Brothers

#### 3.3.2.1. Events leading to the failure

Barings hit the headlines in early 1995, when it turned out that one single broker in its Asian securities branch had ruined the historical financial institution, which the Dutch ING Bank eventually purchased for a symbolic price of one pound. How could one single person lose all the capital of a 233-year old bank, specifically USD 1.4 billion? Nick Leeson was posted to Singapore as a futures trader in 1992, and he was given strict intra-day volumes and product specific limits.<sup>12</sup> From July 1992, however, he engaged deliberately in unauthorized trading in futures and options. By the end of 1994 he had accumulated losses of about GBP 208 million on an account, the transactions of which he kept secret from his superiors. He was able to do this because he was responsible for both settlement and trading activities, thus there was no efficient control over the futures transactions concluded by him. Leeson, concealing the accumulated losses, reported a profit ten times the result of the previous years, leading to the satisfaction and confidence of his superiors. They understood that the profit was made from arbitrage on the Osaka (OSE) and Singapore (SIMEX) stock exchanges for the same products, so it was a risk free activity for Barings. By January 1995, however, the losses were so high that he had to increase his speculative activities. By 23 February he had purchased futures stock indices in an amount of USD 7 billion and sold futures bond contracts for USD 20 billion on his own. Additionally, he built up options positions, which

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<sup>12</sup> Among them, he had no authority to trade in options, only on behalf of clients.



offered a profit should there be less market fluctuation than the volatility built in into the positions. The earthquake in Kobe, however, shook the market and Leeson to counterbalance it – to hinder the decline in prices – purchased Nikkei futures contracts in huge volumes. In the end, however, there was still a drastic decline in prices leading to the collapse of Leeson's positions and Barings Bank as a whole.

### *3.3.2.2. Factors enabling the series of frauds*

In view of the position volumes built up, the first question concerns how these were concealed from the management, the regulators and auditors, right up to the occurrence of failure.

From among management problems, the one-man responsibility of both front office and back office activities is the most important. Although the incorrectness of this technique was indicated by the treasurer of the group early in 1994 – and this was reinforced by the internal audit in August 1994 – due to the failure of internal communication nothing happened to split these functions. The managers in London did not start to make inquiries about the real nature of the activities of Barings Futures Singapore (the direct employer of Leeson), even though SIMEX indicated its concerns regarding the accounts kept with it and the neglect of margin requirements in two letters in January 1995. Ex post investigations revealed the fact that Leeson did not have a responsible superior who would have monitored his activities and led his operation. Thus it was possible for the trader to have access to continuous liquidity from his parent company to maintain positions<sup>13</sup> without any control. The London centre satisfied the need for liquidity on the condition that this was loan extended for clients, which would be used to meet the margin requirements of the positions in Singapore. Nevertheless, the loans extended in this way were not reconciled with the clients' accounts in London, such that the real use of uncovered transfers remained concealed. By February 1995, however, the financing need of positions became so acute that these transfers were not sufficient. From that point on Leeson made his superiors approve large amounts of payments with the indication that the money did not reach the original beneficiary, although the mistaken addressee refunded it. But even these

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<sup>13</sup> The amount of this at the time of failure was GBP 300 million.

“insufficiencies in operation” did not awake suspicion enough in the management to look into the matter.

The management also made a big mistake in the respect that it did not enter these additional transfers into the large exposure registers. If they had been managed properly as client loans, they should have turned up in the gross limits of the particular debtors. On the other hand, if they had been transferred to Singapore to the own account trade, they should have been entered into the large exposure registers against the Singapore subsidiary, and as an exposure against SIMEX on a consolidated basis.

All this is also worth investigating from the perspective of the regulators. At that time the Bank of England<sup>14</sup> performed the consolidated supervision of the Barings Group. Prior to 1 January 1994, when the large exposure directive of the EU<sup>15</sup> entered into force, the Bank of England was authorized to exempt banks from large exposure limits, if those informed it in advance about the purpose and conditions of assuming the position. In this sense Barings got an “informal exemption” from one official of the Bank of England regarding its positions assumed against OSE. Although the extension of this exemption was beyond the authority of the official, there was no upper limit to these allowances. Following the allowance, Barings used it arbitrarily in its positions assumed against SIMEX and later on it even failed in its obligation to make a prior announcement. As a result, its accumulated position against the two stock exchanges was in February 1995 – expressed in the own funds – 73 or 40 per cent.<sup>16</sup>

The preliminary authorization of the solo consolidation<sup>17</sup> of Baring Brothers PLC and Barings Securities London (BSL) was also the responsibility of the Bank of England, since BFS had concluded deals in the name of the latter in the Far East.

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<sup>14</sup> The act on the UK central bank of 1996 ended this activity of the BoE and the task was taken over by the integrated supervisory authority, the Financial Services Authority.

<sup>15</sup> Following the entering into force of the Directive – excluding some exceptional cases – there was no possibility to assume positions over 25 per cent of the capital base in the case of one client.

<sup>16</sup> Obviously, even after entering into force of the Directive there was no change in the practice of the BoE regarding extending large exposure exemptions. Barings received a message from the BoE on 1 February 1995 indicating that it would not tolerate any exceeding of the 25 % limit against the given stock exchanges.

<sup>17</sup> Solo consolidation is a special consolidation procedure acknowledged by the British banking supervision. The gist of it is that the contact is so tight between the parent company and its subsidiary that they prepare common reports –with full-scale consolidation of their assets and liabilities – and they are exempted from preparing individual reports. This method was invented to solve the contradiction between legal independence and tight operational cooperation.

Since the solo consolidation of the two financial institutions beginning in 1992 was a novelty in British practice and for the BoE too, due to the uncertainties of the consolidation procedure the sanction measures in relation to the failures of large exposure reports were not applied to BSL. Due to the consolidation in progress, the BoE regarded the securities firm – without any surveillance of the process – as part of the bank, and it considered its capital adequacy and large exposure limit in terms of the consolidated numbers. It was a consequence of the informal licensing of solo consolidation, too, that there were no limits regarding the volume of institutions' transactions among each other. Thus big amounts could be transacted unhindered – on Leeson's initiative – to the BFS, without any supervisory consideration. In the meantime, Barings presented the profit of BSL among the non-consolidated data. So, the conclusion can be drawn that the BoE did not deal with the problem of consolidation with such care as would have been necessary in view of the novelty of the process.

All things considered, it can be stated that this unique case, where one single person could bankrupt a financial institution with reputation, was able to occur due to the simultaneous existence of several bad techniques. The regulatory aspects of the failure of Barings relevant from the point of view of this study are the following:

1. The relationship between BFS and BSL was not obvious for regulators. This means that Barings was unable to prepare an adequate consolidated financial report, either for itself or for the regulators.
2. The bank was unable to give a real picture of its large exposure, or it concealed that from regulators.
3. The case generated a lot of questions connected with the supervisory responsibility of the Bank of England. The excessive exposure causing the failure of Barings can be connected with the lack of rigour in enforcing the 25% large exposure limit and the level of management granting concessions.
4. The Bank of England did not investigate directly the overseas subsidiaries of Barings. It used the reports of the bank and the auditors only – despite the huge profit reported.
5. The Bank of England preliminarily approved the solo consolidation of Baring Brothers PLC and BSL, without properly analysing the securities firm's transactions. Following that, there was no limit regarding the transactions between the

two institutions. This made it possible that the real use of advances financing the positions of BFS, the subsidiary of BSL, remained hidden until the moment of failure.

### **3.4. Regulatory responses**

#### **3.4.1. The activity of the Joint Forum**

The Joint Forum on Financial Conglomerates (Joint Forum) was established in 1996 with the participation of the Basle Committee on Banking Supervision (BCBS), the International Organization of Securities Commissions (IOSCO) and the International Association of Insurance Supervisors (IAIS). The forum took over the work of the Tripartite Group formed informally, which investigated the problems of **financial conglomerates** from 1993 from a **regulatory point of view**. The Forum includes staff members of banking, insurance and security supervisions in 13 countries, delegated by parent organizations. The purpose of the Joint Forum is, on the one hand, to eliminate obstacles in the way of **regulatory authorities' cooperation** and, on the other, to elaborate concrete **principles to support efficient regulation** of financial conglomerates. The Forum started consultation on its research papers among sector representatives and national regulatory authorities. The purpose of the consultation process was to learn about the standpoint of market players and regulators concerning the principles elaborated by the Forum and to collect proposals connected with it. The Joint Forum continuously investigates the feasibility of principles elaborated and it makes efforts to **build these into the national regulatory structures** as soon as possible.

##### *3.4.1.1. Deviations and inadequacies revealed during the cross-sectoral cooperation*

The Joint Forum set up a working group in 2000 with the purpose of comparing principles elaborated by each parent organization individually, and to help the identification of possible differences. The principles serving as the basis of the work are: *The principles of efficient banking supervision (September 1999) and its methodology (October 1999), Principles of insurance and the connected methodology (October*

2000) and *Principles of securities regulation and its purposes* (September 1998). These are to be regarded as recommendations to the supervisions of the individual member countries; their application is not compulsory. Nevertheless, both market participants and financial organizations regard implementation of these recommendations into national regulation as a primary stability indicator.

First the **difference in the sectors' activities**, then the **structural differences of principles** laid down require that the comparison should be made focusing on themes. This meant that the working group compiled the list of questions relevant in the view of regulators; then it investigated what recommendations international organizations of individual sectors made regarding these questions. There were important themes which were handled by all of the three collections of principles more or less similarly. For example, the operation of supervisory structures, the handling of supervised institutions and the prescription of certain prudential requirements. In the definition of markets or clients, however, there were differences. Regarding all these, the working group drew the conclusion that there is neither a fundamental conflict nor a contradiction in the regulatory environment of the three related sectors.

Nevertheless, there were groups of questions where there is no explanation for the deviations in the opinions, either because of differences in activities, or in definitions. We specify below **the areas showing differences**, where, although the difference in activities is not insignificant, there is some room to draw things together. (See Table 1)

Although there was considerable progress in some aspects since the definition of principles (for example in the elaboration of a consolidated capital adequacy system of insurance companies), there is a lot to do in the convergence of supervisory systems. Although the remit of the working group does not include the formulation of recommendations, members still identified issues which they think should be harmonized.

In order to clarify inconsistencies and misunderstandings, they consider the **reconciliation of the essence of principles** as a basic question. In their opinion it would be necessary to clarify or elaborate basic definitions together. At the same time, they mention the common definition or the **essence of the consolidated supervision**, since the possibility of regulatory arbitrage presents a considerable risk.

<b>Table 1</b> <i>Highlighted topics</i>	<b>Differences</b>		
	<i>BIS (Bank)</i>	<i>IAIS (Insurer)</i>	<i>IOSCO (Security trader)</i>
<b>Supervisory system</b>			
<b>Characteristics of the supervisory systems</b>	Limited publicity of sanctions.	Limited publicity of sanctions.	Highest publicity of sanctions. In requiring adequacy there are instruments to initiate legal steps against supervised institutions, issuers or private individuals.
<b>Process of supervision</b>			
<b>Consolidated supervision</b>	Consolidated supervision in the widest sense, consolidation in accounting, reporting and managing of risks in groups.	Requirement of the fact of consolidated supervision.	Consolidated supervision only on the data-supplying level of connected enterprises.
<b>Supervisory cooperation</b>	Tight cooperation, supervision according to head office, regular change of information.	The weakest cooperation among supervisions, possibility for supervision on the place of head office.	Tight cooperation, division of tasks of supervision and enforcement.
<b>Clients and markets</b>			
<b>Markets</b>	Reporting obligation only in the case of illegal activities, fraud and the suspicion of money laundering.	Reporting obligation only in the case of illegal activities, fraud and the suspicion of money laundering.	Regulation of the market as a whole, ensuring integrity turns up only in this case. Special legitimacy to find out and treat market insufficiencies.

Highlighted topics	Differences		
	<i>BIS (Bank)</i>	<i>IAIS (Insurer)</i>	<i>IOSCO (Security trader)</i>
<b>Consumer protection</b>	Under consumer protection only depositors are mostly considered.	Interests of insured are protected against insurance companies and brokers.	The widest prescriptions to protect consumers.
<b>Transparency</b>	Publication of operational data only for each other.	To make constructions and contracts transparent for clients.	Ensuring transparency of issuers, intermediaries, and markets to promote efficiency of decision-making.
<b>Prudential rules</b>			
<b>Risk management</b>	The most detailed presentation of risks arising (mostly on the assets side of the balance): credit, market, liquidity and operational risks.	Nomination of liability-side risks (arising from errors in calculations and estimations). Special principle for the management of off-balance sheet items.	Less detailed risk management techniques. Prescription of capital adequacy.
<b>Risk concentration</b>	Large exposure exists against a partner, a sector or a geographical region. Quantitative regulation.	Definition of maximum proportion of portfolio to be invested into individual groups of assets.	Definition of the maximum level of positions to be assumed in individual instruments.
<b>Solvency</b>	The most comprehensive risk-based prescription system to cover unexpected risks with capital. International consolidation has happened only in this field.	Sufficiency of capital compared to the volume and complexity of the institution.	Requiring maintenance of market players' liquidity.
<b>Accountancy rules</b>	Special methods apply, which are only necessary to elaborate supervisory reports.	Special accountancy rules were elaborated relying on the sector.	Special stress on the application of accountancy rules accepted internationally.

Reconciliation among sectors, the evaluation of other sector's principles or, while modifying them, the observance of other sector's interests all represent concrete forms of co-operation.

Finally, they consider the **problem-oriented re-evaluation of principles** inevitable, considering the new phenomena in the financial sector, such as electronic banking or the expansion of financial conglomerates.

#### *3.4.1.2. Regulatory recommendations completed*

##### **3.4.1.2.1. Concentration of risks**

Recommendations announced by the Joint Forum specify several dimensions concerning large exposures. Thus, a reliable risk management has to include a clear scope of responsibility, a comprehensive system to reveal, measure and manage core risks, a limit system confining exposure, and a stress-test to estimate the probability of the coincidence of risks, a scenario and correlation analysis. Attention should be paid to measurable and non-measurable risks. Regarding the management of large exposure, the Joint Forum enumerated the following principles:

1. Regulators have to ensure – directly or through the regulated members – that **conglomerates should dispose of appropriate risk management instruments** to manage group-wide concentration of risks. In order to achieve this position regulators may engage in several steps, which they can enforce occasionally through defining **supervisory limits**.
2. **Regulators** have to **follow risk concentration systematically** by means of reports and other measures in order to have a clear picture about the exposure of conglomerates.
3. Regulators have to contribute **to the disclosure of risk concentration**.
4. **Regulators** (acting in different sectors or countries) **have to cooperate** in order to obtain a clear picture of individual conglomerates and so they could intervene in a coordinated way if necessary.
5. Regulators have to implement **necessary intervention efficiently** and in a proper way, if they consider that this is justified regarding the regulated members or the group as a whole.



### 3.4.1.2.2. Intra-group transactions

The Joint Forum summarized its principles regarding intra-group transactions very similarly to the principles elaborated relating to the management of large exposures. Correspondingly, the highlighted questions are also identical, which, however, is not controversial regarding the differences in the nature of risks.

The most important responsibility of regulators regarding intra-group transactions is to ensure that conglomerates should **manage properly internal transactions**, which are considered as problematic, excessive in volume or concluded with an inappropriate distance. Regulators have to hinder the creation of manipulative and damaging internal transactions in a **preventive** way, first of all by **using limits**. Observation of limits and the detailed analysis of transactions should be supported by the comprehensive investigation of consolidated and non-consolidated financial reports. Beyond that they should be convinced that the **internal audit functions** of the conglomerate are adequate to avoid damaging consequences. Throughout the licensing of mergers and fusion special attention is to be paid to the intra-group transaction handling schemes of the management. Those institutions should be in the focus of the attention of regulators where the legal and organizational structure is considerably different, or non-regulated fields are present with a high degree of activity. The form of intervention of regulators might be the **elimination and liquidation of illegal transactions**, but it can make use of moral suasion too, if it does not have enough financial resources to reveal the transaction in detail. Regarding the regulation of intra-group transactions, the Joint Forum formulated the following principles:

1. Regulators have to reach ensure – directly or through the regulated members – that **conglomerates should dispose of appropriate risk management instruments** to manage group-wide intra-group transactions. In order to achieve this regulators may take several steps, which they can enforce occasionally with the help of **supervisory limits**.
2. **Regulators have to follow intra-group transactions systematically** through reports and other measures in order to have a clear picture of the exposure of conglomerates.
3. Regulators have to contribute **to the disclosure of risk concentration**.

4. Regulators (acting in different sectors or countries) should cooperate in order to get a clear picture of individual conglomerates and so they could intervene in a coordinated way if necessary.
5. Regulators have to implement **necessary intervention efficiently** and in a proper way, if they consider that these are justified regarding the regulated members or the group as a whole.

#### 3.4.1.2.3. Prudential regulation

From among challenges created by financial conglomerates, the calculation and regulation of capital adequacy seems to be the most important one – partly due to methodology and importance. From the point of view of conglomerates' prudent activity it is of fundamental importance that institutions can show an adequate quantity of capital as coverage for the incidental occurrence of damaging events. The Joint Forum elaborated its approach in this sense, according to which **rules in individual sectors** are not to be replaced but to be **put on a common basis**. Techniques to be elaborated to measure capital adequacy have to satisfy the following criteria:

1. They have to identify **double or multiply gearing**.
2. They have to disclose and manage transactions which result in **excessive leverage** by identifying certain loans as capital.
3. They must be able to manage situations with excessive **leverage** where the double or multiply leverage is realized **through non-regulated holding companies**, which have members pursuing financial activities.
4. They have to have solutions for managing risks which originate from non-regulated members of the group, which perform activities similar to that pursued by regulated members (i.e. factoring, leasing, reinsurance).
5. They have to touch upon the problem of **handling investments into regulated members**, and they have to care for the prudent management of minority and majority rights.

### 3.4.2. Structure of regulation set up by the European Union

The basis of the stability of the European financial system is the **equality and mutual recognition of supervisions**. This is accomplished by the principle of home-country control, which is a guideline for the definition of the organization responsible for the prudential supervision of financial service providers operating in several countries. Part of the common framework involves directives with compulsory force, which are accepted and inaugurated by the Ecofin meeting, consisting of financial ministers of the EU with the help of international professional organizations. Subsequently, the harmonization and acceptance of directives in the individual countries is the responsibility of finance ministers. Thus, the national authorities do have some room for manoeuvre to highlight the differences in interpretation of directives in their own legislation. This, however, offers the possibility for market players to make use of the regulatory arbitrage due to differences, while it may hurt the conditions of the emergence of real competition.

Several types of framework systems and agreements serve the practical development of the consolidated and comprehensive supervision system. From among these, the most important ones are the bilateral **agreements between national supervisions** (*Memoranda of Understanding*), which are required by the stipulations on the principle of home-country control and on the consolidated supervision.<sup>18</sup> However, these agreements are elaborated in the most detailed way in the case of institutions supervising the banking sector.

To support the cooperation and exchange of information of supervisory authorities between each other and central banks several forums have been established, for the time being only in a sectoral breakdown. The forum of professionals of **banking** regulation for discussing the position of individual institutions and scope of problems is the Groupe de Contact. The Banking Supervision Committee was established to support the ESCB in decision-making, which aims at the stability of the banking and financial system – first of all problems of the payment systems and liquidity crises. Obviously, this organization is also contributing to the international trade of information and cooperation. The exchange of information of the **insur-**

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<sup>18</sup> However, there are also agreements with organizations outside the compulsory scope and with organizations outside the EU, for example with the US FED and the Office of the Comptroller of the Currency, and the supervisory authorities of Canada and Switzerland.

**ance supervisions** is made within the framework of the Conference of Insurance Supervision Authorities of the Member States of the European Union, briefly the Conference. Conciliation forums of **securities supervisions** are the European Securities Committee and the Committee of European Securities Regulators (CESR).

The European Commission aimed at the development and regulation of the unified European financial market when the Financial Services Action Plan was formulated. On the basis of the Action Plan the Financial Services Policy Group was set up in 1999, with the responsibility of defining the priorities of cross-sector regulation. The Mixed Technical Group on the Prudential Supervision of Financial Conglomerates (MTG) was created especially to prepare the regulation of conglomerates, which, following the acceptance of the related directive, became the forum of further cross-sector technical conciliation. A wide range of institutions took part in the outlining of the directive, among them the Banking Advisory Committee, Insurance Committee and High Level Securities Supervisors Committee, with the representation of finance ministers, national supervisory authorities and central banks.

For the principles, structure and organization of regulating financial groups in the European Union and the planned directive on the supplementary supervision of financial conglomerates see chapter 4.

#### *3.4.2.1. The new supervisory framework of FSA*

The British integrated financial supervisory authority, the Financial Services Authority (FSA), responding to the new tendencies in the financial markets and, with special attention to the **high level protection of clients and markets** and the complexity and costs of reporting obligations, elaborated a **new type of supervisory framework**. The regulatory structure created with the active cooperation of market actors was presented to the professional community in 2001. The planned date of inauguration of the final version is 1 January 2004.

The most important innovation of the framework is that instead of investigating institutions in the usual way, on a sectoral basis, they will **supervise them on a risk basis**. Thus the representatives of different sectors will be rated on identical prin-

ciples regarding credit, market, operational, insurance and liquidity risks, but the group level risk will also be specially highlighted. The **same integrated approach** appears in the prescriptions regarding the **measurement of risks, the methods of risk management and the calculation of the available amount of capital**.<sup>19</sup>

The **other dimension in the categorization of individual institutions** is the potential loss in client's assets due to possible failures, and the extent of loss in market confidence. The three categories of institutions separated on this basis – abandoning the sectoral approach again – are **broken down by the risk exposure of clients' assets**. In the course of the **elaboration of supervisory principles, relevant EU directives** in force in June 2001 and the **recommendations of international professional organizations** were taken as a basis. Nevertheless, the **expectations formulated in these principles were exceeded several times**. This happened in cases where the minimum requirements formulated were not sufficient to accomplish supervisory goals. In the **field of consolidated supervision** the following **additional expectations** emerged:

- Consolidated supervision should cover all types of investment companies
  - Expectations of group level supervision should include financial conglomerates.
- The FSA considered the prudential regulation both of homogenous (inter-sectoral) and heterogeneous (relating several sectors) groups. It plans to introduce a unified, consolidated capital adequacy method inspiring efficient capital allocation for the homogenous groups. In this sense intra-group transactions and capital allocations will be exempted from the capital adequacy calculation applying to the group as a whole. As an innovation, in order to facilitate consolidation **proxy prescriptions** will be introduced for the **non-regulated group members**.

In the regulation of heterogeneous groups the anomaly in the EU directives, effective in 2001, was bridged over, namely, in the regulation of insurance companies neither banks, nor investment companies were recognized as financial institutions and vice-versa. Thus, according to the rules of the FSA, if any representatives of the above-mentioned three sectors form a group, they are subject to a unified calculation method of aggregating and capital requirement. Thus the dangers of a double gearing and excessive leverage in holdings operating in more than one sector is avoided. The calculation of the group-level capital requirement is made by

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<sup>19</sup> Nevertheless, cross-sector conciliation still does not turn up in the capital adequacy regulations.

summarizing individual capital requirements of the group members, taking into consideration the values of cross-ownership. Excessive capital over and above the capital elements mutually accepted will be available for group-members with capital shortage. With this, regulators hope that a **real picture will evolve regarding the capital position on the group level**, while at the same time acknowledging the individual members' capital adequacy.

### **3.4.3. Response of the US regulators to the challenge of financial convergence**

The oldest and most often cited act impeding convergence of financial institutions is the **Glass-Steagall Act** approved by the US House of Representatives. This act was inaugurated in 1933 as a response to the mass bank failures due to the Great Depression. The act **separated commercial and investment banking functions**, because in the opinion of the legislators commercial banks exposed the money of investors to an excessive risk, underwriting bond or equity issues of their corporate clients. Similar barriers were established against the fusion of investment banking and insurance activities into one single organization. Moreover, geographical barriers also hindered the expansion of financial institutions.

The need to **satisfy innovation and clients' claims** as far as possible inspired financial institutions – formally obeying legal rules, but in contrary to their spirit – in parallel with expanding their scope of activities, to provide simultaneously banking, investment and insurance services. Banks from the 1980s started to establish subsidiaries, which, although not as a primary activity, underwrote and traded securities. Banks were allowed to sell insurance products, too, but only in communities with less than 5000 inhabitants. With the merger of Citibank and Travelers Group, however, a worldwide conglomerate was set up in 1998 operating primarily in the banking and insurance sector, with the approval of the supervisory authorities. Investment banks and insurers also found a way to sell deposit products. They established tight contacts and common products with specialized credit institutions, i.e. with credit card banks or industrial loan banks. Eventually, as a result of efficient lobbying, not only brokerages and insurers, but also even non-financial institutions were allowed to purchase a thrift.

The controversy between prevailing rules and practice led to the inauguration of the **Gramm-Leach-Bliley Act in 1999**. This act authorised activities, like insurance, portfolio management, underwriting and commercial banking, separate activities until then, **within one organization**. Provision of the whole spectrum of financial activities, however, is the privilege of one type of strictly limited institution, the so-called *financial holding company* (FHC), which can function only with the certificate of the Federal Reserve. They have to have an appropriate **amount of capital, risk management and credit rating**. The above-mentioned strict conditions, however, relate not only to the holding as a whole, but also to individual **subsidiaries** performing special functions. In order to evade excessive risks being shifted to banks operating in the framework of the holding, **limits** were also established regarding the **transactions** between the banks and other subsidiaries of the holding.

The range of **activities of a financial “nature” to be executed by the FHCs** was announced by the Ministry of Finance and the FED in a predefined way, in the form of a list. Holding companies may execute these activities without prior approval, via ex-post announcement. In addition, they may perform **auxiliary financial services and other activities**, assuming the FED has licensed them, and which do not involve an additional risk to the financial system.

Regarding cross-sector activities, **banks’ financial subsidiaries** have a more restricted room for manoeuvre. Besides insurance and investment banking activities, banks’ subsidiaries are barred from insurance portfolio investments, real estate investments and investment developments. The operation of these subsidiaries was separated by the measure that also considerably limited their intra-group activities, with special respect to risks transferred to banks. The purpose of this measure is to protect the deposit insurance fund from risks arising elsewhere. The act also limited the volume of financial activities performed via banks’ subsidiaries; the aggregated balance sheet of subsidiaries may not exceed either 45 per cent of the total assets of the parent bank or USD 50 billion. In addition, the right to acquire one thrift was eliminated.

**The act arranged the supervision of financial institutions on a functional basis.** Practically, the right of regulation remains with the supervisory authorities of the individual sectors, i.e. the Federal Reserve, Securities and Exchange Commission

(SEC), Commodity Futures Trading Commission and state insurance supervisions. **The umbrella supervision of the financial holding companies, however, is made by the Federal Reserve.** In the course of this work it uses information of the functional authorities, and it has an **exclusive role** in the **protection of banks** operating in the framework of holdings. **Functional regulation**, however, extends not only to financial holdings, but also to the **activities of banks**. Thus, security trading and investment service activities are supervised by SEC, insurance activities<sup>20</sup> by state insurance authorities.

The act also provides for the protection of non-public client data. Accordingly, the financial institution has to inform the client when entering in contact – and subsequently at least once a year – on its data protection policy and its practice. On handing over non-public data of clients the act only says that, according to the decision of the client, data are not to be handed over to third parties outside the holding; thus members of the group might have free access to them.

#### **3.4.4. The Australian practice of regulating financial conglomerates**

In March 1999, the Australian Prudential Regulation Authority (APRA) published for the first time a pamphlet about the newly elaborated principles of the supervision of financial conglomerates. This was followed by several more detailed publications, including the reproduction of responses from the financial sector. In the course of regulation the aim of the supervisory authority was to create a proper equilibrium between the costs and benefits of planned regulations. The pamphlet on the capital requirement and large exposure of conglomerates – the last in the series – was published in October 2001, followed by a consultation with the sector. Guidelines might turn into prudential standards in 2002, which will be followed by a three-year grace period. The final regulatory structure will be introduced in parallel with the inauguration of the new Basle capital adequacy requirements. This will help make use of the fact that, in accepting the recommendations, the Australian national regulation – by virtue of its own authority – has to establish

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<sup>20</sup> This includes insurance products licensed by OCC only. Banks and their subsidiaries may usually not trade in title insurance or in some states they can acquire licences, but only for brokering.



rules only with a supplementary character, in subjects that are not regulated in detail by the Basle recommendations.

The basis of the regulation of **financial conglomerates** is that they are **either managed by a credit institution**,<sup>21</sup>, or a **holding company** is on the top of a group, which includes a credit institution.<sup>22</sup> Members of the group may be those performing financial and non-financial activities, and regulated or not regulated by the APRA. Nevertheless, the scope of activity of the group members must be clear, transparent and well documented. The regulating authority **defines the holding's scope of activity**, the possible ways of ownership structure within the holding and it sets up criteria regarding the **composition of the managing bodies** of the holding and its credit institution members. The aim of the criteria is to ensure transparency of the interest system and to avoid conflicts of interest. The members of the management have to satisfy the **qualification standards** set by the conglomerate, which include, beyond professionalism and professional experience, reputation.

Regulatory guidelines emphasize the clear, comprehensive and regular **disclosure of group-wide and individual risks** of the credit institution. The organizational structure and scope of operation of the conglomerate should be transparent enough for the regulatory authority to oversee the risk profile. The CEO of the conglomerate has to declare to the APRA each year that the group has a proper risk-disclosure and risk management policy and practice. Moreover, **the credit institution within the group** has to be liquid and well funded in relation to the requirements, and its transactions concluded with partner institutions should satisfy strict criteria. Special stipulations are given for services provided via **cross selling**, in the case of which the **real provider** has to be indicated. The reason for this is that banking and non-banking products should be differentiated for clients, because of the differences in the safety guarantees.

The APRA aims to supervise **financial conglomerates on consolidated basis and credit institutions individually** as well. Accordingly, it elaborated a three level

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<sup>21</sup> In the Australian terminology, Authorized Deposit-taking Institution. Authors regard them as credit institutions.

<sup>22</sup> The regulatory authority plans to expand the framework in the future to the conglomerates dominated by insurers. Regarding principles (excluding necessary differentiation) the system featuring here will be used there, too. (APRA 2001)

evaluation system consisting of credit institutions,<sup>23</sup> credit institution groups and the conglomerate as a whole. Each level has its specific capital adequacy requirement, which is stricter than earlier.<sup>24</sup> In the first two levels the 8 per cent capital adequacy requirement is general. On the level of credit institutions and subsidiaries connected in the case of acquisitions, the APRA requires a total deduction from the tier 1 capital – except for small volume portfolio investments – in order to avoid double gearing. On the level of credit institution groups, investments into non-consolidated subsidiaries and other credit institutions are also to be covered with tier 1 capital. On the third level – only for the entities indicated by the APRA – a capital adequacy in line with the risk profile of the conglomerate has to be presented. If the APRA is not satisfied with the internal identification of risk, it can prescribe additional capital requirement for the most vulnerable member, the credit institution.

The newly established **large exposure limit** system also includes prescriptions for **intra-group transactions and for external partners**. From among intra-group exposures, the highest limit is set for other, intra-group credit institutions, at 50 per cent of the primary capital, and it may be less only in the case of other members under prudential regulations (25 per cent) and other group members (15 per cent). Total intra-group exposure may not exceed 35 per cent of the credit institution's capital. Maximum amounts against external partners are identical with the levels in international standards.

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<sup>23</sup> On the first level credit institutions are dealt with together with their subsidiaries connecting to them functionally, and they are nominated in the document as Extended Licensed Entities.

<sup>24</sup> Consolidated capital adequacy requirements go beyond the Basle capital adequacy recommendations in the respect that there is a call for consolidated capital requirement for groups, which is not dealt with in the recommendations (i.e. groups performing considerable insurance or trading activities).

## 4. Regulation of financial groups in the EU

Financial sectors convergence became a general tendency in the nineties, in parallel with the globalisation trend characterizing the financial market as a whole. Concentration processes and M&A transactions, which involved most industries, also affected the financial sector as of the end of the eighties. Whereas in the eighties and early nineties the merger and acquisition of homogeneous institutions (i.e. those performing similar activities) took place, in the nineties the establishment of universal banks and financial groups accelerated.<sup>25</sup> Institutions pursuing different financial activities formed conglomerates through M&As or through a company setting up in another financial sector.

The different financial sectors might be defined by activities or types of institutions authorized to perform those activities. These two different definitions do not necessarily result in similar categories, since if we consider, for example, the securities market traditionally as one sector, this includes not only investment companies, but universal credit institutions, institutional investors and the infrastructure and marketplace (stock exchange and clearing houses). From the point of view of **regulating financial groups and conglomerates, in order to review the relevant guidelines of the EU we defined different financial sectors according to their characteristic activities.** Thus, there is the banking sector, defined on the basis of deposit collection and lending activity by directive 2000/12/EC, the investment services sector, defined by directive 93/22/EEC, and the insurance sector in the case of institutions performing insurance activities (life: 79/267/EEC; non-life: 73/239/EEC, 92/49/EEC). Certain types of institutions may belong to more than one sector simultaneously. One of the most well known examples is the universal credit institution, which pursues activity simultaneously in two sectors: besides collecting deposits it may engage in the whole spectrum of investment services activity. The investment services sector includes - along with universal credit institutes and investment companies - management companies, if they pursue investment services activity.

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<sup>25</sup> A further important feature of the merger and acquisition activity in the EU financial market is that transactions were made almost without exception among companies with their headquarters in the same country, or they were oriented into developing countries outside the EU. Cross-border M&As were quite rare.

The big market failures discussed earlier (BCCI and Barings) clearly indicated that the investigation of one single institution is not sufficient to evaluate its stability and its financial position if there is an organizational or interest relation between the institution supervised and another institution or private individual which results in dependence between them. The supervision of groups built upon dependence requires different supervision elements and different emphases than those in the case of individual institutions. Due to their size, however, these groups are the most significant, dominant players; thus their increasing expansion in itself calls for the attention of regulators. The risk of contagion within one organization means contagion among different financial markets (banks, investment firms, insurance undertakings), thus their efficient regulation and supervision is of fundamental importance from the point of view of financial stability. Simultaneously, the emergence of market problems and their consequences requires prompt intervention. Group level supervision is reasonable in the case of any regulated financial service provider, independent of what institution or person it depends on. Group-wide supervision of institutions, however, requires different methods and rules, depending on whether

- they operate in the same financial sector and the same legal rules apply to them (homogeneous groups),
- they are active in different financial sectors (financial conglomerates),
- the majority of the members operate outside the financial sector (conglomerate with mixed activities).

Special risks characteristic for groups can be divided into two categories. On the one hand, the capital and debt of the parent company might be used more than one time, which means only the formal fulfilment of capital adequacy requirements and under-coverage of unexpected risks on the individual level. The other risk factor arising from ownership relations is dependence, since in the case of problems of the owned institution the owner has to step in, which influences the financial situation of the owner. Dependence will be further strengthened by intra-group transactions, which may influence risk exposure of institutions. They often make it non-transparent, and often they take steps to use the possibility of arbitrage offered by differences in regulation, or they even harm the interests of investors. **Group-wide validation of risk limits and capital requirements prevents**

the evasion of individual requirements, while at the same time, regarding individual requirements, it acknowledges the special relationship among institutions, when exempting intra-group risk exposures from fulfilling limits and adjusted capital deductions.

EU regulation of the consolidated supervision of financial entities had taken shape by the nineties. First it was concluded in the banking sector through the directive 92/30/EEC. This was followed by directive 93/6/EEC regarding the consolidated supervision of credit institutions and investment firms, and in 1998 the regulation concerning insurance groups was completed. Rules concerning consolidated supervision can be divided into two groups:

- the disclosure obligation of group members and cooperation between the competent supervisory authorities, and
- group-wide prudential rules (i.e. limits on investments, large exposures and capital requirements).

EU directives regulate consolidated supervision related institutions according their scope. If there is an institution in the group, which belongs to the scope of a different directive or is a non-regulated institution, then consolidated supervision is executed by disclosure obligation or supervisory cooperation. Group-wide prudential rules are prescribed only in the case of institutions with similar activity.

The big failures mentioned earlier called attention to inadequacies in the regulation of financial groups. Examples selected referred to general but corrigible failures in the regulation. These problems were a consequence of the segregation of national regulations and national supervisions and not of sectoral regulation. The failure of BCCI generated a very sharp reaction on the side of regulators, resulting in the elaboration of a new directive as a first step.<sup>26</sup> The case of BCCI called attention first of all to the fact that regarding exclusively capital connections (shareholder or member participations) is not sufficient to disclose all the dependency contacts of the institutions supervised. The new directive modified the terms of authorisation and operational licences, the cooperation of supervisions and other authorities<sup>27</sup> supporting the stability of financial institutions in a way that authorization for groups aiming at regulation arbitrage and incomplete superviso-

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<sup>26</sup> 95/26/EC, the so-called Post-BCCI Directive

<sup>27</sup> Court of registration, competition authority, central bank, auditors, professionals providing independent supervision.

ry surveillance should not be granted at all. The directive stipulates a much wider scope of cooperation among supervisors and authorities than earlier, while eliminating restrictions - first of all in the field of data protection - hindering information disclosure, and it introduces the reporting obligation of auditors and other independent professionals.

The post-BCCI directive, however, did not touch upon consolidation rules in force. Sectoral regulation did not allow group-wide prudential requirements to be related to the group of institutions in other financial sectors, and some insufficiencies and inconsistencies from the sectoral regulation survived (i.e. different requirements relating to the same activity). On the financial markets of the EU, however, financial conglomerates expanded at an increasing rate, being simultaneously active in several financial sectors, and thus their regulation is not obvious or it is deficient. The presence of these financial actors requires that group-wide capital requirements and risk limits should relate to them just as much as to their colleagues acting in one and the same financial sector. Thus, a new directive was elaborated on the supervision of financial conglomerates, which was based first of all on the recommendations of the Joint Forum presented earlier. The debate in the parliament is underway at the time of writing this study (Q2 2002).

#### ***4.1. EU legislation of financial groups and conglomerates in force prior to and following the failure of BCCI<sup>28</sup>***

Rules relating to financial groups and conglomerates can be broken down into three categories:

1. Conditions of the authorization licences of supervised institutions and rules of certain sectoral directives stipulating exclusive or main activities *ab ovo* determine the organizational structure of groups and their participation in each other.
2. The second field to be investigated is the set of prudential rules of groups already existing (i.e. limits on investments and risk exposures, capital requirements). These are also indicated by sectoral directives.
3. Special rules relate to the supervisory system of groups and the supervisory methods.

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<sup>28</sup> Regulation in force is based on the rules accepted until May 2002.

We follow this structure in overviewing rules entering into force in the EU in the period 1970-90 and still effective. Directives of different financial sectors regarding supervision of financial groups were modified for the first time by the 95/26/EC, so-called post-BCCI directive. This directive represented the first attempt to eliminate the most striking insufficiencies in all the directives regulating financial sector entities arising from sectoral regulations by amending them and simultaneously introducing unified rules and definitions regarding authorization and supervisory cooperation (points 1 and 3).

#### 4.1.1. Rules effecting the organization of financial groups

Strict legal rules regarding acquisition limits, reporting obligations and exclusive activities originate from the regulated nature of the financial market. In the case of non-regulated market participants, the authorities do not have as much leeway to intervene in the organizational structure of company groups as in the case of regulated financial players.

##### 4.1.1.1. *Specialization principles*

According to the EU rules there are specialization principles regarding certain sectors. Thus, exclusively those institutions may perform **deposit collecting, insurance and UCITS fund management activities**, which are entitled by law to do so. Consequently, organizations which provide these services simultaneously, may never be established by fusions, only through merger or acquisition via a holding company and by setting up, i.e. by connecting separate legal entities. This connecting may take the following forms, of which the last two involve the creation of a conglomerate (for example in the case of a bank and an insurer):

- By concluding a cooperation agreement among existing institutions (i.e. a bank sells insurance products under the name of the insurer);
- By setting up a joint venture (this is a more formal cooperation, i.e. the bank sells insurance products through its own retail network under the name of the bank);
- A bank setting up an insurer subsidiary (and they use a common distribution network);

- Through merger on a holding level or the bank acquires the insurer as a subsidiary.

Despite the fact that according to the legal rules a legal fusion cannot take place, a level of economic fusion is mostly achieved in the case of conglomerates with merging tasks or managerial responsibilities.

#### *4.1.1.2. Veto of the supervisory authority*

The supervisory authority has the right to veto certain ownership connections of supervised institutions. The acquisition of a certain proportion of ownership or votes (10%, then 20%, 33% and 50 %) should be reported to the supervisory authority. The authority might refuse to issue a licence if the **owner is inadequate**, or if it cannot be taken for granted that the institution will be managed in a reliable and prudent manner. The reporting obligation to the supervisors sets the framework of the consolidated supervision, since the foundation and operation of the institution will depend on its ownership and group structure. This means that already at the start of the institution's activities and from that point on it will be monitored continuously in terms of whom the supervised institution is depending on, who is the person or institution that is able to influence its activity. This is, however, basically constrained by the fact that the possibility of exercising influence is made dependent exclusively on ownership and voting rights. **A much wider possibility of having influence was represented by BCCI, when it was able to influence an institution exclusively through investment consulting.**

### **4.1.2. Consolidation and regulation of homogeneous groups**

#### *4.1.2.1. Scope of the consolidated supervision*

Institutions, which already obtained their authorization **form one group, belong under a consolidated supervision if they exert a dominating influence upon another institution or they might be influenced by another institution.** Thus, with the criterion of forming groups, the measure of mutual dependence is the extent of influence. Dominating influence might be exerted not only in cases stipulated by



accounting rules,<sup>29</sup> which are easily circumvented due to cases constrained to ownership or membership rights, but the opinion of the supervisory authorities on its own is enough to force institutions to adopt consolidated rules. The opinion of the supervisory authorities will be determinant first of all in cases without participation or membership contacts, however the institution has to be influenced dominantly. Dominant influence happens by being managed with another institution on a unified basis, or if the majority of their managing boards are common, or it is influenced significantly by any other means. This implies a quite substantial power of discrimination for the supervision and it facilitates appropriate action in respect of actually existing relations.

The first level of consolidated supervision concerns the possibility for supervisors to have **access to information**, which *involves the widest sphere of financial groups*, since irrespective of their activity and sector any institution might belong to this category, that is in a **parent-subsidiary or participation relationship** with the institution supervised. The parent-subsidiary relationship is stipulated in the accounting rules on the one hand, and is determined by the opinion of the supervisory authority about the existence of dominating influence on the other. In the banking and investment service sectors participation means a voting right or ownership proportion of at least 20 per cent. In the insurance sector, however, the durable contact stipulated in the directive on accountancy<sup>30</sup> is regarded as a participation too, i.e. even in the case of a participation below 20 per cent.

The second level concerns the **consolidated reporting obligation, the group-wide capital adequacy and the regulation of large exposures**. These are the requirements which are able to manage risks featuring groups. These requirements are also regulated by *sectoral directives* and the scope of consolidation is determined

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<sup>29</sup> Financial directives used the narrower definition of the directive on accountancy No. 7 (83/349/EEC) on parent companies under consolidated supervision. Accordingly, a company (parent company) belongs under consolidated supervision, if in an other company

- it has a voting majority,
- it is able to nominate or dismiss the majority of leaders and at the same time is a shareholder or member of the company,
- it has a dominating influence by statute or contract, and at the same time is a shareholder or member of the company,
- the majority of leaders was nominated by its vote (and there is no other parent company which satisfies the first 3 points), and at the same time is a shareholder or member of the company,
- it is the sole leader by voting rights acquired through commission or contract and at the same time is a shareholder or member of the company.

<sup>30</sup> Accountancy Directive No. 4 (78/660/EEC) art. 17

by the **dominating influence among the institutions under the authority of the directive concerned**. This means that in the banking sector, for example, credit institutions and financial institutions have to satisfy prudential requirements on an group-wide level, while with insurance undertakings belonging to them this is not necessary.

**As an essential element, the scope of consolidation in accounting is not identical with the scope of prudential consolidation due to the fundamentally different targets of consolidation.** The primary target of the accountancy report is to present the *financial position of the group*, whereas the target of prudential consolidation is to find out to what extent the *financial situation (risks) of the supervised institution is influenced by its position in the group and the risky character of other group members*.

#### 4.1.2.1.1. Sectoral directives

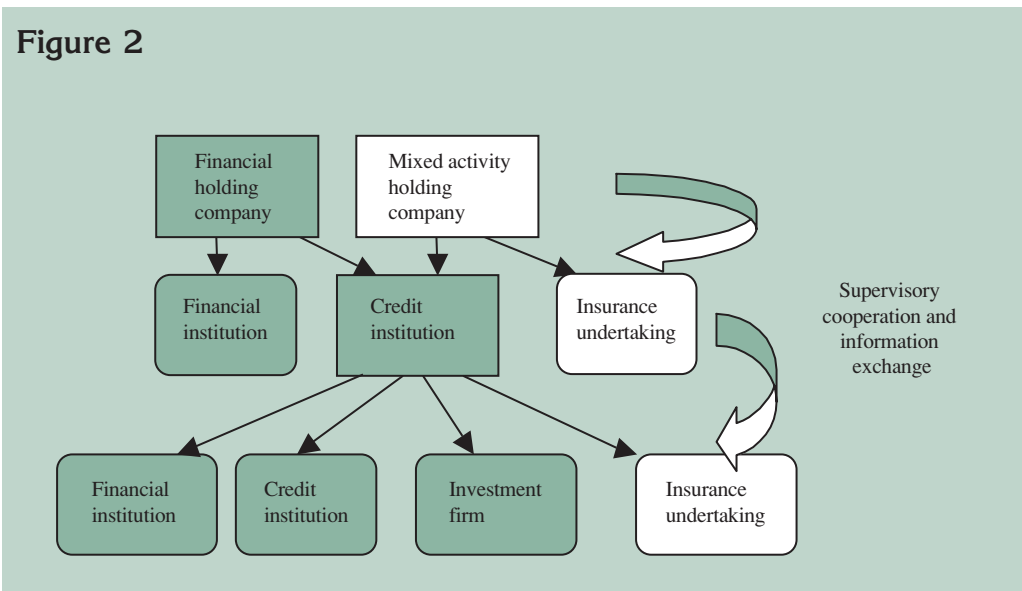
Requirements and rules of consolidation stipulated in bank directive 200/12/EC<sup>31</sup> relate to group members consisting of financial holding companies, holding companies with mixed activity, credit institutions and financial institutions. Consolidated supervision of credit institutions relates to any groups which incorporate at least one credit institution, including parent companies which are not credit institutions.

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<sup>31</sup> Directive 2000/12/EC consolidates legal rules concerning credit institutions existing already earlier, thus Directives 77/780/EEC, 89/646/EEC first and second, Directive 89/299/EEC on the calculation of adjusted capital, Directive 92/30/EEC on consolidated supervision, Directive 92/121/EEC on large exposures and Directive 96/10/EEC on netting.

Directive 2000/12 stipulates consolidated supervision for the following scope of institutions.

**Figure 2**



**The consolidated reporting obligation** concerns institutions highlighted in grey; insurance companies and mixed activity holding companies linked to credit institutions are required only to **cooperate with the supervisory authorities and to supply information**. Cooperation between the supervisory authorities is carried out if the institutions supervised separately belong to the same group, i.e. in the case where the credit institution is in the same group with an insurer or investment firm acting in another state or in a third country. The obligation to supply information empowers the supervision to ask for information directly from not supervised institutions if controlled by a credit institution or financial holding company or via the controlling credit institution or financial institution, which is important for fulfilling supervisory functions and for monitoring the validity of information. The same applies to the mixed activity holding company, where information is relevant from the point of view of supervision of an institution controlled by it.

## Consequences of the different definition of financial institutions

Due to the different philosophy of the Hungarian and EU regulation it is worth clarifying how the concept of financial institution, financial holding company and mixed activity holding company is to be identified. In line with the EU regulation a **financial institution is a non-credit institution undertaking with the main activity of acquiring participations or executing universal banking activities** listed in Annex 1 of Directive 2000/12 with the **exception of collecting deposits** (i.e. according to the Hungarian terminology it is entitled to provide all financial and investment services excluding collecting deposits). One of the purposes of defining the concept of the financial institution is to **ensure consolidated supervision on the basis of activity**. If the institutions specified for the abovementioned activities form a common group with the credit institution, group level regulations (large exposure, capital adequacy, supervision) relate to them. In the case of the banking directive this means **to credit institutions, financial institutions and to institutions providing supplementary banking services**, thus these institutions are to be handled as one single institution from the point of view of taking risks.

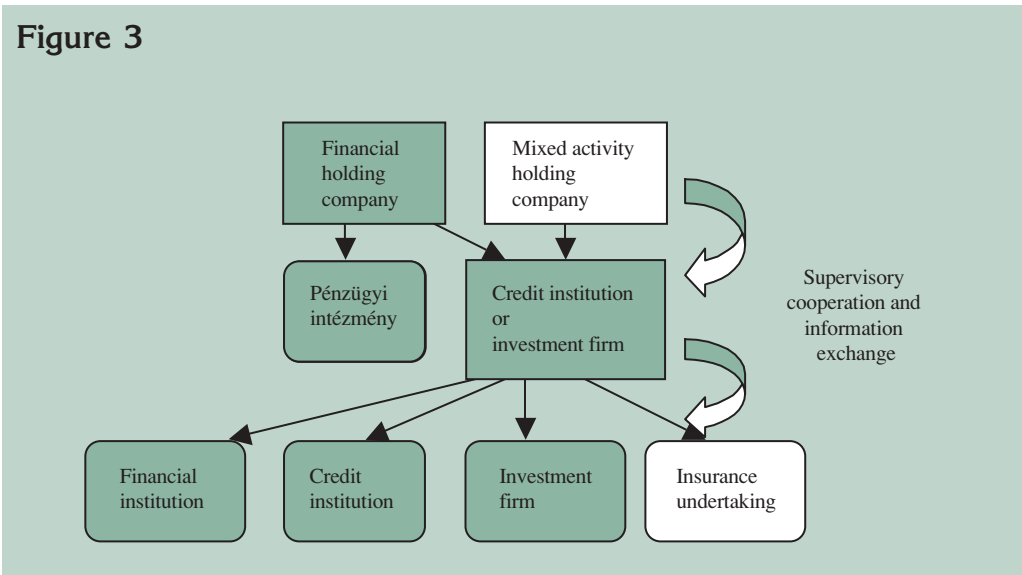
**Financial holding company** is a financial institution, among the subsidiaries of which there are mainly or exclusively credit institutions and financial institutions, but at least one credit institution. While a mixed activity holding company is a parent institution, which is not a credit institution or financial holding company but there is at least one credit institution among its subsidiaries. Thus all non-credit institutions or non financial institutions (for example an insurance undertaking) might be a mixed activity holding company, if it owns a credit institution subsidiary.

**In line with the Hungarian regulation a financial institution is the credit institution and the financial undertaking** (executing certain activities from Annex 1 2000/12/EC), thus it includes different sphere of institutions and different activities compared to the financial institution defined by the EU on the basis of activities. **Financial holding company** is a financial undertaking, the exclusive activity of which is the ownership of financial institutions or investment firms, from among of which at least one is a credit institution. **Exclusiveness like that is not prescribed in the EU rules**. Directive 2000/12/EC requires only that subsidiaries of the financial holding company consist mainly of credit institutions and financial institutions, from among them at least one should be a credit institution, and 93/6/EEC supplements the definition of a holding company with the ownership of investment firms.

Directive 1993/6/CAD reacts to that general market tendency whereby credit institutions and investment firms are competitors on the market of investment services. Thus, in order to offer equal treatment it stipulates prudential requirements for investment undertakings identical with that of credit institutions, and it introduces **the consolidated supervision of investment firms.**

Scope of consolidated institution of Directive 93/6/EC.

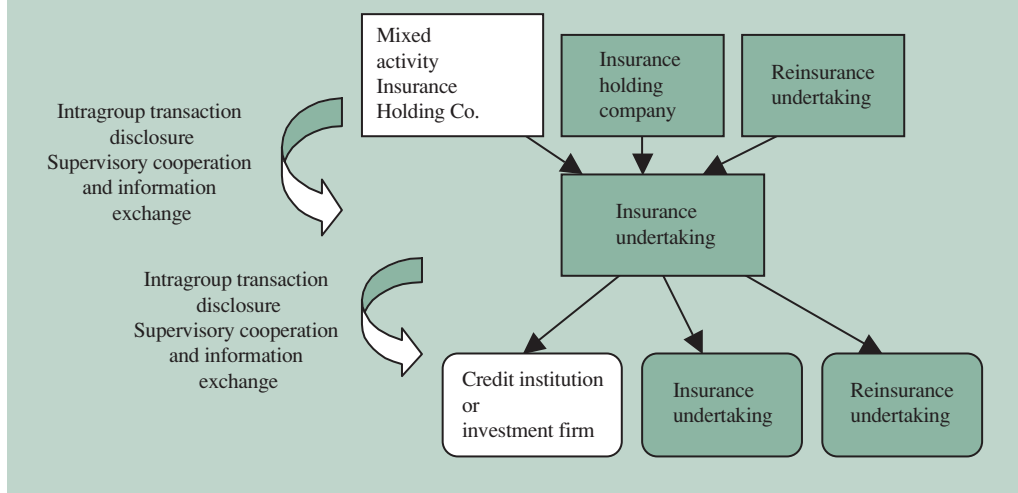
**Figure 3**



**Institutions highlighted prepare consolidated reports on consolidated limits and the capital requirement relating to them.** The definition of financial holding company and mixed activity holding company will be applied, besides credit institutions, to investment firms. Thus, a *financial holding company* involves financial institutions the subsidiaries of which comprise mainly or exclusively credit institutions, investment firms and financial institutions, or at least one credit institution or investment firm. The same is true for a *mixed activity holding company*, which means a controlling institution, which is neither an investment undertaking, nor a financial holding company, but there is at least one investment firm or credit institution among its subsidiaries.

Directive 98/78/EC regulates insurance groups. The range of institutions covered by consolidated requirements is shown by the chart below.

Figure 4



The *insurance holding company* is a parent institution, whose primary activity is to acquire participations exclusively or mainly in insurance and reinsurance undertakings and in insurance undertakings of third countries, and from among subsidiaries at least one insurance undertaking. The *mixed activity insurance holding company* is a parent institution, which is *not* an insurance, reinsurance or insurance undertaking of a third country or an insurance holding company, but there is at least one insurance undertaking among its subsidiaries. The consolidation requirement in the case of insurance undertakings concerns a wider range of institutions, since the participation relationship relates not only to 20 per cent of voting or ownership proportion, but to any durable relation which represents an ownership right below 20 per cent, but influences the operation of the company.

In the case of mixed activity groups consolidated supervision involves, besides rights of collecting information and cooperation, ***supervision of intra-group transactions***. The supervision of intra-group transactions will be executed in such a way that each *undertaking*, which is at least in a participation relationship with the insurance undertaking or with an undertaking in a participation relationship with the insurance undertaking, and *private individuals* who enjoy participation in any of these institutions, have to report *transactions among* each other at least once a

year. These transactions are mostly loans extended to each other, guarantees, off-balance sheet items transacted among each other, investments and transactions relating to adjusted capital elements and agreements regarding the division of capital – but they do not have to satisfy *consolidated capital adequacy requirements*.

**Due to the definitions of sectoral directives there are also overlaps.** Thus, a mixed activity insurance holding company might be a mixed activity holding company according to the banking directive, but it is also possible that the mixed activity insurance holding company is at the same time a financial holding company in the sense of the banking directive, or the mixed activity holding company in the banking directive sense is an insurance holding company according to the insurance directive.

#### *4.1.2.2. Prudential rules of financial groups*

##### *4.1.2.2.1. Capital adequacy requirements*

The primary consideration behind the creation of group-wide capital requirements was the prevention of multiple capital gearing. Participation of the parent company in the subsidiary might involve investment of the parent company's own capital, which, however, is a capital element from the point of view of the subsidiary. Thus, **in the course of individual capital calculation, both institutions regard the same capital as a capital element (double gearing)**, and in a longer ownership chain this might happen several times (multiple gearing). Group-wide requirements sort out these aggregations with the help of one of the recommended methods, so it will turn out if members of the group fulfil capital requirements on their own, but not as a group.

In defining group-wide capital, **the capital of the subsidiary is not to be taken into consideration either, when it originates from the borrowing of the parent company (excessive leverage)**. This loan is to be refunded by the parent company a certain time, so the requirement raised against any capital element, namely, that it should be available at any time to cover unexpected losses, will not be met. Thus, every source the participation of the parent company may generate cannot be taken into consideration in the capital calculation of the subsidiary.

There are three methods of defining the consolidated capital, which all have the same result (capital value). Only their starting points are different, depending on whether consolidated balance sheet data or individual data are available. **The purpose of all of these methods is to define actually available capital elements by sorting out multiple gearing, which in the course of the investigation of capital adequacy is to be compared with aggregated capital requirements.** The information on group-wide capital is important not only because of the investigation of capital adequacy. **The majority of risk limits of the group as a whole, with the exception of insurance undertakings,<sup>32</sup> might be stated in proportion to the regulatory capital.** Thus it is really important that all three methods have the same result. These methods are summarized in Table 2. As is apparent, the methodology used by the Joint Forum and EU Directives is substantially similar, only the denominations are different. (*See table 2*)

The “method of building block approach” or “accounting consolidation based approach” builds on a traditional accounting consolidation, where data of consolidated balance sheet and profit and loss account after sorting out transactions, exposures among each other provide information about the financial status and results of the group as a whole. In certain cases, however, the consolidated accountancy reports are not adequate for the purposes of prudential consolidation. This could happen because the information concerning from which group member a related asset or liability originated may get lost. Consolidation of institutions with completely different balance structures would provide a misleading and distorted picture. The consolidated balance sheet of a bank and an institution acting in a different sector, i.e. an insurance undertaking or not supervised institution, is not appropriate to clarify banking risks and to define banking limits based on balance sheet requirements. The same is also true for the insurance risk, where the basic risk is the uncertainty of the value of liabilities and the fluctuation of value of assets behind them. Reserve and capital requirements of insurance undertakings were defined with regard to these risks. Thus in these cases it is necessary that the risk of some individual activities and the requirements in line with it should be separated from each other. The “building block method” enables this in such a way that it divides the group into sectors according to regulation and activity, calculates the

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<sup>32</sup> The risk limits of insurers will be defined in relation to the technical reserves.



**Table 2****Methods recommended for calculating capital adequacy<sup>33</sup>**

Joint Forum 1999	EU Directives
<p>Method of building block approach</p> <p>Consolidated capital of the group must exceed the aggregated amount of capital requirements of individual group blocks or blocks pursuing the same activity.</p> <p>The consolidated capital of the group = consolidated assets (excluding participations) – consolidated liabilities (excluding liabilities among each other) + reserves</p>	<p>Method based on accounting consolidation</p> <p>Own fund of the group on accounting consolidation basis has to exceed the aggregated amount of capital required for each sector separately (only those elements are to be selected as capital element which are mutually acknowledged by the sectoral rules).</p>
<p>Risk-based aggregation</p> <p>From group capital defined through aggregating individual capital elements the amount of group-wide participation will be deducted and this has to exceed the individual capital requirements' aggregated amount.</p>	<p>Deduction and aggregation method</p> <p>From the aggregated amount of individual capital elements, individual capital requirements and the book value of participations will be deducted (elements to be selected are only those which are mutually acknowledged by the sectoral rules).</p>
<p>Risk-based deduction</p> <p>The excess capital or capital deficit of the subsidiary provides the value of the investment of the parent. Thus, the individual, non-consolidated capital of the parent will be recalculated in such a way that the book value of participations will be deducted and, instead, the excess capital or capital deficit of the subsidiary will be taken into consideration. If the investment of the parent exceeds the capital requirement of the subsidiary, then the excess will be a part of the parent's capital, because it is also available to other members of the group. If, however, there is a deficit, because the investment is less than the capital requirement adequate with the participation of the parent, then the deficit should be replaced by the parent. Thus it will be deducted from capital elements available for the parent and the group. The re-calculated capital of the parent should exceed the capital requirement of the parent.</p>	<p>Requirement deduction method</p> <p>The capital of the parent company has to exceed the capital requirement of the parent and the higher amount from among the book value of participations and the proportional part of the capital requirement of subsidiaries. Based on the conservative principle, the planned EU directive does not take into consideration excess capital of the subsidiary, but it does the deficit (see risk-based deduction).</p>

<sup>33</sup> Illustrative examples can be found in the Annex.

capital requirement of the sector and by aggregating them it investigates if the consolidated capital of the group is sufficient or not.

There are cases when consolidated accountancy reports are not available, but the supervisory authorities need the consolidation of the group member. In this case use can be made of the methods “deduction and aggregation” and “requirement deduction”, which define the amount of the adjusted capital available for the group on the basis of individual data and which enable risk limits to be stated. Also in this case the requirements of different sectors can be easily met, since aggregation or deduction of individual capital elements or capital requirements is made ex post. **These methods prevent multiple gearing without netting for exposures against each other.** Thus, if there is no available consolidated financial report or the intra-group transactions are too complex (and without this data important information would be lost), these methods might be more useful.

#### 4.1.2.2.2. Minority owners

In the course of consolidation a new problem is represented by **the treatment of not 100% owned subsidiaries**. There are pro and contra arguments for their full consolidation, i.e. that they should be consolidated as if they were owned 100 per cent. If there are minority owners, the **full consolidation and pro-rata consolidation of participation is differently conservative**, depending on whether the group members individually have a surplus or deficit.<sup>34</sup> As seen in Table 2, in the course of consolidation the actually available capital of the group members will be defined, deducting mutual ownership and participations at book value. **If members individually have capital surplus, the result of the full consolidation is more favourable** than in the case of pro-rata consolidation. In that case the surplus of the minority ownership is calculated among the available capital elements of the group, whereas when deducting participation, only the participation of the parent will be deducted. **If the subsidiary has a capital deficit the pro-rata consolidation gives the more favourable result**, since a full-scale settlement of the deficit would mean that the substitution of the deficit is exclusively the responsibility of the parent or the group.

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<sup>34</sup> Illustrative example can be found in the Annex.

In respect of a conservative point of view connected with minority ownership, sectoral rules are different. During the calculation of capital adequacy of insurance groups (98/78/EC) capital elements are to be taken into consideration according to the proportion of participations, excluding the case of capital deficit. In this latter case a full-scale consolidation should be performed, in order that the deficit should be taken into consideration to its full extent during the consolidation. In the case of credit institutions and investment firms Directive 2000/12/EC stipulates primarily full consolidation, consolidation according to participations is possible only if responsibility is also limited according to participation.

#### 4.1.2.2.3. Intra-group transactions and risk concentrations

Intra-group transactions on their own do not threaten the system, since even the need for more efficient division of activities within the group, for focusing on the core activity, results in the creation of groups and conglomerates. The responsibility of the regulators is to ensure that the transactions should not weaken the financial position of the group and should not endanger their maintenance. To this end, there should be a clear picture of the flows and accumulation of risks even on the level of groups, too.

From the point of view of supervision there are two aspects which might be problematic: **relations of mutual dependence** as a result of intra-group transactions and **pricing of transactions among each other**. Thus, during the supervision of intra-group transaction, and similar to that of risk concentration, first of all the **danger of contagion within the group**, possible **interest conflicts**, the **risk of evading sectoral rules** and the **level and magnitude of risks** is to be evaluated.

Intra-group transactions and risks on their own rarely cause permanent insolvency, due to the mutual dependence within the group. However, liquidity or profitability problems of individual members in general may temporarily concern to other group members. Mutual dependence within the group and several forms of different internal transactions often lead to the development of accumulating risks. Table 3 summarizes which types of transactions may contribute to the development and strengthening of different risks.

**Table 3: Risks of intra-group transactions**

Types of risks	Types of transactions
Risk of intra-group contagion Risk of interest conflicts Risk of regulatory arbitrage	Intra-group trade (not necessarily at market prices) Intra-group allocation of certain assets under special conditions (more favourable taxation and market terms, presence of professionals) Centralized liquidity management Risk transfer through reinsurance or securitisation Allocation of client claims or of liabilities among parts of the company (according to the interest of the group and not of the client) Intra-group extension of loans, assuming guarantee and commitments (pricing, follow up of flow of assets might be problematic)

EU directives **regulate risk concentration in each sector with quite different methods and to quite a different extent**. In the case of credit institutions and investment firms limits are stipulated in relation to the amount of the regulatory capital. In the case of individual institutions and homogenous groups consisting of credit institutions and investment firms a large exposure is when it exceeds 10 per cent of regulatory capital and 25 per cent is the upper limit. The amount of aggregated large exposures may not exceed 800 per cent of the regulatory capital. As a similarly quantitative regulation, a credit institution may acquire participation only up to 15 per cent, on an aggregated level to 60 per cent of the capital, with the exemption of other credit institutions, financial institutions and undertakings providing ancillary banking services. **Holding limits** of credit institutions and investment companies **do not relate to insurance undertakings** and equities kept temporarily with the purpose of avoiding losses. If, however, the credit institution exceeds holding limits – which it cannot do in the case of large exposures – then it has to cover the amount above the limit with 100 per cent capital. Insurance undertakings also enjoy more favourable treatment in the case of large exposure limits of credit institutions and investment firms; in their case the 25 per cent limit becomes as high as 40 per cent.

EU regulations relating to the acquisition of investment firms is more liberalized than in the case of credit institutions, namely the 15% and 60% limit will not be

applied. The large exposure limits, however, are valid with the same conditions for them as well.

In the case of insurance undertakings, according to the directives, asset spread rules are used only for those assets which are to be regarded as an investment form of the technical reserves. Thus, the investment limits are stipulated in the proportion of the technical reserves.<sup>35</sup> Regarding investment of assets other than technical reserves member countries may not impose limitations. The fundamental approach of investing technical reserves concerns safety, yield and marketability, which is supported by diversification. Consequently, diversification rules significantly contribute to the validation of the above-mentioned aspects. Risks connected with the investments of insurance undertakings are connected with individual institutional levels, while on a group-wide level both technical reserves and investments are aggregated. Thus, if insurance undertakings fulfil their asset spread rules on an individual level, they will be fulfilled automatically on a group-wide level, too.<sup>36</sup> There are no concentration limits connected with commitments of the insurance undertakings (insurance contracts). These risks are to be covered with other instruments, such as reinsurance and mutual insurance.

Due to diverging sectoral rules, banks and investment firms may easily evade large exposure limits through insurance undertakings participating in the group but not included in the consolidation. They are able to do this because in the case of insurance undertakings the investment of assets other than technical reserves, thus, own capital, is not limited at all, and also transactions not connected with technical reserves are not limited either.

#### **4.1.3. Cooperation and information exchange of supervisory authorities**

Although the exchange of information of supervisory bodies with other authorities (supervisory organizations, liquidators, auditors) in order to perform their duties

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<sup>35</sup> For example, they might not invest more than 5% of their technical reserves into securities of one issuer, more than 10 per cent in nearby buildings and land and OTC products, and they cannot hold more than 3% cash.

<sup>36</sup> It is an exemption from individual institutional limits if an insurance undertaking has a more than 50 per cent participation in an investment fund, because in this case the supervisor of the insurance undertaking also has to consider the operation of the fund and its assets when evaluating the insurer.

was not hindered formally by data protection and confidentiality requirements in the directives already in force before the collapse of BCCI, nevertheless the flow of information was (and in several cases it is even today) interrupted.

The cooperation of supervisory authorities in different countries and inside a country is hindered to a various extent by different sectoral directives. Cooperation among supervisory authorities takes place in the case of credit institutions and investment firms when it concerns obtaining information about new owners and when evaluating their suitability. In the case of insurance undertakings, however, there is no measure like this in the directive. In the case of cross-border financial groups, supervisory cooperation agreements form the framework of cooperation and the performance of consolidated supervision functions. Directives on credit institutions, investment firms and insurance groups also provide for this if these institutions belong to the one and the same group. Then the supervisory authorities have to cooperate closely and transfer information supporting each other's work.

Experience of the cooperation of supervisory authorities in the EU in the nineties indicated that the present supervision of cross-border financial conglomerates and groups would be executed in nearly all cases through the Memoranda of Understanding (MoU) defining the target of cooperation. In special cases a similar agreement may define the competent supervisory authority performing the consolidated surveillance if the provision of the directive is not clear (for example, a holding company is registered in a country where its members or at least one of its credit institutions are registered, or the parent company is a credit institution; then the supervisor of the credit institution is responsible for the consolidated surveillance).

During cross-border acquisitions the cooperation and distribution of work between different levels of acquisition, the supervision of institutions acquiring participation and the supervision of the acquired institution will considerably change. Acquisition might be rejected by the supervisory authorities of both countries, either because the new acquisition will weaken the financial position of the acquiring institution, or because the new owner is deemed incompetent to assure the proper management of the institution. The supervisory authority of the institution acquiring the participation is responsible for the consolidated supervision and to

execute this work it is in continuous contact with the other supervisory authority concerned. The supervisory authority of the institution acquired executes the observance of rules of acquisition, and thus the institution purchasing the participation has to cooperate with this supervision, too. As so far as an institution acquired becomes a subsidiary, the supervision of the subsidiary may perform the individual surveillance of the subsidiary and it may collect information on other members of the group only if it has a separate agreement concluded with the supervision of the parent company. The last step during the acquisition is, if the institution acquired becomes a branch, then the surveillance of the branch is limited to an investigation of the liquidity position.

The case of BCCI called attention to the fact that all these orders are not sufficient to undertake efficient surveillance over financial groups which are supervised by several supervisory authorities, or over institutions where the contacts with and accessibility of owners is not clear. It also called the attention to the fact that, in order to discover the problems of institutions, the information is needed from all the authorities which make surveillances of these institutions or have possession of any data connected with them.

#### ***4.2. The post-BCCI directive***

Directive 1995/26/EC, the so-called post-BCCI directive, modified the regulation of all institutions supervised in the financial sector with tightening supervisory licensing and strengthening cooperation between supervisors. Thus there are amended credit institutions directives 77/780/EEC and 89/646/EEC, non-life insurance directives 73/329/EEC and 92/49/EEC, life insurance directives 79/267//EEC and 92/96/EEC, investment services directive 93/22/EEC and a directive on undertakings for collective investment in transferable securities (UCITS) 85/611/EEC. The obvious purpose of the directive was to prevent the establishment of institutions like BCCI, which were created evidently to make use of different regulatory requirements in different countries, the improper cooperation of supervisory authorities and, as a consequence, making use of hidden relations which were not discovered by supervisory authorities. **To discover hidden relations a new definition was introduced: close link.**

### 4.2.1. The close link

Supervisors may refuse to issue authorization or might withdraw it if the ownership and control is a ‘close link’ one, hindering efficient supervisory work. **Close link** is defined by the directive as the contact when there is a **participation or control relationship between two natural or legal persons**.

**Participation** relationship exists if one person has *permanent* ownership over 20 per cent of the capital or voting rights (directly or via control). **Control** relationship is the **parent-subsidiary** (according to the directive on accountancy) or **similar contact**. The parent-subsidiary contact is detailed in the accountancy regulation and makes it compulsory to elaborate a consolidated financial report. In the sense of the accountancy directive, that undertaking controls another one which

- owns the majority of voting rights
- is in the position to nominate or recall a majority of managers and which is at the same time a shareholder or member of the undertaking
- according to the statute or contract has a dominant influence in the undertaking and at the same time is a shareholder or member of the undertaking
- solely on the basis of its votes the majority of the leaders was nominated (and there is no other parent company which would satisfy the previous 3 points) and at the same time is a shareholder or member of the undertaking
- with voting rights acquired through an agreement or contract controls the undertaking on its own and at the same time is a shareholder or member of the undertaking.

Similarly, it is a control relationship and the undertaking can be compelled to submit a consolidated financial report if it is in a **participation relationship** with another undertaking and **over and beyond**

- it practically has a dominant influence in the other undertaking or
- they are managed on a unified basis because they have a common parent company.

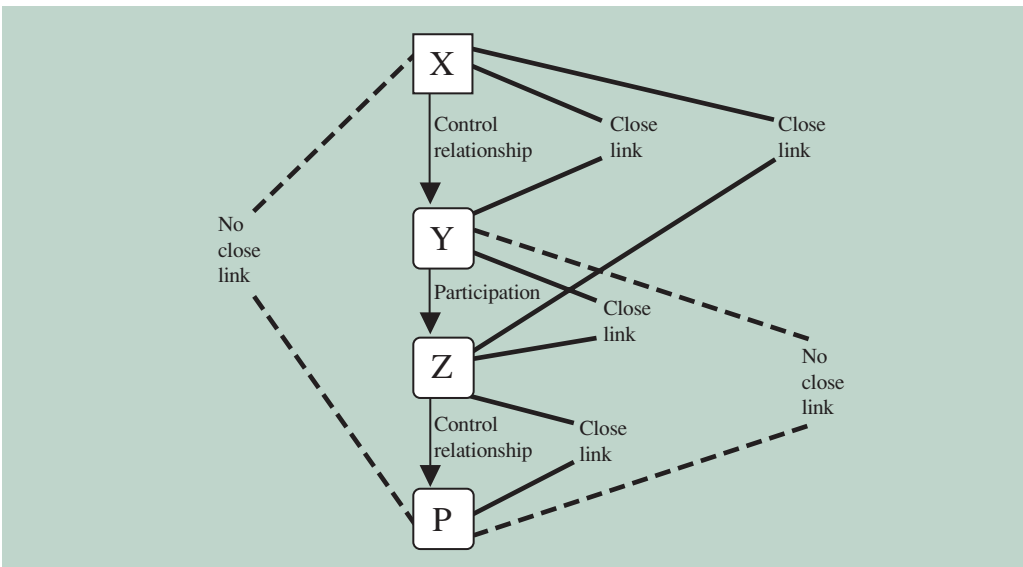
It seems that the person who is able to influence the activity of the institutions will also be determined basically **through ownership or membership relation** in the future. The decisive difference is the **consideration of natural persons, and the addition “similar to that” regarding control relationship, which turns definitions**



of accountancy directives into a basis of correlation regarding the strength of the contact, while not making necessary the presence of a participation or membership relation.

A close link will be evaluated between two legal entities in a sister relationship, too, if they are in a control relationship with a natural or legal person.

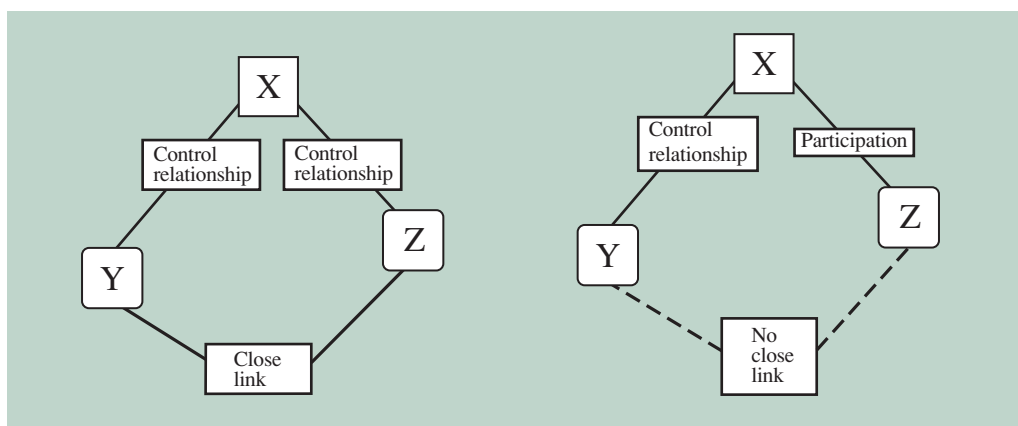
If there is a direct *permanent participation or control relationship* between two institutions, than there is a close link between them and they form a group. If, however, there is a **multiple chain**, i.e. the subsidiary has a subsidiary (control relationship) or other participation relations, *close link will be “inherited” via the control relation only*. This is shown in the figure below:



Similarly, two companies in a sister relation are not in close link if one of them is only in participation relationship with the parent company.

Thanks to the post-BCCI directives, sectoral directives<sup>37</sup> all include the provision that supervisory authorities may *reject authorization or revoke a licence* if ownership and controlling (close) links or legal rules in third countries relating entities in close link with them hinder efficient supervisory work. These obstacles may relate

<sup>37</sup> Directive 2000/12/EC on credit institutions, Directive 92/49/EEC on non-life insurance, Directive 92/96/EEC on life insurance, Directive 93/22/EEC on investment services and Directive 2001/107/EC on asset management.



to the supply of information, thus it may happen that legal rules restrict the flow of information. The supervisory authority should be informed continuously about close links and about changes in obstacles relating to close links, not only at the time of authorization.

The amendment reflects the lesson of the BCCI case, i.e. **the supervisory authority has to see who are those influencing the operation, profitability, solvency of the supervised institution, because the supervision of the institution alone is not sufficient.**

At the same time the EU directives give the minimum interpretation of the definition of close link, compared to which member states might be much stricter by interpreting other relationships also as close links.

### Definition of close link in the British regulation

Definition of close link in Britain is not much different from the definition in the EU directives. The difference is that close link between parent, subsidiary and sister company is accomplished with persons, the instructions, and orders of whom are followed by the institution's managers.

It is about a parent company or subsidiary, if any of the seven characteristics of the controlling relation listed in the EU directive is present and the eighth characteristic is, if a certain person owns a participation of over 20 % of the voting right or capital. Thus certain relations will be differently aggregated, when participation relationship is defined also as parent-subsidiary relationship (participation of over 20 % of the voting right or capital). In the ownership chain, however, only the parent-subsidiary relation representing

controlling relation "spreads" close link, parent-subsiary relation representing participation does not spreads, just like in the EU directive.

#### Close link in the German regulation

The German regulation defines close link among natural and legal persons, where directly or indirectly they own 20 % of voting rights or capital, and there is a parent, subsidiary, sister or similar relationship among them. Practically, they took over the definitions of the directive and they did not strengthen the prescriptions of the directive with enlarging the "list" of the contacts.

### 4.2.2. Unity of head office and registered office

Insufficiencies in the regulation relating to opting for competent supervisory authorities became obvious in connection with the BCCI case. The organizational structure and the geographical location of the financial sector's institutions' activity is often the result of different regulatory requirements, and it is obvious that the home of a registered office and the main geographical location of activity are often different, because the requirements on the site of the registered office are looser. Thus financial entities may use geographical regulatory arbitrage when choosing office locations. In order to arrest this tendency the directive stipulates that a **licence is to be issued only if the head office and registered office are in the same member state**. In the case of credit institutions it is also regulated that only the member state with the *centre of operation* may issue the licence. The definition of head office is stipulated by each member state on its own. In the British regulation, for example, that member state is regarded as having the head office, where the centre of management and control is.

### 4.2.3. Cooperation of supervisory authorities and other authorities

The post-BCCI directive put the cooperation of supervisory authorities and the possibility of requiring information from each other on a much broader basis. **The scope of owners and institutions to be investigated extended with the new def-**

**initiation, close link, and ensuring efficient supervision was made a crucial criterion.** If a close link of owners and a supervised institution hinders efficient supervision, the licence can be refused. In order to perform efficient supervision the cooperation of supervisory authorities and other authorities is needed and supervisory authorities are to be provided with more information. Exchange of information and cooperation was constrained earlier to institutions under consolidated supervision.

Obviously this type of exchange of information is subjected to a certain kind of data protection requirement. Regarding the difficulties, however, the amendments of the post-BCCI directive authorize member states explicitly to allow in the course of the supervision of credit institutions, investment firms, insurance undertakings and UCITSs the exchange of information between relevant supervisory authorities and liquidators, auditors, actuarial supervisors, authorities investigating the observance of corporate law and central banks. Licences and agreements on the exchange of information have to include under what conditions and for what purpose the exchange of information takes place, in order not to compromise data protection requirements. The exchange of information with supervisory authorities in other countries should be regulated by a memorandum of understanding between supervisory authorities and the exchange of data should only take place for the purpose stipulated in the agreement.

For supervisory authorities the mutual knowledge of closely linked institutions and the information available from other authorities provide data giving insight into the dependence of a supervised institution vis-à-vis a group. Thus, the reporting obligation is not doubled or multiplied for market players. As an interesting provision of the directive, the relevant supervisory authorities may require information from authorities supervising corporate law as well, since thus they may acquire some information about institutions, i.e. on holding companies not falling under the scope of their supervision. This, however, is possible only in definite cases, when it is necessary for performing their supervisory activity. The directive provides for the case - which was in force in a few member states already - whereby **auditors have to report to the supervisory authority any problem or abuse realized not only by institutions under the scope of their supervision, but by any (even non financial) institutions which are in close link with a financial undertaking.**

### 4.3. Regulation of heterogeneous groups (financial conglomerates)

In the present regulation of the financial sector it is an inadequacy that only the group-wide regulation of homogeneous groups (credit institution-credit institution, credit institution-investment firm, investment firm-investment firm, insurance group) has taken place in sectoral rules and **the group of insurance undertakings with credit institutions and investment firms was not regulated**. The participation of insurance undertakings with other financial institutions and investment firms in one holding, the so-called conglomerate, creates a new risk, mainly through the regulatory arbitrage possibilities among sectors and non-equal conditions of competition. Thus a new directive was elaborated on the supplementary supervision of financial undertakings creating a conglomerate, the parliamentary debate of which is going on at the time of preparing this present paper (Q2 2002). **The new directive does not replace existing sectoral rules, but it creates the supplementary supervision of conglomerates acting in different financial sectors. Its purpose is to make up for insufficiencies due to sectoral regulation, to eliminate non-consistent overlapping and to create efficient supervision of financial groups.**

In parallel with the new directive, sectoral rules will be amended and clarified by harmonizing certain *definitions* (participation, joint venture, holding company, etc.) and *contacts with supervisory authorities*. It places *mutual cooperation of supervisory authorities on a common basis*, and *modifies the calculation of own capital* (deduction of participations in other financial institutions from own capital) and rules relating to intra-group transactions.

The new directive enables supervisory authorities **to evaluate group-wide**

- the meeting of *capital adequacy requirements* (restricting in this way multiple capital gearing and excessive leverage),
- *risk concentration* and
- intra-group transactions.

Even in the parliamentary phase of the legal procedure (first reading) an intense debate emerged about how it should be decided which institutes belong to one conglomerate. Should it be decided upon “close link” or supplementing the fundamental rule with the parent-subsidiary relationship, or should the opinion of the

supervisory authority decide it in dubious cases, as stipulated in the directive on credit institutions?

Besides the definition of close link in earlier directives the new draft includes the case when one institution exercises a dominant influence on the other only in the opinion of the supervisory authority. Moreover, it considers relationships as a close link when there is no participation, yet the relationship influences the activity of the institutions, or there is a common management, or the majority of the leaders are the same persons. *With this new definition the scope of the group is extended to cases where there is no participation relationship between the two institutions, but where in the sense of accounting rules they are to be consolidated (permanent influencing relationship, common management, common leaders), or they are not even consolidated by accounting rules (opinion of the supervisory authority).*<sup>38</sup>

Besides groups with homogeneous activity already regulated, now the regulation and surveillance of **financial conglomerates** is taking place. There are two steps in deciding which are the groups to be defined as financial conglomerates.

In the first step is to decide whether there is a **financial group** as such. This depends on the proportion of regulated and non-regulated (i.e. holding company) *financial* undertakings in the group. The next step concerns the **significance of activity in different financial sectors** (banking and investment service activity is the same sector), thus connecting insurance activity to a different financial activity. **According to the draft of the directive, the inter-sectoral activity is significant if total assets or capital requirement of the smallest institution acting in the financial sector exceeds 10 per cent of the indicators of the group.** If a regulated financial institution (bank, investment firm or insurance undertaking) is leading the group and the group is also active in other sectors, then it is a financial conglomerate, irrespective of the proportions within the group.

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<sup>38</sup> In the debate going on during the elaboration of this study the opinion of the European Parliament was that the definition of close link and the rules connected with it should be left unchanged; thus, the surveillance of legal or natural persons in close link should be connected to the refusal or revocation of a licence. The consolidated reporting obligation would be adjusted in line with the previous sectoral directives, only its scope would be extended to all the institutions mentioned by the draft acting in different financial sectors. Accordingly, besides a parent-subsidiary relationship the opinion of the supervisory authority would determine which has a dominant influence. With this modification they could ensure that, in contrast to the conglomerate based on close link, institutions merely in participation relationship, or managed on a unified basis but in reality not having a significant influence, would not automatically become a member of the group and the supervision's discretion would decide the matter.

The draft introduces a new institutional form against the earlier institutional system, the *mixed financial holding company*, the holding company which is on the top of the financial conglomerate. Groups with inter-sectoral activities could be ranked into the *definition of mixed activity holding company and mixed activity insurance holding company* until now, too, but group-wide capital requirement regulation, the definition of competent supervision and the obligation of providing information did not relate to them. With the introduction of the new regulation, mixed financial holding companies are to be assigned on the basis of precise definition. Other holding companies (financial holding company, mixed activity holding company, insurance holding company, mixed activity insurance holding company) are inversely defined, i.e. from among earlier holding companies those are not included in the group which are not mixed financial holding companies.

The supplementary supervision relating to conglomerates also stipulates **group-wide requirements for institutions not yet regulated** (newly defined holding companies). **The supervision of these institutions on an individual basis, however, is not necessary.** In the sectoral directives presently in force the aspect is the same, since for financial institutions (thus for a financial holding) or insurance holding companies prescriptions of risk and diversification limits and capital requirements are not applied. However, if they belong to one and the same scope of consolidation with regulated institutions then group-wide requirements take account for their risk exposures, too.

#### **4.3.1. Up-to-date nature of the directive and the Financial Conglomerates Committee**

Since financial conglomerates are rapidly changing organizations, their organizational structure and geographical location is often created to make use of imperfections in the law. Thus the directive enables the Commission to interpret the definitions of a conglomerate at any time due to developments on the financial markets, or to ensure their uniform application. This should proceed in the same way in the case of technical and substantial definitions of capital requirements. With these clarifications there is no need to amend the directive if the development of the financial markets overtakes the level included in this directive. The

Commission's work is supported by the Financial Conglomerates Committee, where all member countries are represented.

#### **4.3.2. Consolidation of group members outside the member states**

The proposal - in order to create a level playing field - attempts to ensure an equal regulation environment for groups with parent companies outside the member states. If the competent supervisory authority is certain, and the Council acknowledges it within two months, that the regulation of the third country is equivalent with that of the EU, then, assuming the cooperation of supervisory authorities, the supervision in the third country will oversee the observance of group-wide requirements. If the rules are not equivalent, the competent supervisory authority of the EU member state might prescribe that institutions registered in member states belonging to the group should create a mixed financial holding company and this sub-group should be treated in line with the new directive.

#### **4.3.3. Prudential rules relating to financial conglomerates**

##### *4.3.3.1. Capital adequacy requirements*

In addition to rules relating to capital requirements the directive encourages the supervisory authorities of member states to ensure an adequate capital allocation policy and to implement internal control mechanisms on the conglomerate level as well. The competent supervisory authority or member state may decide in certain cases which group members should belong under the consolidated capital adequacy requirement. Thus it is not necessary to take into consideration group members which are in third countries and where legal barriers constrain the availability of information, or they are negligible from the point of view of the consolidated supervision (if, however, several negligible members together are significant, they are to be included) and if the drawing in of the group member would result in a misleading assessment.



#### 4.3.3.1.1. Minority owners

Due to inconsistent results of full-scale consolidation and pro-rata consolidation (the latter regards minority owners as independent owners) presented in the section on regulating homogeneous groups, the Council decided in the proposal about the prescription of a conservative procedure of regulation like in the case of an insurance group. The regulation stipulates full-scale consolidation if the subsidiary is undercapitalised and a pro-rata consolidation if it has a capital surplus. Taking into account the subsidiary's total capital deficit is considered because if there are financial problems it is the responsibility first of all of the majority owner to intervene and provide help.

#### 4.3.3.1.2. Capital elements to be selected on group-wide level

Capital elements eligible under sectoral rules are to meet individual level capital requirements. Certain capital elements and the volume and proportion of acceptable capital elements are stipulated by legal rules relating to the course of business risks and risk management common in that sector. At the conglomerate level, however, only capital elements might be accepted which are mutually recognized by the regulation of individual sectors. Limits prevailing among individual capital elements on the individual level are to be applied with appropriate modifications (*mutatis mutandis*) on group-wide level, too. Thus, tier 2 elements may not exceed 100 per cent of the core capital even on group-wide level, as was the rule in the case of banks and investment firms beforehand.

Besides capital elements eligible on a group-wide level, there will be capital elements which are also to be allocated in the future exclusively to risks arising from banking and investment activity or insurance risks. Thus, members of a conglomerate have to meet their individual capital requirements primarily from these capital elements, in order that its total capital surplus should come from capital elements which are acceptable on a group-wide level. Thus, for example, only banks may include general provisions as capital element and only up to the level the regulation of the sector allows. If it disposes of a surplus in general provisions, this will get lost for the group as a whole.

**Table 4 Capital elements eligible on a group-wide level**

Credit institutions investment firms (CAD, Own funds Directive)
Life and non-life insurance institution (1st Life Directive as amended by 3rd Life Directive and 1st Non-Life Directive as amended by 3rd Non-Life Directive)
Paid-up share capital
Capital reserve (not explicitly mentioned with insurance undertakings, but included)
Reserves (in the sense of 78/660/EEC, not technical reserves)
Revaluation reserves (not explicitly mentioned with insurance undertakings, but included)
Retained earnings (profit brought forward from the previous years)
Interim profits, under certain conditions (net profits realized in trading books, too)
Subordinated instruments of indeterminate duration under certain conditions, including undated cumulative preferred shares
Subordinated liabilities, under certain conditions, including fixed-term cumulative preferred shares

On defining eligible capital elements on a group-wide level the requirements concerning the quality of capital will be stipulated. Thus there is no possibility for the capital adequacy on the group-wide level to be ensured on the basis of capital elements which are not eligible for the other sector, thus banking or insurance risk would be undercovered.

#### *4.3.3.2. Intra-group transactions and risk concentration*

With reference to what was said about homogeneous groups earlier, in the case of conglomerates it is even more correct to say that the existence of group-wide transactions in itself is a good thing, but interdependence resulting from group-wide transactions and pricing may give rise to additional risks.

The EU regulators did not find it necessary to introduce any quantitative limits on any risk concentration in the case of conglomerates; however, member states may set such definitions. Instead of quantitative limits they stipulated a reporting requirement for significant transactions and risks. The relevant supervisory authorities may determine what is to be regarded as significant transaction or risk in proportion to the capital or, in the case of insurance undertakings, to technical reserves. The directive did not make any decisions on this level because this decision requires consideration of the nature, management and risk management structure of the group.

Instead of quantitative limits there are 3 pillars regulating transactions and risk exposure: a management policy connected to internal transactions and risk awareness, a reporting obligation and efficient supervision.

The new directive also modifies existing sectoral directives. The calculation of regulatory capital was complemented with investment limits. If the participation of an insurance undertaking, credit institution or investment firm exceeds 10 per cent of the capital of the other insurance or reinsurance undertaking, credit institution or financial institution, that should be covered by capital. The own funds calculation made on an individual basis may deviate from this rule, if they are subjected to a consolidated supervision, or if the participation was acquired temporarily. This rule was in force already earlier for credit institutions and investment firms, but the scope of other institutions exempted included insurance and reinsurance undertakings.

#### *4.3.3.3. Evaluation of the management – cooperation of supervisory authorities*

Sectoral directives always provided that supervisory authorities should be informed about the appropriateness of owners and the abilities, experience and reputation of managers (“fit and proper requirement”) before a nomination or acquisition. The BCCI case called the attention of regulators to the importance of investigating whether persons in “close link” with managers or owners hinder them in properly exercising their duties. Even previously the directives of banking and investment firms prescribed prior consultation with the competent supervisory authorities, in order to gather information about future owners, managers and their “close links”. The directive on insurance undertakings does not include a regulation like that. The directive on conglomerates, therefore, stipulates that insurance undertaking supervisors should also ask for the opinion of the supervisory authority in the other member state, if

- the insurance undertaking is a subsidiary of an insurance undertaking, credit institution or investment firm in another member state,
- the insurance undertaking is a subsidiary of a parent company which has an insurer, credit institution or investment firm subsidiary in another country,
- it will be controlled by a natural or legal person which has an insurer, credit institution or investment firm in another member state.

Directive 12/2000 provided for the co-operation requirement in case of banks and investment firms, but insurance undertakings were not included in the range of institutions with this obligation. Thus Directive 12/2000 was also amended in line with the above-mentioned definition.

#### **4.3.4. Coordinator among supervisory authorities**

In view of the cross-sector and cross-border supervisory requirement of financial conglomerates, the directive deals with the cooperation among supervisory authorities and with the selection and responsibility of a coordinator, who is responsible for the cooperation among supervisory authorities. The purpose of the coordinator's selection is to have a responsible, authorized organization which

- has an overview of the conglomerate as a whole, and even of niches not covered by the competent supervisory authorities,
- is able to prevent double supervisory surveillance; thus surveillance is more cost effective both for supervisory authorities and market players,
- facilitates simpler procedures and more effective supervision.

Sectoral supervision meant until now that different supervisory authorities investigated only individual institutions or different separated sub-groups. If a conglomerate as a whole comes under the control of one supervisory authority, it is important that cooperation among supervisory authorities should be created, which involves awareness with the risk profile of different sectors calling for unified prudential requirements. When deciding on the creation of the supervisory coordinator's function, the directive followed the recommendations of the Joint Forum in 1999. There are only viewpoints formulated in the directive regarding the selection of the coordinator, in order to leave way for selecting the competent supervisory authority by taking into consideration the organizational and risk features of the given conglomerate.

If there is no immediate understanding among the supervisory authorities regarding the coordinator, either the supervisory authority controlling the leading body of the conglomerate or, if the leading body is a holding company (which was not supervised on an individual basis), the supervisory authority of one of the supervised institutions registered in the same member as the holding company, or the

supervisory authority of the institution with the largest balance sheet of the conglomerate will perform the task of coordination.

responsibilities of the coordinator involve:

- continuous gathering and dissemination of information and data
- evaluation of the financial position of the conglomerate, monitoring the fulfilment of group-wide prudential rules (capital adequacy, intra-group transactions, concentration of risks)
- information on the organizational structure, internal control system of the financial conglomerate
- outlining and coordinating procedures of supervisions.

With this new distribution of work among supervisory authorities the EU legislators did not want to create a new form of supervision, a new institution. The tasks and responsibilities of supervisory authorities stipulated by sectoral rules are still in force.

The directive deals with the legal background of the exchange of information among supervisory authorities, especially with the authority of the coordinator to obtain access to information, which can be neglected only in exceptional cases. The information forwarded is related first of all to identification of the members of the group and competent supervisors, the strategy of the conglomerate, M&A plans, financial position, significant shareholders and leaders, organizational, risk management and internal control systems and the verification of information.

The directive also draws central banks into the exchange of information – in their capacity as the monetary authority and the authority responsible for overseeing payment systems – in order to ensure that they should get all the information required at any time without doubling the burden of data supply.

The directive states that the requirements relating to the secret and confidential handling of information stipulated earlier in the sectoral rules are still in force; thus these rules are not compromised.

#### **4.3.5. Changes affecting market players**

The directive relates to all groups operating in all financial sectors, irrespective of their size. These groups and conglomerates, as of the application of the directive,

have to fulfil group-wide requirements and provisions regarding risk concentration, intra-group transactions, the fit and proper nature of managers, and the information about their contacts. The directive prescribes one more reporting obligation, and creates the possibility for the supervisory authority to acquire and monitor all the information which relates to the conglomerate as a whole and its regular operation.

## *5. Regulation in force in Hungary*

The elaboration and practice of the legal rules of financial undertakings and consolidated supervision is inconsistent in the law and practice of supervision in Hungary. As a result of legal harmonization, the amendment (Act CXXIV of 2000) of the Act on Credit Institutions (Act CXII of 1996) introduced a new chapter on consolidated supervision into the Act. As a next step forward, the trading book's regulations<sup>39</sup> introduced similar prescriptions when formulating the capital requirements of market risks. **Thus the provisions regarding group-wide supervision of credit institutions are formally harmonized. However, there are errors in both definition and procedure, which have the consequence that the substance of the Hungarian regulation does not meet either the purpose of legal harmonization or the goals of consolidated regulation.** As a result of these errors and still existing insufficiencies, the Hungarian Financial Supervisory Authority (in the Hungarian acronym: PSZAF) does not require consolidated data supply. **Insufficiencies and errors, which deviate fundamentally from the logic of group-wide supervision, relate to two areas: the scope of institutions to be consolidated with the purpose of prudential surveillance and the method of calculation of consolidated own funds and capital adequacy.**

Nevertheless, the Hungarian supervisory authorities has to be informed about financial groups, about their aggregated risk exposures, even though legal insufficiencies exists. Hungarian financial undertakings also have to observe group-wide requirements, because otherwise individual prudential provisions can be easily circumvented and dependencies remain uncovered not only for the supervision but for financial undertakings as well. Hence, for groups including a credit institution an attempt was initiated in autumn 2001 to amend legislation and in Q1 2002 the supervisory authority ordered an extraordinary supply of consolidated data.

**Financial undertakings not belonging to any credit institution** are not subjected to group-wide requirements, even formally. Thus, **in financial groups with no credit institution there is no consolidated requirement either.** Hence, consolidated reporting rules do not relate to homogenous groups of investment firms or groups controlled by an investment firm, which were already subjected to regulations in

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<sup>39</sup> Government Decree No. 244/2000 (XII.24)

the EU as of 1993, nor, similarly to the insufficiencies of the EU directives, to insurance undertaking or asset management company group members. Group-wide regulations relating to insurance undertakings do not exist in the Hungarian regulation. The definition of different institutions, like insurance holding company or mixed activity insurance holding company, is also missing.<sup>40</sup> The trading book regulations do not surpass the threshold of credit institutions either, since consolidated requirements stipulated in this regulation relate only to the controlling credit institution and its subsidiaries keeping the trading book, i.e. **only specific members of the banking group**.

Similar to the chapter discussing EU regulation, we overview first regulations related to the organizational structure of financial groups, thus determining the corporate structure of financial groups. Then we summarize regulations about group-wide prudential requirements and supervision. We investigate Hungarian rules primarily in relation to the EU regulation in force, the content and logic of which we have seen in the previous chapter. In this chapter we deal with the deficiencies of logic in the Hungarian regulation; however, we don't discuss the guidelines of consolidated regulation in as much detail as we made did in the previous chapter.

### ***5.1. Rules regulating the structure of financial groups***

According to the Hungarian regulation the activity, organizational and legal structure of financial group members are influenced not only by the definition of their exclusive or dominating activity but in the case of credit institutions *also the person of owners is strictly regulated* in terms of who may acquire considerable ownership or voting rights in the individual institutions. This taxative rule, which might seem strict at first glance, is special for the Hungarian regulation. Other rules defining organizational structure (exclusive or main activity), reporting obligation of acquisition, right of veto of supervision) are similar to the EU regulation. It is arguably an important deficiency that “close link” is not defined and, in the case of insurance undertakings, in a situation when new owners are incompetent the supervision has no right of veto.

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<sup>40</sup> The planned modification of the Act on Insurance Undertakings (Act XCVI of 1995) will end these deficiencies.



### 5.1.1. Specialisation principle

Deposit collection, insurance and fund management activities may be executed only by institutions defined by legal rules just as much in Hungary as in the EU. Thus, there may be no legal person in Hungary either, who executes all these activities in one entity. A bank, however, may be involved with the whole range of investment services.

### 5.1.2. Acquisition limits

Pursuant to the Act on Credit Institutions, only the Hungarian government, another credit institution, universal postal service provider, insurance undertaking, investment firm, financial holding company and the Hungarian Deposit Insurance may acquire a 15 per cent or higher ownership or voting right in a credit institution. This provision reflects the intentions of the legislators that a not supervised institution should not acquire decisive ownership in a credit institution. A rule like this does not exist in the EU, and even in Hungary this range of institutions proved to be too narrow. Due to this rule, at present in Hungary only mixed activity holdings may be set up, the leading body of which is an insurance undertaking, universal postal service provider or investment firm. Whereas in the EU it can be any parent company, which is not a credit institution or financial holding company. However, among its subsidiaries there can be at least one credit institution.

### 5.1.3. Right of veto of the supervisory authority

The purchaser of participation is required to inform the authority and apply for a licence if a qualifying holding is acquired in terms of the acts on Credit Institutions, Capital Market and Insurance Institutions,<sup>41</sup> or if 15 per cent (act on insurance

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<sup>41</sup> Qualifying holding (acts on credit institutions, capital market and insurance institutions): a relationship which enables

- a) 10 per cent or higher participation in voting rights, ownership directly or indirectly
- b) the nomination or withdrawal of a significant part of the members of leading bodies (Act on Capital Markets: at least 20 per cent of members)
- c) the exercise of dominant influence over operation on the basis of statute or contract.

undertakings: 20 percent), 33 percent, 50 per cent and 75 per cent of voting right or ownership proportion is reached, similar to the regulations of the EU.

The provisions of the Act on Credit Institutions and the Act on Capital Markets regarding investment firms allow three months for the supervisory authority to refuse a licence, if the activity of the applicant (owner or leading officer) endangers proper management of the credit institution or the financial undertaking, or if the activity, contacts or acquisitions of the applicant hinder the pursuit of efficient supervision.<sup>42</sup> In this rule certain elements of the post-BCCI directive and a simplified formulation of close link is reflected. Nevertheless, **in contrast to the detailed explanations of the EU directives, it is not clarified what level of ownership participation and relationship might hinder efficient supervision and prudent management of the institution.** This, of course, might have the benefit that the supervisory authority can develop its own approach.

However, when licensing investment fund managers no prescription requires the investigation of owners, the owners' relations and their activities, involving the possible refusal of a licence. In EU regulation such rules have been in effect since Directive 2001/107/EC came into force.

The provisions of the Act on Insurance Institutions do not authorize the supervisory authority – in parallel with the notification requirement of acquiring ownership participation or voting rights – to refuse licensing due to the activity or relationships of the owner. There is a general clause, however, which enables the supervisory authority to decide about licensing in view of the interests of the insured and the feasibility of the duties of the insurer.<sup>43</sup>

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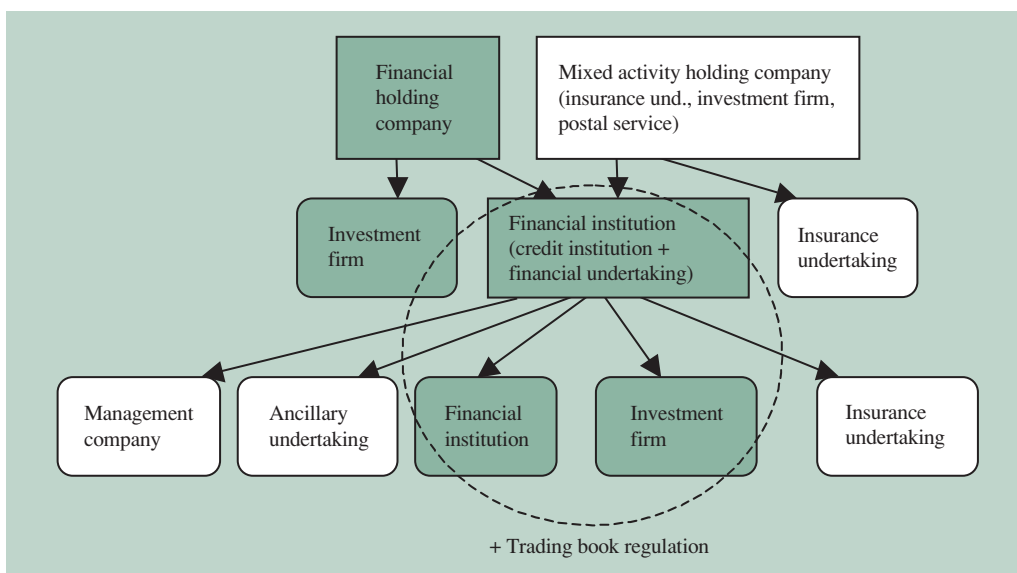
<sup>42</sup> Act on Credit Institutions Section 39 and Act on Capital Markets Sections 106 and 107 ( c )

<sup>43</sup> Act on Insurance Undertakings Section 43. (2)

## 5.2. Consolidated supervision of financial groups

### 5.2.1. Institutions to be consolidated with prudential purpose

The institutions covered by Hungarian consolidated regulations (Act on Credit Institutions, Trading book regulations) are shown in the figure below:



The Act on Credit Institutions regulates the consolidated supervision of groups including credit institutions on three levels, relating to different ranges of institutions.<sup>44</sup> *Data supply and the requirement of prudent operation* are to be met if there is at least one credit institution among the members of the group. This is the widest possible range of institutions and thus members of a banking group, a financial holding and mixed-activity holdings have to satisfy these requirements. A *register* is kept by the supervisory authority on banking groups and financial holdings, *group-wide risk exposure and capital adequacy requirements* are related to financial holdings or banking groups highlighted in grey; the consolidated requirement stipulated in the trading book relates to investment firms or a financial institution controlled by a credit institution.

<sup>44</sup> Act on Credit Institutions, Chapter XIV

Since financial holding companies are defined by the Act on Credit Institutions only, a holding company might be a financial institution, which owns exclusively financial institutions and investment firms, and at least one of them is a credit institution. Consequently, a holding company which owns only investment firms and investment fund managers is not a financial holding company and is not subject to consolidated supervision.

The major part of consolidated supervisory activities relates to institutions which belong to banking groups and financial holdings. Pursuant to provisions, institutions may belong to these groups, which are *controlled* by a credit institution or financial holding company.

The definition of controlling relation is different from the provisions in EU rules, despite the fact that they more or less correspond to each other. A **controlling relation** according to the Act on Credit Institutions exists:

if someone based on a contract or on ownership participation

- disposes of the majority of voting rights
- may nominate the majority of managers,

if, due to its financial, organizational and business contacts

- its leadership is coordinated with a different undertaking
- it can to be instructed to transfer profit, or to take over losses
- it owns voting or leadership rights over and above ownership participation, which is declared as voting shares,

if the majority of leaders is identical with the leaders of other undertakings.

The EU regulation identifies financial groups on the basis of the existence of parent-subsidiary relationship. Financial directives define parent-subsidiary relations specified in the directive on accountancy (83/349/EEC). However, from the point of view of consolidated supervision parent companies are institutions which are in a participation or capital tie other than defined in the accounting directives relationship, though according to the supervision's view they are able to exercise dominant or significant influence on the activity of the other. In addition, institutes representing a certain proportion of participation<sup>45</sup> also come under consolidated supervision.

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<sup>45</sup> As a reminder: direct or indirect permanent participation exceeding 20% of voting rights or ownership. In the case of insurers also permanent relationship.

Hungarian regulation deals with the controlling relationship only in the case of a banking group (group led by a credit institution) when, of the share capital, more than 20 per cent is owned by an undertaking belonging to a banking group,<sup>46</sup> or which is controlled by a person together with an undertaking belonging to a banking group. **Nevertheless, the supervisory authority does not have the possibility of using discretionary instruments and it is quite a crucial deficiency, too, that institutions not belong to a banking group can have 20 per cent or more of voting rights.**

### **5.2.2. Limitations in defining the institutions which are to be consolidated on a prudential basis**

The provisions of consolidated requirement are one-sided in the Hungarian regulation of the financial sector, since only the Act on Credit Institutions deals with this problem. The supervision of insurance groups is under elaboration in 2002, at the time of writing this study, so we may only suppose that rules will be created in line with directive 98/78/EC, with a view to legal harmonization. Due to the lack of comparable regulations in the Act on Capital Markets the asymmetry of regulation will prevail, despite the expected creation of the consolidated supervision of insurance groups.

The example of investment firms and credit institutions demonstrates asymmetric consolidation requirements. In the case where a credit institution controls an investment firm, pursuant to the Act on Credit Institutions they have to comply with group-wide prudential limits, capital adequacy, and, according to the trading book regulations, the evaluation of market risks will be made in a way as if they were one and the same institution.<sup>47</sup> However, if an investment firm is controlling a credit institution, they will be qualified as a mixed activity holding and thus they have to satisfy data supplying requirements on an individual basis; on a group-wide level

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<sup>46</sup> The Act on Credit Institutions mentions in this case only participation over 20% of share capital and it does not mention higher than 20% of voting rights.

<sup>47</sup> In the Trading book position risk, FX-risk and large exposure are stated on an aggregated basis ("as they would be if one institution"). On calculating the capital requirement of the partner risk this is not followed, then only claims against each other might be disregarded. Besides aggregated requirements, they also have to satisfy capital requirements on the individual basis. Group members have to meet capital requirements on the aggregated basis and individual basis as well.

they have no prescription to meet. This, of course, is a benefit for both institutions in that with multiple capital gearing they have the possibility of circumventing individual limits. On the other hand, transactions towards each other will not be exempt from large exposure limits (nor participations from investment limits and capital deductions), which might considerably deteriorate the organizational and economic efficiency of the holding.

In view of this regulation asymmetry, it is a relevant question in Hungary whether a credit institution or an investment firm owns an investment fund manager. The first one creates a banking group according to the Act on Credit Institutions, thus it has to supply data to the supervisory authority. The investment firm and the fund manager owned by it, on the other hand, are registered from the point of view of consolidated supervision as two independent institutions.

EU regulation does not include differences like this. Directive 93/6/EEC CAD says that a credit institution and financial institution owned by an investment firm is not qualified as a mixed activity holding. From the point of view of regulation, this is equivalent to an investment firm and financial institution owned by a credit institution.

Besides requirements depending on organizational structure, *inconsistent definitions* confuse the interpretation of related legal rules. Pursuant to the definition of a financial holding, a financial holding company and all the institutions controlled by it (financial institution, investment firm, insurance undertaking and other undertaking) make up a holding. A financial holding company, on the other hand, may own only financial institutions and investment firms. Thus it is not clear whether a financial holding company may exist at all where the financial holding company controls an insurance undertaking or investment fund manager, or where the insurance undertaking becomes a member of the holding as a subsidiary of a credit institution. The latter would be an obvious development. This, however, needs a provision to clarify the “legacy” of the controlling relationship.<sup>48</sup>

Apart from definition problems and the force of consolidated supervision, **the criterion of building groups, the controlling and participation relationship itself is not equivalent with definitions in the EU directives either. The most important dif-**

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<sup>48</sup> This provision should state that if one institution (A) controls an institution (B) which, in turn, controls a third institution (C), then this one (C) is under the control of the first one (A).

ference concerns the discretionary power of the supervisory authority. The EU provisions for similar cases are built on the experience that **the strength of mutual dependency of institutions, the basis of identifying group members, might not be based exclusively upon tight specifications**. Tight specifications can sometimes be circumvented, but at any time the opinion of the supervisory authority may decide upon the question of dominating influence between two institutions.

As a technical fault, the legal rule stipulates that a participation relationship was made dependent exclusively on the proportion of ownership in share capital, while the ownership of voting rights above 20 per cent as a decisive influence was left out. Due to the above-mentioned problems **the scope of institutions and the relationship among institutions, on the basis of which individual market players are registered as groups and are treated as one entity from the point of view of risk exposures, is different in Hungary and the EU countries**.

### 5.2.3. Prudential rules

The scope of the EU's credit institution directive and the Act on Credit Institutions regarding group-wide limits and capital requirements reflect differences, even irrespective of the above-mentioned institutional asymmetry. These requirements are very important during consolidated supervision, since they enable interdependent institutions be treated from the point of view of risk exposure as a single institution, and transactions aimed at evading individual limits, so-called regulatory arbitrage, are eliminated.

Directive 2000/12/EC regulates these requirements according to the scope of a sectoral directive. Thus the scope of consolidation will be stipulated among institutions **subject to the given directive**. In the case of the banking system this means, for example, that only credit institutions and financial institutions<sup>49</sup> have to meet prudential requirements on a group-wide level, while with insurance undertakings connected to them this is not necessary. The reason for that is basically the fact that these are financial undertakings with different regulation, and the requirements of prudential regulation concern the business procedures, risks and risk management of the related sector.

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<sup>49</sup> The EU definition of financial institutions also includes investment undertakings

The Act on Credit Institutions, on the other hand, in certain sections<sup>50</sup> stipulates for all the undertakings controlled by a credit institution and a financial holding company (financial institution, investment firm, insurance undertaking) the calculation of capital adequacy on an aggregated basis and the fulfilment of aggregated limits. In an inconsistent way, however, it is only for financial institutions and investment firms that these provisions specify precisely which requirements they have to meet together and how. Yet even in their case a specific provision regulating the calculation of own funds on an aggregated basis was not elaborated.

From a certain point of view, however, it is a positive development that the Act on Credit Institutions prescribes the group-wide fulfilment of prudential requirements for all regulated (by capital requirement or risk limits) entities. Hence the EU conglomerate regulation has the same objective. However, the problems and questions presented in the sections<sup>51</sup> on this subject illustrate most clearly how dubious and in many cases controversial are the provisions of group-wide requirements for institutions with different scopes of operation.

#### *5.2.3.1. Group-wide capital adequacy*

The provisions of group-wide capital of financial undertakings with similar risks (credit institutions, investment firms), identical prudential requirements and own fund capital elements will not pose special problems. The well-known accounting consolidation will do in their case to present risk exposure of the group and to state limits and prescriptions adequate for the risk exposure out of the consolidated balance sheet. The special decree on the calculation of the regulatory capital has to decide first of all about questions as to which capital level (tier 1, 2 or 3) new capital elements created as a result of the consolidation will belong, how minority owners should be considered etc.

From the time when one group fulfils the requirements of aggregated capital adequacy, it is not necessary to deduct its holding acquired in other institutions when calculating individual regulatory capital. The sorting out of multiple capital gearing is already accomplished by calculating regulatory capital on an aggregated basis.

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<sup>50</sup> Section 92 (2-3)

<sup>51</sup> See chapter 4.



Thus, if they meet requirements together, it is not necessary to cover investments related to each other with capital on an individual basis. In the presentation of EU regulations we mentioned the convenience of this practice. The Hungarian regulation, however, does not allow an exemption like that. This means that, in the course of individual calculation of credit institutions' own funds, holdings in each financial institution, insurance undertaking and investment firm should be deducted, if they represent a qualifying holding, or exceed 10 per cent of the credit institution's regulatory capital, irrespective of whether it meets the requirement of consolidated capital adequacy or not.

Provision of consolidated own funds of institutions with different activity and different regulation and numerical determination of group-wide risk limits, however, is a much more complex task requiring the observance of several considerations, which cannot be regulated by two paragraphs.<sup>52</sup> In this case, accounting consolidation is not an appropriate method for prudential consolidating of heterogeneous groups, to regulate risk exposure of the group. As mentioned earlier, the consolidation of institutions with completely different balance structure would result in a misleading evaluation. The consolidated balance sheet of a bank and an institution operating in another sector, for example an insurance undertaking or a non-regulated institution, is not appropriate to indicate banking risks and to state banking limits, nor any requirements based on the balance sheet. The same is true for the insurance risk, where the core risk is the uncertainty of the value of liabilities and the change in the value of assets supporting them. The reserve and capital requirement of insurance undertakings were stipulated by observing these risks. Thus, in cases like that the separation of risks of certain activities and the requirements meeting them might be necessary. Simultaneously, the sorting out of multiple gearing is also necessary. Methods presented in Table 2 are suitable for this purpose, but not so the aggregation prescribed in the Act on Credit Institutions,<sup>53</sup> since this does not sort out capital leverages and thus it is unable to define the amount of the adjusted capital available for the group.

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<sup>52</sup> Act on Credit Institutions Section 92. and 94 (5)

<sup>53</sup> Pursuant to Section 94 (5) of the Act, when certain conditions are met, the amount proportionate to the participation of the adjusted capital of the credit institutions, investment undertakings and insurers controlled by the leader credit institution should be added to the adjusted capital of the leader institution and this produces the aggregated adjusted capital of the group.

In the case of heterogeneous groups a further problem is to define capital elements which can be considered on a group-wide level, since certain capital elements (mainly reserves) might be used only by institutions which accumulated them. Moreover, the Hungarian regulation does not elaborate on questions concerning how capital levels (tier 1/tier 2) in different sectors will influence other sectors, etc. The measure of capital adequacy of the group as a whole is an eligible target, but sectoral rules (e.g. in the Act on Credit Institutions), due to their limited scope, are not suitable for setting unified requirements against institutions in different sectors.

#### *5.2.3.2. Intra-group transactions and risk concentrations*

Intra-group transactions are not explicitly regulated, similar to the 2000/12/EC directive of the EU. Provisions regarding reporting requirements of intra-group transactions are regulated even in the EU in the directive on insurer groups only. Thus rules relating to risk concentration are those which influence mutual risk exposure of group members. The relevant Hungarian rules are discussed below, in a similar structure to the chapter discussing EU regulations.

The provisions limiting risk concentration of different sectoral acts (Act on Credit Institutions, Act on Capital Markets, Act on Insurance Institutions)<sup>54</sup> were established in the framework of EU legal harmonization. The quantitative limits completely correspond to the limits in the EU regulation. Differences can be found among the institutions eligible for exemptions. Some of the differences are due to the different scope of directives and Hungarian sectoral rules, and the fact that the regulation of consolidated requirements was not put forward at all (Act on Capital Markets, Act on Insurance Institutions) or only imperfectly and not consistently in the acts.

When regulating large exposures, the prescriptions of the Act on Capital Markets do not treat insurance undertakings separately. *Investments* over 25% of the regulatory capital of the credit institution in an insurance undertaking are to be covered with capital just as much as any holdings acquired in any other undertaking and risk exposures with a *non-parent*, *non-subsidiary* or *non-sister* relationship.<sup>55</sup> Similar to the regulations in the EU, pursuant to the Act on Credit Institutions for

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<sup>54</sup> The Act on Insurance Institutions is under amendment.

<sup>55</sup> EU regulation allows for participation in insurers to be limited at 40%, but only a few member states make use of this possibility.

risk exposure against undertakings in parent, subsidiary or sister relationship no large exposure limit is involved, if they are under consolidated supervision. When calculating regulatory capital, however, all those qualifying holdings are to be deducted which the credit institution acquired in other financial institutions, investment firms, insurance undertakings or ancillary undertakings, irrespective of whether they are subject to consolidated supervision. In this sense, however, the participation acquired in other players of the financial sector will be exempted from other limits. Nevertheless, they are subjected to much stricter regulations.

The *risk exposure* of an investment firm against a client or group of clients – similar to the Act on Credit Institutions – may not exceed 25%, in the case of subsidiaries 20%. However, in contrast with the Act, no exemption is allowed if risk exposure is oriented towards a parent, subsidiary or sister within the same scope of consolidation. This is a consequence of the lack of consolidation rules regarding investment firms, nor is it consistent with the provision of the Act which allows exemption for a credit institution in one and the same group with the investment firm, if they belong under consolidated supervision.

The investments of investment firms are limited not only according to ownership proportion and extent of influence, as in the case of investment limits of credit institutions, but also according to the type of institution. Pursuant to Section 180 of the Act on Capital Markets investment firms may hold participations for the purpose of investment (participation held longer than one year) only in an ancillary undertaking, credit institution, investment firm, commodity exchange, insurance undertaking, clearing house, stock exchange or investment fund manager. Rules like that are non-existent in the EU directives.

In the case of the Act on Insurance Institutions, the full harmonization of the diversification rules relating to the investment of technical reserves will be accomplished during the amendment of the law.

### ***5.3. Summary of the problems of domestic rules of consolidation***

We have investigated the inadequacies of the present regulation in Hungary compared to the EU rules in force. Issues which have also been problematic in the EU regulation of conglomerates (heterogeneous financial groups) and led to the elaboration of the

new directive on conglomerates, were not and will not be discussed. The problems there (lags due to sectoral regulation, non-consistent overlapping and the lack of efficient supervision of financial groups) are naturally problems in the Hungarian regulation as well. Thus we might get a comprehensive overview of the tasks of Hungarian regulators if we consider the recommendations of the Joint Forum (Basle) concerning the regulation of conglomerates and those of the European Council – the more so since, along with legal harmonization, the primary objective is to create efficient regulation of financial groups both for the supervision and for market players.

The limitations of the Hungarian regulation regarding consolidated supervision are:

- A) Due to the incomplete regulations of the Act on Capital Markets (in fact, the lack of full harmonization with the 93/6/EC directive)
- asymmetric requirements depending on the organizational structure
  - lack of consolidated requirements in the case of groups which do not include a credit institution
  - lack of exemption from individual large exposure limits, if the investment firm is subjected to consolidated report
- B) Due to the incomplete regulations of the Act on Credit Institutions
- definition of group building criteria does not correspond to real interrelations and EU provisions (e.g. the lack of discretionary power of the supervisory authority in the case of dominant influence, in the case of participation the lack of definition and leaving out of participation relationship of over 20% of the voting right)
  - contradictory definitions (see financial holding)
  - it is not clear as to which institutions certain provisions are related
  - regarding the institutional scope of consolidated requirement, the Hungarian rules sometimes surpass the effective regulation in the EU (including insurance undertakings into the consolidated limits, capital requirements) or they do not reach them at all (wrong definition or lack of the calculation of consolidated own funds)
  - individual prudential requirements are not always coordinated with the consolidated requirement (i.e. regulatory capital).
- C) Due to the lack of a Ministry of Finance decree on consolidated capital adequacy
- at the moment there is no regulation how different institutions could meet the requirements of consolidated capital adequacy.

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## Annex

Numerical examples to illustrate recommended methods of calculating capital adequacy<sup>56</sup>

A1 Holding company (not regulated)			
Assets		Liabilities	
Book value of participation in		Capital	300
B1 bank	800		
B2 insurer	200	Liabilities	800
B3 leasing company	100		
Total	1100	Total	1100
B1 Bank (100% subsidiary of A1)			
Assets		Liabilities	
Loans	900	Capital	800
Other assets	400	Liabilities	500
Total	1300	Total	1300
B2 Insurance company (100% subsidiary of A1)			
Assets		Liabilities	
Investments	7000	Capital	200
		General reserve	100
		Technical provision	6700
Total	7000	Total	7000
B3 Leasing firm (100% subsidiary of A1, not regulated)			
Assets		Liabilities	
Leases	2000	Capital	100
		Liabilities	1900
Total	2000	Total	2000
Group (consolidated)			
Assets		Liabilities	
Bank loans	900	Capital	300
Other bank assets	400	General reserve	100
Investments of insurance undertakings	7 000	Other liabilities (bank)	3 200
Leases	2 000	Technical provision	6 700
Total	10 300	Total	10 300

<sup>56</sup> On the basis of Joint Forum (1999)

***Individual level capital requirement, capital adequacy***

	Capital requirement	Regulatory capital	Surplus/deficit
B1 Bank	100	800	700
B2 Insurance company	300	300	0
B3 Leasing firm (proxy, "notional")	150	100	-50

***Group level capital requirement, capital adequacy***

	Capital requirement	Regulatory capital	Surplus/deficit
Building- block method	100+300+150= <b>550</b>	300+100 (consolidated)= <b>400</b>	<b>-150</b>
Risk based aggregation	<b>550</b>	300(parent)+800(B1)+300 (B2)+100(B3) -1100(participations)= <b>400</b>	<b>-150</b>

Risk based deduction:

The new balance sheet of the parent after substituting the value of participations with the amount of surplus or deficit:

Assets		Liabilities	
Participation in		Capital	-150
B1 bank	700		
B2 insurance company	0	Liabilities	800
B3 leasing firm	-50		
Total	650	Total	650

The amount of capital deficit on the group-wide level is 150.

## Numerical examples to illustrate differences between full-scale consolidation and pro-rata consolidation<sup>57</sup>

The first example illustrates the case when the pro-rata consolidation has a more conservative, lower result. If the *capital surplus* of subsidiary No.1 is accounted to the full extent on a group-wide level, this has a much more positive result than the regulatory capital and capital requirement calculated according to the proportion of participation. Full-scale consolidation might be based on the assumption that the surplus capital of subsidiary No. 2 is to the full extent available for the group members. In the example given, the capital taken into consideration at the parent company instead of at minority owners is even able to compensate the deficit of subsidiary 2 on the group-wide level.

	Capital	Capital requirement	Participation	Capital surplus
Parent company	100	75	35 (25 in subsidiary 1.+10 2. in subsidiary 2.)	25
subsidiary 1 (50%)	60 (parent 25, minority own. 25, reserves 10)	10		50
Parent + subsidiary 1 <b>full scale consolidation</b>	160	85	25	160– (85+25)= <b>50</b>
Parent + subsidiary 1 <b>pro rata consolidation</b>	130	80	25	<b>25</b>
subsidiary 2 (100%)	20 (10 capital+ 10 reserve)	50		–30
Parent + subsidiary 1 + subsidiary 2 <b>full scale consolidation</b>	180	135	35	<b>10</b>
Parent + subsidiary 1 + subsidiary 2 <b>pro-rata consolidation</b>	150	130	35	<b>–15</b>

<sup>57</sup> On the basis of Joint Forum (1999). Examples were made on the basis of risk-based aggregation, but any method would have the same result.

**Example No. 2.** In the case of the consolidation of subsidiary 1 – although each of both group members has surplus capital – there is capital deficit on the group-wide level. Individual capital surpluses develop due to multiple capital gearing. The case of consolidating subsidiary 2 illustrates that if the subsidiary, which is not owned 100% by the parent, has a capital deficit, then full-scale consolidation has a lower result, since in this case the full deficit will be accounted at the majority owner parent (the parent is the company which substitutes the deficit).

	Tőke	Tőke-követelmény	Részesedés	Tőkefelesleg
Parent company	100	90	60 (40 in subsidiary 1+10 in subsidiary 2)	10
subsidiary 1 (100%)	40 (anya 40)	25		-5
Parent + subsidiary 1	140	115	40	-5
subsidiary 2 (50%)	20 (parent 10, minority own. 10)	25		-5
Parent + subsidiary 1 + subsidiary 2 <b>full scale consolidation</b>	160 (100+40+20)	140 (90+25+25)	50 (40+10)	160- (140+50)= -30
Parent + subsidiary 1 + subsidiary 2 <b>pro-rata consolidation</b>	150 (100+40+10)	127,5 (90+25+12,5)	50 (40+10)	-27,5