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CHILE

CONGLOMERATE SUPERVISION SUPPLEMENTARY REPORT ON INTERNATIONAL EXPERIENCES

Carlos Medeiros (Mission Chief), Clarence Hillerman (formerly Banco Central do Brasil), Diane Mendoza (IMF), Fahmi Hosain (Australian Prudential Regulation Authority), Junghoon Park (IMF), Koji Uemura (IMF), Linda van Goor (formerly European Union), Teresa Rutledge (Office of the Comptroller of the Currency, United States), and Romain Veyrune (IMF)

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GLOSSARY

ADIs	Australia's Authorized deposit-taking institutions
APRA	Australian Prudential Regulation Authority
ASIFI	Act on Structural Improvement of the Financial Industry
BA	Banking Act
BAI	Board of Audit and Inspection of Korea
BHC	Bank Holding Company
BHCs	Bank Holding Companies
BNDES	O Banco Nacional do Desenvolvimento
BOK	Bank of Korea
CA	Company Act
CET1	Australia's Common Equity Tier 1
CFPB	Consumer Financial Protection Board
CFTC	Commodity Futures Trading Commission
COREMEL	Comitê de Regulação e Fiscalização dos Mercados Financeiro, de Capitais, de Seguros, de Previdência e Capitalização
COSIF	Plano Contábil das Instituições do Sistema Financeiro Nacional
CRD IV	Capital Requirement Directive IV
CVM	Comissão de Valores Mobiliários
DFIBO	Designated Financial Instrument Business Operator
DPA	Deposit Protection Act
DPC	Designated Parent Company
EC	Australia's Eligible Capital
ESA	European Supervisory Agency
FBOs	Foreign Banking Organizations
FDIC	Federal Deposit Insurance Corporation
FFIEC	Federal Financial Institutions Examination Council
FHC	Financial Holding Company
FICOD	European Financial Conglomerate Directive
FIEA	Financial Instruments and Exchange Act
FINCEN	Financial Crimes Enforcement Network
FINRA	Financial Industry Regulatory Authority
FRB	Federal Reserve Board
FSA	Financial Service Agency
FSC	Financial Services Commission
FSI	Financial System Inquiry
FSOC	Financial Stability Oversight Council
FSS	Financial Supervisory Service
FTC	Fair Trade Commission
FX	Foreign Exchange
GECC	General Electric Credit Corporation
GHQ	General Headquarters of the Allied Forces
IBA	Insurance Business Act
ICAAP	Australia's Internal Capital Adequacy Assessment Process
IGT	Intragroup Transactions

IHC	Insurance Holding Company (Japan)
IHC	Intermediate Holding Company (U.S.)
ILC	Industrial Loan Company
ISB	Insurance Supervisory Board
JGB	Japanese Government Bond
JPB	Japan Post Bank
JPI	Japan Post Insurance
KDIC	Korea Deposit Insurance Corporation
KOFIU	Korea Financial Intelligence Unit
KR&C	Korea Resolution and Collection
MEFM	Macroeconomic and Finance Meeting
MIS	Australia's Management Information Systems
MoF	Ministry of Finance
MOSF	Ministry of Strategy and Finance
MPC	Monetary Policy Committee
NBFI	Nonbank Financial Institution
NCUA	National Credit Union Association
NSA	Nonbank Supervisory Authority
OBS	Office of Bank Supervision
OCC	Office of the Comptroller of the Currency
OFAC	Office of Foreign Assets Control
OTS	Office of Thrift Supervision
PCA	Prompt Corrective Action
PCR	Australia's Prudential Capital Requirement
PREVIC	Superintendência Nacional de Previdência Complementar
RFI	Management, Financial Condition and Potential Impact Risk
SEC	Securities and Exchange Commission
SESC	Securities and Exchange Surveillance Commission
SIFI	Systemically Important Financial Institution
SLHC	Savings & Loan Holding Companies
SPE	Special Purpose Entity
SSB	Securities Supervisory Board
SUSEP	Superintendência de Seguros Privados
U.S.	United States

PREFACE

At the request of the Ministry of Finance (MoF), an advisory mission from the IMF's Monetary and Capital Markets Department (MCM) visited Santiago, Chile during December 3–17, 2014, and January 7–14, 2015 to provide TA on consolidated supervision. The mission met with officials of the MoF, the Central Bank of Chile (BCCh), Superintendencia de Bancos e Instituciones Financieras (SBIF), the Superintendencia Valores y Seguros (SVS), and Superintendencia de Pensiones (SP), and financial sector representatives, academics, attorneys, and consultants. This report provides case studies of supervisory approaches to conducting consolidated supervision of financial conglomerates.

The mission wishes the Chilean authorities every success as they move forward to consider the outstanding issues with consolidated supervision in Chile.

I. AUSTRALIA

Financial Sector Landscape

1. **Australia's financial sector is large and mature with assets totalling over US$4 trillion[1] at June 2014, which represents over 300 percent of GDP.** The financial sector has grown rapidly mainly due to the expansion of home mortgages and superannuation funds (a retirement scheme comprising mandatory contributions by employers and voluntary and tax-concessional contributions by employees). Authorized deposit-taking institutions (ADIs), mostly banks, are the dominant group of financial institutions with 69 percent of financial sector assets supervised by the Australian Prudential Regulation Authority (APRA), followed by superannuation funds with 23 percent. The life insurance sector represents 6 percent of financial sector assets supervised by APRA and the non-life insurance sector is relatively small with 2 percent.

2. **Australia's regulatory structure follows the 'twin peaks' model with prudential regulation the responsibility of APRA and consumer protection/market conduct the responsibility of the Australian Securities and Investments Commission.** APRA is an integrated regulator in that it supervises all ADIs, life insurers, non-life insurers and superannuation funds.[2] APRA was established in 1998. Prior to this time, prudential regulation was conducted by separate industry-specific regulators.

Conglomerate Groups

3. **There are four bank-led conglomerate groups that dominate Australia's financial sector.** The banks in these groups together represent approximately 80 percent of total ADI assets. Including these groups, APRA identified eight conglomerate groups that it believes warrant conglomerate supervision. These eight groups represent over 80 percent of total financial sector assets that are supervised by APRA, which highlights the importance of a conglomerate supervision framework in Australia.

4. **APRA has for some time been cognisant of the complexity of business and financial structures of conglomerate groups and the contagion risks faced by APRA regulated entities within such groups.** Recent international experience has shown that these complexities and risks could contribute to the failure of APRA regulated financial institutions, highlighting the need for conglomerate supervision. Membership of a conglomerate group may provide benefits to APRA regulated institutions, but may also increase and change the risks they face. The more material a group's activities outside its primary industry, the greater the risk that an industry-focused supervisory regime will not appropriately detect or respond to risks associated with these activities, and the greater the danger of a supervisory 'blind spot' that may result in risks building up without adequate remediation.

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[1] An exchange rate of 0.82 has been used throughout this section where U.S. dollars are quoted.

[2] Self-managed superannuation funds are regulated by the Australian Taxation Office. These are funds that are governed and managed by the superannuation members themselves.

5. **APRA's primary objective in developing a conglomerate supervision framework has been to ensure that supervision adequately captures the risks** to which APRA regulated institutions within a conglomerate group are exposed and which, because of the operations or structures of the group, are not adequately captured by existing prudential arrangements at a regulated entity-only level. The framework is intended to give APRA formal oversight of the material risks faced by conglomerate groups that include APRA regulated entities, supported by the implementation of conglomerate-specific prudential standards.

6. **Possible risks arising from membership of a conglomerate group include:**

- financial risks, stemming from transactions between group members or transactions involving both group members and third parties, such as intra-group investments and loans, insurance and reinsurance, guarantees, letters of comfort and cross-default provisions. Entities within the group that are not regulated by APRA might be undercapitalized or group treasury arrangements may oblige or encourage APRA regulated entities to pass surplus capital to other members of the group;

- reputational risks, where adverse publicity about a group entity, whether accurate or not, may cause a loss of confidence in the integrity of an APRA regulated entity within the group. Such damage may threaten its relationship with existing and potential customers and other stakeholders. A loss of trust and confidence on the part of investors in the group may also impair an APRA regulated entity's access to funding. Reputation risk to APRA regulated entities is increased with group practices such as common group branding, common funding and common management;

- moral hazard risks, which may arise where a group entity engages in excessive risk-taking activities on the assumption that, if a problem arises, another group entity will come to its assistance. Any group entity in financial stress that seeks support from a holding company or other group members may induce riskier behaviour than would otherwise occur;

- operational risks, associated with internal processes, people and systems or external events that originate in one part of the group and may adversely affect other parts of the group. This risk can be driven by the size and complexity of the group; and

- governance and strategic risks, which may arise from the legal structure, managerial structure or diversity of the group. Governance arrangements typically become more complicated where there are common directors and management across group entities. This can threaten the ability of individual APRA regulated entities in the group to make strategic decisions and business judgments in the best interests of the regulated entity, with due consideration to the interests of depositors, insurance policyholders and superannuation pension members (collectively 'APRA beneficiaries').

Conglomerate Supervision Framework

7. **The risks outlined in the paragraph above already affect APRA regulated entities that are part of conglomerate groups** to varying degrees and are addressed to some extent through the prudential requirements of APRA's regulated entity supervision framework. However, this framework largely focuses on the individual APRA- regulated entities without full consideration of the conglomerate group in which the entity may operate and the implications of group membership. The interaction of these risks within a group context requires more effective group-wide supervision beyond the existing stand-alone prudential frameworks. APRA's conglomerate supervision framework is designed to address this and is composed of the following four pillars, which will be discussed in more detail later in this appendix:

- a conglomerate group must have a robust governance framework that is applied appropriately throughout the group;
- a conglomerate group must have an effective group-wide risk management framework in place;
- the intra-group exposures and external aggregate exposures of a conglomerate group must be transparent and prudently managed; and
- a conglomerate group must have sufficient capital such that the ability of its APRA regulated entities to meet their obligations to APRA beneficiaries is not adversely impacted by risks emanating from non-APRA regulated entities in the group.

8. **For the purposes of applying APRA's conglomerate supervision framework, APRA defines a conglomerate group as a group where it considers that material activities are performed** within the group across more than one APRA regulated industry and/or in one or more non-APRA regulated industries. However, APRA applies this definition at its own discretion. This approach enables APRA to manage the risk of conglomerate groups restructuring to avoid meeting a strict definition of a conglomerate group.

9. **For the eight conglomerate groups identified by APRA, the ultimate parent entities of these groups are licensed by APRA.** As a result, the scope of conglomerate supervision applies to all entities (APRA regulated or not) that are consolidated onto its balance sheet. This enables APRA to take regulatory action against the ultimate parent if there are concerns emanating from non-APRA regulated entities within the group.

10. **If APRA considers that there are prudential reasons for doing so, it may determine a supervisory adjustment to be included in the capital requirement for the conglomerate group.** This outcome may reflect concerns APRA has with how a group has addressed any aspect of the four pillars of the conglomerate supervision framework. This is

consistent with APRA's ability to adjust capital requirements at an APRA regulated entity level.

Corporate Governance

11. **Corporate governance requires conglomerate groups to develop and maintain group-wide policies that establish consistent business practices for the Board of Directors, fitness and propriety of key staff, business continuity management and outsourcing.** In addition, the conglomerate group should also appoint an auditor for assurance on the appropriateness and effectiveness of group-wide policies. APRA's existing cross-industry behavioral prudential standards cover governance, fit and proper, outsourcing and business continuity management. These standards currently apply to all ADIs, general insurers and life insurers. These requirements have largely been extended to apply to the ultimate parent of the conglomerate group. Where the standards indicate that requirements are to apply across the group, the responsibility for compliance with these requirements will be on the ultimate parent. Some examples of governance requirements include:

- the Board of the conglomerate group is responsible for ensuring that directors and senior management of the group, collectively, have the full range of skills needed for the effective and prudent management of the group;

- the ultimate parent must establish and maintain a documented remuneration policy that outlines the remuneration objectives and structures of the group;

- all persons responsible for material activities within the entire conglomerate group must meet fit and proper standards;

- the ultimate parent must maintain a group-wide outsourcing policy and ensure that if non- APRA regulated institutions engage in outsourcing arrangements that are material to the group, these arrangements must adhere to the outsourcing prudential standard;

- the ultimate parent must maintain a group-wide business continuity management plan that ensures that if non-APRA regulated institutions engage in activities that are material to the group, these activities must adhere to the business continuity management prudential standard; and

- the ultimate parent must appoint a group auditor (Appointed Auditor) who must provide assurance on APRA data collections in relation to conglomerate group information. The Appointed Auditor must provide assurance that the ultimate parent has controls that are designed to ensure the ultimate parent has complied with all prudential requirements.

Risk Management

12. **Risk management is a fundamental discipline for any APRA regulated institution.** APRA's conglomerate supervision framework requires the ultimate parent to

ensure that the material non-APRA regulated entities in the group are captured by an overarching group-wide risk management framework. The group-wide risk management framework must include a risk appetite statement, a risk management strategy and a risk management function that address risks across the group. The purpose of this group-wide framework is to ensure that the Board of the conglomerate group has clear and effective oversight of the material risks of the group, whether they emerge from APRA regulated or non-APRA regulated entities. In other words, APRA expects the Board of a conglomerate group to ensure that there are no risk management 'blind spots' within the group. Some examples of risk management requirements include:

- the conglomerate group's risk management framework must, at a minimum, address:
  - credit risk
  - market and investment risk
  - liquidity risk
  - insurance risk
  - operational risk
  - risks arising from its strategic objectives and business plans
  - other risks that, singly or in combination with different risks, may have a material impact on the institution

- the Board of a conglomerate group must ensure that it forms a view of the risk culture across the group, and the extent to which that culture supports the ability of the group to operate consistently within its risk appetite, identifies any desirable changes to the risk culture;

- the ultimate parent of a conglomerate group must develop and maintain a Board-approved liquidity management policy for the group to adequately and consistently identify, measure, monitor, and manage its material liquidity risks. The policy must include a strategy that ensures the group has sufficient liquidity to meet its obligations as they fall due, including in stressed conditions, and outline processes to identify existing and potential constraints on the transfer of funds within the group;

- a conglomerate group's risk management framework must include forward-looking scenario analysis and stress testing programs, commensurate with its size, business mix and complexity, and which are based on severe but plausible assumptions; and

- a conglomerate group's management information systems (MIS) must provide the Board of the group, board committees and senior management with regular, accurate and timely information concerning the group's risk profile. The MIS must be supported by a robust data framework that enables the aggregation of exposures and risk measures across business lines, prompt reporting of limit breaches, and forward-looking scenario analysis and stress testing. The group's data quality must be adequate for timely and accurate measurement, assessment and reporting on all material risks across the group and must provide a sound basis for making decisions.

Risk Exposures

13. **Conglomerate groups must develop and maintain risk exposures policies to ensure that a concentration of risk in one part of, or across, a group does not pose a threat to the APRA regulated entities in the group.** To adequately manage this risk, conglomerate groups should have systems and processes to monitor aggregate risk exposures across the group as well as intra-group transactions and exposures. The governance, data capabilities and risk reporting should be meaningful and support decision-making.

14. **A conglomerate group's Board is required to identify and manage risk concentrations across the group.** While APRA does not set quantitative limits or thresholds on a group basis, APRA requires groups to include limits on acceptable levels of aggregate risk exposures across the group as well as intra-group exposures within the group. There is a wide diversity in the types of aggregate risk concentrations that a conglomerate group must consider and these are likely to be unique to each group.

15. **In relation to aggregate risk exposures, APRA expects the following list of considerations to be taken into account when conglomerate groups establish their policies:**

- on and off-balance sheet exposures to:
    - various types of counterparties
    - an individual counterparty or group of related counterparties
    - individual industry sectors
    - geographical locations
    - financial products, including risk transfer products
    - specific funding sources
    - various asset classes such as equities, property holdings and other investments
    - various market risks such as interest rate, foreign exchange and commodities

16. **The ultimate parent must also conduct forward-looking scenario analysis and stress testing of the conglomerate group's material aggregate exposures and intra-group exposures.** The analysis must assess the impact of changes in market conditions and key risk factors on these exposures and how these changes impact the group's risk profile, capital strength and earnings.

Capital Adequacy

17. **Capital adequacy is an integral component of the conglomerate supervision framework.** It aims to ensure that a conglomerate group is adequately capitalized such that the likelihood of difficulties in any non-APRA regulated entity in the group having an adverse impact on the group's APRA beneficiaries will be limited. The capital adequacy framework consists of a number of important elements and these are described below.

18. **A conglomerate group must have an Internal Capital Adequacy Assessment Process (ICAAP).** The ICAAP must:

- include processes for assessing the risks arising from the group's activities;

- ensure that capital held is commensurate with the level of risk; and

- include a strategy for maintaining adequate capital over time, including the setting of capital targets consistent with the risk profile of the group, the risk appetite and regulatory capital requirements of the group.

19. **A conglomerate group must have sufficient capital** such that the ability of its APRA regulated entities to meet their obligations to APRA beneficiaries is not adversely impacted by risks emanating from non-APRA regulated institutions in the group. APRA will determine a minimum prudential capital requirement (PCR) that reflects all material risks to the group's APRA beneficiaries, including contagion risks from non-APRA regulated activities. Operational separation or separability of non-APRA regulated institutions can reduce contagion risk to APRA beneficiaries, which may reduce the PCR. A conglomerate group may demonstrate to APRA that it has credibly reduced the risk to APRA beneficiaries through the operational separation or separability of non-APRA-regulated institutions.

20. **The Level 3 capital adequacy framework is a Common Equity Tier 1 (CET1) framework.** Both conglomerate level eligible capital (EC) and the PCR will be based on CET1-equivalent criteria.

21. **The capital adequacy framework will consist of two tests:**

- a Level 3 group must at all times have EC in excess of its PCR; and

- a conglomerate group must have sufficient unrestricted surplus capital to cover any shortfall in eligible capital held by non-APRA regulated entities. APRA does not require a non-APRA regulated entity itself to hold EC to cover its contribution to the PCR. However, where there is a shortfall, the group must be able to demonstrate that other group entities are able to transfer sufficient eligible capital to cover this shortfall within a short timeframe.

22. **The PCR is determined by aggregating the requirements for six 'industry** blocks' and must reflect all material risks to APRA beneficiaries of the conglomerate group, including contagion risks from the non-APRA regulated activities. These blocks are:

- four APRA-regulated blocks: ADI, general insurance, life insurance and superannuation. Required capital for APRA-regulated blocks is based on the existing industry-specific CET1 requirements; and

- two non-APRA-regulated blocks: funds management and other activities. Required capital for these blocks is determined by the group using its internal capital allocation.

Status of Australia's Conglomerate Supervision Framework

23. **APRA's conglomerate framework was finalised and published in August 2014.** However, an implementation date has not been set in light of the Financial System Inquiry (FSI), which was conducting its work throughout 2014. The FSI was charged with examining how Australia's financial system could be positioned to best meet Australia's evolving needs and support Australia's economic growth. Recommendations were made at the end of 2014 that aimed to foster an efficient, competitive and flexible financial system, consistent with financial stability, prudence, public confidence and capacity to meet the needs of users. Once the Australian Government responds to the FSI's recommendations, which is expected to occur by the middle of 2015, APRA will announce a formal implementation date for its conglomerate supervision framework. Current expectations are an implementation date in 2016.

24. **APRA has released its conglomerate supervision framework in its entirety on its website.**[3] In addition, it has consulted heavily with all eight conglomerates. Therefore, all conglomerate groups are familiar with the requirements. Based on estimates, APRA does not expect any conglomerate group will have to raise additional capital to meet the conglomerate capital rules as they all currently have sufficient capital. Most conglomerates have indicated that they are meeting most governance and risk management requirements already. However, a number of conglomerates are expected to make further investments in their IT and reporting capability in order to meet the risk exposure requirements.

II. BRAZIL

Structure of the Financial System

25. **The National Monetary Council, created in 1964 along with the central bank, is the principal instrument within the executive branch of government for matters dealing with the financial system.** Its main function is to formulate policies for currency and credit, with the purpose of social and economic progress for the country. Its principal objectives are: to improve the financial institutions and instruments, with a view to increased efficiency of the payment system and the mobilization of resources; to seek to maintain the liquidity and solvency of the financial institutions; and to coordinate monetary, credit, budget and fiscal policies, as well as internal and external public debt policies.

26. **The National Monetary Council, which in the past was composed of several government and private sector members, is now made up of only three members**: the minister of finance, the minister of planning and the governor of the central bank, who has the status of a minister. The members of the board of directors of the central bank and the head of the securities commission attend the meetings, without voting rights. They meet ordinarily once a month and a large portion of the regulations applicable to the financial institutions and instruments, as well as to the securities sector, are discussed and decided

[3] http://www.apra.gov.au/CrossIndustry/Pages/Supervision-of-conglomerate-groups-(Level-3), August-2014.aspx

upon at those meetings. It also regulates limits and modes of investment for the insurance sector and the private pension funds.

27. **Brazil has a fairly sophisticated and well diversified financial system, in which financial conglomerates dominate, predominately headed by commercial banks or multiple banks with commercial bank portfolios.** There are few independent financial institutions in the country. The public sector, especially federally owned financial institutions, has a strong presence in the system and has increased its share in the market since the outbreak of the financial crisis in 2007. The participation of foreign banks is limited due to constitutional restraints. Requests to establish new institutions or to purchase or increase participation in those already in existence require presidential approval, on a case by case basis, in which it has been demonstrated that it is in the public interest that the financial institution be admitted into the market, or that the foreign investment is relevant.

28. **The approval is granted only after the central bank has duly examined the feasibility of the proposal and the National Monetary Council has recommended approval.** Aside from presidential approval, petitions formulated by foreign institutions and investors are subject to the same requirements as those presented by domestic entities and individuals (national treatment). Foreign financial institutions compete in the markets on an equal basis with domestic entities. In more recent years, several foreign financial institutions have established a presence in the country.

29. **The Banking Act and the initial capital market legislation date from the mid 1960s, with the intent that the individual financial institutions be independent of one another, each performing certain duties.** By the end of the decade, however, several conglomerates had been formed, in some cases by incorporating failing or weak institutions. By the late 1980s regulations were issued by the National Monetary Council permitting that multiple banks be created, with distinct portfolios for each type of activity, or product line. It was mandatory that each multiple bank have at least two portfolios, one being equivalent to either a commercial bank or an investment bank. Portfolios of the multiple banks also include housing finance, consumer finance and leasing, as well as the equivalent to a development bank for public sector banks.

30. **There is a wide variety of financial institutions present in Brazil, both banking and nonbanking,** which include, among others aside from commercial banks and multiple banks, investment banks, consumer finance companies, housing finance companies, brokers, dealers, leasing companies and credit cooperatives. All financial institutions, with the exception of insurance companies and pension funds, require prior approval of the central bank to operate in the markets. The commodity and stock exchanges, as well as operations carried out by financial institutions in the securities market, require the approval of the Commissão de Valores Mobiliários (CVM), the securities commission.

31. **Insurance companies, insurance brokers and open pension funds are authorized and supervised by the Superintendência de Seguros Privados (SUSEP).** Broader regulations for the sector are established by the National Council for Private Insurance and representatives of the Ministry of Finance, the central bank and the securities commission are

members of that Council. The closed pension funds, that is, those that are established for certain companies or groups of companies are supervised by the Superintendência Nacional de Previdência Complementar (PREVIC), entity subordinated to the Ministry of Social Security. These funds are separate entities from the companies and do not form part of conglomerates.

32. **Regulations for the closed pension funds are approved by the National Council for Pension Funds that include the ministers of planning and finance as members.** The closed pension funds, when their portfolios are not managed in-house, contract authorized institutions for that purpose. These funds are independent entities of the companies which initially formed them. The insurance supervisor and the securities commission, as well as the central bank in terms of administration, are subordinated to the Ministry of Finance.

33. **The governor and vice-governors of the central bank do not have fixed mandates, nor is the budget of the central bank separate from the general government budget.** The president and other board members of the securities commission have five year mandates, but do not have a separate budget. The insurance superintendant does not have a fixed mandate, or a separate budget.

34. **Mutual funds are important financial instruments for individuals and nonfinancial institutions in the Brazilian markets.** They can be either open or closed and are not established as firms. Rather they are a pool of resources belonging to the individual investors. Almost all are managed by financial institutions. They are authorized and supervised by the securities commission.

35. **Independent credit card managers recently fell under the regulation and supervision of the central bank.** These are the issuers of private label credit cards, that is, ones that are usually created for use in certain commercial establishments, not for general use. These commercial establishments may grant credit to customers using their own funds and interest rates are not subject to limitations. However, because long term financing, as well as the options available for a commercial entity to obtain funds in the market, is limited in Brazil, financing by commercial establishments is also limited and funds obtained from the public by financial institutions are more readily available. Credit card managers themselves may not extend credit to card holders.

36. **The factoring entities established in Brazil are unregulated enterprises.** In the past, as the discount of receivables by the banks, with recourse to the client, was practiced on a large scale, there was no demand for factoring services. The entities sprang up because of credit restrictions placed on financial institutions in the 1980s and continue to operate, mainly by purchasing receivables from small companies that have limited access to bank credit.

37. **In recent years, microfinance has seen growth, both within and outside of the banking sector.** As practices in this segment are much different than traditional banking, special entities are frequently established, many times within the conglomerates.

38. **Directed credit remains relatively strong in Brazil.** At least 25 percent of demand deposits must be lent to the agricultural sector at set rates, below those practiced in the market. A small portion of demand deposits must also be directed to microcredit and very small credit operations to earmarked individuals, at established rates. Most of the savings deposits must be utilized in residential real estate financing, with maximum rates and fixed durations.

39. **Domestic financial institutions dominate the banking sector, with a strong presence of public banks that continue to retain a large portion of deposits and credit operations.** Since the financial crisis of 2007, the public banks have increased their share in the markets, extending credit at a faster pace than the private sector.

40. **Private banks in December 2013 held 48.9 percent of the credit operations on their books, while 51.1 percent were held by the public banks.** These numbers have changed considerably since December 2009, where the percentages were 58.3 and 41.8, respectively.

41. **Credit as a portion of GDP is still quite low in Brazil compared to developed countries.** Over the past decade there has been significant growth as facilities have been created especially in regards to consumer credit, where payments are discounted directly from paychecks. In December 2013 total credit was R$2.6 trillion, or 54 percent of GDP, compared to R$1.2 trillion in December 2009, or 37 percent of GDP. Interest rates continue high in the country, in comparison to other developing countries, and debt is concentrated in the short term.

42. **Total assets in the system are around 180 percent of GDP,** more than half of which are held by depository institutions, one-third by investment and pension funds, and about 6 percent by insurance companies. Financial conglomerates control around 75 percent of total assets.

43. **Financial institutions are highly concentrated.** Of a total of 176 banks (multiple, commercial, investment, development, savings and foreign exchange), the five largest in December 2013 held 68.5 percent of total assets, while the 20 largest held 89.6 percent. Of the five largest banks in total assets, three are public.

44. **Government-owned banks account for over 40 percent of total banking assets,** and directed credit for low-income housing, agriculture and infrastructure represents around 35 percent of total credit. Foreign bank participation is only about 17 percent of banking assets; lower than in other Latin American countries.

Joint Forum Principles

Supervisory Powers and Authority

45. **The central bank is responsible for the supervision of most of the financial institutions, aside from insurance companies and pension funds.** These two segments are

currently not significant compared to other financial institutions. However, insurance is a sector that has shown increased growth rates recently, and, with the creation of the public sector pension fund, significant growth is expected in that segment as well. The central bank also drafts prudential regulations that are submitted to the National Monetary Council for approval, as well as issuing complementary regulations.

46. **For the last 15 years the central bank has focused on risk-based supervision of the financial institutions.** Risk culture in Brazil is strong. More recently, the securities commission has also adopted a risk-based approach to supervision for the securities market, publishing a biannual plan containing regulatory and supervisory priorities.

47. **In order to coordinate activities, which include the regulation and supervision of all integrants of the financial system, a committee (COREMEC) was formally created in January 2006.** The chief executive, as well as one other member of the board of directors of each of the four supervisory entities (central bank, securities commission, insurance superintendence and complementary pension superintendence), attend meetings to address questions that arise and subjects that are of common interest. At least one meeting is held each quarter, and the presidency is rotated on a quarterly basis among the heads of the entities. Subgroups are formed to discuss and present proposals for decision by the members. Some decisions are published as a consensus of the group and implemented by each of the members.

48. **In 2011 the central bank created a financial stability committee,** with the objective of evaluating financial stability and defining its strategies to mitigate systemic risk. The committee is composed of the members of the board of directors and meets on a bimonthly basis.

49. **Aside from the committees mentioned above, formal technical committees have also been formalized using memorandum of understandings (MOUs) with other supervisory agencies.** For example, on a monthly basis, representatives of the central bank and the securities commission meet to discuss proposals for regulations and integrated supervision. Members of the board of directors also attend programmed meetings on a regular basis.

50. **Greater integration and cooperation between the supervisory agencies is a difficult task, and the agencies must be willing to participate in the process.** It requires perseverance and especially the involvement of top-level senior management. It took a great many years for the central bank and the securities supervisor to arrive at a point in which the exchange of information and discussions involving draft regulations and supervisory issues among the staff members has become a routine process. The establishment of meetings on regular intervals with a defined agenda is also a key measure. Greater integration is still needed with the insurance superintendence, but is being pursued.

51. **The banking law establishes that the central bank may examine documents of individuals and entities that control financial institutions,** as well as request any information from the financial institutions that is deemed necessary to adequately carry out

its functions. The failure to present information requested or should the information furnished be incorrect or inadequate, the financial institution is subject to administrative penalties.

52. **The central bank also has the legal power to determine actions to be taken by the financial institution, to safeguard the financial system and the interests of depositors, investors and creditors.** These include: (i) capitalization of the institution, in amounts the central bank deems necessary; (ii) transfer of control of the institution; and (iii) corporate reorganization, which could encompass incorporation, mergers or division of the institution. These actions may be taken even if, at a later moment, intervention or liquidation is declared.

53. **All financial institutions, except brokers, dealers and credit cooperatives, must be corporates and are also subject to corporate legislation.**

Supervisory Responsibility

54. **There is integration among supervisors for the supervision of financial conglomerates.** The definition used for a financial conglomerate is found in the Accounting Plan of National Financial System Institutions (COSIF), issued by the central bank, which considers a financial conglomerate "a group of financial entities directly or indirectly linked, by way of participation in equity shares or by effective operational control, characterized by common administration or management, or by operating in the markets using the same brand or commercial name."

55. **Likewise, the aforementioned accounting plan considers an economic-financial conglomerate a group** in which financial institutions licensed to operate by the central bank hold equity shares in other enterprises, located both within the country and abroad, in which they detain, isolated or together with other business associates, including voting agreements, the rights of partners that ensure, solitarily or cumulatively: (i) the preponderance in the decision-making of an enterprise; (ii) the power to elect or dismiss the majority of senior management; (iii) effective operational control, characterized by common administration or senior management; (iv) corporate control, represented by the sum of the interests held by the institution, independent of the percentage, with those held by its senior management, controllers and related companies, as well as those purchased, directly or indirectly, by investment funds.

56. **The above mentioned conglomerates must present their financial statements** in a consolidated manner to the central bank, as well as publish their monthly statements, and are subject to external auditing. The consolidated financial statements must be prepared and published according to international accounting standards issued by the International Accounting Standards Board (IASB).

57. **All financial institutions licensed to operate by the central bank must request its authorization to participate in the capital of other entities, and they must be of a financial nature.** This authorization is waived in the case of investment banks, development banks and development agencies with relation to typical shareholding portfolios, due to specific legislation for these entities.

58. **Corporate law contains provisions that characterize a group of societies, which are applicable to the controlling entity and its subsidiaries.** However, it is a formal agreement in which the parts are obliged to combine resources or efforts to accomplish its objectives or to participate in common activities. The controlling entity must be Brazilian. Very few groups have been formed, both within and outside of the financial system, due to the rituals that must be followed and possible legal implications. There appears to be no incentive to adopt a formal group structure.

59. **A financial institution must obtain prior authorization of the central bank to establish branch offices abroad or to purchase, directly or indirectly, equity interests in financial institutions or similar entities abroad.** That authorization will only be granted in those cases in which the central bank shall have access to information, data and documents deemed necessary to properly evaluate operations carried out by means of those investments abroad, so as to ensure global consolidated supervision. Before processing the request, the central bank will contact the supervisor in the host country. When foreign financial institutions present requests of this nature, the home country supervisor is also contacted.

60. **Should the equity interests held by the financial institution in corporations abroad require consolidation of financial statements, the authorization also implies** that the central bank shall also have total and unrestricted access to any information required to properly assess the risks taken by the subsidiaries, regardless of its operational activity.

61. **Equity interests held by financial institutions in other domestic entities** that require consolidated financial statements imply that the central bank have total and unrestricted access, by way of the financial institution, to all information, data and documents required to properly evaluate the operations and risks taken by the subsidiaries, regardless of its operational activity.

62. **When the controllers of a financial institution are not individuals, a holding company must be set up.** All shareholders that hold a minimum of 5 percent of the equity shares of the institution must be identified and informed to the central bank. These shareholders, when legal entities, must identity the ultimate individual shareholders, that possess, directly or indirectly, a minimum stake of 5 percent.

63. **On-site supervision is performed in an integrated manner and information is exchanged between the various supervisors.** A series of MOUs have been signed with foreign supervisors to facilitate the exchange of information involving foreign financial institutions and operations, as well as operations carried out by Brazilian financial institutions abroad. Both on-site and off-site supervisors examine the financial conglomerate as one unit, even though some prudential operational limits must also be met on a solo basis. Information regarding mutual funds is published regularly and the securities commission receives monthly information regarding the portfolios and transactions.

64. **Financial institutions are prohibited by law to lend to related parties.** A definition of related parties is contained in the banking law, which includes: (i) senior management and members of statutory bodies of the institution, as well as their spouses; (ii) parents up to the

second degree of those mentioned in (i); (iii) individuals and corporates that possess an equity holding of more than 10 percent of the capital of the institution; (iv) corporates in which the institution holds an equity interest of more than 10 percent; and (v) corporates in which the senior management of the institution, their spouses and parents up to the second degree detain equity interests of more than 10 percent. Regulations also consider related parties entities in which there is a common member of the senior management.

65. **Subscription of initial capital and all increases in capital** of financial institutions, with the exception of incorporating reserves and retained earnings**,** must be made in cash and deposited with the central bank until the license or authorization has been granted.

Corporate Governance

66. **All senior management of financial institutions, as well as members of statutory bodies, must be approved prior to taking office.** The exchange of information between supervisors assures that an individual considered not suitable in one segment of the market be permitted to operate in another.

67. **As most financial institutions are licensed by the central bank and the financial conglomerates are led by one of these entities,** in the majority of cases by a multiple bank or commercial bank, the central bank is identified as the leading supervisor. As mentioned, the supervisory activities are carried out in a coordinated manner, either through a joint inspection or by sharing information between supervisors when indications are seen that another supervisory agency must be called in to review certain aspects.

68. **Senior management in financial institutions is composed of an administrative council and a board of directors.** If the corporate is not listed on a stock exchange or on a regulated over-the-counter market, it need not have an administrative council. Audit committees are mandatory for all financial institutions that: (i) have capital requirements of R$1 billion (equivalent to approximately US$400 million) or more; (ii) manage third party funds of R$1 billion or more; or (iii) receive deposits and manage third party funds of R$5 billion or more. They are also mandatory for conglomerates in which at least one institution meets those requirements. The audit committees are statutory bodies and their members must be previously approved by the central bank. Their terms of office are limited to three years. The audit committee of the head institution of the conglomerate may perform its duties for the conglomerate as a whole.

69. **Many of the banks have their shares listed on the stock exchange.** However, in most cases, only a small portion of total capital is traded. Even then, in some cases, only preferential shares are negotiated. The Brazilian economy continues to be dominated by family-owned enterprises, and the financial sector is no exception.

70. **The controllers and senior management of the financial institutions are, by law, held jointly responsible in the case of intervention or extrajudicial liquidation of the entity.** The property of the individuals and legal entities are declared unavailable for any type of transaction and may be used to pay-off or reduce exposures.

71. **The financial institutions are required to have in place an internal audit component.** This component must report directly to the administrative council of the institution or, in its absence, to the board of directors. Internal controls must be periodically reviewed and revised and a semi-annual report by the audit committee must be presented to senior management for action. The central bank has access to these reports, as well as to the working papers. It may determine that the institution, or group: (i) adopt additional controls when it is felt that they are inadequate; (ii) reduce operational limits when it fails to implement the additional controls within the fixed timeframe. New business lines must be adequately evaluated before becoming operational and must be closely reviewed by the internal auditors.

Capital Adequacy and Liquidity

72. **All financial institutions are subject to minimum capital requirements, which must be met on an individual and a consolidated basis and calculated as a function of the risks involved.** Shares and other financial assets recognized as capital held by a financial institution in another financial institution must be deducted from its own capital, when calculating minimum capital requirements, even when held through mutual fund investments, for example, to prevent double gearing.

73. **The financial institutions must implement specific management structures for capital and liquidity, compatible with the nature of their operations,** the complexity of products and services offered and proportionate to risk exposure. These structures must comprehend all entities, financial and nonfinancial, that form part of the conglomerate. The processes must be assessed periodically by the internal auditors and annual reports must be published.

74. **Basel III recommendations are being implemented as scheduled.** The system in general is well capitalized and there are no expected difficulties with the financial institutions meeting the stricter requirements, although there may be a few individual cases to be dealt with.

75. **Liquidity is an issue with many small and medium sized banks that depend upon deposits and other forms of obtaining funds in the market.** Many depend upon interbank deposits and funds obtained from institutional investors. Since the outbreak of the financial crisis, the deposit guarantee agent, a private entity owned and funded by the financial institutions, has granted a special guarantee for specific deposits placed with these banks (up to US$8 million), which well exceeds the normal guarantee offered to depositors and holders of bank debt, which is approximately US$100,000. The special deposits will be phased out over time, and no new deposits with the additional guarantee will be permitted as of January 1, 2016.

Risk Management

76. **Financial institutions must implement specific management structures for operational, market and credit risks.** These structures must be compatible with the nature

and complexity of the products, services, activities, processes and systems of the financial institution and group. These structures must also be able to: (i) identify, evaluate, monitor, control and mitigate risks; (ii) document and store information relating to losses; (iii) produce, at least on an annual basis, reports that permit the identification and timely correction of deficiencies; (iv) perform at least annual tests to evaluate the effectiveness of the control systems implemented; and (v) prepare and disseminate the policy for managing risks to all levels of the institution, establishing roles and responsibilities.

77. **Should the central bank consider the structures inadequate or insufficient, it may determine that additional controls be adopted.** It may also determine the observance of more restrictive limits, should the additional controls not be adopted within the timeframe established. The activities for managing risks should be carried out by specific components of the organization, independent of internal controls, and a board member must be indicated as responsible for each area.

78. **Financial institutions, on a solo or consolidated basis, are subject to specific limits that have been established for fixed assets and for exposures.** The limit for fixed assets is 50 percent of risk-based capital, while exposures are subject to two different limits—an individual limit of 25 percent of risk-based capital for individual and group exposures and 600 percent of risk-based capital for large exposures, which encompass all exposures that exceed 10 percent of risk-based capital.

79. **Stress-testing is carried out by the financial institutions, as well as by the central bank, on a periodic basis, and involves group-wide activities.** Financial institutions must implement and maintain a remuneration policy for senior management. For listed companies and those that require audit committees, a remuneration committee, which is a statutory body, must be established. A single committee may be formed for all institutions that make up the financial conglomerate.

Final Remarks

80. **The most recent FSAP was carried out in 2012.** Two prior FSAPs were conducted, the more recent in 2002. Although Brazil seemed to have weathered well the global financial crisis of 2008 and systemic risk appears to be relatively low, it was felt that there was a need for policies to be implemented for the development of private long-term finance. The major provider of long-term finance is the federal development bank—BNDES.

81. **The further strengthening of financial safety nets was also recommended, with the deposit insurer taking a more active role in providing emergency liquidity assistance.** New regulations were issued by the National Monetary Council last year in which the role of the deposit insurer was more clearly defined.

82. **As for consolidated supervision, it was felt that additional regulation was required for the insurance sector, with the establishment of capital requirements at a group level**. Very recently, regulations were issued by the Superintendency of Private Insurance establishing minimum capital requirements, including risk-based capital

requirements. These regulations will come into effect as of January 1, 2015. They do not, however, address capital requirements at a group level.

III. European Union

Structure of the Financial Market

83. **About 6,000 banks are authorized to operate in Europe's internal market.** These banks held about 27 trillion euro total assets in 2013, and are organized in about 2,600 groups of several licenses. The vast majority of these 6,000 licensed entities is part of one of the 120 banking groups that are supervised by the European Central Bank (ECB) since November 2014.[4]

84. **In the years preceding the crisis, the global financial system had grown significantly in size and become increasingly interconnected** through long and complex intermediation chains, increasing systemic risks. The total assets of monetary financial institutions in the European Union (EU) increased to more than €45 trillion (or more than 350 percent of EU GDP), with the largest EU banks holding more than €1 trillion each. Leverage strongly increased as part of the active balance sheet expansion of banks, and banks relied more on short-term wholesale funding. The rapid growth of the financial sector was also facilitated by a surge in innovative but often highly complex financial products that allowed financial institutions to expand activities on and off their balance sheets.

85. **In 2008, the world was hit by a financial crisis which was global in scale and imposed significant costs on the EU economy and its citizens.** In the immediate aftermath of the crisis, together with its international G20 partners, the EU committed to engage in a fundamental overhaul of the regulatory and supervisory framework of the financial sector.

86. **The financial and economic crisis caused large costs to the EU economy, among which 1.5 trillion euro in state-aid, and induced a significant decrease of banks' total assets.** Also, output declined, and GDP remains under pre-crisis levels, financial wealth was considerably affected, and unemployment rose from 7.2 percent in 2007 to 10.8 percent in 2013, with unemployment rates over 25 percent in Greece and Spain. More than 60 percent of EU citizens surveyed in 2013 stated that they had lost confidence in the financial sector, as well as in the relevant authorities, as a consequence of the crisis.

87. **Alongside its control over state aid granted during the crisis, the Commission acted quickly to make immediate regulatory interventions that strengthened deposit guarantee schemes and reformed accounting rules.** Over the past five years, more than 40 proposals have been tabled by the European Commission, many of which are already in force today, aimed at restoring market confidence, financial stability, and the integrity and efficiency of the European financial system. Among these are deposit protection rules, a single rule book for the European banking market (CRD IV), financial market instruments

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[4] https://www.ecb.europa.eu/pub/pdf/other/bankingstructuresreport201410.en.pdf

rules, transparency rules for all financial market participants, recovery and resolution rules, market infrastructure rules, and etcetera.

88. **Stability is also reinforced by a new regulatory framework for the insurance sector.** Well before the crisis, it had become apparent that the prudential regime for insurers was no longer adequate. From 2016, a new prudential framework (Solvency II) will be applied which is risk-based and market-consistent to increase the resilience and stability of the European insurance sector.

89. **The European insurance market is the largest in the world, making up around 33 percent of the total premiums written globally in 2012.** The second and third largest markets are North America and Asia, which are very similar in size with 30 percent and 29 percent of global premiums respectively. Total European gross written premiums amounted to more than €1,100 billion in 2012. More than 5,300 insurance undertakings were operating in Europe in 2012. The majority were joint stock companies and mutual insurers, but also public institutions, cooperatives, etc. The European insurance industry employs more than 930,000 people directly. There are also around 1 million outsourced employees and intermediaries. The insurance sector has the largest pool of investments in the European Union, with almost €8,400 billion invested in the global economy in 2012. This is equal to 58 percent of the GDP of the EU. The insurance sector is a key source of the investment needed to support growth in the economy and it is the largest institutional investor in Europe, with more than 50 percent of all European institutional assets under management in 2011.

90. **About half of the total assets of banks and insurers is on the balance sheets of** 71 **financial conglomerates**, 29 of which are supervised directly as bank-led conglomerates by the ECB, which operates as the coordinator (the supervisor taking the lead in operations) for group-wide supervision of those 29 groups.

Supervision of financial conglomerates

91. **The European Financial Conglomerate Directive (FICOD) was adopted in 2002.** It follows the Joint Forum's principles of 1999, aiming in particular to provide methods for assessing the capital adequacy of conglomerates, including: detecting multiple gearing; facilitating the exchange of information among supervisors; coordination among supervisors; testing the fitness and propriety of managers, directors, and major shareholders of the conglomerate; and the prudent management and control of risk concentrations and intra-group transactions and exposures.[5]

92. **The first review of FICOD (FICOD1) was adopted in 2011 following the lessons learned during the financial crisis of 2007–09.** Revision was needed to fill the identified gaps immediately by giving supervisors more powers. FICOD1 amended the sector-specific directives to enable supervisors to perform consolidated banking supervision (CRD IV) and

[5] English and Spanish version of European fico-framework: http://eur-lex.europa.eu/legal-content/EN-ES/TXT/?qid=1421176450052&uri=CELEX:32002L0087&from=EN

Amendments 2011: http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2011:326:0113:0141:EN:PDF insurance group supervision (Solvency II) at the level of the ultimate parent entity, also if that entity was a mixed financial holding company. In addition to that urgently needed solution, FICOD1 introduced a waiver for the smallest conglomerates, added a transparency requirement for a group's legal and operational structures, and brought non-harmonised asset managers (a.o. hedge funds) within the scope of supplementary supervision in the same way as harmonised asset-managers. Another review was carried out to finetune the European financial conglomerates framework with the latest Joint Forum principles in 2013.[6]

93. **The objective of Europe's supplementary supervision of financial conglomerates, on top of sector-specific banking and insurance supervision, is to detect, monitor, manage and control group risks.** The current requirements in FICOD1 concerning capital adequacy (Article 6), risk concentrations (Article 7), intra-group transactions (Article 8) and internal governance (Articles 9 and 13) are meant to achieve this objective. Amongst other criteria, they should be assessed against the need to strengthen the responsibility of the ultimate parent entity of conglomerates, the lack of which was the main conclusion of the latest review. The support of sector-specific supervision with supplementary tools detecting group-wide risks is ensured by a coordinator with clear responsibilities and powers to access information take measures (Articles 10–12 and 14–17).

Scope

94. **Most of the groups operating in the European financial sector have a broad spectrum of authorizations.** Focusing on the supervision of only one type of authorized entity ignores other factors that may have a significant impact on the risk profile of the group as a whole. Fragmented supervisory approaches are not sufficient to cope with the challenges that current group structures pose to supervision. In this respect, the Joint Forum advised to apply supplementary supervision to any group of companies under common control or dominant influence, including any financial holding company, which conducts material financial activities in at least two of the regulated banking, securities or insurance sectors. Moreover, the Joint Forum advised that jurisdictions should consider the application of the Principles to other financial groups which conduct activities in one of these regulated sectors while also conducting material activities in any other financial sector, where these financial activities are not subject to comprehensive group-wide supervision under the sectoral frameworks.

95. **The European supplementary supervision framework for conglomerates is meant to strengthen and complete the full set of rules applicable to financial groups, across sectors and across borders.** However, from a regulatory standpoint, additional layers of supervision have to be avoided when the sectoral requirements already cover all the types of risk that may arise in a group.

96. **To address group risks, which is the original aim of FICOD** and the Joint Forum principles, group supervision should cover all entities in the group which are relevant for the

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[6] http://ec.europa.eu/internal_market/financial-conglomerates/docs/121220_staff-working-document-conglomerates_en.pdf

risk profile of the regulated entities in the group. This includes any entity not directly prudentially regulated, even if it carries out activities outside the financial sector, including non-regulated holding and parent companies at the top of the group. Each unregulated entity may present different risks to a conglomerate and each may require separate consideration and treatment.

97. **Among unregulated entities, special importance is attached to special purpose entities (SPEs).** The number of SPEs and the complexity of their structures increased significantly before the financial crisis, in conjunction with the growth of markets for securitization and structured finance products, but have declined since then. While the use of SPEs yields benefits and may not be inherently problematic, the crisis has illustrated that poor risk management and a misunderstanding of the risks of SPEs can lead to disruption and failure. The need for enhanced monitoring of intra-group relationships with SPEs was also highlighted in the Joint Forum's 2009 SPE report.[7]

98. **The challenges of supervising conglomerates are most evident for groups whose size, inter-connectedness and complexity make them particularly vulnerable and a source of systemic risk.** Any systemically important financial institution (SIFI) should, in the first place, be subject to more intense supervision through application of the CRD IV and Solvency II framework, both at individual and group/consolidated level. If the SIFI is also a conglomerate, supplementary supervision under FICOD would also be applicable. Although most SIFIs are conglomerates, this is not always the case. Also, systemic risks are not necessarily the same as group risks.

99. **All the issues mentioned above are linked to the definition of a conglomerate and the thresholds for identifying one.** The two thresholds set out in Article 3 of FICOD take into account materiality and proportionality for identifying conglomerates that should be subject to supplementary supervision of group risks. The first threshold restricts supplementary supervision to those conglomerates that carry out business in the financial sector, and the second restricts application to large groups. The combined application of the two thresholds and the use of the available waiver by supervisors have led to a situation where very big banking groups that are also serious players in the European insurance market are not subject to supplementary supervision. Furthermore, the wording of the identification provision may leave room for different ways to determine the significance of cross-sectoral activities. It could be improved to ensure consistent application across sectors and borders.

100. **To ensure legal clarity, it is important to have easily understandable and applicable thresholds.** However, the question remains whether the FICOD's thresholds and the waivers should be amended or complemented to enable supervision in a proportionate and risk-based manner, or whether the tools to detect and correct group risks should be included in the banking rules (CRD), as was done for insurance groups in Solvency II's Title III on group supervision.

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[7] http://www.bis.org/publ/joint23.pdf

Joint Forum Principles

Supervisory Powers

101. **Observing that the facilitating role of the coordinating supervisor** in the 1999 framework appeared to have played quite a minor part in times of high stress, the Joint Forum suggests in the revised principles that it may be worthwhile exploring whether supervisors should be empowered to approach the head of a financial conglomerate and impose corrective measures if deemed necessary.

102. **In European legislation, supervisory provisions apply to authorized entities, but not to the holding company as a stand-alone entity,** even though this holding company may have an important role as the head of a group of authorized entities, including responsibility for group-wide policies. FICOD1, however, amended both the banking law (CRDIV) and the insurance law (Solvency II), such that consolidated supervision has to be applied at the level of the ultimate parent entity, which made group-wide supervision more effective.

103. **This new power of applying consolidated sector-specific supervision at the level of the ultimate parent emphasized the use of a long existing power** under the FICOD of 2002: access to information of the ultimate parent, also when that is a non-regulated holding company, and the power to take any necessary measure to rectify a situation that potentially jeopardizes the soundness of one or more of the regulated entities in the group.

Supervisory Responsibilities

104. **The Joint Forum observed that the regulatory framework had assumed that the resources, skills and systems of supervisory authorities would be sufficient to implement the agreed rules, e.g. the Basel agreements.** However, the Financial Sector Assessment Programs (FSAPs) carried out by the IMF revealed that countries may be aware of the necessary supervisory programs, but they were not able to implement them sometimes because the basic preconditions were not fulfilled. For example, they had no ready-to-use set of prudential standards against which to assess firms' behavior (other than the capital ratio), including standards for group risks and triggers for corrective action.

105. **In Europe, prudential standards, including those governing supervisory responsibilities, are set out in sectoral legislation and supplemented by FICOD.** Their consistent implementation is ensured by supervisory coordination and common standards and guidelines to be developed by European Supervisory Agencies (ESAs). The recently revised European framework for supervision of banks and insurers explicitly requires member states to provide supervisors with the necessary powers to enforce compliance. The review observes that existing tools could be used more effectively, while noting that an enforcement regime applying to the ultimately responsible entity may need to be established.

106. **The new provisions enforce the use of the existing coordination obligations put on the coordinator of the supervision of a financial conglomerate.** For each financial conglomerate a coordinator is appointed. The list of coordinators of financial conglomerates, together with the collective of relevant competent authorities (other heavily involved supervisors), is published annually and determined following a set of objective criteria concerning ownership and relative size of the regulated entities:[8]

- **To ensure proper supplementary supervision of the regulated entities in a financial conglomerate**, a single coordinator, responsible for coordination and exercise of supplementary supervision, shall be appointed from among the competent authorities of the member states concerned, including authorities of the member state that is home to the mixed financial holding company.

- **The appointment shall be based on the following criteria:**

(a) where a financial conglomerate is headed by a regulated entity, the task of coordinator shall be exercised by the competent authority that has authorized that regulated entity pursuant to the relevant sectoral rules;

(b) where a financial conglomerate is not headed by a regulated entity, the task of coordinator shall be exercised by the competent authority identified in accordance with the following principles:

> (i) where the parent of a regulated entity is a mixed financial holding company, the task of coordinator shall be exercised by the competent authority that has authorized that regulated entity pursuant to the relevant sectoral rules;
>
> (ii) where more than one regulated entity with a head office in the community has as their parent the same mixed financial holding company, and one of these entities has been authorized in the member state that is home to the mixed financial holding company, the task of coordinator shall be exercised by the competent authority of the regulated entity authorized in that member state.

(c) where more than one regulated entity, being active in different financial sectors, has been authorized in the member state in which the mixed financial holding company has its head office, the task of coordinator shall be exercised by the competent authority of the regulated entity active in the most important financial sector.

(d) where the financial conglomerate is headed by more than one mixed financial holding company with a head office in different member states and there is a regulated entity in each of these states, the task of coordinator shall be exercised by the competent authority of the regulated entity with the largest balance sheet total if these entities are in the same financial sector, or by the competent authority of the regulated entity in the most important financial sector;

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[8] http://www.esma.europa.eu/system/files/jc_2014_071_list_of_identified_financial_conglomerates_2014.pdf

(iii) where more than one regulated entity with a head office in the community has as their parent the same mixed financial holding company and none of these entities has been authorized in the member state in which the mixed financial holding company has its head office, the task of coordinator shall be exercised by the competent authority that authorized the regulated entity with the largest balance sheet total in the most important financial sector;

(iv) where the financial conglomerate is a group without a parent entity at the top, or in any other case, the task of coordinator shall be exercised by the competent authority that authorized the regulated entity with the largest balance sheet total in the most important financial sector.

- **The tasks to be carried out by the coordinator with regard to conglomerate supervision include:**

(a) coordination of the gathering and dissemination of relevant or essential information in going concern and emergency situations, including the dissemination of information that is of importance for a competent authority's supervisory task under sectoral rules;

(b) supervisory overview and assessment of the financial condition of a financial conglomerate;

(c) assessment of compliance with the rules on capital adequacy, risk concentration, and intra-group transactions;

(d) assessment of the financial conglomerate's structure, organisation, and internal control system;

(e) planning and coordination of supervisory activities in going concern as well as in emergency situations, in cooperation with the relevant competent authorities involved.

The supervisors responsible for the supervision of regulated entities in a financial conglomerate and the competent authority appointed as the coordinator for that financial conglomerate shall cooperate closely with each other. This cooperation shall at least provide for the gathering and the exchange of information with regard to the following items:

(a) identification of the group’s legal structure and the governance and organizational structure, including all regulated entities, non-regulated subsidiaries and significant branches belonging to the financial conglomerate, the holders of qualifying holdings at the ultimate parent level, as well as of the competent authorities of the regulated entities in the group;

(b) the financial conglomerate's strategic policies;

(c) the financial situation of the financial conglomerate, in particular capital adequacy, intra-group transactions, risk concentration, and profitability;

(d) the financial conglomerate's major shareholders and management;

(e) the organization, risk management and internal control systems at financial conglomerate level;

(f) procedures for the collection of information from the entities in a financial conglomerate, and verification of this information;

(g) adverse developments in regulated entities or in other entities of the financial conglomerate that could seriously affect the regulated entities;

(h) major sanctions and exceptional measures taken by competent authorities in accordance with sectoral rules or this Directive.

The ESAs further developed internal guidance how colleges of coordinating and cooperating supervisors could be used most effectively, including the interaction with the consolidated supervision carried out on a sector-specifc basis by the home-supervisor of a banking or insurance group, also when they are part of a bigger financial conglomerate.

Corporate Governance

107. **The Joint Forum suggests that a supervisor should be able to require a legal and organizational group structure that is consistent with the group's overall strategy and risk profile** and is well understood by the board and senior management of the head company. Also, the Joint Forum suggests imposing an explicit responsibility on the head of the conglomerate to define and implement a group-wide strategy. Finally, the Joint Forum suggests that the remuneration requirements should no longer be limited to regulated entities only, but should apply to any employee of the financial conglomerate.

108. **Given the inherent complexity of financial conglomerates, corporate governance should carefully consider and balance the combination of interests** of recognized stakeholders of the ultimate parent and the other entities of the group. The governance system should ensure that a common strategy achieves that balance and that regulated entities comply with regulation on an individual and on a group basis.

109. **FICOD, as amended, contains a requirement for conglomerates to have in place adequate risk management processes and internal control mechanisms, a fit and proper requirement** for those who effectively direct the business of mixed financial holding companies, a 'living will' requirement, a transparency requirement for the legal and organizational structures of groups, and a requirement for supervisors to make the best possible use of the available governance requirements in CRD and Solvency II. The regulated entities, at the level of the financial conglomerate, must provide their competent authority with details on their legal structure and governance and organisational structure including all regulated entities, non-regulated subsidiaries and significant branches. Moreover, supervisors require the regulated entities to disclose publicly, at the level of the financial conglomerate, on an annual basis, a description of their legal structure and governance and organisational structure.

110. **CRD IV and Solvency II require further strengthening of corporate governance and remuneration policy in light of the lessons learnt during the crisis.** The living will requirement in FICOD is strengthened by the Bank Recovery and Resolution Framework.

111. **What these frameworks do not yet cover is the enforceable responsibility of the head of the group or the requirement for this legal entity to be ready for any resolution and to ensure a sound group structure and the treatment of conflicts of interest.** The Bank Recovery and Resolution Framework requires the preparation of group resolution plans covering the holding company and the banking group as a whole.

Capital Adequacy and Liquidity

112. **The Joint Forum observes that financial conglomerates should calculate capital adequacy on a group-wide basis** and have in place group-wide capital management policies as well as liquidity management policies.

113. **The European prudential framework stipulates that the level of required capital buffers against sector-specific risks is to be addressed within the sector-specific frameworks.** However, the supplementary framework should ensure that the allocation of capital across the legal entities of the group as a whole is such that the required capital buffer is indeed available at all times when an unexpected loss hits a regulated entity. To this end, the new requirement of publishing the group's legal and business structures, combined with the rule of applying consolidated requirements at the ultimate parent level, will support financial conglomerate supervisors.

114. **The calculation of capital at the ultimate parent level of a financial conglomerate was set out in a regulatory standard of the ESAs in 2014** and as such supports the enforcement of consolidated capital requirements for both sectors at the ultimate parent level.[9] However, the review observes that supervisors sometimes lack insight into the availability of capital at the level of the conglomerate given the complex legal structures. This could be addressed by requiring the reporting and market disclosure of capital on an individual or sub-consolidated basis (currently waived if certain conditions are met) in addition to reporting at the consolidated level of the regulated entity, which is one of the issues alerted in the latest FICOD-review.

115. **Liquidity requirements are in place for banking groups, and Solvency II will set out requirements for undertakings to identify and manage any kind of risks,** including liquidity risks. FICOD's provisions on intra-group transactions also cover a broad spectrum of transactions and exposures, and could therefore capture liquidity swaps and similar potential liquidity problems.

[9] Spanish version of financial conglomerate capital calculation standards: http://eur-lex.europa.eu/legal-content/ES/TXT/PDF/?uri=CELEX:32014R0342&from=EN

Risk Management

116. **The 1999 Joint Forum framework, as well as the 2002 FICOD, included several provisions to deal with group risks, especially risk concentration and intra-group contagion.** The Joint Forum published many additional analyses and guidelines to illustrate, clarify and strengthen the application of these provisions. The Joint Forum suggested introducing more detailed policy requirements to deal with contagion and risk concentration.

117. **FICOD gives a lot of discretion to supervisors to perform one of the most important functions of FICOD: the detection of an excessive build-up of aggregated risks across the group.** Risk concentrations could take many forms, including exposures to individual counterparties, groups of individual counterparties or related entities, counterparties in specific geographic locations, industry sectors, specific products, and service providers. In addition, specific risk types could build up if aggregated across the group, such as market risk, interest rate risk and operational risk. FICOD is accordingly drafted in a broad manner, enabling supervisors to limit concentrations of risks, including funding risk, whenever they may jeopardize the soundness of the licensed entities in the group.

118. **Two specific powers are worthwhile mentioning.** The power to require stress testing of a conglomerate's exposures for extreme scenarios (Art 12a) allows for the detection and control of risk concentrations building up throughout the conglomerate out of sight of the sector-specific monitoring tools. The power to require the reporting of intra-group transactions (IGT) (Art 8) serves the detection of potential contagion channels, especially when certain entities appear to operate as an IGT-hub for thousands of intra-group flows of funds and cash. This is where FICOD meets the Resolution plan requirements: those entities that serve as a crucial platform for intra-group flows justify more intense supervision under stress.

119. **These powers, combined with the observed need to extend the scope of supervision to unregulated entities and identification of the ultimately responsible entity** for compliance with FICOD requirements, should ensure an adequate framework for the supplementary supervision of risk management.

Final observation: supervision of ultimate parent entities

120. **Imposing requirements at the group level will not ensure compliance unless this is accompanied by clear identification of the entity ultimately responsible in the financial group** for controlling risks on a group-wide basis and for regulatory compliance with group requirements. This would allow more effective enforcement of the requirements by the supervisory authorities. In Europe, this ultimate responsibility may need to be extended to non-operating holding companies at the head of conglomerates, even though a limited scope may be envisaged for those holding companies whose primary activity is not in the financial sector.

121. **The latest review of the European framework for financial conglomerates concluded that the criteria for the definition and identification of a conglomerate,** the identification of the parent entity ultimately responsible for meeting the group-wide requirements and the strengthening of enforcement with respect to that entity are the most relevant issues that could be addressed in a future revision of the financial conglomerates directive. The identification of the responsible parent entity should also enhance the effective application of the existing requirements concerning capital adequacy, risk concentrations, intra-group transactions, and internal governance. However, the regulatory and supervisory environment with regard to credit institutions, insurance undertakings and investment firms is evolving, and the impact of new, sector-specific rules applied at ultimate parent level may already significantly enhance group-wide supervision as meant in FICOD. Therefore, the European Commission will keep the situation under constant review to determine an appropriate timing for a legislative revision, if deemed necessary.

IV. JAPAN

Landscape of the Financial Sector

122. **The Japanese financial system represents almost 600 percent of GDP and is predominantly bank-oriented**. Banks hold approximately 60 percent of all financial sector assets. A small number of large financial group dominate the banking and insurance sectors. There are about 2,000 deposit-taking institutions but a few banks dominate the sector. Five city banks[10] are large commercial banks, three of which respectively belong to the three major banking groups ("megabanks"), holding about half of Japan's banking sector assets. The shareholders of these groups are fragmented in the financial market and financial groups owned by the industrial companies (mixed conglomerates) exist only in the margin. Sixteen trust banks offer both commercial and trust banking, including asset management services for large (often export-oriented) corporations. About 100 of regional banks are typically based in the principal city of prefectures and finance mainly local enterprises and governments. Foreign banks have traditionally played a minor role in the domestic market. Japan Post Bank (JPB)[11] represents about 10 percent of all deposit taking institutions' assets (including banks and cooperative financial institutions), and is the largest deposit-taker in the world. Japan Post Bank mostly invests in Japanese Government Bonds (JGBs). Most of the others are cooperative style financial institutions.

123. **As of end-2010, the total assets of the insurance sector represented 78 percent of GDP, with a large majority of these assets (close to 80 percent) being in the life insurance sector.** About one-third of assets in the life insurance sector are held by Japan Post Insurance (JPI),[12] the largest life insurer in the world, and the balance held by a few large

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[10] The headquarters of city banks are located in a large city such as Tokyo. They also have business network across regions.

[11] JPB is a subsidiary of Japan Post Holding which is 100 percent owned by the government. It has already been programmed to be privatized by September, 2017.

[12] JPI is also a subsidiary of Japan Post Holding, and to be privatized by September, 2017

insurance companies. The nonlife sector is dominated by motor insurance (nearly two thirds of the market). About 6 percent of nonlife business and less than 2 percent of the life business is reinsured, primarily in the local market, and the large insurers have capacity to retain most risks. Overall, less than 1 percent of the insurance business is reinsured abroad, and less than 1 percent of the premiums of Japanese insurers relate to reinsurance of foreign risks.

124. **High public sector indebtedness and slow growth are two central risks.** Growing risks to fiscal sustainability have heightened concerns about possible feedback to financial stability. Gross public debt reached 240 percent of GDP (end-FY2013), the highest ratio globally. An increasing share of the financial system's balance sheet is invested in JGBs. However, household and corporate balance sheets appear sound, and continued supply of bank deposits has provided indirect support for government debt markets. Profitability is low across sectors, reflecting slow growth and weak borrowing demand. In seeking new sources of profit, megabanks are increasingly shifting their lending and other activities abroad, particularly to emerging economies in Asia. Both risks are considerable especially to regional banks. The latest FSAP in 2012 recommends reconstruction of these regional banks through consolidation.

Brief History About Financial Conglomerates

125. **Strong firewalls across sectors were established just after the end of WWII and those were maintained until 1990s.** Following the war, the government was under the control of the General Headquarters of the Allied Forces (GHQ). The GHQ saw the very large mixed conglomerates as one of the driving forces behind the war, and forced their dissolution. In 1947, the Anti-Monopoly Act was established and it prohibited the establishment of a holding company. In the same year, the Securities and Exchange Act stipulated the separation of banking and securities business, referring to the Glass Steagall Act. This separation was smoothly accepted mainly because Japan itself experienced a series of financial crises during 1920s. Firewalls between banking, insurance and security were in place basically until the 1990s. Although there were a few entries into insurance business from industrial sectors, such movement occurred only in the margin of the financial sector.

126. **During the 1990s, in response to global trend and requests from financial institutions seeking more opportunities, MoF, later FSA, gradually removed those firewalls.** The first step came in 1993 with the lifting of the ban on the mutual business entries through subsidiaries between banks and securities. In 1996, the ban on mutual business entries through subsidiaries between life and non-life insurance companies was removed. In 1998, the Anti-Monopoly Act lifted the ban on holding companies. Following this lifting, the Banking Act and Insurance Business Act respectively established the legal framework of Banking Holding Company (BHC) and Insurance Holding Company (IHC), both of which are allowed to hold banks, insurance companies and securities companies. In response to these regulatory changes, major banks and insurance companies re-organized themselves as BHCs and IHCs, respectively. Mutual entries between banking and security also increased. However, the major players in these two sectors did not enter the insurance business. Some restrictions between security and bank/insurance, including the ban on tying

arrangement and the restriction of concurrent positions of directors have been maintained, others were gradually loosened.

127. **After the global financial crisis, the supervision and resolution framework of systemically important institutions, including insurance- and security-led financial conglomerates, has been strengthened.** Before the crisis, consolidated capital requirement was only applied to BHCs. Given that insurance- or security-led groups could also trigger systemic risks, capital requirements on IHC and security-led groups were set up and their supervision tools were strengthened in 2012. Also, cross-sector resolution framework in systemic risk situation was established under the Deposit Insurance Act, which, before the crisis, had provided a legal resolution framework only for banks.

Joint Forum Principles

Financial supervisory powers and authority

128. **Since its establishment in 2000, the Financial Supervisory Authority (FSA) has been an integrated regulator for the banking, security and insurance sectors.** Financial supervision was conducted by Ministry of Finance (MoF) until the late 1990s, and then separated from MoF during 1998-2000. The latest Financial Sector Assessment Program (FSAP) made some recommendations, including to strengthen the JSA's legal framework and budgetary autonomy. The current total number of FSA staff is approximately 1,100. Even though the FSA is an integrated regulator, supervision of local financial institutions has been delegated to MoF's local branches comprising of about 1,500 staff. On-site monitoring of security companies is delegated to the Securities and Exchange Surveillance Commission (SESC). Based on the results of its inspection, the SESC may make a recommendation on enforcement actions to the FSA. The BoJ also undertakes on-site examinations in the context of its function as lender of last resort for financial institutions including banks and securities companies.

129. **The FSA also has the authority to plan and draft proposals and legislation for financial supervision and financial stability including crisis resolution.** Major laws under the jurisdiction of the FSA include the Banking Act (BA), the Insurance Business Act (IBA), and the Financial and Exchange Instruments Act (FEIA, into which Securities and Exchange Act and other related laws were integrated in 2008). The FSA shares regulatory responsibility with other government ministries and agencies in certain areas. For example, the Deposit Insurance Act is under the joint jurisdiction of the FSA and MoF. The Financial Instruments Sales Law is under joint jurisdiction of the FSA and the Consumer Affairs Agency.

130. **As an integrated regulator, the FSA gives particular importance to information sharing and harmonization of regulations across sectors.** The functional bureau structure has facilitated cross-sector regulatory coordination within the FSA. The FSA has three bureaus: (i) Planning and Coordination Bureau; (ii) Supervisory Bureau (Off-site monitoring); and (iii) Inspection Bureau (On-site monitoring). Senior officials in each bureau almost automatically engage in regulation and supervision and communications across sectors.

131. **The FSA, however, faces challenges.** This is particularly the case in maintaining expertise in the insurance and security sectors and integrating and harmonizing of off-site and on-site monitoring. As a result of the priority on the banking sector, the FSA has faced difficulty in retaining expertise in the insurance and security sectors. Though the FSA aggressively tries to hire external professionals, it often ends employing short-term experts since it is difficult for the FSA to offer adequate level of compensation because of the remuneration limits as a public entity. The difference in the organizational culture between supervision (off-site monitoring) bureau and inspection (on-site monitoring) bureau is considerable. The supervision bureau focuses on policy issues, but is not always familiar with financial practice in detail, while the inspection bureau concentrates on the workings of the financial market but tends to lack broader views. Personnel exchanges partly mitigate the negative impact. In this context, information sharing and policy coordination are still ongoing challenges.

Supervisory Responsibility

132. **The FSA is an integrated regulator of financial conglomerates.** While there is no comprehensive definition of financial holding company, Japan has two legal frameworks for financial conglomerates: The Bank Holding Company Act (BHA) and the Insurance Holding Company Act (IHA). A holding company owning both a bank and an insurance company can be BHC and IHC at the same time. The Anti-Monopoly Act, in general, defines a holding company as (i) a company holding other companies as subsidiaries (more than 50 percent of the total voting rights) and (ii) the ratio of the total acquired shares of its subsidiaries to the whole assets of the company is more than 50 percent. The BA follows this definition and further stipulates the disposition of BHC, which is a holding company owning (a) bank(s) as subsidiary. The activities of the BHC are limited to management and control of its subsidiaries and incidental issues. A person or legal entity seeking to establish or acquire a BHC needs prior authorization from the FSA. In the review of the application, the FSA examines the applicant based on the following points: (i) good prospects for balancing income and expenditure; (ii) adequacy of equity capital; (iii) knowledge and experience to carry out the business management of its subsidiary bank; and (iv) social credibility. An almost identical framework is applied in the case of an application for an IHC.

133. **The FSA counts with a set of regulatory tools for the BHCs and IHCs that are equivalent to the tools for solo banks and insurance companies.** As indicated above, the FSA closely examines the qualification of BHCs and IHCs in the authorization process. To ensure the soundness and appropriateness of the business of these institutions and their financial subsidiaries, the FSA has the authority to directly conduct off- and on-site monitoring. Holding companies are required to report to the FSA and also disclose basic information of the company, including consolidated financial statements and governance and risk management framework. They are also required to respond to the FSA's ad-hoc request for information sharing. The FSA may require them to submit a corrective action plan to remedy or improve their business situations.

134. **In addition to BHCs and IHCs, the major shareholders of banks and insurance companies also come under the direct supervision of the FSA.** The basic regulatory framework of major shareholders was established in 2002 in response to the increasing number of financial business entries by industrial companies. The determination of major shareholders is not only based upon direct ownership, but also indirect ownership such as the ultimate beneficiary owners that could control a bank's voting rights.

- Shareholders who have 5 percent or more of the voting rights are required to notify to the FSA. Relevant financial institutions are required to disclose a list of these shareholders.

- Shareholders who seek to acquire 20 percent or more of the voting rights are required to get prior authorization by the FSA. To ensure the soundness and appropriateness of the business of the relevant financial institutions, the FSA examines the applicant on the basis of a set of principles that comprise: (i) purpose of shareholding and financing; (ii) good prospects for balancing income and expenditure; (iii) sufficient understanding of the public nature of the business; and (iv) social credibility. The FSA may require them to report and submit the documents related with the relevant financial institutions. The FSA may also conduct on-site inspection.

- Shareholders who have 50 percent or more of the voting rights are required to be directly responsible for the sound and appropriate business of subsidiary banks or insurance companies. They need to submit a business improvement plan of the subsidiary banks or insurance companies, in response to the FSA's request. The FSA may also order them to recapitalize subsidiaries.

135. **The FSA has also strengthened supervision of security-led financial conglomerates, based on lessons learned from the global financial crisis.** Large security companies and security-led groups are required to satisfy the capital requirement on a consolidated basis. Shareholders who own more than 50 percent of the total voting rights are required to submit a business improvement plan of the relevant security company, in response to the FSA's request.

Corporate Governance

136. **The BHCs, IHCs and security groups are required to be stock issuing companies as stipulated by the Company Act (CA).** Based on the CA, BA, IBA, FIEA, and related administrative orders, these entities are required to have Board of Directors and internal company auditors. They are also required to establish their own corporate governance framework, including internal audit unit well aligned with the size and scope of their business. The corporate governance framework and its substantial implementation are checked through off- and on-site monitoring. The qualification of those senior management staff is reviewed by FSA. They are also required to have their consolidated balance sheets audited by external independent auditors.

137. **Governance firewalls within conglomerates have been gradually loosened.**

- Restrictions of concurrent holding of board of directorships. Directors engaging in the ordinary business of a bank or an insurance company are not allowed to engage in other business except when authorized by the FSA. Directors engaging in the ordinary business of a BHC are not allowed to engage in other business except when authorized by the FSA. The FSA may grant an authorization if it does not see a risk to the sound and appropriate management of the subsidiary bank.

- Other firewalls. In general, conglomerates are required to establish the management system to address conflict of interests in the group. Although restrictions on sharing computers and branch office space were abolished in 2006 and 2002, respectively, restrictions on sharing confidential customer information across subsidiaries are still in place.

Capital Adequacy and Liquidity

138. **The BHCs, IHCs, and FIBGs are required to prepare consolidated financial statements and satisfy respective consolidated capital requirements.** Subsidiary banks, insurance companies and large security companies, together with their consolidating subsidiaries, are also required to satisfy capital requirements on solo basis. The adequacy of capital, governance framework of capital assessment process and its implementation are subject to both off- and on-site monitoring. If the level of capital is inadequate or there is a flaw in the capital assessment process, the FSA can order them to restore the capital level and improve their assessment framework. The FSA, in cooperation with the BoJ, assesses the adequacy of liquidity and assessment framework.

139. **For banks and BHCs, there are two different capital requirements, depending on whether or not they have international activities.** The coverage of consolidation includes (i) subsidiary banks; (ii) security companies; and (iii) other related business companies. Subsidiary insurance companies are deducted in the process of consolidation.

- Banks and BHCs with international business activities are required to have capital equivalent to 8 percent of risk weighted assets. The capital calculation framework draws from Basel II. The transition to Basel III, which kicked off in 2013, is expected to be completed by 2019.

- Other banks and BHCs (non-internationally active banks) are required to have capital equivalent to 4 percent of risk weighted assets again on the basis of Basel II. Though the level itself will remain unchanged, the calculation framework is envisaged to be updated following a step-by-step process within the context of the Basel III framework. The latest FSAP called for the reconsideration of the distinction between international and non-international operations. Even so, the FSA considers that non-internationally active banks engage in community based businesses and, thus, their minimum capital ratios should reflect a balance between the two objectives of facilitating financial intermediation in different regions and ensuring safety and soundness of financial institutions.

140. **One standard is applied to all the insurance companies and IHCs.** The solvency margin should be more than 200 percent. Most insurance companies and IHCs have a solvency margin well above 200 percent. The coverage of consolidation includes subsidiary insurance companies, banks and security firms. Consequently, a financial conglomerate that owns a bank and an insurance company is required to satisfy two different capital standards, the consolidated equity capital ratio and consolidated solvency margin.

141. **Large security firms and security-led conglomerates are required to satisfy consolidated capital requirement.**

- Security companies holding more than a certain level of total assets (currently 1 trillion yen, determined by FSA) are specified as Designated Financial Instrument Business Operator (DFIBO). DFIBOs are required to satisfy capital requirements on a consolidated basis. Although the number of DFIBO is only 5 percent of that of total security companies, the assets of DFIBO are approximately 90 percent of total security companies' assets.

- The FSA, when necessary, can classify a group, including a DFIBO, as Designated Parent Company (DPC). DPCs are required to satisfy consolidated capital requirement. To avoid regulatory duplication, the BHCs and IHCs are not specified as DPC.

- The coverage of a DFIBO and DPC for consolidation purposes includes subsidiary banks, security companies and related business companies. Subsidiary insurance companies are not included in the consolidation.

142. **In case industrial companies hold banks or insurance companies, the FSA uses the legal framework of major shareholders to ensure the independence,** soundness and appropriateness of the business of subsidiary banks or insurance companies. Quantitative capital requirement is not applied to the industrial companies.

- In the context of the preauthorization and subsequent monitoring process, the FSA closely examines the qualification of industrial companies as major shareholders. For example, shareholding for short-term trading purpose, purchase and holding relying on excessive borrowing, inadequate cash flow, and concurrent position of directors and employees are typical reasons why the FSA may reject their major shareholder status.

- The FSA also requires the industrial companies to establish measures to protect banks and insurance companies from their industrial business risks. The FSA examines the effectiveness and appropriateness of those measures. The measures should at least include following components:

- Industrial companies will not receive financial support from subsidiary banks or insurance companies when their business conditions have deteriorated.

- Industrial companies are required to take into consideration various risks, including reputational risks to their subsidiary banks or insurance companies stemming from their industrial business, and establish mitigating strategies. These risks, for example, could include the deterioration of their industrial business, sales of shares of financial subsidiaries, or drawing down of deposits. The mitigating strategies could include measures for (i) securing their revenue stream; (ii) securing their funding sources; and (iii) strengthening their capital base. In particular, when the financial subsidiaries share branch office with the industrial companies, a business continuity plan is required in case of the bankruptcy of the industrial company.

Risk management

143. **Based on the BA, IBA, FIEA and related administrative orders, the BHCs, IHCs and FIBGs are required to establish effective governance framework of risk management at the group level.** The framework and practice are regularly checked through on- and off-site monitoring. The latest FSAP generally points out that (i) the roles of company auditors could be expanded; (ii) their de-facto independence and function should be strengthened; and (iii) practice of stress testing could be much more sophisticated and integrated into business management of financial institutions.

144. **Financial activities of banks and insurance activities are restricted in various ways to ensure appropriate risk taking.**

- Exposure limit is applied in both solo and group basis. Banks or BHCs' exposure to an entity or group is limited up to a maximum 25 percent of equity capital. Insurance company or IHCs' exposure is limited to a maximum of 10 percent of total assets.

- Related party transactions are also regulated in both solo and group basis. Related parties include subsidiaries, BHCs/IHCs, other subsidiaries of BHCs/IHCs, and major shareholders are at least included in related party. Unless authorized by FSA, transactions, which could be harmful or undermine the soundness and appropriatness of subsidiaries' businesses, are prohibited.

- Stock holdings of industrial companies are restricted. Banks, insurance companies, and BHCs are only allowed to own up to 5 percent, 10 percent and 15 percent, respectively, of total voting rights of an industrial company. The prototype of these restrictions was originally established in 1940s. These regulations seek not only to regulate risk taking of banks and insurance companies but also to curb their direct influence over industrial companies.

- Banks' stock holding is limited up to Tier1 capital. This limitation, which was established in 2002 based on the severe experience of the financial crisis during the late 1990s, aims to protect banks' balance sheets from sharp declines in stock prices.

V. REPUBLIC OF KOREA

Financial Sector Landscape

145. **Korea's financial sector is large and diversified.** The assets of banking and nonbanking institutions amounted to 310 percent of GDP as of end-2012. Since the mid-1990s, the financial sector has increasingly diversified while primarily dominated by the banking sector. The banking sector is composed of commercial, specialized banks and two foreign-owned banks, and accounted for 48 percent of the aggregate financial sector assets as of end-2012. Lending activities contributed 73 percent of the commercial bank's total assets, which was above the average percentage for other advanced Asian countries. The nonbank sector has experienced a strong growth in recent years, representing 52 percent of the total assets of the financial sector as of end-2012, up from 41 percent at end-2000. The nonbanking sector is composed of depository and non-depository institutions. The former includes credit cooperatives, accounting for about 11 percent of aggregate financial sector assets at end-2012. Non-depository institutions mainly comprise insurance companies, asset management companies, and securities companies, accounting for 19 percent, 8 percent, and 7 percent of aggregate financial sector assets, respectively.

146. **Local capital markets are comparatively mature in size.** The bond market is among the largest in Asia, with outstanding securities accounting for 123 percent of GDP at end-2012. Growth in the bond market is driven by the corporate bond segment, one of the largest in the world. The derivatives market is also large, with trading activity concentrated in exchange-traded derivatives. Daily turnover of equity-linked derivatives at the Korea Exchange was the second highest globally, only behind the Chicago Mercantile Exchange (CME). Trading of foreign exchange (FX) and interest rate derivatives is also very active.

147. **The financial system is dominated by 13 financial holding companies (FHCs) constituting 55 percent of the financial sector assets at end-2013.** The FHCs have steadily increased their market share in total financial sector assets from about 39 percent at end-2010. The FHCs have 87 percent of their consolidated assets in banking (accounting for about 70 percent of the banking sector assets). Among the 18 commercial and specialized banks in Korea, 11 are operating under bank holding companies, which have a total of 316 subsidiaries. The financial companies under the bank holding companies operate across a broad cross-section of the financial sector. In particular, the trend has accelerated since the onset of the global financial crisis in 2008 as nine financial holding companies are newly established.

Financial Groups

148. **There are three types of financial groups in Korea.** The first type is a financial holding company, the second type is a parent-subsidiary model, and the third is a mixed

conglomerate. Financial holding companies are subject to consolidated supervision, which includes group-wide regulatory guidance. Financial firms under the parent-subsidiary model and the mixed conglomerate structure are only subject to individual supervision. They are not subject to direct group-wide regulations on risk management, capital adequacy, intra-group transactions, or limits on credit exposure.

149. **Korea had only two kinds of financial groups before the Asian Financial Crisis in 1997.** One is the 'financial conglomerate' whose businesses were exclusively in financial activities. Its structure took the form of a parent-subsidiary model. The financial firms with this type of structural form were prohibited from establishing financial holding companies, in order to keep those entities from monopoly and other anti-competitive behaviors. However, Korea later adopted the law that allows the creation of financial holding companies following the crisis as a part of the government's restructuring efforts.

150. **The other form is "mixed conglomerate."** The mixed conglomerate is composed of a group of businesses at least one of which is a regulated nonbank financial institution (NBFI). Many NBFIs are owned by the 'chaebols' (large family-owned conglomerates). According to the Fair Trade Commission, the amount of assets for 10 largest mixed conglomerates totaled to about 1,240 trillion won (US$1.13 trillion) as of September 2014.

151. **Korea's regulations and supervision of financial holding companies significantly evolved after the 1997 Asian Financial Crisis.** The holding company structure was first introduced in February 1999 as a part of the amendment of the Monopoly Regulation and Fair Trade Act (Monopoly Act). A holding company is defined as a company that holds ownership of its subsidiaries by holding their shares.

152. **In addition to the aforementioned amendments, the Financial Holding Companies Act (the FHC Act) was enacted in 2000 to enable financial institutions to adopt the structure of a holding company.** The Monopoly Act is the mother law of the FHC Act, but it was insufficient to adequately oversee the financial firms as it was designed to regulate the general holding companies. The FHC Act provided a ground for the necessary rules on financial businesses such as restrictions on bank ownership and requirements for the authorization of financial businesses. Financial holding companies were recognized and specified as different from general holding companies. The enactment of the FHC Act was a result of an effort to restructure the financial industry in the wake of the 1997 Asian Financial Crisis by increasing transparency in ownership and governance of financial companies, and also was a response to the trend of financial conglomerates for further growth and diversification.

153. **The number of holding companies under the Monopoly Act has been on the rise since its establishment in February 1999.** Only 25 holding companies existed in 2005, but the number increased to 115 by September 2014. The continued increase in holding companies is due to an improvement of the financial regulation, such as relaxation of the requirements for minimum share ratio of affiliates, which facilitated an establishment or a change to a holding company. In addition, the market gave a positive assessment of the holding company system for the simpler and the more transparent form of ownership or

governance, and more companies joined the flow of transformation towards the holding company structure.

154. **Some key rules are commonly applied to general holding companies and financial holding companies.** The first one is the prohibition of simultaneous ownership in financial and nonfinancial subsidiaries. A general holding company may not control financial firms as its subsidiaries, and a financial holding company also may not own non-financial firms as its subsidiaries. This is based on the principle of separation of finance and commerce. The second one is the prohibition of a subsidiary of a holding company to own stocks in other subsidiaries or the holding company. Such restriction is to prevent the unfavorable effects from the circular or mutual investment, including the spread of risk among group affiliates.

155. **However, there are some differences between these two types of holding companies.** The first difference depends on whether or not a holding company conducts other businesses in addition to the control of its subsidiaries, which can be distinguished between an operating holding company and a pure holding company. Financial holding firms may found only pure holding companies, which exclusively control the subsidiaries. General holding companies are allowed to establish both.

156. **The second difference is the establishment procedures.** General holding companies must register with the Fair Trade Commission (FTC) upon their establishment while financial holding companies must seek an approval from the Financial Services Commission (FSC) prior to its establishment.

157. **The third difference is the transactions among subsidiaries such as the granting of credit are restricted.** This is to prevent widespread risk among subsidiaries under a single financial holding company. The granting of credit among subsidiaries are limited up to 10 percent of the equity capital, and other types of appropriate security bonds such as government bonds must be procured. The granting of credit from subsidiaries to financial holding companies and the trading of classified assets among subsidiaries and financial holding companies are prohibited. The establishment of lower-tier subsidiaries is allowed only in exceptional cases such as when they are related to the subsidiaries' businesses. Second-tier subsidiaries are not eligible to get such permission.

158. **Financial holding companies are subject to a variety of restrictions, but there are clearly benefits.** First, customer information such as transactions and credit may be shared within affiliated financial firms with the same financial holding company. Second, the concurrent holding of executive positions at a holding company and at a subsidiary is widely accepted. Considerable exceptions are allowed such as the ban on keeping an executive officer from holding more than one office, depending on the specific regulations that oversee the business concerned. Executives and staff members of a holding company may concurrently hold executive positions at subsidiaries while executives at subsidiaries may concurrently hold executive positions at other subsidiaries in the same category of business. Third, tax benefits, such as deferred taxes on gains from equity transfer, are possible.

Supervisory Framework and Characteristics of Financial Holding Companies

159. **As mentioned above, the regulation and supervision of financial conglomerates in Korea is primarily based on the FHC Act.** The FHC Act governs financial conglomerates within the financial holding company structure. More precisely, the FHC Act oversees financial holding companies and their interaction, or interconnectedness, with their affiliates, while the financial business affiliates are primarily governed by the relevant financial laws. In comparison, a bank is regulated under the Banking Act. The FHC Act encompasses a number of regulatory aspects that are essential to effective regulation and supervision of FHCs.

160. **The FHC Act defines the criteria of a financial holding company.** A financial holding company is a company, the primary business of which is to control other companies closely related to the operation of financial business through the ownership of their stocks according to the standards prescribed by Presidential Decree. This decree should meet all the following items:

(a) It shall control at least one financial institution;
(b) Its total assets shall be not less than 100 million won; and
(c) It shall obtain authorization from the Financial Services Commission.

161. **The FHC Act stipulates three types of financial holding companies.** These are bank holding company, insurance holding company, and financial investment holding company.

162. **The supervisory framework for FHCs is essentially similar to that for banks.** But as FHCs are financial groups consisting of a number of financial units, they are supervised on a consolidated basis. Regulations of FHCs seek to minimize potential FHC-related vulnerabilities, including by prohibiting FHCs to control nonfinancial subsidiaries. Group-wide supervision is based on the monitoring of consolidated financials and on assessments on the internal control over management of the various businesses. Group monitoring focuses on the banking side through stand-alone supervision, given its relevance to the activities of the FHCs.

163. **Restriction on ownership of a financial holding company is the key feature of the FHC Act.** Under the Financial Holding Companies Act, a financial institution may not control a financial holding company. For a bank holding company that controls nationwide banks, any single shareholder or person who has a special relationship with the business may acquire beneficial ownership of no more than10 percent of the total issued and outstanding shares of voting rights.[13] However, "non-financial business group companies"[14] may not

[13] The Korean government and the KDIC are not subject to this limit.

[14] "No-financial business group companies" as defined under the FHC Act include: (i) any same shareholder group where the aggregate net assets of all nonfinancial business companies belonging to that group equals or exceeds 25 percent of the aggregate net assets of all members of that group; (ii) any same shareholder group where the aggregate assets of all nonfinancial business companies belonging to that group equals or exceeds 2 trillion won; or (iii) any mutual fund where a same shareholder group identified in (i) or (ii) above owns more than 4 percent of the total issued and outstanding shares of that mutual fund.

acquire the beneficial ownership of shares of a bank holding company controlling nationwide banks in excess of 4 percent of that bank holding company's outstanding voting shares, unless they obtain the approval of the Financial Services Commission and agree not to exercise voting rights in respect of shares exceeding the 4 percent limit. In this case, they may acquire beneficial ownership of up to 10 percent. Any other person (regardless of the nationality) may acquire no more than 10 percent of total voting shares issued and outstanding of a bank holding company that controls nationwide banks, unless they obtain an approval from the Financial Services Commission that allows the total holding will exceed 10 percent, 25 percent, or 33 percent of the total voting shares issued and outstanding of that bank holding company controlling nationwide banks.[15]

Joint Forum Principles

Supervisory Powers and Authority

164. **The FHC Act clearly sets out the responsibilities, objectives and authority related to the supervision of a financial holding company.** The Act provides a comprehensive range of supervisory tools including the prior approval and standards of authorization, criteria for controlling ownership of subsidiaries, permissible activities, capital adequacy, prompt corrective action (PCA), restrictions on intergroup transactions, and information sharing among others. The current legal framework effectively authorizes financial holding companies to conduct the necessary supervision, to ensure compliance with laws and to undertake corrective actions for safe and sound financial transactions.

165. **The Act establishing the Financial Services Commission (the Establishment Act) provides the FSC-FSS with the authority and power for coordination, and information sharing for group-wide supervision.** The FSC-FSS shares an authority to require financial holding companies and banks to submit information on both a standalone and a consolidated basis. There are several formal and informal mechanisms that secure efficient and effective cooperation, coordination, and information sharing among the FSC, the Financial Supervisory Service (FSS), Ministry of Strategy and Finance (MOSF), Bank of Korea (BOK), and Korea Deposit Insurance Corporation (KDIC) stipulated in either various laws or MOUs among the authorities. At the international level, the FSC-FSS has the legal basis to ensure the exchange of information with foreign financial supervisory authorities in the securities sector. The FSC-FSS is signatory of the IOSCO MMoU.

166. **Compared to the Joint Forum principles, however, the FHC Act and the Establishment Act have their limitations.** Unlike the Joint Forum Principles, the FSC and FSS are not clearly mandated to require the structural transparency of financial conglomerates. Also, the Financial Sector Assessment Program (FSAP) 2013 states that the responsibilities particularly linked to fair financial transactions and consumer protection, often required by the FSC and FSS, can create a conflict between the "developmental"

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[15] The same concepts and restrictions apply to the ownership of banks under the Banking Law in Korea.

objective and the safety-and-soundness objective. Further limitation of the FSC-FSS comes from a lack of power to increase the prudential requirements for individual banks and banking groups based on their risk profile and systemic importance.[16]

167. **The 2013 FSAP saw the need to further strengthen the independence of the FSC-FSS from the political processes to facilitate greater focus on promoting the safety and soundness of the banking sector.** The legal status of the FSC within the Government structure as a Ministerial agency can potentially grant the FSC additional means to exercise its independence in comparison to structures where the supervisory agency is within the authority of the Ministry of Finance. There are also checks and balances in the FSC and the FSS through various vehicles including its internal audit, audit from the Board of Audit and Inspection of Korea (BAI) as well as the investigations by the Parliamentary Assembly. Nevertheless, legal protection for these regulatory bodies needs to improve as the current setup can potentially jeopardize effective supervision.

168. **The FSAP also noted that offsite supervision of the group is conducted through a dedicated FSS team, which focuses principally on banking issues and in liaison with subject matter experts.** The assessment recognized that there should be a better coordination between the teams responsible for offsite supervision in identifying risk exposures among group affiliates.

Supervisory Responsibility

169. **The FSC-FSS oversees all financial services firms including financial holding companies, as the integrated supervisor as mandated by the Establishment Act.** The FSC-FSS monitors how group-wide consolidated risks are managed from an internal control and operational management perspective. In addition, surveillance of the consolidated balance sheet of banks is performed through the use of the CAMEL, to the extent that refers to consolidated entities. Full-scope examinations of the large banks, which are conducted every two years, encompass a module related to the FHC, resulting in an RFI (Risk Management, Financial Condition and Potential Impact). According to the 2013 FSAP, however, there are currently no procedures in place for overall monitoring/assessing relative to contagion and reputation risk that may jeopardize the safety and soundness of the bank and the banking system.

170. **The FSC-FSS maintains an integrated financial information analysis system to collect and manage data from banks both on a monthly and a quarterly basis.** The data include information about banking operations and financials, regarding regulatory compliance. The BOK and KDIC can request the FSS to undertake joint examinations of regulated entities and share examination reports. Following joint BOK/FSS examinations, the BOK may request the FSS to take any necessary corrective measures in areas under its mandate.

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[16] The FSAP 2013 could be applied to, or at a minimum provide hints on the assessment of the conglomerate supervision in Korea.

171. **Under the FHC Act, FHCs have specific prudential standards and limits applied on a consolidated basis.** These encompass capital adequacy (8 percent), large exposures (25 percent), and lending to major shareholders (25 percent). Banks are also required to apply prudential standards on a consolidated basis. Exceptions to large exposures and lending limits to related parties include special circumstances due to national economic reasons or reductions in capital of the FHCs (in case of the latter, the FHC will have a year to comply with the lending limit). Lending of over 1 percent or 5 billion won up to 25 percent of regulatory capital can be granted by a unanimous approval of the Board of Directors, followed by communication to the FSC.

172. **Monitoring and supervision are conducted at various stages as provided under the FHC Act.** A fit and proper test is required for the promoters of a bank or FHC under the licensing process but not for all large shareholders or senior management of parent companies. During the authorization process, the FHC Act requires the largest shareholder and major shareholders (holdings of 10 percent or more), its related parties as well as shareholder(s) which is deemed to exercise "de facto" influence to have "adequate investment capacity, financial soundness and social credibility". There is no requirement regarding senior management of parent companies. The FSC-FSS also monitors soundness and the management of the FHCs and their subsidiaries through periodic evaluations of the overall management performance. The management performance evaluations take into consideration the following three components: Risk management (R), Financial condition (F), and Impact (I).[17]

173. **The FHC Act has supervisory tools to compel timely adjustment.** Where an FHC falls under each of the criteria for prompt corrective actions, the FSC/FSS recommends it to take necessary measures; (i) Management Improvement Recommendations; (ii) Management Improvement Requirements; or (iii) Management Improvement Order. (Table 1)

Corporate Governance

174. **The FHC Act has several provisions on corporate governance requirement.** It includes an audit committee, independent outside directors, and internal controls for executives/employees performing multiple functions as well as delegation/outsourcing of functions within a financial conglomerate. The number of outside directors of an FHC should be at least 3 and represent 50 percent of the total number of board members, if the total assets of the FHC exceed 100 billion won. An FHC is required to set up a recommendation

[17] The evaluation ratings consist of five ratings: Rating 1 (Strong); rating 2 (Satisfactory); rating 3 (Less Than Satisfactory); rating 4 (Deficient); and rating 5 (Critically Deficient).

(R) is rated based upon an assessment of four evaluation factors: i) board and senior management oversight; ii) risk management policies, procedures, and limits; iii) risk monitoring and reporting; and iv) internal controls;

(F) is rated based upon an assessment of four evaluation factors: i) capital adequacy; ii) asset quality; iii) earnings; and iv) liquidity; and

(I) rating reflects the potential impact of the FHC and its other subsidiaries on its leading subsidiary. The leading subsidiary is the one which takes up the largest part of the business. The impact component is rated based upon an assessment of three evaluation factors: i) business strategies, oversight of subsidiaries, subsidiaries' dividend policies, asset quality, cash flows and leverage; ii) the latest composite ratings of subsidiaries; and iii) intra-group transactions.

committee for outside directors to recommend candidates to be selected and appointed by the shareholders at the general meeting. An FHC should also form an audit committee, of which not less than two-thirds must consist of outside directors. At least one of the members should be an expert in accounting or finance.

175. **An FHC should disclose the balance sheet, the income statement, and consolidated financial statements as required under the FHC Act.** During an external audit, companies must disclose the information within 3 months from the end of a fiscal year. For any document that cannot be disclosed within this period due to unavoidable reasons, the disclosure deadline may be extended upon approval of the FSC. Also, every financial holding company should disclose matters necessary to protect depositors and investors of its subsidiaries on a regular basis.

Capital Adequacy and Liquidity

176. **Certain restrictions apply to the capital adequacy of FHCs to prevent "double gearing."** These restrictions are to prevent mutual capital contributions among affiliates of the FHC and to ensure that the characteristics of capital structure for each subsidiary are appropriately reflected. The ratio of aggregate net equity capital to aggregate requisite capital must be 100 percent or higher for a nonbank holding company. For a bank holding company, the BIS capital ratio must be 8 percent or higher on a consolidated basis.

177. **Liquidity requirements for FHCs are not applied on a consolidated basis.** The won-denominated liquidity ratio (assets to liabilities) must be 100 percent or higher, and the foreign currency denominated liquidity ratio must be 80 percent or higher. In order to prevent foreign currency maturity imbalance, the ratio of the difference between assets and liabilities to assets must be positive if the maturity is less than 7 days, and better than *minus 10* percent if the maturity is less than a month. However, the foreign currency liquidity restriction is not applicable to an FHC whose ratio of foreign currency debts to total assets is less than 1 percent.

178. **In December 2013, Korea's supervisory authorities introduced Basel III for banks and bank holding companies.** This move complies with the decision by the Basel Committee on Banking Supervision to start the implementation of Basel III, the newly enhanced capital regulations. Bank holding companies and their subsidiaries are subject to capital regulation as a standalone entity and maintain group-wide risk management systems. In addition, the higher-quality capital that the new framework requires is expected to keep banks from yielding to excessive dividend demands and encourage more prudent capital management.

Risk Management

179. **FHCs are required to have a group-wide risk management system under the FHC Act.** The system would enable the FHCs to set risk limits and tolerances for each subsidiary, department, and business and measure and manage credit risk, market risk, liquidity risk, and all other risks on a group-wide basis. The risk management of an FHC is rated based on the assessment of four evaluation factors: (i) board and senior management

oversight; (ii) risk management policies, procedures, and limits; (iii) risk monitoring and reporting; and (iv) internal controls.

180. **The FHC Act includes a number of safeguards to prevent significant risks from intra-group transactions exposure.** The safeguard measures include: (i) the subsidiaries may not invest in or extend credit to the FHC; (ii) the subsidiaries also may not invest in other subsidiaries of the FHC; (iii) there is a credit ceiling among FHC subsidiaries: for each subsidiary, the credit extended should be within 10 percent of equity capital and in total, within 20 percent of equity capital; (iv) extension of credit to other subsidiaries by a subsidiary of an FHC will be secured by collateral appraised at fair market value; and (v) FHCs and their subsidiaries, are barred from acquiring low quality assets (categorized as "precautionary" or below) from each other.

181. **The law specifies the FHCs' types of activities that a consolidated group may conduct to financial activities or financial related activities.** The restrictions include the following: (i) an FHC may hold stocks issued by another company that is not its subsidiary within 5 percent limit of the total number of stocks issued by such company; (ii) a bank holding company may not invest more than 1 percent of its capital in stocks issued by a large shareholder (0.5 percent in a non-listed stock). A weighted average limit is applied to a nonbank holding company; (iii) an FHC is prohibited from holding stocks issued by its subsidiaries in excess of its equity capital, provided that this does not apply to a capital increase for improving the financial standing of the subsidiary; and (iv) an FHC should accumulate not less than 10 percent of its net earnings into the reserve account until the reserve amount has reached the total amount of legal capital.

182. **Lending limit on a single borrower is provided under the Act as well.** There are a number of restrictions on lending to a single borrower, such as: (i) the total amount of credits that can be extended by an FHC (including its subsidiaries) to a single borrower may not exceed 20 percent of the total capital of the bank holding group; (ii) the amount of credit to a large shareholder holding more than 10 percent of the total voting shares is restricted to the lower of either (a) 25 percent of the capital or (b) the amount corresponding to the shareholder's capital contribution in the bank holding company; and (iii) a weighted average limit is applied for a nonbank holding company.

Institutional Arrangements for Financial Supervision

183. **Financial regulation and supervision in Korea is based on an integrated supervisory approach through the FSC and the FSS.** The FSC and the FSS, established in 1999, have different supervisory functions. The FSC does a macro supervision of the overall financial industry and sets out the general financial policies. The FSS does the micro supervision that regulates and monitors the financial market and institutions, under the direction of the FSC. Unlike the FSC, the FSS is staffed by non-civil servants and headed by the Governor. The FSS consolidated the former four financial supervisory authorities—the Office of Bank Supervision (OBS), the Securities Supervisory Board (SSB), the Insurance Supervisory Board (ISB), and the Nonbank Supervisory Authority (NSA). In 2008, the Financial Supervisory Commission was integrated with the Financial Policy Bureau of the

former Ministry of Finance and Economy—currently the Ministry of Strategy and Finance (MOSF) to compose the present Financial Services Commission.

184. **The institutional arrangements, however, still involve multiple government agencies.** These agencies include: (i) the MOSF which is responsible for FX policies and financial and economic coordination; (ii) the FSC which is responsible for financial sector policy, prudential policy, supervision, enforcement, sanctions, and financial institution resolution;[18] (iii) the FSS which is responsible for the inspection and supervision of financial institutions under the guidance and oversight of the FSC; (iv) the Korea Deposit Insurance corporate (KDIC) which operates the deposit insurance and resolution functions under the guidance and oversight of the FSC; and (v) the Korea Financial Intelligence Unit (KOFIU) which was established under the oversight of the FSC, which performs the financial intelligence function.[19]

185. **Formal and informal inter-agency mechanisms have been established to facilitate policy coordination, licensing, sanctions and resolution, and cross-representation at top decision-making level and multiple government agencies.** The formal inter-agency mechanisms are stipulated in various laws that include: (i) the Financial Services Committee, chaired by the FSC Chairman and composed of nine members including the MOSF, BOK, FSS, KDIC, plays a decision-making role for all the important policy, regulation, supervision and enforcement issues; and (ii) the BOK and KDIC can enforce requests from the FSS to undertake joint examinations of regulated entities and share examination reports. Following joint BOK/FSS examinations, the BOK may request the FSS to take any necessary measures in the areas under its jurisdictional mandate. The BOK's Monetary Policy Committee (MPC) may also request that the FSC reconsider its decision if it bears upon monetary and credit policies. Also, several informal mechanisms are in place where an MOU has been signed among the BOK, FSS, and KDIC that provides a venue for sharing periodic and non-scheduled financial information submitted by financial institutions to the BOK, FSS, and KDIC.

186. **Macroprudential policy in Korea is coordinated at various levels and through a range of interagency meetings.** The systemic risk assessments and policy measures are discussed during a Macroeconomic and Finance Meeting (MEFM), which is conducted at least quarterly at the deputy level. The meeting is composed of the FSC, the FSS, the BOK, and the MOSF, which chairs and prepares the agenda. The coverage of the meeting is broad enough to cover all aspects of macroeconomic and financial policy. The interagency coordination is not confined to the MEFM and is also very active at working level especially among the MOSF, the FSC, and the FSS. A revised Memorandum of Understanding signed in 2009 has helped improve information exchange among these agencies, especially in the sharing of supervisory data.

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[18] The Securities and Futures Commission (SFC) is established within the FSC: responsible for monitoring, supervising and investigating capital market activities. The SFC has a separate Board but no staff or secretariat of its own and relies on access to staff from the FSC as needed to fulfill its individual mandate.

[19] Joint examinations between the BOK and FSS are also possible.

187. **The legal framework has also established a special resolution regime for distressed financial institutions in Korea and identified the roles and responsibilities of different authorities with clear mandates.** The Act on Structural Improvement of the Financial Industry (ASIFI) identifies the FSC and KDIC as the key resolution authorities, with the FSC taking on the leadership. Although the BOK is not a resolution authority, it still plays a key role in providing financial assistance through its participation in funding the KDIC or public funds. The special resolution regime for entities under the financial sector, the ASIFI and the Depositor Protection Act (DPA) extends to banks (except the specialized banks), the Industrial Bank, investment traders, brokers, collective investment business entities, investment advisory business entities, discretionary investment business entities, insurance companies, mutual savings banks, trust business entities, merchant banks, and financial holding companies.

188. **A broad range of resolution tools is available to the resolution authorities.** The resolution tools include merger and acquisition, purchase and assumption, bridge banks, funding by government and other relevant authorities (including the KDIC), and liquidation. The FSC can appoint an administrator (management supervisor), who undertakes the necessary resolution procedures when an insolvent bank fails to comply with prompt corrective actions. The DPA mandates an application of the least cost test in the choice of a resolution method adopted by the KDIC. For this purpose, the Korea Resolution and Collection (KR&C) was established as a separate and independent entity for the conduct of resolution proceedings.

Final Remark

189. **Korean authorities have developed a framework for consolidated supervision by enacting the FHC Act in 2000.** Further effort is being made to achieve effective consolidated supervision of mixed conglomerates. The focus of supervision of mixed conglomerates is to gain consolidated view of the risks from linkages within the organizational structure and inter-group transactions.

Table 1. Prompt Corrective Actions for Financial Holding Companies

Measures	Conditions	Detailed Measures
Management Improvement Recommendations	• The ratio of equity capital to the requisite capital falls under 100 percent for a nonbank holding company (For a bank holding company, the BIS capital ratio falls under 8 percent on a consolidated basis); • The composite rating is 3 or higher but the rating for capital adequacy is 4 or lower; • Financial irregularity or nonperforming loans of significant gravity or magnitude occurs.	• Improvement in personnel management and organizational operation; • Cost reduction; Restrictions on new asset acquisition and new business expansion; • Restrictions on investment in new subsidiaries; • Disposition of bad assets; • Increase or reduction in shareholder contributed capital; Restrictions on dividend distribution; • Special provisioning for loan losses
Management Improvement Requirement	• The ratio of equity capital to the requisite capital falls under 75 percent for a nonbank holding company (For a bank holding company, the BIS capital ratio falls under 6 percent on a consolidated basis); • The composite rating is 4 or lower; • The FHC is judged to be below the standards mentioned in the above two items due to serious financial accidents or nonperforming loans; • The FHC subject to the management improvement recommendation fails to satisfactorily implement its management improvement plans.	• Downsizing of organization; • Restriction on the holding of risky assets and disposal of assets; • Replacement of executive officer(s); • Partial suspension of business operations; • Divestitures of subsidiaries, etc.; • Drafting plan(s) for merger, third-party takeover, or transfer of business entirely or partially
Management Improvement Orders	• The FHC becomes an ailing financial institution as defined in the Act on the Structural Improvement of the Financial Industry; • When the ratio of equity capital to the requisite capital falls under 25 percent for a nonbank holding company (For a bank holding company, the BIS capital ratio falls under 2 percent on a consolidated basis); • When the normal operation of an FHC subject to management improvement requirement seems to be in serious difficulties because the FHC fails to implement its management improvement plan.	• Retirement of all or parts of outstanding stocks; • Suspension of duties of executive officers and appointment of administrator(s); • Full or partial transfer of business operation; • Third-party take-over of the FHC; • Suspension of business operations for less than six months; • Merger; Full or partial transfer of contracts.

VI. United States of America

Financial Sector Structure[20]

190. **The U.S. financial sector is complex, with many financial institutions and regulators with distinct, but sometimes overlapping responsibilities.** The structure of the financial system and its oversight continue to evolve, due in part to the sweeping changes that were required by the Dodd-Frank Act of 2010. New regulations, along with regulatory structural changes, were intended to help strengthen the financial system. However, these changes did not reduce complexity of the U.S. financial system.

191. **The primary regulatory structural changes from Dodd-Frank resulted in creation of several new bodies, closure of one regulatory agency, and expansion of scope for several existing regulatory bodies.** Two changes had the most profound effect on the supervision and regulation of financial conglomerates.

- *Financial Stability Oversight Council (FSOC*—New; formed in 2011). Powers include the responsibility to designate a nonbank as systemically important, thus being subject to oversight by the Federal Reserve Bank (FRB). FSOC is chaired by the U.S. Treasury Secretary. It is comprised of nine additional voting and five nonvoting members from banking, securities and insurance related bodies with financial sector oversight responsibilities.

- Office of Thrift Supervision (OTS)—Dissolved in 2011. Supervised entities were transferred to other regulators. Supervision of Savings & Loan Holding Companies (SLHC) was transferred to the FRB, while supervision of the licensed subsidiaries under SLHCs was transferred to other federal regulators.[21]

Combined, these two changes expanded the supervisory scope of the FRB from only bank holding company-lead conglomerates to nonbank financial institutions.

192. **The United States does not have a definition of a financial conglomerate, although financial conglomerates exist in many forms.** Using the traditional demarcations of banking, insurance and securities, by asset size most financial conglomerates are under a bank- or insurance-led model. Mixed conglomerates exist, but they are not prevalent in the United States compared to the total asset size or number of financial institutions in the United States; albeit one mixed conglomerate owns a financial subsidiary that FSOC has designated as systemically important.

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[20] A detailed description of the U.S. financial sector can be found in the IMF's Detailed Assessment of Observance (DARs) reports for U.S. banking, insurance and securities, along with the self-assessments for each of these sectors. The self-assessments can be found at www.treasury.gov/resource-center/international/Pages/us-fsap.aspx#2015. The DARs and other IMF assessment documents will be posted to this web site also.

[21] Office of the Comptroller of the Currency, Federal Deposit Insurance Corporation.

193. **The bank/insurance/investment banking financial conglomerate model faded with the sale of Citigroup's insurance business in 2002 (property and casualty) and 2005 (life).** Shedding of the Travelers insurance units was attributed to their lower growth rates and the synergies with other business units not being realized to produce the desired returns.

194. **Of banks/insurance/investment banking, combinations of two of these three exist in the U.S. financial system.**

- *Bank/broker-dealer*—The largest broker-dealers in the United States are full-fledged investment banks and are under bank holding companies (BHCs). This is a structural change that was a result of the 2008 financial crisis, where the largest investment banks either failed (Lehman Brothers), were acquired (Bear Stern/JPMorgan, Merrill Lynch/Bank of America) or became BHCs (Goldman Sachs, Morgan Stanley). Additionally, about a dozen SLHCs have broker-dealers, although they are not considered full-fledged investment banks.

- *Insurance/broker-dealer*—In the prevalent structure, the broker-dealer is part of an insurance company. One reason an insurance company has a broker-dealer is because variable annuities are considered securities. To sell these products, insurance companies need a broker-dealer. These broker-dealers are generally not among the largest.

- *Bank/insurance*—There are no BHCs in the United States that include a bank and an insurance company. However, U.S. banks sell insurance products. There are about 15 SLHCs that include at least one deposit-taking institution and an insurance company.

195. **Structures differ with respect to mixed conglomerates, where a financial institution is affiliated with a nonfinancial company.** As noted above, the regulated institutions that are part of a mixed conglomerate are not large in comparison to the total size of the U.S. financial system, although data on this makes citing exact figures a challenge. Below is a general description of the types of models.

- *SLHC*—Most only hold thrift depository institutions, with a few holding insurance companies and broker-dealers. A handful of SLHCs are commercial firms holding deposit-taking institutions or the SLHC is a financial subsidiary that is part of a commercial firm. Examples include John Deere (equipment manufacturing), Macy's and Nordstrom (both department stores). All SLHCs became subject to FRB supervision with the closing of the OTS in 2011.

- *FSOC designated*— General Electric Credit Corporation (GECC), the financial subsidiary of General Electric, has been designated as systemically important. Thus, GECC is subject to higher prudential standards that are in the process of being established by the FRB.[22]

[22] See the request for public comment on the FRB's proposed supervision and regulation standards for GECC at www.federalreserve.gov/newsevents/press/bcreg/20141125b.htm.

- *Industrial Loan Companies and Trust Companies* —U.S. law contains provisions expressly permitting any type of company to control a credit card bank or industrial loan company (ILC).[23] While the total size by number and assets is small relative to the total U.S. financial system, companies they are affiliated with can be large (e.g., Target, BMW, Toyota, Talbots). The licensed credit card bank or ILC is supervised at the entity level by banking regulators. Both types have FDIC insurance coverage, but are limited in the types of deposits they can accept. There was a moratorium on new ILCs starting in 2006, although this ended in 2013.

- *Other* —These companies have regulated financial entities with nonfinancial entities and there is not a consolidated supervisor over all of the regulated financial entities (e.g., Berkshire Hathaway). There are other types, such as large asset management companies (e.g., Fidelity) that do not have a consolidated supervisor. The extent to which this diverse range of financial related companies will be subject to a different supervision model will be sorted out over the next several years. This would occur through the FSOC designation process, i.e., designating a nonbank financial company as systemically important.

196. **One distinguishing characteristic of the U.S. financial system is the large number of supervisors and other entities with some level of oversight responsibility.** Depending on the type of financial institution, its location, activities, products and services, it could be supervised and regulated by any combination of federal agencies (FRB, FDIC, OCC, NCUA, SEC, CFTC, CFPB),[24] state agencies (50 states with bank, insurance and securities regulators) and other entities (e.g., FINRA, OFAC, FINCEN, attorneys general).[25] One U.S. bank holding company with foreign operations reports having several hundred regulators in the United States and abroad.

197. **Only BHCs, SLHCs, and FSOC-designated systemically important nonbanks are subject to a strong consolidated supervision model.** The consolidated supervisor in these cases is the FRB. The FRB's new mandate to supervise SLHCs and FSOC-designated systemically important nonbanks has made approximately one-third of the insurance industry subject to consolidated supervision. This reflects the fact that several SLHCs have insurance companies and three large insurance companies have been designated as systemically important nonbanks. The remainder of the insurance industry is not subject to supervision by a federal regulator. Rather, insurance is supervised at the legal entity/state level, although there is more focus at the group level. Broker-dealers are supervised at the legal entity level by the Securities and Exchange Commission (SEC).

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[23] For additional background, see www.gao.gov/assets/590/587830.pdf.

[24] FRB-Federal Reserve Board, OCC-Office of the Comptroller of the Currency, FDIC-Federal Deposit Insurance Corporation, NCUA-National Credit Union Association, SEC-Securities and Exchange Commission, CFTC-Commodity Futures Trading Commission, CFPB-Consumer Financial Protection Board.

[25] FINRA-Financial Industry Regulatory Authority, OFAC-Office of Foreign Assets Control, FINCEN-Financial Crimes Enforcement Network.

198. **FSOC's role to designate nonbanks as systemically important is evolving and could have a major impact on financial conglomerates oversight.** To date, FSOC has designated three insurance companies and a subsidiary of a mixed company (GE) as systemically important. Additional nonbanks could be designated as systemically important and thus come under the FRB's consolidated supervisory regime and requirements for enhanced prudential standards.[26] FSOC has published the criteria to be used in deciding whether a nonbank firm should receive further evaluation.[27]

199. **Given the complexity of the U.S. financial system and its fragmented regulatory regime, strong communication and coordination among regulators are key to ensuring oversight is effective and contributes to the financial stability of the United States.** Much behind the scenes work is being done to improve cooperation and coordination among the regulatory agencies. However, this will remain an ongoing key challenge for the U.S. regulators.

Joint Forum Principles

Supervisory Powers and Authority

200. **BHCs are subject to strong consolidated supervision**. The legal framework provides the FRB with the necessary powers and authority to perform comprehensive group-wide supervision. In accomplishing this, the FRB must rely heavily on many other supervisors who have mandates to regulate and supervise the subsidiaries of a bank holding company. The majority of bank holding company subsidiaries are supervised by other regulators.

201. **SLHCs and FSOC designated nonbanks are subject to the same strong consolidated supervision by the FRB as banks are, but supervision for those that are insurance-led is evolving.** For those SLHCs that are insurance dominated and for the FSOC-designated nonbanks that are insurance companies, the FRB is in the process of establishing its supervisory regime.[28]As in banking, the FRB must rely on the primary supervisor of the insurance holding company subsidiary. The FRB has taken a bank-like approach to the insurance holding company to date; however, there is not yet a regulated framework on capital rules nor a formal rating system. For these two reasons, the U.S.

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[26] The Dodd-Frank Act requires that the FRB establish heightened prudential standards for designated nonbank financial companies. These heightened standards must be more stringent that the standards that apply to other nonbank financial companies and BHC that do not pose similar risk to the financial system. In particular, these heightened standards must include risk-based capital and leverage requirements, liquidity requirements, overall risk management requirements, concentration limits, along with living will and credit exposure reporting requirements, along with other prudential standards as deemed appropriate.

[27] FSOC designations and process can be found at www.treasury.gov/initiatives/fsoc/designations/Pages/default.aspx.

[28] For example, the FRB announced September, 2014 that it is conducting a quantitative impact study to better understand how to design a capital framework for insurance holding companies it supervises. www.federalreserve.gov/newsevents/press/bcreg/20140930a.htm. For General Electric Credit Corporation, see the request for public comment on the FRB's proposed supervision and regulation standards www.federalreserve.gov/newsevents/press/bcreg/20141125b.htm.

banking regulators were deemed largely compliant with the banking consolidated supervision principle.[29]

202. **For insurance holding companies that are not subject to new FRB consolidated supervision, the supervision is based on a weaker state-based model.** State insurance supervisors lack direct legal authority over the insurance holding company, and, thus, insurance supervision has historically been at the state licensed entity level. By one estimate, when measured by insurance premiums, 70 percent of the insurance industry is under a state based supervision model. However, the ability to supervise groups is improving and strengthening (e.g., lead state concept for coordination at the entity level, power to obtain information from a holding company, prior approval of transitions between regulated entity and the insurance holding company). Because of weaknesses, the insurance group-wide supervision principle for the United States is only considered partially observed.[30]

203. **Broker-dealers are not subject to consolidated supervision by their regulator (SEC).** Broker-dealers are supervised at the licensed/registered entity level. The SEC uses a risk-based approach to determine where to focus its resources for approximately 4,000 broker-dealers. Large broker-dealers that are under BHCs and other broker-dealers who hold customer assets and engage in proprietary trading receive higher focus. Onsite visits occur for larger firms, with most firms being subject to off-site review.

204. **The source of strength doctrine was strengthened under the Dodd-Frank Act; banking regulators are in the process of writing joint rules to carry out the requirement.**[31]

205. **The Dodd-Frank Act defines "source of financial strength" to mean "the ability of a company that directly or indirectly owns or controls an insured** depository institution to provide financial assistance to such insured depository institution in the event of the financial distress of the insured depository institution." The definition of financial distress and what actions the parent companies must take to support distressed subsidiaries will be addressed in the proposed rule, expected to be released in 2015. The insured depository institutions to be addressed in the rule include ILCs and credit card banks that are owned by commercial firms.[32]

206. **The Dodd-Frank Act contains several provisions designed to preserve the traditional separation of banking and commercial activities, related to the FRB's new powers to supervise and regulate SLHCs.**

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[29] Principle 12 of the Basel Core Principles for Effective Banking Supervision.

[30] Principle 23 of the Insurance Core Principles.

[31] Section 616(d) of the Dodd-Frank Act requires that certain parent companies serve as sources of financial strength to their depository institution subsidiaries. The Dodd-Frank Act also requires that the OCC, FDIC, and FRB jointly issue rules carrying out this requirement.

[32] Also, the banking agencies are empowered to require the company serving as a source of strength to submit reports to the appropriate federal banking agency regarding its financial health.

- Since 1999, for a BHC to engage in a broader array of financial activities, including securities, insurance and merchant banking, it must meet the enhanced capital and managerial standards to become a Financial Holding Company (FHC).[33] The Dodd-Frank Act provides for an SLHC to conduct expanded activities permissible to an FHC, such as insurance underwriting, only if such SLHC satisfies the same capital, managerial, and other criteria that govern whether a BHC qualifies as an FHC.

- The Dodd-Frank Act also requires the FRB to establish criteria for determining when certain SLHCs that engages in commercial activities must form an intermediate holding company (IHC) through which to conduct its financial activities. The FRB may do so if it determines that it is necessary to appropriately supervise the SLHC's financial activities and to ensure that its supervision does not extend to activities that are not financial in nature. Such IHCs would be subject to FRB supervision as an SLHC, and the FRB may promulgate regulations to restrict or limit transactions between the IHC and any affiliate.

207. **An important change in the oversight of systemically important financial institutions concerns crisis management**. BHC over US$50 billion and nonbanks designated as systemically important by FSOC are required to prepare plans for an orderly winding-up in the event of material financial distress or failure. These plans are reviewed by regulators and a portion of the plans are made public.[34] A benefit of this is that the regulators have increased significantly their understanding of financial institution structures and the interrelationships that create contagion risk. The effort to simplify structures for resolution purposes is another benefit.

208. **All U.S. regulators have a comprehensive range of supervisory tools that can be used to ensure timely corrective actions of their respective supervised entities.** Coordinating supervisory responses when issues are found in a financial institution subject to multiple supervisors can be a challenge. This is also the case when a matter of concern is horizontal, such as when loan underwriting standards are weakening and supervisors want to send a coordinated message to industry.[35]

209. **The requirements of the Dodd-Frank Act have stretched supervisory resources due primarily to increased mandates and rule writing responsibilities.** Federal banking supervisors do not rely on funding from Congress; they set their own budget and are required to pay employees comparable wages to the banking sector. Their increased resource needs have been met in part by shifting of priorities as opposed to a material increase in funding. While stretched, they are generally considered to have adequate resources. Additionally, with new powers over insurance, the FRB has had to hire additional staff with expertise in that area. It is challenging to make a conclusion about the adequacy of resources for state

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[33] Required by the Gramm-Leach-Bliley Act of 1999.

[34] For the portion of recovery plans that are made public, see www.federalreserve.gov/bankinforeg/resolution-plans.htm.

[35] One example relates to the federal banking regulators' guidance and examination of leverage lending, which can be found at www.occ.gov/news-issuances/news-releases/2014/nr-ia-2014-153.html.

insurance supervisors, as they are state-based and funding models vary. The federal securities regulators (SEC, CFTC) rely on funding appropriated by elected officials (i.e., Congress). This has led to underfunding of resources the securities regulators need to meet new obligations imposed by law. The SEC has expanded use of an SRO (FINRA) in response.

Supervisory Responsibility

210. **As noted above, not all U.S. insurance and broker-dealers are subject to consolidated supervision, although some are if they are part of a bank holding company, SLHC, or are designated as a systemically important nonbank by FSOC.** The FRB serves as the group-level supervisor over BHCs, SLHCs, and FSOC-designated systemically important nonbanks. The FRB is the group-level supervisor for insurance-led SLHCs and insurance holding companies; however, for other insurance holding companies, state supervisors do not have direct legal authority. Broker-dealers are not subject to consolidated supervision unless they are under a bank holding company.

211. **Because of the number of supervisors and their overlapping responsibilities, effective cooperation, coordination and information sharing is critical for effective supervision in the United States.** Since the crisis, all U.S. regulators have increased their efforts to cooperate and coordinate. For some agencies, a "tone at the top" has been set that has had a major impact (i.e., the agency and all staff will coordinate and cooperate with other agencies). However, challenges will always persist.

212. **In general, there are no legal impediments to sharing supervisory information among banking, insurance and securities regulators.** Impediments exist that are in part cultural between the sector regulators. Each agency has either formal or informal policies, procedures and delegated authorities established for information sharing.

213. **Coordination and information sharing of supervisory information among the federal banking agencies is well established.** Agencies share exam reports and other supervisory material through a shared data base. Bank supervisors at all levels of their respective agencies know their counterparts and have no restrictions from "picking up the phone" to discuss issues with their counterparts. Annual supervisory exam plans for the largest banking groups are now being more closely coordinated. Prior to the crisis, sharing of supervisory strategies existed. However, due in part to differing supervisory planning cycles, input and coordination among the bank-lead supervisors was not high. Banking supervisors are participating in each other's exams more often.

214. **The Federal Financial Institutions Council (FFIEC) was formed in 1979, in part to improve coordination among banking regulators.** FFIEC plays a role in developing uniform approaches in setting policy, e.g., cybersecurity. It also develops and provides training. In addition, the FFIEC maintains a public database on financial and structural banking information. The FFIEC does not have a central role in coordinating direct supervision.

215. **Sharing between banking and securities regulators is less routine but is improving.** Sharing is challenged at times by the different mandates of these supervisors and potentially how information will be used.

216. **Sharing among the numerous state insurance supervisors and between insurance and banking supervisors is improving.** This is due in part to the new FRB consolidated supervision responsibilities over some of the insurance sector and because of the increasing focus of the state supervisors on group-wide supervision.

217. **Sharing between the new Consumer Financial Protection Bureau (CFPB) and other supervisory agencies is evolving.** The CFPB's consumer protection mandate includes supervision of financial institutions that are regulated by other agencies with different mandates. Information sharing agreements between CFPB and banking regulators has been established, as banks were the initial focus of CFPB supervision work. To improve coordination, at its beginning stages, CFPB staff was invited to attend bank supervisors meetings.

218. **Cross-border cooperation and information sharing has increased dramatically since the crisis.** U.S. supervisors serve as both home and host supervisor in supervisory colleges for banking and insurance led groups. These formal meetings are seen as useful in analysis of risks, establishing examination plans, and developing a good rapport with other supervisors. The formal supervisory colleges meetings have led to more informal communications among cross-border supervisors.

219. **Banking supervisors have significantly increased their intensity of supervision over the largest banks since the financial crisis.** For example, enhanced prudential standards for BHCs over US$50 billion have been enacted.[36] The requirements cover foreign banking organizations (FBOs) operating in the United States and require creation of an intermediate holding company for the largest FBOs. There has been a significant emphasis on stress testing, horizontal reviews on specific risk areas, corporate governance and risk management. The use of dedicated on-site examination teams and offsite monitoring remains. Noteworthy is that resources devoted to horizontal examinations of risk areas has increased.

220. **Supervision of the largest insurance holding companies is also subject to more intense supervision**. For those designated systemically important, they are subject to enhanced prudential standards covering the same areas as banks.

Corporate Governance

221. **After the crisis, the U.S. banking regulators increased their focus on corporate governance, particularly in the largest institutions.** Expectations were strengthened in areas such as competence and independence of the board of directors, along with board

[36] Enhanced Prudential Standards for BHCs and Foreign Banking Organizations can be found at www.federalreserve.gov/newsevents/press/bcreg/20140218a.htm.

involvement in setting risk appetite, establishing risk culture and overseeing the risk governance framework.

222. **There are a limited number of insurance industry laws or regulations that explicitly address corporate governance.** Criteria regarding corporate governance issues are dispersed throughout state insurance and commercial codes through statute, regulation and administrative orders. In general, the U.S. insurance supervisory approach for corporate governance of insurers is based upon a proportionality principle. Under this principle, larger and more complex entities are subject to more stringent requirements in the application of corporate governance standards.

223. **Neither state nor FRB supervisors have set formal broad-based, insurance-specific governance requirements, at legal entity or at group/holding company level.** Both state and FRB supervisors rely primarily on assessing the risks in individual companies and groups, through regular oversight and the on-site supervisory process. The FRB is relying on guidance and a supervisory approach developed for banking groups.

224. **State insurance laws generally impose various restrictions on a licensed insurer's ownership by, or affiliation with, other financial or non-financial companies provided the owner meets criteria through the regulatory approval process.** Instead, U.S. insurance supervisors review compliance with many of the corporate governance criteria at the licensing stage for new insurers and producers, as well as in requiring and reviewing annual statements, conducting periodic financial and market condition reviews, approving mergers or other changes of control involving domestic insurers, and applying solvency oversight. Another way that U.S. insurance supervisors address many of the corporate governance criteria is through conducting on-site inspections.

225. **The FRB has a supervisory program that establishes and implements a corporate governance framework for institutions under its jurisdiction and continues to adapt an existing framework to account for the unique characteristics of insurance companies.** Corporate governance expectations for all FRB-supervised firms with assets over US$50 billion were detailed as part of consolidated supervision framework guidance issued in 2012.

Capital Adequacy and Liquidity

226. **Group level capital requirements for insurance groups do not exist.** A risk based capital approach is applied by state regulators at the legal entity basis for life, property and casualty, and health insurers. Some insurers are not subject to this RBC, such as title insurers, monoline financial guaranty insurers and monoline mortgage guaranty insurers.

227. **Under the Dodd-Frank Act, the FRB must establish minimum leverage and risk-based capital requirements for the insurance groups it regulates, which it has not yet done.** The FRB has started a quantitative impact study to evaluate the potential effects of

applying bank capital requirements to insurance companies.[37] This follows from the Dodd-Frank Act which requires the establishment of minimum risk-based and leverage requirements for firms regulated by the FRB that are not less than the generally applicable risk-based capital and leverage requirements that apply to insured depository institutions.

228. **Most holding companies supervised by the FRB and all banks, regardless of size, are subject to risk-based capital rules that are based on Basel standards.** However, capital requirements have not yet been established for SLHCs with substantial commercial or insurance operations. An assessment of U.S. adoption of the Basel risk-based capital standards concluded that the U.S. risk-based capital requirements for internationally active banks are "largely compliant" with the applicable Basel framework.[38]

229. **The FRB sets the capital requirements for BHCs, while the three federal banking agencies set capital requirements for banks.** These capital requirements include both risk-based capital and leverage capital requirements. The federal banking agencies have broad statutory authority to establish such minimum capital levels for a bank or holding company. The banking agencies have clear statutory authority to take a number of remedial measures in the event a bank falls out of compliance with applicable capital adequacy requirements.

230. **BHCs are required to serve as a source of managerial and financial strength to its subsidiary banks.** In addition, on an annual basis, the FRB performs a Comprehensive Capital Analysis and Review of the largest BHCs. Their capital planning processes and capital adequacy are evaluated, including the firms' proposed capital actions such as dividend payments and share buybacks and issuances. Results are made public.

231. **The liquidity regime for BHCs and banks is considered robust.** The FRB conducts horizontal examinations of liquidity risk across large BHCs. An annual Comprehensive Liquidity Assessment and Review has been conducted. The regime is supported by extensive reporting requirements of supervised banks.

232. **For insurance, liquidity within each insurance subsidiary and at the holding company level is analyzed based on the detailed financial information each insurance company submits quarterly.** If there are concerns regarding liquidity or cash flows, the insurance supervisor can consider having a cash flow analysis performed by an actuary. Since the financial crisis, there have been increased special requests and detailed information provided by individual insurers to allow the supervisor to assess stress liquidity exposure and financial flexibility for coping with both expected and unexpected cash demands.

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[37] September 2014 announcement http://www.federalreserve.gov/newsevents/press/bcreg/20140930a.htm

[38] www.bis.org/bcbs/implementation/l2.htm

Risk Management

233. **BHCs are required to have in place comprehensive risk management policies and processes, with larger BHCs being subject to higher standards.** The enhanced risk management standards for large BHCs include requirements for establishing a risk management framework and an independent risk management committee, along with requirements for a chief risk officer.[39]

234. **A major change since the crisis is the emphasis on stress testing.** For the largest BHCs and for FSOC-designated systemically important nonbank financial firms, annual stress tests are conducted and the results published by the FRB. Additionally, such firms are required to conduct their own stress tests on a semiannual basis.

235. **Regarding insurance, neither the FRB nor the state supervisors have a comprehensive set of requirements on risk management and controls tailored to the business and risks of insurance companies.** State supervisors have a supervisory approach which relies less on explicit and detailed rules, but on high-level principles and expectations that are formulated in examiners' handbooks. State insurance supervisors are beginning to require an Own Risk and Solvency Assessment, which is an internal process undertaken by an insurer or insurance group to assess the adequacy of its risk management and current and prospective solvency positions under normal and severe stress scenarios. The FRB's application of bank-like risk management expectations to the insurance institutions it supervises is evolving.

236. **For FSOC firms designated as systemically important, the FRB is required to adopt risk management standards.** For example, see the FRB's proposal for General Electric Credit Corporation.[40]

Summary

237. **Significant changes are occurring in the oversight of financial conglomerates in the United States that are in various stages of development.** The FRB gained new supervisory powers over a more diverse group of financial institutions after the crisis (e.g., nonbank systemically important institutions, SLHCs). The FRB is in various stages of developing its approach towards consolidated supervision of these institutions. A strong consolidated supervision model is expected to be the outcome, with the FRB's bank holding company consolidated supervision model serving as the starting point. Heightened prudential standards that are required for BHCs since the crisis are also being adapted for certain SLHCs and nonbank financial institutions.

[39] Enhanced Prudential Standards for BHCs and Foreign Banking Organizations can be found at www.federalreserve.gov/newsevents/press/bcreg/20140218a.htm.

[40] See the request for public comment at www.federalreserve.gov/newsevents/press/bcreg/20141125b.htm.