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Monetary and Capital Markets Department

CHILE

CONGLOMERATE SUPERVISION

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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. As part of this process, the mission met with officials of the MoF, the Central Bank of Chile (BCCh), Superintendencia de Bancos e Instituciones Financieras (SBIF), Superintendencia Valores y Seguros (SVS), and Superintendencia de Pensiones (SP), and financial sector representatives, academics, attorneys, and consultants.

The mission wishes to express its sincere thanks to the Head of the Capital Market and Financial Institutions Department of the MoF, Ms. Bernardita Piedrabuena, and Advisor of the Capital Market and Financial Institutions Department of the MoF, Mr. Jorge Tapia, for holding extensive discussions on consolidated supervision in Chile and elsewhere; arranging more that 50 meetings in Chile to discuss consolidated supervision; and facilitating the work of the mission. The mission also wants to express its heartfelt gratitude to Chilean officials, financial sector representatives, attorneys, consultants and academics for the extensive and fruitful discussions on consolidated supervision.

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

GLOSSARY

APRA	Australian Prudential Regulatory Authority
BCCh	Central Bank of Chile
CEs	Constituent Entities
CET1	Common Equity Tier 1
EC	Eligible Capital
EU	European Union
FC	Financial Conglomerates
FDIC	Federal Deposit Insurance Company
FSA	Financial Services Agency in Japan
FSC	Financial Stability Council
FSOC	Financial Stability Oversight Council
IB	Industrial Banks
ICA	Internal Capital Allocation
ILC	Industrial Loan Companies
IMF	International Monetary Fund
MCM	Monetary and Capital Markets Department
MoF	Ministry of Finance
MOU	Memorandum of Understanding
PCR	Prudential Capital Allocation
PFA	Pension Fund Administrators
SBIF	Superintendencia de Bancos e Instituciones Financieras
SERNAC	Servicio Nacional del Consumidor
SCFI	Superintendent Committee of Financial Institutions
SVS	Superintendencia Valores y Seguros
SP	Superintendencia de Pensiones
TA	Technical Assistance
UDFI	Utah Department of Financial Institutions

Table 1. Summary of Recommendations

Recommendation	Timing
Use the recently approved financial stability law to gather more information on the conglomerates’ structure, business opportunities, and risks.	Short term
Empower the Superintendent Committee of Financial Institutions (SCFI) to strengthen the coordination of the activities of supervisors.	Short term
Empower the SCFI to determine a supervisory strategy for Financial and Mixed Conglomerates.	Short term
Consider providing supervisors with legal independence.	Short term
Conduct forward looking risk assessment of conglomerates.	Short term
Provide the supervisor with legal powers, authority, and resources to conduct group-wide and comprehensive supervision of conglomerates.	Medium term
Establish a process for coordination of the work of supervisors and identification of a group-level supervisor.	Medium term
Require conglomerates to establish a sound and transparent corporate governance framework.	Medium term
Determine prudential norms for capital adequacy and liquidity at the conglomerate level.	Medium term
Compel conglomerates to have in place a comprehensive and effective risk management framework.	Medium term

EXECUTIVE SUMMARY

Chile has long relied on an approach to supervision that focuses on individual financial institutions. This approach to supervision has met with great success. The Chilean financial institutions are solvent, profitable, and liquid. These institutions have continued to play a key role in Chile's rapid economic growth and development. Moreover, such institutions have been able to weather remarkably well the global financial crisis, while rapidly expanding their operations outside Chile, particularly in South America.

Chile is seeking to strengthen financial sector supervision in light of the organizational structure of the financial sector. In particular, Chile is looking to ensure the effective supervision of financial institutions that belong to conglomerates and are offering ever increasingly complex financial products and services and expanding rapidly across borders. While some of these financial institutions are part of conglomerates whose activities center in the financial sector (i.e., financial conglomerates), other financial institutions are part of conglomerates whose activities span both the financial and commercial sectors (i.e., mixed conglomerates). The conglomerates also operate in both the regulated and unregulated sectors. Key to the strengthening of supervision is to gain a thorough understanding of the risks posed by these conglomerates, while assessing their capability to manage these risks.

As part of any efforts to strengthen the supervision of conglomerates, Chile needs to choose an institutional approach to supervision. International experience suggests that Chile could choose from at least four institutional approaches, each with its own advantages and disadvantages. The application of any of these approaches would require significant changes in the legal, regulatory, and supervisory framework in Chile. Underlying these approaches is effective information sharing and coordination.

Regardless of the chosen institutional approach to consolidated supervision, Chile should build on its existing supervisory structure to strengthen supervision. In the short term, Chile should make use of the recently expanded information gathering and sharing powers to give continuity to the recent initiatives to assess the conglomerates' business models, opportunities and risks. Chile should also strengthen the coordination of the activities of supervisors, enhance the capacity of supervisors, and provide the supervisory agencies with the needed resources to expand supervision to financial conglomerates. In the medium term, Chile could consider the adoption of high-level principles to conduct effective consolidated supervision. In the context of an institutional approach to consolidated supervision that best fits its particular circumstances, Chile should contemplate the adoption of the principles that focus on supervisory powers, authority and responsibility, corporate governance, capital adequacy and liquidity, and risk management.

I. INTRODUCTION

1. **Chile has achieved a high level of financial development, while preserving financial stability.** Chile's financial sector is one of the deepest in Latin America, and is highly integrated in the global financial system. It weathered particularly well the global financial crisis as banks remained well capitalized, liquid, and profitable. As the 2011 Financial Sector Assessment Program noted, the financial sector benefited from a strong financial regulation and supervision framework. However, this exercise also highlighted the need to reinforce the supervision of financial conglomerates.

2. **International experience suggests that the presence of both financial and mixed conglomerates require the adoption of consolidated supervision.** In addition to the credit, market and liquidity risks, the increasingly complex activities of conglomerates—through their operating and non-operating companies, unregulated parent companies and subsidiaries, or special purpose vehicles—could generate a myriad of risks, including systemic, credit, concentration, transfer, strategic, and leverage risks. In the context of a fragmentary approach to supervision, this could severely challenge supervisors' ability to assess the conglomerates' risk profile. In this light, and the perception that the global financial crisis partly reflected weaknesses in the supervision of financial conglomerates (FCs), the need to strengthen consolidated supervision of conglomerates has received considerable attention in recent years. The Joint Forum updated the Principles for the supervision of FCs with a view to providing a set of internationally agreed, high-level supervisory principles.

3. **The presence of conglomerates in Chile makes it essential to consider adopting group-wide and comprehensive supervision of conglomerates.** In addition to some of the same risks as the activities of conglomerates in other jurisdictions, the presence of mixed conglomerates in Chile could exacerbate the contagion risk stemming from the activities of commercial companies on financial institutions within the same conglomerate. The co-existence of financial institutions and commercial companies within the same conglomerate also poses challenges to understand fully this conglomerate's overall risk profile because of the differences in the types of risks and ability to address these risks across financial and commercial activities. This is even more challenging in the case of Chile because the approach to supervision centers on financial institutions and could lead to an oversight of information, data, and risks from the commercial activities.

4. **In this light, the Chilean authorities would like to enhance their consolidated supervision framework, and have sought technical assistance (TA) from the Fund to identify next steps**. To this end, they have taken some steps to put in place the building blocks for consolidated supervision, including, recently, an initiative to identify and monitor conglomerates and broaden the legal powers of supervisors to request information on capital from the owners of conglomerates. They have also sought TA from the Fund to identify the next steps to enable effective consolidated supervision.

5. **This report is structured as follows.** The second section reviews the structure of the financial sector in Chile and the regulatory and supervisory framework for conglomerates. The third section provides a summary of the Joint Forum Principles and a review of the current international experiences with conglomerate supervision. The fourth section provides recommendations to enhance consolidated supervision.

II. Structure of Conglomerates

6. **The structure of conglomerates is complex.** At the top of conglomerates sit the parent companies organized as investment vehicles,[1] whose main purpose is to ensure the control by a limited number of investors, while limiting their personal financial liability. The parent companies are in some cases simply wealth management vehicles with a limited role in the companies' management and design of a business strategy. Among the key local investors are a limited number of wealthy families, whose business interests span across many economic sectors in Chile and abroad. The investment vehicles in the same conglomerate, sometimes located abroad, make the identification of the conglomerates' ownership structure difficult.

7. **Below the parent company reside the main profit centers and subsidiaries or constituent entities (CEs).** Conglomerates typically include banks, insurance companies, pension funds' administrators (PFAs), and nonfinancial companies as independent entities (i.e., "sister" companies). Banks operate CEs that support their market and commercial activities (mutual funds, leasing companies, insurance companies and securities' brokers). Similarly, insurance companies operate mortgage companies to generate long-term assets with maturities that match their liabilities' maturities. Nonfinancial companies now increasingly extend consumer credit in the form of credit card and car loans. This has allowed these companies to fill a market niche not fully covered by banks and continue operating after banks' closing hours.

8. **Determining the size of conglomerates appears to be a major challenge.** The assets of the different entities of the conglomerates need to be identified with a view to avoiding double counting. This requires careful attention as, for instance, the assets under management in pension and investment funds are, in part, invested in local banks. No institution in Chile has made an effort to keep and update the data base on conglomerates on a continuous basis.[2]

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[1] They could be investment funds or investment companies, but their exact legal statute may be unknown to the supervisors.

[2] In this light, the section below on the structure of the financial sector relies on an analysis of the sector made in September 2012 by the working group on financial conglomerate of the Financial Stability Council (FSC) and an update by the BCCh in September 2014.

9. **Both financial and mixed conglomerates have a strong presence in the financial sector in Chile.** According to the Chilean authorities, conglomerates comprise 16 systemically important domestic institutions, with assets totaling 125 percent of GDP as of end-December 2011 (the last time the authorities measured these assets on a consolidated basis). As a sign of the concentrated holdings among these conglomerates, conglomerates held more than one-third of the assets of local pension funds and life insurers, which total some 60 percent of GDP (or US$162 billion) at end-December 2011.

10. **Conglomerates operate mostly in the financial sector.** Out of the 16 conglomerates, as measured by their asset holdings with respect to total assets, five conglomerates focus on banking activities (blue shade in Table 2), four concentrate in the insurance and pension sectors, and four focus on both the banking and insurance sectors (green shade in Table 2).

11. **Seven conglomerates operate in both the financial and commercial sectors.** These mixed conglomerates have more than 5 percent of their assets in nonfinancial activities (red shade in Table 2). One of these mixed conglomerates, and the second largest conglomerate, is associated with a group that has important mining, manufacturing and media activities. Two mixed conglomerates are associated with large real estate, forestry, education and hospital groups. Three mixed conglomerates are related to important retail groups. These mixed conglomerates, through both their banks and retail operations, offer both consumer lending and credit cards. These mixed conglomerates are expanding their operations to other countries in South America. One of the mixed conglomerates recently experienced difficulties due to excessive leverage and deteriorating financial conditions in retail business.

12. **Mixed conglomerates have increased their market share.** In particular, mixed conglomerates that include retail stores have increased their market share rapidly because of their willingness to absorb the risk associated with consumer lending that banks appear reluctant to accept. As a result, their assets increased three times faster than the financial conglomerates' assets from 2004 to 2011. Even so, financial conglomerates continue to be larger than mixed conglomerates. In this light, any assessment of the overall risk profile has to take into account all sources of risk.

13. **Conglomerates are well integrated in the international financial markets.** Out of the 16 conglomerates, two are led by major international banks and four by major international insurance companies. In addition, four local mixed conglomerates have significant operations both in the financial and nonfinancial sectors of neighboring countries, underlining the importance of establishing coordination with other regulators in the region.

Table 2. Structure of Conglomerates

Conglomerate	Bank	Pension and insurance	Other financial assets[1/]	Total financial assets	Market share[2/]	Nonfinancial activity
	in percent of conglomerates' financial assets			in percent of conglomerate assets	in percent of the total financial assets	
C1	0%	99%	0%	100%	13.2%	None
C2	4%	91%	4%	99%	12.6%	None
C3	99%	1%	0%	100%	11.8%	None
C4	96%	0%	3%	75%	11.6%	Mining, transport, food, and manufacturing
C5	0%	99%	0%	100%	9.0%	None
C6	98%	2%	0%	99%	8.9%	None
C7	0%	98%	0%	100%	8.3%	None
C8	100%	0%	0%	91%	7.5%	Retail
C9	92%	1%	7%	100%	4.8%	None
C10	64%	30%	6%	99%	2.9%	None
C11	64%	34%	3%	38%	2.9%	Forestry, electricity, and real estate
C12	24%	71%	5%	100%	2.7%	None
C13	47%	0%	53%	54%	1.7%	Retail
C14	35%	65%	0%	79%	1.2%	Hospital, education and real estate
C15	72%	0%	28%	56%	0.4%	Retail
C16	28%	0%	72%	10%	0.4%	Retail

1/ includes credit cards and financial assets in neighboring countries.

2/ includes assets under pension funds' management

Source : BCCh

III. SUPERVISORY FRAMEWORK

A. Supervisory Structure

14. **The MoF, BCCh, and the supervisory agencies are responsible for the financial regulation and supervision in Chile**. The MoF is responsible for the preparation of financial sector laws. In addition to having an advisory role regarding the preparation of laws, the BCCh is directly responsible for the determination of liquidity requirements, regulation and supervision of derivative operations, and the payments system.[3] The BCCh conducts twice-a-year top down stress tests that focus on both credit and market risk for the banking sector, and shares these results with the supervisory agencies. In addition to their responsibilities for the issuance of norms—particularly concerning corporate governance, credit classification, and provisioning—the supervisory agencies are responsible for the supervision of financial entities.

15. **Supervision relies on a sector or silo approach**. The SBIF supervises banks, their subsidiaries, some cooperatives, and credit card issuers. The SVS supervises insurance companies and security companies, and the SP supervises PFAs. The SBIF and the SVS respond to the MoF, while the SP responds to the Labor Ministry. The law makes explicit that the three superintendents are autonomous from the ministries and derive their authority from their direct nomination by the President.

16. **The SBIF and SVS apply down-stream consolidated supervision.** The SBIF supervises all banks' subsidiaries and has the authority to establish standards for these subsidiaries' operations with the aim of promoting banks' stability. Recently, the SBIF extended its supervision to credit card issuing companies that are affiliated to banks. Similarly, the SVS supervises insurance subsidiaries, while taking into account the risks related to the conglomerate in the supervision of these subsidiaries. Finally, the SBIF and SVS occasionally organize joint inspections of banks' subsidiaries that fall under the purview of SVS supervision (public funds issuers or brokers).

17. **The SCFI coordinates the activities of the supervisory agencies.** This committee, which has brought together the three supervisory agencies since 2001, has established guidelines for sharing information relevant for the supervision and regulation of financial institutions. The BCCh attends the committee as a permanent guest and contributes, when requested, to the analytical work of the committee. Since 2012, the committee has made a special effort to monitor conglomerates.

[3] Other area includes derivatives, foreign exchange regulation, mortgages, nonbank consumer financing, and the collection of saving deposits. These prerogatives are derived from the central bank's law, which includes the proper function of the payment system as a responsibility of the BCCh.

18. **The FSC is also involved in matters related to conglomerates**. The FSC has brought together the members of the SCFI under the coordination of the MoF. The FSC facilitates the exchange of information and technical coordination of its participants in matters relating to the prevention and management of situations that may impose risks for the financial system, thereby safeguarding the financial stability. The involvement of the FSC clearly reflects the systemic importance of the conglomerates.

19. **Firewalls govern the relations within conglomerates.** The purpose of these firewalls is to minimize the conflict of interest within the conglomerate and manage risks that arise from the structure of conglomerates. They take the form of prudential limits on permissible activities, ownership of other companies and connected lending/investments, as well as prohibitions on shared infrastructures/client databases. Banks cannot directly own insurance companies or PFAs, and, reciprocally, insurance or PFAs cannot own a bank. However, insurance companies can have PFAs as subsidiaries. The exposure of banks, insurance companies, and mutual funds to their "sister" companies (related counterparties) is limited.[4] Finally, PFAs, as single purpose financial institutions, are not allowed to have any relation with the other parts of the conglomerate. They can be neither a parent organization nor a subsidiary of other financial service providers.

20. **Case studies help monitor conglomerates.** In the context of the activities of the SCFI, supervisors have begun to prepare case studies to gain a better understanding of the conglomerates' structure, business models and risks. The supervisor in charge of supervising the main financial activity of the conglomerates leads the preparation of the case studies. With experience, the structure of the case study is likely to become more stable and to cover the critical topics of governance, solvency and liquidity (or leverage) with a particular emphasis in one of these areas depending on its perceived importance. If and when a particular case is deemed to have systemic implications, the supervisors should send it to FSC for consideration as required under the new financial stability law approved by Congress in November 2014.

21. **The new financial stability law represents an important step to strengthen consolidated supervision.** In addition to giving legal status to the FSC, the law explicitly removes all perceived or actual barriers to information sharing among the members of the council (i.e., the MoF, the supervisors, and the BCCh). The law amends the banking, insurance, securities, and PFA laws to provide supervisors with the capacity to require financial information from the final owners of banks, insurance companies, and PFAs.

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[4] The total exposure of a bank to related counterparties could not exceed more than 100 percent of capital. Insurance companies could not invest more 7.5 percent of its technical reserve and assets at risk with related counterparties. Mutual funds could not invest more than 10 percent of its assets in related counterparties' debt.

It requires that the ultimate owners of the bank permanently[5] maintain a consolidated net wealth at least equal to the core capital of the bank.[6] The law also provides the supervisor with the capacity to suspend insurance companies' relations with the rest of the conglomerate in case of insufficient capital. The law gives the financial sector one year to incorporate this new requirement.

22. **Consumer protection is pursued separately from the financial sector supervision**. As part of its attribution, the customer protection agency (SERNAC) focuses on addressing abusive terms in financial contracts and deceptive advertising. It has given particular attention to channeling customers' complaints to courts and publicly denouncing the wrongdoing of financial services' providers. A project is now under consideration to reinforce the role of SERNAC in issuing and enforcing norms.

B. Supervisory Gaps

23. **The legal framework does not address conglomerate supervision, resulting in a large gap between the supervisory framework in Chile and the Joint Forum Principles.** The current legal framework does not provide supervisors with the necessary powers and authority to enable comprehensive group-wide supervision**.** Supervision is authorized only for a financial institution and its subsidiary. However, the authorities believe that the legal framework contains some elements of conglomerate supervision. Supervisors are making efforts to include as part of supervision the conglomerate's entities that have grown outside the supervisory perimeter.[7] This includes the credit card companies, which the SBIF now directly supervises, and investment funds, including parent companies, which the SVS supervises.[8] However, some companies still remain outside the supervisory perimeter, in particular commercial and industrial CEs. Also, cooperation among sector supervisors in the context of the SCFI is still developing in facilitating information sharing, coordinating assessments of conglomerates, and applying consistently supervisory policies across sectors.

24. **Risk-based minimum prudential standards for financial conglomerates have yet to be established.** Standards have yet to be set for corporate governance, capital adequacy, liquidity, and risk management. Risks emanating from double gearing, contagion or conflicts of interest have yet to be addressed in a prudential framework for groups. Also, supervisors

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[5] The solvency was checked at the time of the licensing of the bank. Under the new law it can be required at any time.

[6] The General Bank Act (Article 66) defines core capital as paid-up capital and reserves.

[7] These entities escape the regulatory net as they are not listed financial companies, do not issue bonds or notes to the public or are below the threshold regarding the number of shareholders.

[8] The requirement concerns financial information disclosure, including ownership, governance, and related counterparties, but not solvency.

do not have the authority to impose sanctions or require corrective actions on a financial conglomerate.

25. **Supervisors may not have sufficient resources to expand supervision to financial conglomerates and lack legal protection.** As the SBIF, SVS, and SP receive funding from the general budget, they may not have the necessary resources to supervise conglomerates. None of the supervisors appear to have enough supervisory staff to conduct group-level supervision of conglomerates. More generally, staff in supervisory functions do not have legal protection; currently only superintendents have this protection.

26. **Supervisors are not independent.** Superintendents' appointments and removals are made by the President. However, a reform now under consideration of the SVS would introduce a board structure and change the nomination process to reinforce the supervisor independence vis-à-vis the executive branch.

27. **The case studies prepared in the context of the SCFI face limitations.** The case studies suffer from limited access to information in the conglomerate, which makes it difficult to assess the conglomerate's structure, business model, and risks. They do not include a methodology to assess consolidated capital and determine a flow of funds in the conglomerate. The exercises often focus on an industry-by-industry basis, which does not provide an aggregate picture of the conglomerate.

28. **The conglomerates' complex structures pose a challenge to the supervisors' capacity to monitor their compliance with prudential risk exposure limits**. The complexity of the conglomerate structure makes the monitoring of the limits a challenging exercise, which could give rise to an oversight of exposures. Financial development also opens opportunities to circumvent the limits. Moreover, the complex structures of conglomerates pose a challenge for regulators, given the need to coordinate and communicate with regulators in other countries, to address issues such as regulatory arbitrage and contagion risks.

IV. Principles and Approaches to Consolidated Supervision

A. The Joint Forum Principles

29. **The *Principles for the supervision of FCs* provide country authorities and supervisors with a set of internationally agreed principles.** The Principles support the consistent and effective supervision of FCs, with the aim of comprehensively addressing all sources of potential risk posed by and arising within these institutions. The Principles were released in 2012 by the Joint Forum's parent committees—the Basel Committee on Banking Supervision, the International Organization of Securities Commissions, and the International Association of Insurance Supervisors.

30. **The Principles are flexible and use a nonprescriptive approach to the supervision of financial conglomerates to cover a wide range of structures.** The Principles emphasize the importance of recognizing structural complexity and the potential risks it poses. This includes risks arising from all entities—unregulated or regulated—that affect the financial conglomerate's overall risk profile. The flexibility of this framework is intended to enable policymakers and supervisors to appropriately regulate and supervise FCs, while limiting the scope for regulatory arbitrage.

31. **The Principles provide guidance on supervisory powers and authority for comprehensive group-wide supervision.** The Principles, which are directed to both policymakers and supervisors, highlight the need for a clear legal framework that provides supervisors with the powers, authority, and resources to perform—with independence and in coordination with other supervisors—comprehensive group-wide supervision. The supervisory framework for FCs is supplementary to the existing supervisory frameworks.

32. **The Principles stress that the responsibilities of supervisors include the identification of a group-level supervisor with coordination responsibility.** Effective mechanisms for resolving differences between supervisors are also contemplated. The Principles emphasize the importance of supervisory cooperation, coordination, and information exchange. The role and responsibilities of supervisors in implementing minimum prudential standards, monitoring and supervising activities of financial conglomerates, and taking corrective action are also addressed.

33. **The Principles offer guidance for supervisors to ensure that FCs have robust corporate governance, capital, liquidity, and risk management frameworks.** The corporate governance principles address structure, board, and management responsibilities; conflicts of interest; fit-and-proper requirements; and remuneration policy. The capital adequacy principles cover group-wide capital management and highlight the role of supervisors in assessing capital adequacy on a group basis, taking into account unregulated entities and the risks they pose to regulated entities. A principle on liquidity assessment and management provides guidance for supervisors to ensure that financial conglomerates properly measure and manage liquidity risk. The risk management principles set out the need for a financial conglomerate to have a comprehensive risk management framework. The focus of the Principles is on closing regulatory gaps, eliminating supervisory blind spots, and ensuring effective supervision of risks arising from unregulated (financial activities and) entities.

B. Approaches to Consolidated Supervision

34. **Countries use many approaches to financial sector supervision.** Principally among these are the Institutional, Functional, Integrated, and Twin Peaks approaches. While the Institutional and Functional approaches are disaggregated supervisory structures, the Integrated and Twin Peaks methods are integrated supervisory structures. Despite their

differences in supervisory structures, all four approaches aim at promoting prudential oversight to ensure the safety and soundness of financial institutions and advancing business conduct supervision to protect consumers of financial products and services. Countries' decision to use any one particular approach appears to respond to many factors, including the development of the financial sector, the size of the economy, political economy considerations and international trends. In all approaches, effective implementation has been key to their success. While Chile's approach to supervision has elements of the disaggregated supervisory structures, it has little in common with the integrated supervisory structures. Any decision by the authorities to adopt the integrated structures would require significant institutional changes.

35. **The Institutional Approach to supervision depends critically on the legal status of financial institutions**. While, for instance, the banking supervisor is responsible for the supervision of legally registered banks, the insurance supervisor is responsible for the supervision of legally registered insurance companies. This approach appears to be particularly adept to achieve a consistent application of supervisory policies to financial institutions that operate—wholly or predominantly—in one activity, for example, banking. However, this approach could give rise to inconsistent application of these policies to financial institutions that operate across multiple activities. This could give rise to regulatory arbitrage. To address these shortcomings, this approach would require effective information sharing and coordination among supervisors.

36. **The Functional Approach is a supervisory structure based on regulated institutions' business activities.** Different supervisors are therefore responsible for overseeing each of the financial institutions' activities. This approach would ensure the consistent application of supervisory policies to particular business activities. Nevertheless, this approach may be ineffective when business activities are not clear enough to determine who among the supervisors has jurisdictional responsibility. Also, given that no supervisor has responsibility for the overall assessment of the financial institutions, this approach could result in the failure to notice of critical information and risks, and compromise the overall assessment of the safety and soundness of a financial institution. This approach could also be costly to financial institutions that would have to deal with many supervisors.

37. **The viability of both the Institutional and Functional approaches to supervise financial conglomerates depends crucially on cooperation among supervisors.** As the experience of the jurisdictions that have successfully used these approaches to supervise FCs shows, cooperation among supervisors should facilitate information sharing and coordinated assessments of FCs. This should minimize regulatory overlaps, duplication of efforts, and omissions, while opening the way to obtain a view on the aggregate risks of financial conglomerates. Coordination should also promote the development and strengthening of the regulatory and supervisory framework. To work best, coordination should center on a Memorandum of Understanding (MOU) that calls for continuous contacts among the

agencies that regulate and supervise financial institutions, including the MoF, central bank, and supervisors.

38. **The Integrated Approach relies on one supervisor to oversee all financial markets, institutions and products to advance prudential oversight and business conduct supervision.** This approach aims at (i) providing greater consistency and accountability in the application of supervisory policies across all financial sectors; (ii) taking a more comprehensive and broad approach to group-wide supervision; (iii) making more efficient use of scarce supervisory resources by establishing clear jurisdictional responsibilities; and (iv) facilitating the exchange of information across the integrated supervisor's units. However, this approach's lack of checks and balances from multiple supervisory agencies may result in shortcomings in supervision, including under- or over-regulation and/or oversight. This approach could also lead to the oversight of critical information, data and risks because of the application of a policy or policies that do not take into account differences in the financial sector. Moreover, this approach may face a challenge striking the right balance between prudential oversight and business conduct supervision**.**

39. **The Twin Peaks Approach separates prudential oversight in one peak from business conduct supervision in another peak.** In doing so, this approach explicitly recognizes the differences in the regulatory and supervisory framework to prudential oversight and business conduct supervision. At the same time, this approach makes it possible to distribute fairly supervisory resources. Also, by explicitly separating functions, this approach aims at balancing the conflicts that could arise between prudential oversight and business conduct supervision. However, this approach may lead the authorities responsible for each of the peaks to compete against each other, while pursuing inconsistent policies.

40. **Regardless of the approach to supervision, coordination at the international level is necessary when dealing with financial institutions that operate across borders.** This is particularly important for countries that are both home and/or host to financial institutions. Coordination could take place through both informal and formal contacts and/or supervisory colleges. Coordination at the international level is essential to encourage exchange of information on financial institutions; reach a common understanding about the business models, strategy, and health of these financial institutions; and understand how changes in the global financial markets may affect such financial institutions.

C. International Experience with Consolidated Supervision

41. **Australia, Brazil, the European Union (EU), Japan, Korea and the United States have gained considerable experience with consolidated supervision.** Each of these jurisdictions has adopted at least some key elements of consolidated supervision. They also represent both advanced and emerging market countries. Even so, their experience with consolidated supervision does not necessarily constitute international best practices. These

jurisdictions began to introduce consolidated supervision only in the late 1990s, and they are still adjusting their framework in light of the lessons drawn from the global financial crisis.

42. **Consolidated supervision in the six jurisdictions has focused on FCs rather than on mixed conglomerates.** FCs comprise operations in at least two among the banking, insurance, or securities sectors. In addition to financial institutions, mixed conglomerates include nonfinancial companies.

43. **Mixed conglomerates exist in all six jurisdictions**. While they are large in Brazil and Korea, they are small in Australia, the EU, Japan, and the United States, with their assets constituting only a small part of total financial assets. Brazil, Korea, and the United States place restrictions on ownership of financial institutions by commercial companies. In all cases, prudential rules that apply to regulated entities cannot be extended easily to nonregulated entities.

44. **The jurisdictions have used different institutional approaches to consolidated supervision.** Australia, Japan, and Korea have opted for an integrated approach to consolidated supervision, while Brazil, EU and the United States have chosen a decentralized approach to supervision. Annex I explains the different institutional models for consolidated supervision. However, all jurisdictions have given supervisors the powers to supervise the conglomerates' ultimate controllers and coordinate the supervisory work.

45. **The six jurisdictions have legal or de-facto supervisory powers and the authority to conduct consolidated supervision.** Even so, the scope and coverage of the supervisory powers and authority vary across jurisdictions. In all six cases, supervisors have the necessary powers to conduct consolidated supervision at the level of financial conglomerates. In Brazil, the de-facto supervisory powers and authority are vested in the central bank on the basis of an MOU signed between this institution and other supervisory agencies. In Korea, where mixed conglomerates generally center on insurance or security companies, the supervisory powers entail solo supervision for each financial institution in the mixed conglomerate and consolidated supervision for financial holding companies. As noted above, Brazil, Korea, and the United States place limits on or outright prohibit commercial firms to control or own a bank.

46. **Supervisory authorities are largely independent and autonomous in the six jurisdictions.** Supervisory authorities rely on financing that guarantees their independence and autonomy to conduct effective supervision and oversight. They also benefit from full legal protection in Australia, the EU, Japan (de facto), and the United States, and to a more limited extent in Brazil and Korea. The heads of supervision are subject to strict term periods in Australia, the EU, and the United States. In most jurisdictions, there are no legal impediments to sharing supervisory information, domestic or cross-border.

47. **The six jurisdictions rely on an integrated or lead supervisor to conduct or coordinate consolidated supervision.** The supervisor is selected informally or formally. In

Brazil, as the supervisor of commercial banks, the central bank is the de-facto lead supervisor of financial conglomerates that generally are bank dominated. In the EU and the United States, the European Central Bank and the Federal Reserve Bank, respectively, are designated by law as lead supervisors. In virtually all jurisdictions, the integrated or lead supervisor bases his responsibility on the basis of powers granted informally or in MOUs for the coordination of activities ranging from information sharing to joint inspections. To fulfill its mandate, an integrated or lead supervisor (i) utilizes supervisory tools to implement a comprehensive framework of risk-based minimum prudential standards for financial conglomerates; (ii) undertakes on-site and off-site supervision; and (iii) imposes, when appropriate, sanctions or compels timely corrective actions.

48. **The jurisdictions generally require the larger and more complex conglomerates to meet both solo- and group-level requirements.** All jurisdictions require to varying degrees key elements of corporate governance, including fit and proper test for senior management, internal controls and external auditing at the group level. Australia requires enterprise-wide corporate governance at the level of the ultimate parent company regardless whether it is a financial or mixed conglomerate. The EU, Japan, and Korea require corporate governance at the financial holding company level, and Brazil applies corporate governance in a limited fashion to bank-led holding companies. The United States is adopting corporate governance for insurance-led conglomerates to keep a level playing field with other conglomerates subject to supervision.

49. **All jurisdictions require conglomerates to have transparent organizational and managerial structures.** To achieve this objective, jurisdictions use to different degrees licensing powers, incentives or moral suasion. Some jurisdictions (Australia, the EU, Japan, and the United States) provide supervisors with the legal powers to require, if necessary, changes of the organizational and managerial structures of both regulated and nonregulated entities to facilitate supervision.

50. **The six jurisdictions have in place capital adequacy requirements on a consolidated basis for conglomerates dominated by financial institutions.** The aim is to ensure that conglomerates have on a permanent basis the level of capital necessary to meet the minimum requirements of all regulated entities in the conglomerate and to avoid double gearing. The six jurisdictions also set capital adequacy assessment and planning to ensure that financial holding companies avoid excessive leverage and to serve as a source of financial strength for the financial institutions. However, with the exception of Australia, the jurisdictions do not have in place capital adequacy requirements for the nonregulated entities that control mixed conglomerates. In Australia, the supervisor factors in the risks that regulated entities incur because of the presence of nonregulated entities in the conglomerate, as well as the capital of these nonregulated entities, to determine the capital needed at the consolidated level (see Appendix II).

51. **The jurisdictions do not have liquidity requirements for conglomerates, not least because of the difficulty of measuring liquidity risks across financial institutions.** In the absence of specific liquidity requirements, Australia requires the head of a group to develop and maintain a Board-approved liquidity management policy that consistently identifies, measures, monitors, and manages material liquidity risks. In the EU, supervisors have the power to stress test the conglomerate to assess the funding risk and liquidity of assets. Also, supervisors of different entities may gather on an ad hoc basis to assess the transferability of assets in the conglomerate and the resulting impact on the soundness of the individual regulated entities. In the United States, large bank holding companies and systemically important nonbank conglomerates are subject to heightened prudential standards, which include an assessment of compliance with liquidity risk management standards, conduct of liquidity stress tests, and a requirement to hold a buffer of highly liquid assets based on projected funding needs during a 30-day stress event.

52. **In most jurisdictions, FCs that are required to establish corporate governance also need to set up a risk management framework at the group level.** The risk management framework depends on the monitoring and management of credit exposure on both solo and group basis, although the scope and intensity of those regulations vary across jurisdictions. In most cases, the risk management framework also includes the conduct of stress testing at the group level.

53. **The firewalls across financial sectors and between financial and commercial sectors differ in the many jurisdictions.** All jurisdictions allow mutual business entries among banking, insurance, and security businesses. Many jurisdictions allow commercial firms to own financial subsidiaries, but Korea and Brazil strictly limit the commercial firms' ownership of banks. Banks' equity investments in industrial firms are subject to restrictions to (i) limit exposure to real sector business risks; and (ii) curb banks' influence over industrial companies (the EU, Japan, Korea, and the United States).

54. **Some jurisdictions, either quantitatively or qualitatively, try to identify risks to the financial institutions stemming from nonfinancial business within the mixed conglomerate.** Australia requires stress testing of the mixed conglomerate group's material aggregate exposures and intra-group exposures. The EU, Japan, and the United States require group-level risk management frameworks for mixed conglomerates, although these jurisdictions rely on different approaches and thresholds.

V. Recommendations

55. **The Chilean authorities need to establish an effective framework to supervise conglomerates.** The authorities need to choose an institutional approach to supervision of these conglomerates that reflects Chile's own preferences, while considering the institutional approaches to supervision of other jurisdictions. Regardless of the institutional approach to supervision, the authorities should adopt principles of conglomerate supervision that are

sound, comprehensive and consistent. The adoption of these principles would require a significant change in the legal framework, and a reexamination of the effectiveness of the existing firewalls, including engagement with CEs, with a view to strengthening them if necessary.

56. **As a first step, the authorities should define the appropriate scope of consolidated supervision.** The definition of a financial conglomerate could usefully follow from the definition of a financial conglomerate in the Joint Forum Principles as any group of companies under the 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.[9] However, the definition would require a modification to include commercial companies as CEs to take into account the presence of mixed conglomerates in Chile. As a preliminary observation, among the 16 conglomerates identified by the FSC in 2012 (see Table 12), 13 would meet the definition of a conglomerate.

57. **The authorities should also continue to strengthen the existing supervisory structure.** In particular, they should increase their efforts regarding information sharing among the supervisory authorities, while focusing to an even greater extent on the SCFI's recent initiative to assess such institutions' business models, opportunities, and risks. The authorities would benefit greatly from institutionalizing the assessment of these institutions. The authorities should expand the powers of the SCFI. In light of the need for additional resources required to put in place an effective framework to supervise conglomerates, the authorities should give careful consideration to enhancing supervisory capacity. In the medium term, the authorities could consider the adoption of robust principles for consolidated supervision in the context of a supportive institutional framework**.**

A. Short-Term Recommendations

58. **The supervisory authorities should make use of the expanded information gathering powers granted in the new financial stability law.** The supervisory authorities should employ the powers provided in this law to request additional information on the conglomerates' ownership structure, business models, operations, and financial condition. As the law increases the frequency for the provision of evidence for the capital parity between the owners and the conglomerates, the supervisory authorities should also make use of these powers to ask owners of conglomerates to provide their net worth positions as soon as possible to benchmark figures for assessing compliance as soon as November 2015. As allowed by the law, the supervisory authorities should share this information with all members of the SCFI, which would make it possible to conduct a more in-depth assessment of the aggregate risks of the conglomerates. While the new law is a first step toward

[9] Article 96 of the Securities Law defines a "business group" as a group of entities having relations in terms of ownership, management, or credit responsibility that indicate that the business and financial decisions of the group are guided by or subordinate to a common interest.

gathering financial data on the conglomerates, it is not sufficient to conduct effective supervision of these institutions. For this purpose, Chile still needs a comprehensive law that defines adequate supervisory powers, authority and responsibilities for the supervision of conglomerates; delineates the supervisory perimeter; and establishes requirements for group-level corporate governance, capital adequacy and liquidity, and risk management.

59. **The SCFI would benefit from establishing an even more effective coordination among supervisors.** As is now the case, the SCFI should continue to include all parties involved in the supervision of conglomerates, including the central bank because of its role as advisor regarding changes in financial laws, overseer of the payments system and supervisor of derivatives markets, as well as its responsibility for stress testing. In addition to promoting the timely and consistent supervision of conglomerates, the SCFI should have the capacity to coordinate the actions of supervisors and address conflicts in priorities among supervisors. To this end, the authorities should consider changing the MOU underlying the SCFI, or, if necessary, introducing legal changes, to provide this entity with (i) a clear mandate; (ii) a leadership structure; (iii) powers to coordinate supervisors' actions; and (iv) a mechanism to resolve conflicts.

60. **The SCFI should encourage SERNAC to participate more actively in the supervisors' activities.** This participation could range from observer status to full-fledged membership in the SCFI, and would depend on the importance that the SCFI places on consumer protection.[10] Regardless of the extent of the participation, given the significance attached to consumer protection in Chile, the SCFI could benefit from having SERNAC's perceptions and input to gain a better understanding of the financial institutions' treatment of consumers; risks to financial institutions arising from the operations of CEs, including conduct and reputation; and actions taken by financial institutions to address these risks and ensure the fair treatment of consumers. In the context of a more active role in SCFI, SERNAC would also come to understand better the financial institutions that it supervises. Further, by enforcing consumer protection rules consistently and fairly, SERNAC may help the consumer finance market to work better.

61. **The SCFI could usefully establish coordinated supervisory strategies for each conglomerate.** These strategies would outline the supervisors' plans to review each conglomerate over the coming year. Such strategies would also make allowance for the coordination of the supervisors' activities in each conglomerate. These activities should include joint on-site inspections, meetings with the conglomerates' management and the board, any special studies of the conglomerates, and the joint conclusions of the assessments. Importantly, the strategies should also include a mechanism to address any conflicts among the supervisory authorities. Moreover, as a regular and permanent practice, the strategies

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[10] The Federal Consumer Financial Protection Board is a member of the USA's Financial Stability Oversight Council. See http://www.treasury.gov/initiatives/fsoc/about/Pages/FSOC-Member-Agencies.aspx

should provide for the FSC to receive the joint conclusions of the assessments of the systemically important conglomerates, not least as a way to promote effective cooperation in risk assessment and mitigation. This would help the FSC understand and monitor the risks associated with the operations of these conglomerates and take actions if and when necessary to address these risks, including in the context of crisis situations.[11]

62. **As part of the coordinated supervisory strategies, the authorities should conduct forward-looking risk assessments of the conglomerate.** In particular, the supervisors should conduct stress tests that assess the impact on the main financial institutions of shocks to the related financial institutions and/or commercial enterprises within the conglomerate. The supervisors should conduct stress tests that cover the new definition of liquidity needs by Basel III, while encouraging systemically important domestic financial institutions to conduct bottom-up stress tests.

63. **In light of the additional resources required to establish an effective framework to supervise conglomerates, the supervisors should receive additional resources.** The supervisors should increase both their human and technological resources to carry out a timely and consistent supervision of conglomerates. At the same time, the supervisors should retain or hire persons to assess the interrelationships among the different entities within conglomerates and carry out stress tests. It may also be necessary to upgrade the technological systems to accommodate the expanded scope of data submitted by conglomerates.

64. **The Chilean authorities should consider providing supervisors with legal independence.** This would make supervisors fully accountable for the discharge of their responsibilities. At the same time, this would free supervisors from legal liabilities for actions taken in good faith. This would also provide for the removal of the management of supervisors only under clear and publicly specified circumstances. In light of the importance of legal independence, Chile could consider taking advantage of the insurance and securities law now under consideration by Congress and the draft general banking law now under preparation to seek legal independence for supervisors.

B. Medium-Term Recommendations

65. **The Principles provide the foundation for the establishment of group-wide supervision of conglomerates.** As noted above, the Principles center on supervisory powers and authority, supervisory responsibility, corporate governance, capital adequacy and liquidity, and risk management. As the Principles focus on financial conglomerates, the introduction of these Principles may require changes to take into account the fact that Chile

[11] For a discussion on the information required to identify systemic risks and design macroprudential policies to mitigate these risks, see International Monetary Fund, 2014, "Staff Guidance Note on Macroprudential Policy," December.

has both financial and mixed conglomerates (see Appendix I). The introduction of these principles in Chile would also require a change in the legal framework, and the issuance of norms on capital, liquidity, and risk management. Moreover, it would also be necessary to issue a single set of accounting instructions to the financial conglomerates and require the audit of consolidated financial statements. This phase may well benefit from consultations with financial sector representatives.

Supervisory powers and authority

66. **Supervisors should have the necessary powers and authority to conduct group-wide and comprehensive supervision of conglomerates.** Supervisors should have the legal powers to bring about effective cooperation, coordination and information sharing among supervisors to facilitate group-wide supervision. Supervisors should also have adequate resources—human, technological, knowledge, and informational—to carry out effective oversight of conglomerates. The authorities should, if and when necessary, be able to engage external experts in supervisory activities. In this context, the authorities should seek to extend legal protection to all persons involved in supervisory functions.

Supervisory responsibilities

67. **In the light of their supervisory powers and authority, supervisors should establish a process for coordination of the work of supervisors and identification of a group-level supervisor.** The process should make it possible for the delineation of roles and responsibilities of the sectoral supervisors to enable effective group-wide supervision. This should also facilitate the establishment of supervisory strategies and coordination with respect to on- and off-site supervision. Moreover, this should open the way to identify a group-level supervisor from among the sector supervisors.

68. **The group-level supervisor should have overall responsibility for determining the conglomerates' risk profile and clarifying the objectives, roles, and responsibilities of the sectoral supervisors.** In light of international experience, the group-level supervisor may well be the supervisor of the largest financial activity within the conglomerate. It would follow, for example, that in conglomerates dominated by a bank, the group-level supervisor could be the supervisor of the bank. Notwithstanding any decisions on the group-level supervisor, it would be essential to develop a common methodology if and when possible to supervise the financial conglomerates, while recognizing that there may still be some differences in the methodology because of the different business focus of the conglomerates. It would also be necessary to set up a conflict-resolution mechanism in cases of disagreement among the supervisors in the assessment of a conglomerates' risk profile. Establishing mechanisms for conflict resolution should center on a process rather than focus on a one-time fix. The SCFI and supervisors' mandates and the issues of concern should shape the process.

69. **The group-level supervisor should have the authority to collect information from both the head and CEs of conglomerates.** This would be essential to identify, measure,

monitor, and manage risks, as well as to understand whether the individual entities represent a source of strength or weakness. In this light, the group-level supervisor should have the authority to:

- access records, board members, and management of the conglomerates and CEs;
- request on ad hoc basis information from the conglomerates and CEs as necessary;
- set up the frequency and scope for the conduct of on-site inspections;
- establish a program for periodic meeting with the conglomerates' board, management, and auditors;
- conduct periodic reviews on exposures, by borrower, economic sector, and name concentration;
- require notification from conglomerates when structural changes occur, including the creation of a new CE; and
- determine a reporting schedule for the conglomerate, as well as accounting, audit, and disclosure requirements.

70. T**he group-level supervisor should have a comprehensive range of supervisory tools to request timely corrective actions.** The group-level supervisor should have the ability to ask conglomerates to address deficiencies in prudential standards, large exposures, and inappropriate group transactions. The group-level supervisor should have the powers to tackle issues related to resolution and recovery. The group-level supervisor should also have:

- the power to establish—preferably through the issuance of norms—the regulatory perimeter, and determine the parameters for identifying the entities within the group that should be subject to supervision;
- a mandate to assess the level and potential risks posed by mixed conglomerates' commercial operations to the head entity, and determine if the controllers of the mixed conglomerates are a source of strength or weakness;
- the authority to establish supervisory colleges given the rapidly growing operations of Chilean conglomerates across borders and supervisors' concerns about the difficulty of fully grasping the risks posed by these operations; and
- the authority to request changes in conglomerates to create a sufficiently transparent group structure to facilitate effective group-wide supervision. This could include requiring changes to the ownership structure such that all the

financial service providers in a mixed conglomerate are held by one entity that is subject to consolidated supervision.

71. **In sum, the group-level supervisor should supplement the work of the existing banking, insurance, securities, and PFA supervisors.** The group-wide supervisor should coordinate the work of the various supervisors, assess the prudential risks arising from the conglomerates, close gaps in the supervisory activities, and eliminate blind spots in the current supervision framework.

72. **Supervisors should also take steps to promote additional processes to enable effective supervision.** These processes could include:

- Promoting a culture of cooperation and coordination at all levels of the supervisory ranks.
- Identifying individuals that would serve as "change managers" or drive the efforts to change the practices, tools, and culture to facilitate effective cooperation among supervisors.
- Reviewing the supervisory processes of the SBIF, SVS, and SP with a view to streamlining and harmonizing these processes and requests from conglomerates.
- Assessing the adequacy of the supervisors' resources to ensure that they are able to conduct comprehensive and effective group-wide supervision.
- Creating a periodic accountability report by the supervisor.

Corporate governance

73. **Supervisors should require conglomerates to establish a sound corporate governance framework.** In particular, supervisors should ensure that conglomerates establish a comprehensive and consistent corporate governance framework across all entities of the conglomerates. Supervisors should also require conglomerates to have a transparent organizational and managerial structure that promotes effective and comprehensive group-wide supervision. Conglomerates and CEs should identify the board members, key management and reporting lines, while reducing the potential for conflicts of interest by naming independent board members. To this end, supervisors should have the authority to establish suitability criteria of board members, management, and ultimate beneficial significant owners on a continuous basis. Currently, supervisors in Chile identify the significant owners only at the time of an acquisition or establishment of a Financial Institution. Moreover, supervisors should require the board and management to define the conglomerates' strategy and risk tolerance and appetite, and take responsibility for the implemention of this strategy.

Capital adequacy and liquidity

74. **Consolidated supervision requires a careful and continuous assessment of capital adequacy and liquidity.** As stressed in the Principles, supervisors should require conglomerates to (i) maintain adequate capital on a group-wide basis to act as a buffer against group-wide risks; (ii) develop capital management policies that are approved by the board; and (iii) consider the group-wide risks when undertaking capital management (see Appendix II). Supervisors should ask conglomerates to conduct capital adequacy assessments that explicitly take into account leverage ratios and the down-streaming of debt in the form of equity in a subsidiary. These assessments should give particular attention to the ability of capital to absorb shocks, the quality of capital, and the degree of support of capital for the operations of the different entities within the group. Supervisors should require that such assessments evaluate the limitations, if any, on intra-group transfers of capital. Supervisors should also require conglomerates to assess group-wide liquidity risks and establish a funding program. Moreover, supervisors should require group-level stress tests on the financial institutions' solvency and liquidity, while taking into consideration the CEs.

Risk management

75. **Consolidated supervision depends crucially on sound risk management.** To this end, supervisors should compel conglomerates to have in place a comprehensive and effective risk management framework. This should include a robust system of internal controls, and effective internal audit and compliance functions. Supervisors should call on conglomerates to establish appropriate group-wide risk tolerance levels and a risk appetite policy. Supervisors should also require conglomerates to aggregate the risks they face, including from off balance sheet activities and consumer protection issues. Finally, supervisors should expect conglomerates to have processes to manage and report group-wide risk concentrations, intra-group transactions, and exposures.

C. Long-Term Recommendations

76. **Supervisors would benefit from establishing a common platform for the collection, maintenance and analysis of financial data and qualitative information.** This would require an assessment of information needs, and, as noted previously, efforts to streamline the collection, analysis and distribution of information. This would facilitate the supervision of financial conglomerates.

Appendix I. Consolidated Supervision of Mixed Conglomerates

Many jurisdictions across regions allow mixed conglomerates to operate. Mixed conglomerates center on ownership and/or affiliations across banks, insurance companies, security companies, and commercial enterprises. However, most of these jurisdictions are still in the process of developing a supervisory framework for mixed conglomerates. Below are summaries of how four jurisdictions are dealing with mixed conglomerates.

In Australia, a conglomerate is defined as a group where material activities are performed across more than one industry regulated by the Australian Prudential Regulatory Authority (APRA) and/or in one or more non-APRA regulated industry. APRA licenses the ultimate parent and applies conglomerate supervision to all entities in the group that are consolidated into the ultimate parent. APRA has the power to take supervisory actions against the ultimate parent if there are concerns emanating from non-APRA regulated entities within the group.

In the EU, commercial enterprises may own or be affiliated with financial institutions. For instance, some industrial groups own financial companies that are usually specialized in corporate finance or leasing (and not retail). However, industrial groups do not participate in the bank-insurance model that dominates the European market. In terms of consolidated supervision, the EU does not supervise nonfinancial companies. However, the EU gives the supervisor the power to request information from the ultimate parent of the conglomerate and require corrective action with regard to conglomerate governance.

In Japan, mixed conglomerates exist only at the margin of the financial markets and have no systemic importance, and the ultimate controllers are subject to the supervision of the Financial Services Agency (FSA). The FSA supervises the ultimate leading entities that are the major shareholders of financial subsidiaries. Prior authorization by the FSA is required before starting any financial businesses. Mixed conglomerates are subject to on/off site monitoring and reporting, but they are not subject to capital requirements. The FSA may require major shareholders to take remedial actions with a view to strengthening financial subsidiaries.

The United States has long prohibited commercial enterprises to own banks, and is now establishing consolidated supervision for systemically important financial institutions. Industrial loan companies (ILCs), also known as industrial banks, are not subject to this prohibition. ILCs are supervised by the supervisory authorities in the state in which they received their license. All bank holding companies and nonbank financial institutions designated systemically important by the Financial Stability Oversight Council (FSOC) are subject to consolidated supervision by the Federal Reserve. The Federal Reserve is developing its supervisory processes for the FSOC-designated insurance companies and a large credit provider whose holding company is a part of a larger conglomerate.

With 17 licensed industrial banks (IB) as of September 2014, holding US$101 billion, Utah supervises the majority of IBs in the United States. The Utah Department of Financial Institutions (UDFI) requires IBs' parent holding company to register annually and IBs themselves to obtain insurance from the Federal Deposit Insurance Corporation (FDIC). IBs are subject to the same state and FDIC regulatory and supervisory oversight as commercial banks. In addition to a robust licensing application, the UDFI gives considerable weight to: (i) the independence of the majority of board of directors; (ii) autonomous decision making authority by the board and management; (iii) control by the board and management of the IBs' strategy and activities; and (iv) independence of the local management from the parent.

With respect to the latter, the UDFI recognizes the need for the implementation of the parent's goals and policies if included in the IB's business plan. In carrying out its supervisory oversight, the UDFI requires IBs to provide periodic financial information to the state and FDIC. The UDFI conducts routine on-site joint examinations with the FDIC, including reviews of transactions with affiliates. The UDFI discloses formal corrective actions taken but not informal actions.

A range of holding companies with different business models and markets own IBs in Utah. Among these companies are automakers, a postage machine maker, and a national retailer. UDFI applies the *source of strength* doctrine when considering the IBs' holding companies. To this end, the UDFI conducts periodic on-site visits to the parent company and issues a report that, in addition to evaluating the financial institutions, provides an assessment of the source of strength of the holding company. The UDFI also monitors the financial and market information of the ultimate parent.

The UDFI is authorized to take any action against IBs to protect the interest of depositors, including requiring the holding company to take corrective actions. Customarily, the UDFI ring fences banks in the mixed conglomerate through the corrective action that focuses on these banks (for instance, by cutting affiliated party transactions or prohibiting dividends).

Appendix II. Australia's Conglomerate Capital Requirements

APRA makes use of a straightforward method for determining capital for conglomerates. In particular, APRA requires the parent organization to have, at a minimum, consolidated capital greater than the aggregate capital requirements of all industries in the conglomerate. APRA identifies two industry groups: APRA regulated and non-APRA regulated. The APRA-regulated industries include: (i) banking; (ii) general insurance; (iii) life insurance; and (iv) pension administrators; each with their own capital requirements. Non-APRA regulated industries comprise fund managers and other activities, including CE that operate in different economic sectors. APRA also requires the parent organization to prepare an Internal Capital Allocation (ICA) that covers the entire conglomerate and is subject to APRA approval. The ICA must identify the Common Equity Tier 1 (CET1) capital requirements for the nonregulated industries. Fund managers are expected to hold capital equal to at least 15 basis points of funds under management (equivalent to requirements for pension administrators).

The capital calculation requirements are simple. Intra-group transactions and exposures are eliminated from capital. Both the conglomerate level eligible capital and conglomerate prudential capital requirement (PCR) are based on CET1 criteria. For example, if a bank's total capital requirement is 8 percent of risk-weighted assets, but the CET1 is 4.5 percent, the latter is used.

APRA uses both a bottom-up and top-down approach to measure capital requirements. In the context of the bottom up approach, APRA aggregates the capital requirements of both the regulated industries and internally identified capital requirements of the nonregulated industries. In the context of the top-down approach, APRA determines a minimum PCR by aggregating the capital requirements for six industries that take into account all material risks to the conglomerate's beneficiaries, including contagion risks from the non-APRA regulated industries. Clearly, separation of non-APRA regulated institutions from the conglomerate could reduce contagion risk to beneficiaries, which may reduce the PCR.

APRA requires the conglomerate to meet two additional tests. The first test requires the CET1 of the conglomerate to be greater than the PCR of the conglomerate. The second test calls for the conglomerate to have surplus capital to cover any capital shortfalls in the nonregulated entities. As part of the ability to cover any capital shortfalls, the conglomerate must provide evidence that the capital is available on short notice.