Managing Risk and Capital in Financial Conglomerates

Patrick Edwards*

1. Introduction

In recent years, the Australian financial system has been subject to a large degree of convergence with the functional distinctions between different institutions and markets becoming blurred. This development is in line with the move towards an integrated world economy. It reflects changing demands for financial services by borrowers, savers and investors, occasioned by the deregulation and internationalisation of financial markets and rapid technological advancement.

In such an environment, it is not surprising that financial conglomerates have begun to emerge. In today's marketplace, very few institutions have not, in some way or another, crossed the traditional boundaries between banking, insurance and investment markets. Banks now provide insurance products, and managed funds and insurers provide a range of banking services. In fact, it could be argued that the Australian financial system comprises a number of financial conglomerates that principally undertake banking or insurance business, but offer a range of secondary activities also. For the purposes of this paper, however, a financial conglomerate is deemed to be an integrated financial services provider that is not predominantly a bank or predominantly a life insurer.1 In Australia, the Colonial Group is the first and, currently, the only example of a financial conglomerate meeting this criterion.2 Overseas, such financial conglomerates include ING, Fortis and, more recently, Citigroup.

This paper examines some of the unique opportunities and difficulties faced by financial conglomerates, and discusses how these are dealt with in the Colonial Group. Section 2 provides an overview of regulatory changes to permissible corporate structures for conglomerates and briefly considers some of the problems associated with the structure which regulators presently favour. The principle of separation between entities within a financial conglomerate is also discussed. Section 3 focuses on one of the key drivers of convergence, namely, the ability to distribute a wider range of products more efficiently. The Section discusses how distribution channels within the financial sector have changed as part of the growing trend towards convergence and considers some of the initiatives that Colonial has implemented to enhance 'cross-selling' throughout the Group.

Sections 4 and 5 discuss the management of risk and capital resources in a financial conglomerate. Although the principles of risk and capital management are common to banks, life insurance companies and fund management firms, there are often significant cultural differences between the three disciplines. Accordingly, these Sections also consider some of the complexities that may arise when such cultural differences exist. Finally, Section 6 examines the potential for regulatory capital arbitrage within a conglomerate and Section 7 provides a brief conclusion.

2. Corporate Structure

The corporate structure of a financial conglomerate is, at least in part, determined by practical and regulatory considerations. For example, it is generally not possible for a financial services group to provide a range of financial products from a single balance sheet. While banking assets and liabilities can generally be written onto a financial institution's balance sheet without limitation, life policies must be issued via a statutory fund and investors' superannuation funds are typically segregated from an institution's other funds through some form of trust structure. As a result, a financial institution that has the objective of providing a diversity of products across various sectors will require a number of separate entities within a corporate group. In turn, this necessitates various decisions regarding the allocation of scarce capital resources to these entities.

Until recently, a banking authority was only available to the parent entity of a financial services group.3 This meant that many non-bank institutions were prevented from entering the banking market in a significant manner. Hence, such institutions were not able to reap the many benefits that flow from diversified business streams. Over the last few years, changes to financial sector policy have relaxed some of the restrictions on corporate structures, allowing financial conglomerates to begin to emerge. In particular, the 1997 Financial System Inquiry recognised the significance of conglomerates in

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1 The Tripartite Group of Banking, Securities and Insurance Regulators defined a financial conglomerate as "any group of companies under common control whose exclusive or predominant activities consist of providing significant services in at least two different financial sectors (banking, securities, insurance)" (see Tripartite Group of Banking, Securities and Insurance Regulators (1995)).

2 Colonial is regarded as the pioneer of the 'allfinanz' strategy in Australia. Allfinanz is a German expression describing an integrated financial services provider; the Colonial Group aims to provide its customers with a range of integrated financial services covering insurance, banking, stockbrokerage and funds management.

3 Refer to Thompson and Gray in this Volume for further discussion of the regulatory policy applied to financial conglomerates.

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the finance industry and recommended a range of reforms intended to improve efficiency and enhance competition.\(^4\)

Figure 1 depicts a non-operating holding company structure for a financial conglomerate. As shown in the Figure, the non-operating holding company may own subsidiaries involved in banking, insurance and funds management. Additionally, there may be separate subsidiaries engaged in general insurance and life insurance. Thus, a full-service financial conglomerate may have four main operating subsidiaries, although other (possibly commercial) activities might also exist. Note, though, that activities would still be conducted through separate entities, rather than from a single balance sheet.

Figure 2 outlines, in broad terms, the corporate structure for the Colonial Group. The structure more or less assumed its current form in 1996. At this time, the Colonial Mutual Life Assurance Society demutualised and sold the State Bank of New South Wales (now Colonial State Bank)\(^5\) to the newly formed holding company.

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\(^4\) See Financial System Inquiry (1997). Editor’s note: In 1999 the Banking Act was revised such that authorised non-operating holding companies are now formally allowed to head financial services groups or sub-groups.

\(^5\) In 1994, the State Bank of New South Wales was privatised by the State Government through a sale of 100 per cent of outstanding capital to the Colonial Mutual Life Assurance Society. The Bank’s trading name was changed to the Colonial State Bank in 1996.
company of the Group, Colonial Limited. More recently, the Group acquired the Australian business of Legal & General and the Australian and New Zealand businesses of Prudential. The Colonial Group presently holds total assets in excess of $50 billion and, in terms of market capitalisation, is ranked the eighth largest financial institution in Australia. Colonial’s product range and geographic spread of business is relatively diverse. Currently, the Group includes the second largest life insurance company in Australia (measured by in-force business and new annual premiums), the seventh largest bank (in terms of assets held), and the fourth largest funds management firm (by funds under management). Moreover, in addition to its subsidiaries in Australia, Colonial has subsidiaries in Fiji, Hong Kong, New Zealand, The Philippines and the United Kingdom, and joint ventures and representation in China, Indonesia, Malaysia, Thailand and Vietnam.

A non-operating holding company structure offers some advantages, particularly for regulators and credit rating agencies. This type of structure isolates business streams and enables each company to be evaluated as a stand-alone business, uncontaminated by the activities of the other subsidiaries. The sole role of the holding company is to raise and allocate capital to each operating entity; the adequacy of that capital can be assessed against the risks arising from the business being undertaken in each entity. In theory at least, the structure can also provide a number of firewalls that prevent financial difficulties in one part of the group’s operations spreading to other parts of the group.

While there are some advantages, this type of corporate structure also gives rise to a number of potential difficulties. In particular, under such a structure it is not always clear to the customers as to which entity in the conglomerate the customer is dealing with. Hence, there is an issue of how much information should be provided to educate customers about the differences between subsidiaries, such as between Colonial State Bank and Colonial Mutual Life Assurance. At present, regulators deal with this issue by requiring the placement of disclaimers on different types of financial products, detailing the extent of recourse to the conglomerate as a whole. For example, the Colonial Group is required to place disclaimers on funds management prospectuses to highlight to customers that the resources of the Colonial State Bank do not stand behind customers’ investments in a managed fund. It is important that customers understand that the various institutions within the financial conglomerate are legally separate. The notion that customers should be clearly informed about the institutions with which they are dealing, and the limits to the obligations of other parts of a financial group, is often referred to as the ‘separation principle’.6

While disclaimers provide some comfort to the conglomerate’s lawyers, and presumably to the regulators also, the reality is that separation may not always be possible. Damage to the credit standing of one subsidiary will, in all likelihood, affect the standing of the other subsidiaries in the group. Financial difficulties in the life insurance subsidiary, for example, would adversely impact on the ability of the bank to obtain funds. Moreover, the impact on the banking subsidiary would be evident in both the retail market and the wholesale market. Although the disclaimers mentioned above are primarily aimed at the retail (or ‘unsophisticated’) investor, anecdotal evidence suggests that the wholesale markets would also react negatively to the financial conglomerate, regardless of the source of the problem. Quite clearly, separation is often extremely difficult to achieve.

A structure involving a non-operating holding company also creates a potentially significant problem for shareholders. In such a structure, tax deductions associated with head-office costs and debt-servicing costs may be wasted if the only income of the holding company is dividends from its subsidiaries. This is because the otherwise tax-exempt dividend income absorbs the tax losses in the non-operating holding company and thus no tax benefit is obtained from these costs. Furthermore, franking credits would also be lost. This contrasts with the situation where the holding company is also an operating company, in which case there would be taxable operating income to shelter head-office costs and debt-servicing costs. Corporate groups in Australia generally attempt to manage this potential problem by on-charging all head-office costs and debt-servicing costs to their operating subsidiaries. Intermediate holding companies may allow head-office costs to be transferred between entities without any loss of value to the Group (and its shareholders). Unfortunately on-charging costs or the presence of additional companies also means that the corporate structure, and consequent capital allocation, is more complicated than might otherwise be desirable.

3. Product Distribution and Efficiency

Convergence provides the basis for improved shareholder return. This arises principally from the

6 The principle of separation is explored further in the discussion by Knox in this Volume.
greater reach that stems from a wider range of distribution channels, as well as from the enhanced efficiency obtained by selling more products through the same infrastructure. A key driver of the convergence trends observed in the financial sector is the desire of financial services providers to be able to distribute a wider range of products more efficiently. There has long been some degree of overlap between the products offered by banks, life insurers and fund managers. Moreover, this overlap has gradually increased as technology, competition and regulatory changes have reduced the barriers to entry for many markets. Most financial institutions have tended to continue to offer products through traditional distribution channels, despite having a wider product range. The distribution and efficiency benefits that a financial conglomerate can provide therefore warrant further examination.

It is important to recognise that the biggest difference between banks, life insurers and fund managers is not the products offered, but rather the channels via which these products are distributed. Traditionally, banks have distributed primarily through branches, insurers through agents, and fund managers through intermediaries. While there are valid historical reasons underlying these particular distribution channels, developments in technology, coupled with competitive pressures, have largely destroyed the rationale for them. For example, banks have traditionally assessed and controlled the risks arising from their dealings with customers by having a local presence. The local branch was staffed by experienced employees who understood the bank’s requirements and possessed the local knowledge and necessary connections to assess the customers with whom the bank was dealing. Today, however, improved communications, together with the development of statistically-based analytical tools such as credit scoring, mean that banks no longer need to be ‘in the field’ to assess the extent of bank exposures.

Similarly in the life insurance industry, increasing competition has led companies to focus, not just on the generation of new business, but on customer retention. As a consequence, the high up-front commissions paid to agents, common until recently, have been moderated or replaced by trailing commissions, and agents are playing a much reduced role in the distribution of life office products, relative to salaried staff and intermediaries.

Competition is forcing down margins in every form of financial product sold. Deregulation of domestic financial markets, enhanced price transparency and increased customer promiscuity have been important contributing factors in this regard. Given declining margins, the maintenance of profitability requires greater sales levels or lower costs, or a combination of the two. In the current environment, the ability to reach the largest number of customers with the greatest possible range of products is a key to survival. A financial conglomerate, as defined, has the advantage of being able to reach its customers through many different distribution channels and to offer a range of products to satisfy diverse customer needs.

That said, in a competitive market, achieving greater sales of existing products to new customers is difficult. The alternative is to sell more products to the existing customer base. The latter achieves the same objective and may also assist in improving customer retention. In Colonial’s terms, cross-selling describes a sale to a customer from two or more different business lines. Hence, the sale of a housing loan and a life assurance policy is deemed a cross-sale while the sale of two banking products, such as a housing loan and a credit card, is not. A customer with only one product is more vulnerable to being poached on the characteristics of that product, particularly the price. By contrast, a customer with a suite of products must be tempted by an offer that is attractive in terms of the whole package to induce a change of provider. The benefits derived from cross-selling - improved profitability and increased customer retention - are one of the most fundamental advantages available to a financial conglomerate.

Faced with a changing environment, Colonial has taken a number of steps to modify distribution arrangements. For example, the force of tied agents was replaced by franchisees in 1997 and 1998, with the objective of integrating sales channels, marketing and information technology within a franchised allfinanz network. The key to the franchisees’ success is the incentives involved in running their own businesses. The franchisees come from a variety of backgrounds but are primarily retailers rather than bankers. The shift from branches to franchisees is hoped to facilitate integrated distribution channels, presenting a ‘seamless’ face to
customers and opening the way to greater cross-selling.

One relatively new distribution channel for banking and life insurance products that is rapidly becoming commonplace is direct sales, either through a mobile sales force or through telephone sales centres. Another important distribution medium is electronic banking. Colonial State Bank has embraced electronic banking, offering customers automatic teller machine and EFTPOS facilities, as well as computer and multimedia services. While the role played by the Internet is growing in importance, at present the proportion of Colonial’s sales made through this particular distribution channel is very low.

Colonial’s strategies to improve cross-selling have proved very successful so far. The industry performance indicator is the cross-sell rate: the percentage of customers holding more than one Colonial product. Three years ago the cross-sell rate was only 3 per cent of customers. By mid 1998, this had increased to 21 per cent and is well on the way to achieving the target rate of 50 per cent by the end of 1999.7

Selling a bundle of products reduces the cost per product sold. This reduced cost can be shared with the customer by way of cheaper products. This aspect of pricing can be particularly useful on price-sensitive products such as home loans. For example, Colonial has used the concept of an ‘annual stocktake sale’, whereby a low-cost housing loan is available for a short period of time each year, on the basis that borrowers subscribe to other Colonial products.8 This promotion has proved successful to date in that it has helped to reduce the Group’s overall distribution costs, encouraged cross-sales and reinforced the Group’s position as a one-stop financial services provider. However, the product poses an interesting management issue. Low-price sales will obviously depress the reported profits of the business line that produces the discounted product. For internal management purposes (particularly performance assessment and risk-reward analysis), it is necessary to compensate the lending department for the marketing benefit provided to the other products.

It is worth noting that it is not essential for a financial services provider to manufacture all of the products required to be a single-source solution to customers. For example, Merrill Lynch was very successful in introducing its Cash Management Account (CMA) in the US. The product provides the customer with a managed fund savings account that facilitates purchases and sales of mutual funds (unit trusts) and individual shares. Through an ‘outsourcing arrangement’ with another institution, customers are able to draw cheques on the CMA and are provided with a credit card that is automatically settled against the CMA. The customer receives a single monthly statement. The advantage of such an outsourcing arrangement is that Merrill Lynch is not required to develop the complete infrastructure for handling the cheque and credit card transactions. These services can be offered by institutions with the economies of scale that allow them to provide an efficient, low-cost service. In turn, Merrill Lynch is able to provide these products to its own customers at a lower price. Unfortunately, the drawback to such an arrangement is that it does not necessarily enhance an institution’s ability to source new customers and business. This will be an ongoing problem for the provider of ‘outsourced’ products vis-à-vis the financial conglomerate.

4. Risk Management

The formation of the Australian Prudential Regulation Authority (APRA) represents a major improvement over the previously fragmented regulatory environment in Australia and is a significant step towards an improved regulatory understanding of the risks that exist across financial conglomerates. It is also important that conglomerates themselves acquire a more comprehensive understanding of the risks to which they are exposed. In the case of Colonial, for example, the integration of the banking and insurance businesses led to the realisation that there was limited understanding of the risks and risk management practices within other businesses. In part, this was due to a deficiency of knowledge regarding the products sold, the risk management tools available and, most simply, the terminology used within each of the business lines.

This lack of understanding was seen as a major barrier to the realisation of many of the benefits for a financial conglomerate that a more consistent approach to risk management could offer. As a starting point, removing these barriers required the establishment of a series of educational workshops for staff. Essentially these involved treasury, operational and credit risk staff from Colonial State Bank explaining their roles to actuarial and accounting staff in the Australian life company, and vice versa. Clearly, the ability to understand the risks that exist across the Group is an essential precondition to a more consistent and efficient approach to risk management throughout the conglomerate.

7 Author’s note: Targets have subsequently been adjusted to reflect the influx of new customers caused by the acquisition of the Legal & General and Prudential businesses in Australia.
8 The Australian Competition and Consumer Commission has confirmed that this form of promotion is acceptable practice.
Colonial recognises four broad categories of financial risk in each of its business lines: market risk, liquidity risk, credit risk and operational risk. At this stage, however, Colonial's approach to risk management is still largely on a company-by-company basis. The Group is working towards the establishment of a group-wide approach to risk exposures, however, a good deal more work is required for the Group to completely overcome the problems associated with differing cultures, terminologies and technology.

4.1. Market Risk

Market risk is the uncertainty of future earnings due to changes in the market value of assets. In the insurance business, market risk is typically controlled by establishing acceptable 'boundaries' for the investment portfolio. In the life insurance companies in Colonial, this is achieved by requiring investment managers to adhere to documented investment mandates. These are prepared by the Actuarial Department, reviewed by the Asset and Liability Committee (discussed below) and approved by the Board of Directors of each company. The mandates set out the asset classes in which investments may be made and define the benchmarks by which performance will be measured. Investment mandates are prepared on the basis of the policy terms and other obligations given to policyholders. The life company in Australia also uses 'sensitivity grids' to monitor potential affects of market changes in equities and interest rates.

In the banking business, a more exact measure of market risk is used. Specifically, the bank uses a value-at-risk methodology (VaR) to estimate its potential exposure to traded market risk. The framework is supported by open position limits for foreign exchange, sensitivity limits for option-related products and a traditional mismatch ladder to measure the market risk arising from changes in interest rates. This VaR model has been recognised by APRA as being adequate for determining part of the Bank's regulatory capital requirements for market risk.

Colonial is in the process of introducing a similar VaR methodology for the life insurance companies in the conglomerate. In addition to enabling a consistent approach to market risk measurement to be adopted, this will allow exposures to be consolidated and amounts at risk assessed across the Group as a whole. VaR is a useful tool in this regard in that it permits risks arising from different markets to be quantified using a single and consistent measure. Introducing a group-wide VaR measure, however, does not mean that the risks across the Group can be managed purely on a net basis. Market risk will still need to be measured for each business separately. In part, this reflects the distinct entities involved. Nevertheless, a measure of market risk that covers the conglomerate as a whole will provide a useful indication of the Group's ability to withstand adverse movements in market rates and prices. In this regard, Colonial also plans to implement a group-wide stress-testing regime to assess the impact of extreme events on the Group's capital position.

The Asset and Liability Committee (ALCO) plays a key role in the oversight and co-ordinated management of market risk on a group-wide basis. There are ALCOs in each of the Colonial businesses, with each being key to the risk management process. Membership consists of the Chief Executive Officer and Chief Financial Officer of each business together with the Actuary and, in Australia, the Treasurer of Colonial State Bank. The Group Chief Financial Officer, Group Actuary and Group Treasurer represent the Group on the Australian ALCO. Minutes and papers for the overseas ALCOs are provided to Group Treasury to ensure relevant matters are reported and considered.

Within Colonial, ALCOs meet monthly. At each ALCO meeting, the fund manager presents to ALCO on investment performance and compliance with the investment mandate. The Actuary reports on capital adequacy for the life company. Colonial is probably a little unusual in reviewing capital adequacy monthly, with most other institutions operating on a quarterly, semi-annual or even annual basis. The Colonial State Bank Treasurer reports on market risk and liquidity positions and limits. The Australian ALCO is responsible for establishing investment mandates for the Australian life companies and trading risk limits and liquidity risk limits for Colonial State Bank. Investment mandates and risk limits are reviewed on a regular basis, usually annually, to ensure that they remain valid. Investment mandates for shareholders’ funds are set in accordance with guidelines provided by the Group.

4.2. Credit Risk

Credit risk refers to the possibility that counterparties may not meet their obligations to Colonial. It arises from lending activities, investing activities and from buying and selling financial assets on behalf of others. The Group manages credit risk by setting prudential limits for exposures to individual transactions, counterparties and portfolios. Credit limits are set by reference to credit
ratings established by recognised rating agencies, or by methodologies established by Colonial State Bank.

Historically, banks have been much more active in the management of credit risk than life insurance companies. This has been the case at the portfolio level and even more the case at the transaction level. Banks dedicate significant attention to the specific characteristics of individual counterparties and transactions (such as security arrangements and other terms and conditions). By contrast, life insurance companies tend to adopt a risk-averse approach, which typically involves an absolute, ratings-based limit. For example, a portfolio manager may only be able to invest in securities that are rated A+ and above, with investments in lower-rated securities not permitted regardless of the risk-return relationship of those securities. The management of credit risk in life insurance companies is an area where there is, perhaps, a great deal to be gained from a conglomerate structure, with the skills and expertise developed in the banking business able to be shared among the Group.

4.3. Liquidity Risk

Liquidity risk is the risk that Colonial will be unable to meet its obligations in a timely fashion because it cannot liquidate assets at reasonable prices when required. Colonial State Bank and the life insurance companies in Colonial maintain holdings of cash and readily realisable assets, such as short-term bank and inter-bank deposits and Government notes and bonds, to meet estimated liquidity requirements. The Group also holds reserves for unexpected liquidity demands. The Group’s ALCO has responsibility for setting and monitoring liquidity risk limits.

In the case of Colonial State Bank, changes are currently occurring to the liquidity requirements imposed by APRA. To date, banks have been required to hold a minimum ratio of prime assets to Australian liabilities (the ‘Prime Assets Ratio’ or PAR). Prime assets comprise securities of undoubted credit quality, ie cash and deposits with the Reserve Bank of Australia and Commonwealth and State Government securities. The PAR requirement ensured that banks held a minimum stock of high-quality liquid assets that could be called upon in times of financial difficulty.

APRA is in the process of replacing these requirements with a scenario-based approach.\(^9\) This change reflects the fact that banks’ balance sheets can vary markedly depending on their business mix. Hence, banks have different liquidity needs. Under the revised approach, banks will be required to forecast their liquidity requirements under two scenarios, namely, normal operating conditions and a situation where there is a crisis of confidence in the bank’s name. A bank must demonstrate to APRA that it has adequate liquidity arrangements under both scenarios to ensure it is able to meet its obligations as these fall due.

The use of a scenario approach, rather than the traditional stock approach, requires banks to be much more analytical in assessing liquidity needs. For example, data on the volume and withdrawal rates of deposits and the speed and variability of repayment rates of loans must be collected and analysed. As with the management of credit risk, despite differences in the structures of many products, there is no reason why the analytical tools and techniques applied by banks to the management of liquidity risk cannot be usefully applied in life insurance businesses also.

4.4. Operational Risk

The principal operational risk arising within Colonial is the risk of incurring legal or moral obligations to customers as a result of incorrect or inappropriate investment advice or deployment of customer funds.\(^10\) In the Colonial Group, fiduciary risk arises principally in the life insurance companies and in the investment management businesses. To manage this risk the Group has established documented policies and procedures. These attempt to ensure that the provision of any investment advice meets statutory requirements and is based on a proper assessment of customer needs and expectations. In addition, regular and comprehensive training is provided to ensure that staff and distributors are aware of Colonial’s own requirements, and statutory requirements, concerning the giving of investment advice.

5. Capital Management Objectives

The objective of capital management is to provide the most efficient use of capital; that is, to achieve the lowest cost of capital for the corporation while attaining the highest return on capital for shareholders, within acceptable degrees of risk. To achieve this objective, it is important that the organisation understands where it is achieving, not just profits, but growth in shareholder value. This is an area where life insurance companies appear to have been more advanced than banks.

\(^9\) Editor’s note. The revised liquidity policy came into effect in August 1999 (see Australian Prudential Regulation Authority (1998)).

\(^10\) This type of operational risk is also called fiduciary risk. See the paper by Morony in this Volume for further discussion of fiduciary risk in the managed investments industry.
Life insurers’ use of embedded value and appraisal value as measures of the worth of a business focus management attention on the factors which give rise to value growth and those that detract from value. Furthermore, Margin-on-Services accounting has enabled the value being created by new business to be disclosed. The profitability of life insurance business is measured by discounting the future cash flows emanating from each class of business. Where business is ‘profitable’, the profit is spread over the life of the business in an appropriate manner. Where business is ‘unprofitable’, the loss is expensed on inception. In this context, profitable (unprofitable) reflects a positive (negative) discounted cash flow figure. Hence, a profitable class of business is one that achieves a return in excess of the discount rate used. Similarly, an unprofitable business is one that produces a return that is less than the hurdle rate; the business may or may not be unprofitable in an accounting sense. To the best of my knowledge, banks are not, as yet, using a method such as this to measure product profitability.

Achieving a low cost of capital requires the attainment of the right mix of debt and equity in the capital structure. The regulatory capital adequacy rules applied to authorised deposit-taking institutions set limits on this mix. Capital adequacy is assessed against the consolidated on- and off-balance sheet exposures of the bank (using a system of clearly defined risk weights). These rules also specify exactly, those items that can be regarded as ‘Tier One’ and ‘Tier Two’ capital for regulatory purposes. The capital adequacy rules applied to life insurance companies clearly define capital in statutory funds but are less precise about the capital structure of the company itself.

Capital adequacy in banks is openly reported to shareholders. This has led to market expectations of a ‘correct’ capital level. The expectation is for a ratio that is well above the regulatory minimum. This transparency does not exist for life companies and, consequently, there is no market expectation as to the ‘correct’ excess over the regulatory minimum. For each of its life companies, Colonial operates on the basis of an estimated appropriate excess (referred to as working capital). In the case of the Group’s Asian life insurance businesses, working capital is kept to a minimum and supplemented with capital of the parent company as and when required.

APRA’s existing rules for non-operating holding companies, in so far as they apply to Colonial, are straightforward. Capital adequacy for the Group is measured as for the bank using a notional consolidation of the holding company and the bank; investments in the non-bank part of the Group are deducted from Tier One capital. This framework prevents any form of ‘double leveraging’ by Colonial.

Double leveraging refers to the situation where debt is raised by the holding company and downstreamed to the operating subsidiaries as equity. Regulators in Australia have sought to prevent this practice. In Colonial, all non-Tier One capital raised by the holding must be treated as a deduction from Tier One capital in the Colonial State Bank. This applies even if the money is downstreamed into the non-bank part of the Group. While this may appear unduly harsh, raising debt in a non-operating holding company in Australia and downstreaming the proceeds as equity is tax-inefficient in any case. That said, this practice contrasts with that overseas, particularly in the US. Table 1 (over the page) shows the capital structure of US bank holding companies, as well as the amount of their investments in subsidiaries. Two issues are worth noting. First, there is a considerable amount of ‘gearing up’, with most holding companies making use of high levels of long-term debt. Second, in the majority of cases, investments in subsidiaries exceed shareholders’ funds in the holding company, suggesting that double leveraging is occurring to some extent.

6. Regulatory Capital and the Potential for Arbitrage

Ultimately, the focus of shareholders is the return earned on capital employed. Where attractive returns are available, shareholders will generally be willing to provide additional capital. Given this, one of the decisions that a financial conglomerate must make is where products should be ‘booked’; that is, management must determine which balance sheets of the various group entities should particular classes of business be written to. The implications of this decision affect, amongst other things, the amount of regulatory capital needed to support each business. APRA applies different capital requirements to banks and insurance companies. Hence, a financial conglomerate may be able to reduce its total regulatory

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11 Margin-on-Services accounting, or MoS, refers to the accounting methodology used to value the (uncertain) policy liabilities of a life insurance company. The approach aims to release profit as it is earned.
12 The components of Tier One and Tier Two capital can be found in Australian Prudential Regulation Authority (1999).
13 APRA’s capital adequacy rules for life insurance companies are detailed in Life Insurance Actuarial Standards Board (1996). Also refer to the paper by Jenkins in this Volume.
14 See Glading’s discussion of this paper.
capital requirement by booking business to that balance sheet where the regulatory capital charge is lowest. This is commonly termed ‘regulatory arbitrage’.

On a bank’s balance sheet, for example, a housing loan is 50 per cent risk weighted while a commercial loan is risk weighted at 100 per cent. Thus a housing loan requires less regulatory capital support. However, since life insurers have a natural appetite for loan assets that match policy liabilities, the same loan on the balance sheet of the life insurance subsidiary could attract a low (or zero) marginal capital requirement. The same loan booked as an asset of a managed fund would also require no additional regulatory capital.

There are, of course, good reasons why regulators impose different capital requirements on different types of financial institution. These primarily relate to the extent and complexity of financial institutions’ obligations to their customers. That said, differences in capital requirements between institutions could provide a comparative advantage for one type of institution over another. In these cases, the affected institutions will often operate to exploit any differences in capital requirements. In an environment where the majority of financial institutions are predominantly banks or insurance companies, these differences might lead to a tendency for certain types of business to be concentrated on the balance sheets of a particular type of institution (ie the institution with the lower regulatory capital requirement for that particular business). For example, banks are increasingly securitising their housing loan portfolios, transferring these assets off their balance sheets to investors who find the associated returns more attractive (often because lower capital support is required).

These practices can occur not just between different types of financial institution, but also within the conglomerate itself. The potential for regulatory arbitrage will obviously be of concern to regulators if it results in the financial conglomerate holding inadequate levels of capital relative to the risks inherent within the entities in the group.

There are also several good reasons that explain why a financial conglomerate may not automatically book a loan as an asset of the entity requiring the least regulatory capital.

- First, the return provided to shareholders varies according to where the asset is booked. In the case of a bank, all of the profits from that asset accrue to the shareholder. In the case of a life insurance company, the distribution of profit depends on whether the entity is a non-participating fund or a participating fund. In the former, 100 per cent of the profits go to the shareholder. In the latter, 80 per cent of profits (or more) accrue to the policyholders and 20 per cent to the shareholders, as required by the Life Insurance Act of 1995. In a managed fund, the shareholder earns only a management fee. As a result of these differences, the return to shareholders may decline if an asset is booked to a particular entity, even where the capital requirement of that entity is lower.
- Second, an asset booked to a non-participating fund must have attributes that match the liabilities of that fund. Many housing loans are variable rate loans.

<table>
<thead>
<tr>
<th>Shareholders' Equity</th>
<th>Long-Term Debt</th>
<th>Long-Term Debt Ratio(a)</th>
<th>Investments in Subsidiaries</th>
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<tbody>
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<td>Chase Manhattan</td>
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<td>36%</td>
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<td>Citicorp</td>
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<td>62%</td>
</tr>
<tr>
<td>JP Morgan</td>
<td>11,404</td>
<td>9,727</td>
<td>46%</td>
</tr>
<tr>
<td>Norwest</td>
<td>7,032</td>
<td>5,805</td>
<td>45%</td>
</tr>
<tr>
<td>State Street</td>
<td>1,995</td>
<td>768</td>
<td>28%</td>
</tr>
</tbody>
</table>

(a) This is the ratio of long-term debt to the sum of long-term debt and shareholders’ equity.

Source: 1998 Bank Annual Reports.
Theoretically at least, interest rates on variable rate loans change as the cost of funding changes. In practice, the interest rates on variable rate loans are often changed to match the rates charged by competitors. In certain market conditions, competitors may delay rate rises or accelerate cuts in interest rates. This makes variable rate housing loans unsuitable for interest rate sensitive funds. Additionally, variable rate loans typically include a no-cost prepayment option, which introduces prepayment risk to the owner of the loan.

- A third reason is that the financial conglomerate must have in place systems that are able to administer loans booked in a number of entities. Not all systems provide this capability and with Year 2000 remediation taking priority, there are not always resources available to make the required changes.

- Fourth, there is a need to demonstrate that there is no conflict of interest between shareholder interests and the interests of the policyholder (in the life company) or the investor (in the managed fund).

- Finally, in considering regulatory arbitrage opportunities when designing products, the effects on customers must also be considered. Products that are identical in substance may have different characteristics from the customer’s point of view. A term deposit and a term annuity, for instance, have identical cash flows for both the bank and the life company but are treated differently for social security purposes; the classification can significantly affect the customer’s pension entitlement.

Additionally, there are accounting differences that can also influence decisions about where assets are booked. Banks use historical-cost accounting and do not defer acquisition costs. Life companies use market-value accounting and defer acquisition costs. The difference between historical-cost accounting and market-value accounting is immaterial where assets and liabilities are properly matched – as is the case in Colonial. Decisions on where assets are to be booked are the responsibility of Colonial’s Australian ALCO. This Committee has responsibility for managing the balance sheets of Colonial State Bank as well as the life insurance companies. It determines in-principle asset allocations, which are then implemented by a Sub-Committee consisting of representatives from Colonial State Bank’s treasury, the life company’s actuarial area and the fund manager.

7. Summary

Convergence in the financial services industry is ultimately being driven by continually increasing competition. As a result, financial institutions of all types are being forced to improve efficiency and offer a wider range of products to their customers. In such an environment, financial conglomerates have a competitive advantage over banks, insurance companies and other financial services providers in being able to bring together a broad product range and a diverse set of distribution channels.

That said, as long as it is necessary to offer various types of financial products on different balance sheets, a financial conglomerate will need to be comprised of a number of separate legal entities. While recent regulatory changes have given conglomerates more freedom in establishing a corporate structure, a range of practical considerations means that this structure will often be more complex than otherwise desirable.

The complexity of corporate structure gives rise to a number of risk management, performance measurement and capital allocation decisions. In Colonial’s case, the integration process has been made more difficult by the need to merge cultures, practices and languages. Nothing has arisen to date to suggest that risk and capital management in a financial conglomerate cannot be incorporated within an integrated framework. The benefits that flow from this – such as improvements in risk measurement, capital management, product pricing and performance assessment – will be of value to management, customers and shareholders alike.

8. References

Australian Prudential Regulation Authority (1999), ‘Capital Adequacy of Banks’, Prudential Statement C1, June.


Discussion

1. Bob Glading *

For the purposes of this discussion, a financial conglomerate is assumed to mean a group of statutorily regulated or supervised entities operating internationally, predominantly in the financial sector, with significant activities in at least two of the banking, insurance and securities businesses.

Edwards’ paper discusses some of the forces underlying the emergence of financial conglomerates. In particular, the paper identifies an institution’s expectations for economies of scale, efficiency of capital usage and effectiveness in marketing synergies for customer penetration and satisfaction. While the formation of a conglomerate brings many benefits, it is not without problems. In particular, there are difficulties in creating an efficient corporate legal structure and establishing an effective organisation around management authority and responsibility. For a variety of reasons, financial conglomerates are often structured very differently from each other. The organisational structure, decision making processes and controls within a financial conglomerate can be complex, making them difficult to be understood not only by regulators and supervisors, but also by the market more generally and by the conglomerate’s own managers and employees.

In the mid 1990s, the risks arising from conglomeration, and the consequent implications for supervisors, were first considered jointly by banking, insurance and securities regulators around the world. The result was the Tripartite Report of July 1995.1 As suggested above, a major concern for regulators is the potential lack of transparency within conglomerate structures. Hence, supervisors require that there be clarity in, and ability to obtain full details of, the conglomerate’s operations and organisational structure (including details of the various legal entities within the conglomerate and the managerial lines of communication). Without transparent accountability within the conglomerate, supervisors will not be able to properly evaluate the risks attributable to the particular entity they regulate, as other companies within the group may affect these risks. The market also will be at a disadvantage if it cannot recognise the constraints that may arise because of a particular group structure. The commercial risk to the conglomerate, itself, is that it may then be prevented from conducting profitable businesses in some jurisdictions or sectors (be it banking, insurance etc) owing to the inability to obtain a license in these jurisdictions.

A Conflict of Purpose

The Board and chief executive of a conglomerate are driven by shareholder considerations. Hence, they attempt to maximise supportable quality earnings and provide increasing net profits and shareholder value. A particular operational emphasis is placed on the creation, employment and maintenance of capital, as well as on the cost of capital. Along similar lines, management act to retain the maximum amount of capital in that part of the group where capital is most advantageous commercially and where they have most control over how that capital is used.

By contrast, prudential regulators, driven by customer considerations, seek to ensure the continued financial strength of the conglomerate. In particular, supervisory focus is on the continuing capital adequacy and liquidity of all regulated entities. Recognition is given to the fact that those entities must remain profitable if consumer demands for innovative and competitive services and products are to be satisfied.

This conflict between the management of financial conglomerates and the supervisors who regulate those entities will be particularly pronounced in conglomerates that operate on a global basis. In these groups, the chief executive, wanting freedom to move capital across borders, is dealing with the considerations of regulators who have no jurisdiction beyond their national boundaries. The range of concerns identified by the Tripartite Group evidences this underlying conflict.

What are the Risks?

Regulated Entities

Clearly, the minimum amount of capital to be held within each regulated entity is that which is necessary to meet that entity’s minimum solvency standard. Not only is this the remit of the regulators of those entities, but it is sound business practice in order to minimise the risk of contagion within the conglomerate.

It is arguable whether the additional capital needed to fulfil the business plans of each subsidiary should be held within each subsidiary or maintained more centrally. Direct group control provides more flexibility

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* Ernst & Young.

for the conglomerate’s operations, however, changes in the operating environment can be so frequent, occur so suddenly and be so dramatic that the consequences to a subsidiary’s financial condition can be severely adverse. Moreover, there may be long delays in identifying a problem and taking the appropriate corrective action. For these reasons, there is a sound argument for maintaining this additional working capital, as well as solvency capital, within each regulated entity, even where there is no regulatory requirement to do so, in order to minimise the possibility of future insolvency.

If there are no legal impediments (as hopefully there would not be) to transfer surplus capital arising from operating profits across the group, either across national borders or across sectors, management of the conglomerate will have the flexibility that is required for optimum decision making.

Unregulated Entities

The contagion risk inherent within financial conglomerates, particularly that which arises when there are unregulated entities within the group structure, is a significant regulatory concern. Those entities in the group which are not prudentially regulated, particularly those undertaking similar functions to those of the regulated entities, can potentially cause difficulties for the conglomerate. The level of capital retained in these entities is likely to be small or even zero. As a consequence, supervisors concerned about the financial soundness of unregulated entities may look for additional strength in the regulated subsidiaries – especially if they have the power to require such action.

Management of the conglomerate should recognise the risks across the group as a whole and ensure that a commensurate amount of capital is maintained. The amount of capital to be held – desirably in the entity but more likely in the parent – should equate to the capital that would be held if the unregulated subsidiary was, in fact, regulated. Disclosure to the market, as well as regulators, is also desirable. Additionally, the cost of that capital should be priced into the unregulated subsidiary’s products and services. Group-wide advantages in administration and distribution costs, as well as the group’s perceived superior standing in the market, should counterbalance any apparent pricing disadvantage to a stand-alone unregulated company in that market.

Group-Wide Capital Adequacy

Even if all regulated subsidiaries are adequately capitalised, the conglomerate as a whole may not be. The essential philosophy is that in addition to the necessary independent prudential supervision of each regulated entity in the group, a group-wide assessment must be made to ensure that double, or multiple, gearing is avoided. (Multiple gearing refers to the practice of using the same capital to support the capital requirements of two or more companies.) This philosophy is strongly supported at an international level (such as by the Joint Forum) and should not be overturned within a single jurisdiction.

The risks within the conglomerate should be evaluated at the group level. Where additional capital needs to be maintained, whether in the parent or elsewhere, the appropriate transfers should be made. Given that such capital may be used at a future date to support one or other businesses in the group, it is essential that the capital can be transferred from an entity with surplus capital and, if transferred, can be regarded as eligible capital in a regulatory sense. Unfortunately, some jurisdictions and sectors have controls on surplus transfer. Moreover, the attributes of regulatory capital can, and do, vary by jurisdiction. Hence, the availability of capital in one location does not necessarily mean it will be available elsewhere or, if available, that it can be usefully applied as intended.

Intra-Group Exposures and Transactions

Intra-group exposures and transactions are important determinants of the financial status of the conglomerate. These transactions can also affect the strength of individual entities and be to the disadvantage of consumers and minority interests in one company relative to another in the group (especially where they are on non-commercial terms or are made by direction). There are many forms of intra-group exposures, including cross investments, deposits, shareholdings, guarantees, services or trading.

The managerial structure and control of the conglomerate, and its component entities, has an important bearing on the relative strengths of those entities. The constitution of Boards, for example, is undoubtedly a contributing factor in this regard. The risk of having subsidiary Boards that consist only of group operating executives and/or parent company directors is that the legitimate interests of that entity’s
customers and minority interests are suborned to what is perceived to be the ‘greater good’ of the parent. For reasons such as this, regulators take an interest in Board structures and management lines of authority, responsibility and accountability as part of their supervisory role. If the group is seen to have obscure intra-group relationships or its operating subsidiaries are virtually subservient to the parent, the group may be risking more intrusive supervision.

The risks arising from conflicts of interest and contagion, discussed above, are also important issues. Lost opportunities may not only lower company and group profitability but can, in extreme cases, endanger company solvency. In this regard, intra-group exposures in complex structures are a particular source of concern.

Management of the conglomerate should consider the implications, especially with regard to the responses of taxation and prudential authorities, of directing financial subsidiaries, overt or covert, to invest the assets covering own liabilities in other parts of the group. The same applies to accepting services at inflated prices from other conglomerate entities. Individual company management should be able to operate largely independently, within an overall group philosophy. Achieving this will probably require external independent directors, at least in regulated subsidiaries, and supervisors should be more wary when this is not the case. Even for unregulated subsidiaries, intra-group exposures can be a problem if the activities of the subsidiaries, overall, are significant.

Large Group Exposures

Large group exposures are an even more difficult issue to resolve. While individual regulated entities will each be subject to rules that limit exposures to any one obligor, different supervisors have varying definitions of regulatory capital and apply different weighting factors to the various elements of assets and liabilities. This is particularly the case for the banking and insurance supervisory regimes and arises from the quite different nature of the respective assets and liabilities of these sectors. Although each entity may conform to the requirements, the total group exposure can prove excessive, both commercially and prudentially. In view of the importance of banks in relation to the payments system and systemic risk, such a position would be regarded as unacceptable in a group with banking business.

Intra-group exposures, lack of subsidiary autonomy and inadequate group controls may aggravate the problem of group-wide large exposures. This is essentially a problem that must be dealt with by the management of the conglomerate. At a minimum, regulators should require thorough internal reporting, to ensure that excessive group exposure does not occur inadvertently. Moreover, it will most probably be very difficult for regulators to quantitatively assess the risk and capital position of the group, at least in the foreseeable future. Given the differences in capital definitions and asset and liability valuations across the group, consolidated accounts will not provide regulators with a solution.

Operational Risk

Operational risk within individual companies is the subject of much discussion at an international level and, indeed, has been well canvassed throughout the conference. There are many operational risks that, while generally affecting the offending subsidiary significantly, may result in an experience sufficiently adverse as to affect the group as a whole, or a substantial part of that group. These risks include political risks (such as exchange control and sequestration), legal risks (such as poor documentation and poor compliance with statutes and regulations), unethical conduct through fraud or money laundering and foreign exchange settlement risks. In addition, group control must consider its own operational risks.

Some particular operational risks that warrant elaboration are discussed below.

Auditors

The external auditor of the parent will be reliant on the competence and, possibly, the integrity of the external auditors of the individual companies. This reliance may be particularly important across national borders, especially where there are different accounting and auditing standards. Proper group controls via the internal audit function and sound compliance should make this less of an issue in managing the identified risks.

Outsourcing

If a number of subsidiaries outsource major functions to external parties, the financial soundness of those providers should be evaluated. If a provider fails and there is a lack of internal capabilities, continuation of

\(^{2}\) See, for example, Basel Committee on Banking Supervision (1998).
Managing Risk and Capital in Financial Conglomerates

Group operations might require crisis management. This problem may become acute if one provider is acting for several subsidiaries across different jurisdictions. If outsourcing is to an intra-group company, the additional risks may revolve around a wide range of considerations such as contagion, conflict of interest, equitable arrangements for minority interests and general market conduct.

Regulatory Changes
Regulatory changes designed to eliminate practices such as transfer pricing and regulatory arbitrage are potentially a risk to the conglomerate structure. It is not clear whether prudential regulatory arbitrage, as distinct from taxation arbitrage, actually exists. In some quarters it is certainly seen to do so with substantial reference made to convergence and the blurring of products. In these instances, however, there is little or no recognition of the reality of diversification of products and markets, mostly through separate legal entities. Moreover, the current sectoral division still remains pertinent. The example that is typically identified is the different capital requirements on term deposits from banks and quasi-term deposits from life insurance companies. Although the liabilities of the two sectors are seen to be the same (in fact, there are differences), the assets backing banks and life insurers can be quite different. While banks are effectively limited in terms of the assets that can be assumed, life companies are less constrained (although in practice there will be a high degree of matching). Life companies can take on more risk – for which they will be required to maintain more capital – in a bid to provide terms which are more favourable than those offered banks. If life companies do not provide enhanced terms relative to banks, they will not be able to compete because of market perceptions.

Regulatory arbitrage is more likely to exist within a sector, either within or across jurisdictions, especially when unregulated entities are involved. The result of such arbitrage is some level of intra-group exposure, as already discussed.

Operating in Unregulated or Poorly Regulated Countries
A conglomerate with operations in unregulated or poorly regulated countries is another concern. Particular difficulties may occur if some sectors within a country are regulated but others are not, particularly if there is an intermediate holding company incorporated in that country. In these situations, intra-group exposures should be minimised or avoided.

Conglomerate Failure
It is notable that several high-profile industrial and commercial conglomerates have been broken up into their constituent parts. Alternatively, particular elements have been discarded as non-core business. While the current view is that financial conglomerates are different to other conglomerate forms, it is quite possible that within a decade or so similar deconglomeration will be under way in the financial sector. The risk for the conglomerate is that, in seeking maximum efficiency now, it will disregard such an eventuality and leave its subsidiaries not capable of operating independently or economically for a potential purchaser.

Derivatives
Much of what has been discussed above is made easier by the advent and rapid growth of financial derivatives. A recent International Monetary Fund Report, which considered the implications of information technology and mathematical models on risk management, noted that “the ability to unbundle, repackage, price and trade risk separately, by both regulated and unregulated entities, has made it difficult, if not nearly impossible, to know the distribution of private financial risk across institutions, markets and countries”. The development of markets for foreign exchange and interest rate derivatives and, more recently, credit derivatives and securitisation, raises concerns about the transparency of institutions’ exposures. Regulators must rely, increasingly, on the integrity of institutions’ disclosures.

Conclusion
A conglomerate is exposed to a number of significant risks over and above the risks within its constituent companies. Hence, a group-wide capital assessment should be undertaken once the risks of individual entities have been analysed. Whilst recognising that there may be some ameliorating effects from the diversification of activities across sectors and countries, the possibility of severe adverse conditions, beyond those demanded by regulatory requirements, should be taken into account. Additionally, internal group controls must be strong, comprehensive and extensively monitored; they cannot be minimised.

3 International Monetary Fund (1998).
Conflicts of interest should be avoided and contagion possibilities recognised.

Finally, the acceptance of risk demands an appropriate capital base. Since an exact quantitative assessment of required group capital cannot be made, a full qualitative assessment is also needed to determine that level of capital which is appropriate given the risks across the financial conglomerate.

2. General Discussion

Discussion examined the difficulties experienced when distinct businesses are brought together to form a financial conglomerate. Particular mention was made of the problems in integrating risk management systems and procedures and in establishing a common language across a financial group comprising banking, insurance and funds management operations. Consumer expectations with regard to retail products purchased from a financial conglomerate were also discussed.

Participants were interested in exploring the extent to which Colonial has been able to standardise risk measurement techniques and terminology across the different businesses. Edwards noted that while Colonial’s progress had been slower than desired, certainly the intention was to have in place an integrated risk measurement framework for the Group as a whole. As outlined in the paper, in the early stages of the conglomerate’s development Colonial undertook to educate businesses on differences in terminology and procedures. The education process involved different areas of the group coming together and providing presentations on products, risk management etc. Colonial found that there are a lot of similarities in terminology, once the initial hurdles are overcome, but also some clear differences in approach to risk management. The process proved to be a very useful one, in terms of both education and the cross-fertilisation of ideas.

As in earlier discussions, there was broad agreement that common terminology across the finance industry would simplify the integration process. It was suggested that one reason why a uniform language has not yet been adopted is that businesses must still communicate with regulators who use different terminology depending on which type of institution they are regulating. All participants agreed that there existed a lot of scope for APRA to lead the way in the development of a common language.

Participants questioned the capacity of retail consumers to fully understand the risks inherent within the products being purchased. When a consumer invests in a typical product, such as a term deposit, repayment of capital on redemption is certain. By contrast, the nature of funds management is such that no capital or interest guarantee exists. Many participants were of the view that the distinction between banking and funds management products, from the perspective of the consumer, was sometimes not clearly defined. It could be the case that a consumer intending to invest in a term deposit is sold, instead, a ‘blue chip’ fund. If, on redemption of that investment, its value is shown to have declined, there is a risk that the bank experiences serious reputational damage as a result of perceived misleading conduct.

As further illustration of this point, a distinction was made between consumers’ understanding of the functional characteristics of a product and that product’s institutional risk. For example, would a customer regard capital guaranteed life products and banking products offered by the same financial institution as having the same degree of institutional risk? If the customer were dealing with a bank as a stand-alone business then the customer would have a view about the soundness of the bank. If the customer were dealing with a managed investment business or a life insurance business as part of a larger banking group, it was possible that the customer would perceive

References

the bank as standing behind all products, be they funds management products, life products or banking products. Participants felt that it was very difficult to overcome this perception, no matter how bold the print on the product document. It was suggested that responsibility for ensuring that the distinction is clear rests with the market conduct regulator.

There was some discussion of how best to determine the capital requirements of a financial conglomerate. Participants noted the difficulty in assessing the amount of capital that should be held against different types of business. There were divergent opinions regarding the ability to determine quantitatively the capital requirements for the group. Some participants were of the view that a quantitative solution to the question of an appropriate level of aggregate capital is possible. While that solution is, as yet, unknown, participants felt it was essential for financial institutions to attempt to quantify risk to the best of their abilities. Other participants were of the view that it was impossible to attain a mathematical formula to calculate risk-based capital figures for each business and the group as a whole. The issues associated with adequately providing for diversification effects between businesses were thought to be especially difficult to overcome.

It was broadly agreed that qualitative assessments, such as fit and proper tests, should supplement any quantitative analysis of capital requirements. Furthermore, participants acknowledged that even if an adequate capital holding is determined, other issues might also be present, such as an inability, in particular jurisdictions, to access available capital. One participant noted that a typical role of a group treasury function is to examine the availability of standby lines of capital and how that capital can be utilised in a crisis.

Finally, mention was made of the reputational risks for the financial group arising from problems in subsidiaries. The general view was that the proposition of having to bail out troubled subsidiaries should not be accepted without question. Some participants equated a decision to support subsidiaries with holding capital against once-in-a-lifetime events. It was felt that, ultimately, the decision is a judgemental one; there is no correct answer. Participants noted that during the property-related crisis of the early 1990s, few if any fund managers received assistance from parent banks. At that time, structurally unsound property trusts were common, and most investors, not surprisingly, moved to redeem their funds. In general, the only assistance for the funds management industry came by way of relaxed government policy. Hence, participants felt that the arguments supporting preservation of the separation principle were valid ones. It was noted that irrespective of the degree of separation, problems in one area of the group’s operations would immediately affect other parts of the group, at both the retail and wholesale level. For example, problems in the life insurance business would make it very difficult for the bank to acquire funds at reasonable market rates.
The Interim Working Committee on Financial Conglomerates (IWCFC) received the third call for technical advice from the European Commission. The Commission services is requesting the IWCFC to conduct a stocktake to assess of practices implemented in the Member States. The IWCFC has already delivered advice with respect to cross sectoral work on the eligibility of own funds, and the equivalence of financial conglomerates supervision in Switzerland and in the US. These contributions providing useful input to the review of the Financial Conglomerates Directive Read more ». The largest conglomerates diversify business risk by participating in a number of different markets, although some conglomerates, such as those in mining, elect to participate in a single industry. 1:42.

Conglomerate. Buffett’s approach is to manage the capital allocation and allow companies near total discretion when it comes to managing the operations of their own business. Another example is General Electric. The financial health of a conglomerate is difficult to discern by investors, analysts, and regulators because the numbers are usually announced in a group, making it hard to discern the performance of any individual company held by a conglomerate. Conglomerates in the 1960s. Conglomerates were popular in the 1960s and initially overvalued by the market.