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Globalisation and Conglomeration of the Financial Industry

There is an ongoing trend towards internationalisation, concentration and conglomeration on the world's financial markets. In recent years, we have seen an increasing number of large, internationally active groups with operations in several financial sectors.

In banking and insurance, much capital is required in order to match risk exposures and to meet statutory capital requirements. Increased competition and a more conscious attitude among customers have made it more difficult to reach profitability with small or local businesses. Subsequently, we see mergers, concentration and internationalisation in order to achieve enough size to take advantage of large-scale solutions.

The risk spreading factor may also be relevant for forming larger groups. Financial operators may feel that they are too much exposed to a certain geographical area, a certain financial sector or market or to certain kinds of risks. Spreading operations to other geographical areas, financial sectors or both may level this.

By conglomeration, efficiency may be enhanced. Large-scale solutions have become more common in order to achieve cost efficiency, not least in the area of capital management. Financial conglomerates usually have one unit that manages capital for the entire conglomerate. By a common, discretionary management of mutual funds, life insurance companies and pension funds, the conglomerate achieves economics of scale.

The use of existing office premises and other facilities can be optimised, which of course is cost beneficial. ”Cross selling” of various financial products may also be facilitated by such a co-ordinated approach.

Customers have also become more accustomed to multi-service financial institutions and discovered the advantages of being able to get all services from one supplier.

Supervision of Financial Conglomerates

The trend of conglomeration requires new regulatory and supervisory measures. Sectoral risks within a conglomerate vary in character. One important variation is the time horizon. Risks in life insurance, for instance, are typically much more long-term than credit risks, while market risks could be extremely short-term. Risks regarding pensions are even more long-term than in “average” life insurance.

Supervising conglomerates with complicated structures and comprehensive risk profiles, is very much facilitated by integrated supervision. During the last fifteen years, integrated supervisors have been established in several countries. There are some obvious advantages by being an integrated supervisor:

- Good overview
- Common supervisory framework and methodology structure
- Easy communication
- Co-ordinated supervisory approach and balance between group supervision and supervision of individual companies

Integrated Supervision in Sweden

In Sweden, supervision has been integrated since 1991, when the two former supervisory authorities merged. All kinds of financial institutions and their activities are regulated and supervised by Finansinspektionen. Pensions are an integrated part of these activities and are thereby monitored, primarily by supervision of life insurance companies and friendly societies. For several years, supervision has been risk oriented, focusing on internal control and management of main risks, such as credit risks, markets risks, various risks in the insurance area, operational risks etc.

Finansinspektionen introduced a process-oriented organisation on 1 September 2000. The present organisation consists of four main departments: the Strategy & Analysis department, the Banks & Investment firms department, the Insurance & Mutual funds department and the Markets department.

The three main processes are: *licensing and regulating*, *financial stability analysis* and *supervision*. These processes cover the core operations of Finansinspektionen and form a matrix across the organisation.

Groupwide Risk Assessment

Group wide supervision and risk analysis is very much emphasised in Swedish supervision. A number of top-ranked banks, insurance groups and security firms will be evaluated annually based on Finansinspektionen's review process. Under the supervision of an inspector, acting as a lead supervisor, a group wide assessment is made. This assessment involves a number of people from different parts of the organisation. The lead supervisor also takes the necessary contacts with foreign supervisors in the supervision of international activities.

Typically, the group wide assessment of a large financial group includes the following elements

- Business areas and strategy
- Corporate governance
- Management control in essential risk areas
- Organisation and internal control
- Pricing of risks
- Capital allocation to risks
- Capital strength
- Stress tests
- Liquidity
- Ownership
- Public accounts, rating, etc.
- Compliance

The analysis and results will be captured in annual assessment reports. These reports have several important functions.

First of all the risk assessment report is used for a dialogue between supervisors and top management of the selected firm regarding the risk profile and risk management activities.

Secondly, the report is the supervisor's major instruments in risk audit, being a synthesis of the most relevant information about the institution. This means a number of inputs from different sources, internal data and observations from different risk management and decision-making activities.

Risk Analysis

Risk management is becoming more and more crucial in financial institutions and Finansinspektionen has developed a risk focused supervisory approach. Three specialised sections have been set up with functional responsibilities for credit- and market risks, insurance related risks and operational risks. The risk analysis sections analyse essential risks and develop methods to evaluate performance of risk measurement, pricing and capital allocation to risks. The findings made by analysis sections are of course important for the annual group wide risk assessment.

International Co-ordination an Co-operation

The trend of conglomeration and internationalisation has called for a co-ordinated supervisory approach world-wide. In order to tackle this situation, supervisory methods are developed globally on several levels.

Joint Forum

The Basle Committee, IAIS and IOSCO established the Joint Forum on Financial Conglomerates in 1996. The forming of The Joint Forum offers opportunities for a dialogue across traditional borderlines and gives opportunities to discuss consolidated and correlative supervisory issues.

Apparent issues are

- Information sharing
- Co-ordination of supervision of conglomerates
- Capital adequacy
- Risk concentrations and intra group transactions
- Fit and proper principles

The work of the Joint Forum has resulted in a number of recommended principles regarding capital adequacy, sharing of information and co-ordination between supervisors. All in all, this is a great step forward in international joint efforts to supervise financial conglomerates.

The Joint Forum also has issued comparative reports on core principles in the three sectors, risk management and capital. Another report on corporate governance and transparency is underway.

Europe

In Europe, EU has opened up a more free market where establishments of new operations and cross-border activities have increased. Several EU-directives regulate how financial institutions should be supervised, both on a solo and on a group level.

Supervision of financial conglomerates is topical on the European agenda. Directives have been adopted regarding financial groups and insurance groups, where capital issues, risk exposures and intra group transactions are being dealt with. Last year, the European Commission presented a proposal regarding a new directive on financial conglomerates, covering the same issues on a conglomerate level.

Some of the main topics in the directive are:

- Capital requirements on a conglomerate level

- Methods for risk management and internal controls on a conglomerate level.

- Reporting of intra-group transactions and substantial risk concentrations on a conglomerate level

The principles recommended by the Joint Forum have been used as guiding rules when preparing for the new directive on supervision of conglomerates, particularly regarding calculation methods for capital and rules regarding co-ordination, information sharing and intra group transactions.

Co-ordination arrangements for insurance groups and financial conglomerates have also been put in place within the European Union through the so-called Helsinki Protocol. This protocol is based on the EC Directive on the Supplementary Supervision of Insurance Undertakings in an Insurance Group.

What needs to be done Regarding Supervision in the Future?

EU directives deal with the issue of establishing cross-border branches and how to supervise them. This works well when such operations are relatively small compared with head operations in the home country and when they are in the form of branch offices. Today, however, we see a large variety of establishments of financial groups. In some cases, a company establishes branches that may represent a considerable part of the host country's market. In other cases, there is a mixture of branch establishments and establishments of subsidiaries. This development will continue and the various national and sectoral markets will gradually be more and more integrated.

Agreements between supervisors may solve practical co-ordination issues on a temporary basis. There is, however, a need for far-reaching co-ordination of supervisory activities between the countries involved, far beyond what has been laid down in EU-directives and protocols on collaboration.

In order to keep up with the trends and developments in the financial sector, integrated supervision has become a necessity.

There is also a need for further convergence of supervisory methods and practices between sectors and countries.