XV/A-4 July 1988

Conference on Financial Conglomerates

14/15 March 1988
Borschette Centre
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COMMISSION OF THE EUROPEAN COMMUNITIES
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OPENING OF THE CONFERENCE

Ladies and Gentlemen,

I am pleased to welcome you to this Conference on Financial Conglomerates. Indeed, the Commission is most grateful to you for your participation in this Conference. A Conference, which certainly for me, and I suspect for most of you, represents something of novelty.

Of course, even at European level, the problems of financial congolomerates have been perceived and studied in various bodies already. As far as the banking sector is concerned, for instance, the Banking Advisory Committee and especially the "Groupe de Contact" of Banking Supervisors have done most valuable work in looking into links between banking, insurance and securities markets and in raising some of the questions which we will have to study, for instance the question of a broader consolidation which might be required for banking groups. In the field of insurance, the "Conférence des Services de Contrôle des Assurances des Pays de la CEE" has set up a sub-group which has started to study the borderlines between banking, insurance and other services. The "High-Level Committee of Securities Markets Supervisors", likewise, has perceived the problems which can arise with the blurring of the frontiers between the various sectors of the financial industries.

What is novel about this Conference is the fact that the authorities responsible for all three sectors are meeting together for the first time at the European level; and as far as we are aware even on national level the extent of inter-disciplinary cooperation between the supervisors of all the sectors varies considerably between Member States.

There are two reasons why we thought a Conference of this novel character would be timely and useful. The first is that supervisors in the three different financial markets represented here are increasingly being confronted by difficult problems arising from the breakdown of the frontiers between different types of financial institution; from the blurring of the distinctions between apparently different financial products (insurance and savings) and from the growth of conglomerates. It seemed to us that it would therefore be of interest to bring together all three groups simply in order to enable experiences to be shared between the different disciplines and between the different Member States. (In saying what I have just said, I am aware that I am already begging one important question. That is whether the phenomenon of financial conglomerates is really all that new. At least one Member State with a universal banking system has, it could be argued, lived with the phenomenon for decades without apparent difficulty. That in itself may provide an interesting point for argument).

The second reason for setting up this Conference is the potential impact of financial conglomerates on the Commission's own work in legislating for the internal market in financial services, which we are all committed to achieving by 1992. I will be talking about this aspect at greater length tomorrow morning; so will not go into detail now. But the possible implications for our work here in Brussels if different prudential and policy solutions are found in different Member States to the problems of supervising conglomerates.

The Commission's approach as you know is based on the triad of harmonization of supervisory rules, mutual recognition and home-country control in each of those sectors - banking, insurance and securities markets. A long series of Directives in each of these sectors have prepared the ground on which mutual recognition and home country control can be based. But this very basis might be jeopardized if all Member States felt the need, and in different ways, to bring in new techniques and legislation to deal with financial conglomerates. Suppose that different countries have different rules as to the structure and composition of financial conglomerates. Imagine individual Member States want to introduce specific rules to avoid conflicts of interest or to guarantee the appropriate capitalisation of an entire conglomerate. If each country follows a different path, we could face a situation in which our coordinating efforts in all the sectors are disrupted and the basis of home-country control and mutual recognition are endangered.

We hope therefore the Conference will concentrate very much on the practical problems which supervisors are having to face as a result of the growth of conglomerates and that we should avoid purely academic debate for example on how to define a conglomerate, except where this is strictly necessary for the discussion.

PROF. GOWER

INTRODUCTION

We are here to discuss the problems posed by financial conglomerates in relation to the planned completion, by the end of 1992, of the internal European market in so far as concerns financial services. If we are to do so we need, as I see it, first to ensure that we are all in agreement about what we understand by (a) "financial services" (b) an "internal European financial market (and the proposed methods of achieving it) and (c) "financial conglomerates". My main task, if I have understood my instructions aright, is in 20 minutes to outline my understanding (or misunderstanding) on each of these and then to allow you 10 minutes in which to question and correct my misunderstandings.

(a) Financial Services

This expression clearly includes all types of service (whether that of marketing, managing or advising) relating to banking, insurance (general and long term), or securities and other investments. Its range is therefore wide - even wider than that of "investment business" which is the expression used in the UK to describe the scope of its Financial Services Act 1986. We do not need to attempt to define its precise boundaries and I do not suppose that the Commission would thank us if we did that. What is clear, however, is that at present most Member States have no regulation of many of these types of financial services. This has obvious implications on the Commission's programme. The object of that must be to provide comprehensive and adequate standards throughout the Community without requiring any country which has effective regulation in some areas to lower its standards - unless these are excessively anti-competitive; in other words, to harmonise up and not down. If adequate harmonised standards throughout the Community are to be achieved by 1992 it will be a remarkable feat.

(b) The European Internal Financial Market

The European Internal Financial Market obviously does not mean just the integration of European organised markets such as stock exchanges and futures exchanges. It includes that, but goes much wider. What is aimed at is a situation in which a firm established to provide financial services in one Member State will be able lawfully to provide such services in every other Member State, so that the former independent national markets are fused into a unified Community-wide market without internal frontiers. And it is clear both from the published statements of the Commission and from the remarkable progress that it has already made, particularly in relation to banking, insurance, unit trusts and mutual funds, and marketing of listed securities, that the main mechanisms for achieving this are envisaged as : the abolition of restrictions on the right of establishment, freedom of capital movements, freedom to provide financial services across frontiers without establishment and, to the extent necessary, harmonisation of legal regulations.

This programme faces obvious dangers which will have to be guarded against and obvious problems, which will have to be solved. The problems are particularly acute in relation to financial conglomerates but before I turn to them may I draw attention to three general points.

The first arises from the distinction which the Commission draws between the right of "establishment" (where, as I understand it, there will need to be harmonised prudential regulation) and freedom to provide services across the frontiers (where the conduct of business and marketing rules of each host State can operate with only minimal Community prescription - though some general harmonised principles may need to be laid down). This seems to assume that once the firm concerned has been tested as fit to provide financial services in the Member State where it is established (the home state), it can safely be treated as fit to supply such services in every Member State and, indeed, that the home state, when allowing it to be established, will have checked that it is so fit. Neither part of this assumption can really be true. Both might be, if fitness depended only on capital adquacy and absence of criminal convictions but it obviously depends on mcuh more than that - including familiarity with the language and legal regulation of the host state or states. It is true that if the firm proves unfit to carry on business in any host country it may ultimately be prevented from continuing to carry on business there. But this will take some time and the objective of initial prevention rather than later cure is defeated. Presumably the Commission feels that that is a price worth paying for greater freedom across frontiers. And maybe it is, having regard to the undoubted fact that it is normally impossible to prevent services being provided so long as this is done without establishing a place of business but (for example) through the post or telephone. Nevertheless, it is a bit disturbing.

My second point is that already in this area a global twenty-four hour market is developing. Not only are links being established between exchanges (including links by those within the Community and those outside) but, thanks to modern technology, an order to a broker in, say, London may be executed immediately on any one or more of the world's financial centres - and, in practice, is often more likely to be executed in New York, Chicago, Tokyo or Hong Kong than within the EEC. Moreover, the technology already exists which will, before long, enable an investor from his home computer instantly to obtain the best quotation being offered by any market-maker anywhere and to have the order executed immediately. The principal obstable at present is not absence of technology, but primitive legal rules, particularly perhaps those relating to formal transfer of securities which lead to inordinate delay and expense in completing the paper-work subsequent to the bargain. This can be solved only by "dematerialisation" of securities, a process which may present peculiar difficulties to those European countries where bearer securities are popular.

If the creation of a European market were to lead to anything in the nature of a cordon sanitaire around it, handicapping European investors in the use and benefits of the developing global market it would be calamitous. They would be deprived of "best execution" and internationally the European market would become a stagnant backwater. The European market has to be seen, as indeed the Commission does see it, as a contributing to the developing global market by substituting one European market for 12 national ones. But is there not a danger that it might prove an obstacle ?

My third point relates to the apparent belief of the Commission that, in the field of financial services, when harmonisation is needed, the same type of harmonisation as that achieved, say, by the Company Law Directives will suffice. In other words, that Directives should lay down objectives, leaving national legislation to provide the means (although Directives have in fact become in fact increasingly detailed). This may have sufficed in relation to the progress made so far but I venture to doubt whether it will in all future parts of the programme. It seems to me that it just is not good enough to say simply that Member States shall not allow the establishment of firms undertaking financial services unless they are satisfied that the firms are fit and proper, leaving each member to prescribe its own tests of fitness. There must, surely, be detailed prescriptions at least on such matters as capital adequacy for each type of financial business ? And, at least in some areas, the same applies, I suggest to conduct of business and marketing regulations. For example, the Commission has identified the segregation of clients' money as a matter on which harmonisation will be needed. But, if a firm undertaking business which impinges on more than one State finds itself subject to different sets of rules in relation to the same transaction or client, it will find life impossible. This is a problem with which SIB, in the UK, had already has to wrestle. The regulatory authorities in the UK, the USA and Australia have segregation rules - but they differ somewhat and, in some circumstances, it is impossible to comply with one without breaching another. If that occurs where all the countries concerned are Common Law Countries which recognise trusts, it is still more likely to happen when two of the Member States are Common Law Countries and the rest Civil Law Countries. And the same applies, I would have thought, to insider dealing. The Commission will need to prescribe the rules - perhaps by Regulations rather than Directives. In such matters, as it seems to me, harmonisation needs to be as near to unification as can be achieved while the Community lacks one common language.

(c) Financial Conglomerates

Belatedly, I turn to "financial conglomerates". The meaning of this is clear and so is the fact that financial conglomerates pose particularly grave problems for the Commission's programme - we would not be here if they did not. We mean firms which, instead of carrying on a single type of financial business, carry on several. It matters not whether they do so throught separate incorporated companies or through branches or departments. It will be tempting to try to solve some of the problems by requiring separate incorporation of certain types of business and for each separate establishment in the EEC. I hope this temptation will be resisted. Business structures should be determined by the commercial needs and not by the convenience of bureaucrats.

This introduction is not the place to attempt to itemise the particular problems thrown up by conglomerates. Many of them are identified in the Third Commission Working Paper and others will doubtless emerge in the course of our discussions. And some are self-evident; for example assessing capital adequacy, increased opportunities for insider dealing and conflicts of interest or of interest and duty (the Bank of England, in one of its papers on "Big Bang", identified 14 possible conflicts arising from a single transaction by a conglomerate).

All I want to do in concluding this introduction is to emphasise that here we are dealing, not with a situation which will or may arise, but with one that is already with us. In the UK, for example, the greater part of all types of financial services is now undertaken by and through financial conglomerates. They control all but one of the major member firms of the Stock Exchange. Some are "pure" financial conglomerates, others also carry on a wide range of industrial and commercial activities. For example, BAT combines its traditional, but declining, tobacco interests with a range of financial ones. The Burton Debenham Group, which originally arranged for a stock-broking firm (itself part of a multi-national financial conglomerate) to run share shops in its department stores, now itself operates such shops. The clearing banks now control broker/dealers, mechant banks, insurance companies, unit trust management companies, insurance brokers, estate agencies, etc.

The major financial conglomerates operate globally. In the case of the most powerful their homes and heads are not in the Community but in the USA or Japan. The more dubious conglomerates operate from off-shore financial centres with lax or no regulation. All this aggravates the problems of Community regulation. Moreover, as the Working Paper points out, of the Member States, only Denmark (and it only since the first of January) has a single regulatory authority for all its regulated types of financial services. That is typical of the non-EEC world also : the only other country known to me that has a single authority is Signapore. Most have at least three. That may change as a result of the "Crash of 1987"; it has been suggested in the USA and in the UK that a single overseer is needed and that it should be the banking regulator. Since banks now dominate so much of the financial services industry that makes some sense and might solve some problems more effectively than consultation between several regulators. But the suggestion has not gone down well with the other regulators and has not, in my view, been thoroughly thought through.

My 20 minutes is up. I have, I fear, said too little about conglomerates and too much about other matters. But I though that background was what was needed at this stage in our deliberations and I hope that I have at least proved sufficiently provocative to encourage you to fill the next 10 mintes.

Discussion after Prof. Gower's speech

Mr. Fitchew :

Thank you very much indeed Prof. Gower for what I think certainly from the Commssion's point of view is both a stimulating and a provocative presentation. Provocative in the sense that you were I think at certainly one point suggesting that we should go down a rather different road from the one we are actually going down. Namely in your suggestion that our legislation will need to be more rather than less detailed; in particular you suggested that we needed not to follow the example of the Company Law Directives, which you described as being concerned essentially with the principles and leaving the Member States to fill out the details. I have to say that that is a suggestion which certainly took me by surprise, because if anything, since I am also responsible for company law, as well as financial markets, on the whole the approach that we have been following, is precisely the opposite, namely that we have taken the view that company law directives do not present a good model, because they are if anything too detailed. I would like to ask two specific questions arising out of what you said :

1. Is there a conflict between the point to which I just referred, namely your view that we ought to be going down the road of more detailed harmonisation, is there a conflict between that and the second phenomenon which you identified, namely the globalisation of the market and the fact that any individual investor, anywhere, with a home computer will, sooner or later, if not already, be able to contact a supplier of financial services, a dealer, anywhere else in the world, not merely in the major financial centres, but in the off-shore centres as well, and do a deal on his own terms. Is the kind of detailed approach to regulation, which you are suggesting for the Community, compatible with that kind of world ?

2. You raised the question whether the fact that a bank, or an insurance company, which is considered to be fit and proper in one Member State, really qualifies it to do business in another Member State ? It seems to me there is rather an interesting comparison there with the manufacturing sector, where there is no test of fitness and propriety applied in the manufacturing sector. Why should one go beyond the simple tests of deciding whether these people are fit and proper people to run a bank, the kind of

people that you are prepared to see in charge of a bank in terms of their previous experience, their honesty and integrity and so on, and capital adequacy being the two main tests. I must say I remain unconvinced by the need to test their language ability and their knowledge of local legislation, it seems to me clearly if they want to do business in other Member States, they will make sure that they are equipped in that way and it is not the business of supervisors to determine that aspect of it.

Reply by Prof. Gower to these questions

I intended to be controversial and provocative and I seem to have succeeded. All I think I am saying is that there are many areas, and I think this is one, where harmonisation in the sense that you merely prescribe general principles and leave the details to be worked out, just will not work. You have got to have something approaching unified regulation in so far as that is possible, so long as we don't have a single language throughout the whole of the Community. You will never get complete unification while the language is different, because regulation depends on words and the translation of words from one language to another immediately alters to some extent the content, but I do not believe that you can really achieve what is needed without doing your damnedest to have unification.

Your second point, I think was : "is that approach not in conflict with the fact that somehow the European market has got to be regarded as part of the growing global market ?" I would have thought the answer is, far from its being in conflict, it's an essential part of it, but that is perhaps more arguable. So far as banking is concered, I think it is correct what you have said about fitness in one place may suffice to show fitness everywhere, but we are not dealing in this programme only with banks, we are also dealing with individual investment advisers for example, and they may be individuals. It just is ludicrous, to me; I might be able to pursuade the Securities and Investments Board that I am a fit and proper person to act as an adviser in the United Kingdom, I imagine Kenneth Berrill will shake his head at that, but still it is just conceivably possible. But the idea that because I have been allowed to undertake that, means that I am a fit and proper person to advise Greeks on investments in Greece, is absolutely ludicrous. In other words, if you think you can apply the bank analogy to every branch of the financial services industry, I think that you are wrong.

Mr. Fitchew

I think I accept that point certainly in relation to investment advisors and rather for that reason, we have ......

Interruption by Prof. Gower

At the moment you pretend to have some sort of harmonisation of insurance brokers, with a directive on this, but it does not mean much.

Mr. Fitchew

I accept that point as well, the reason why is that there are a host of other obstacles which have prevented the investment intermediaries directive from working in practice. Could I ask whether anyone else one from the floor would like to put any questions to Prof. Gower at this stage ?

Mr. Boye-Jacobsen

You thought, Prof. Gower, that company law directives only set out objectives. I think if you take, for example, the fourth company law directive, I can not imagine even a national law being more detailed. The only thing you could do to stop the choices which Member States have is simply to say there are no choices. Is that what you mean ? That is my first question.

My second question was, you said that when you dematerialise the papers, or if you have bearer shares, then you would have international problems. Why ? We in Denmark happen to have both and we think we have an advantage there and not a disadvantage. Why should there come up problems ?

Prof. Gower

It seems to be generally accepted that if one is to solve the back-office problem in investment dealing, the great problem is not so much completing the bargain, but in the formal transfer of the investment after that has been done, and everybody is saying the only solution of this is to dematerialise securities, so that the whole thing is done on some computer, which should enable it to be effected immediately. I do not see how you can dematerialise a bearer bond. It may be that there is no problem, but I suspect there is; I mean, somehow you have got to have a system whereby the man who has bought his bearer security, gets the bearer bond. That, in some countries, clearly is presenting grave problems.

PART 1: GENERAL OVERVIEW OF THE PROBLEM

General presentation on recent history of and perspectives for the development of financial conglomerates and the breakdown of frontiers between different types of financial institutions and products

Mr. Padoa-Schioppa

The blurring of financial frontiers: in search of an order

Summary

I. INTRODUCTION

The calling of this Conference is in itself a sign that the Commission is becoming increasingly aware of the need not only to dismantle national frontiers but also to help manage a period of financial change that affects markets, institutions, and supervisors. This attitude is to be welcomed.

To be in tune with the Conference and well briefed about the Commission's thinking I have carefully read the "Third Commission Working Paper on Financial Conglomerates". Let me say that while the subject of this Conference is exceptionally stimulating and topical, the paper does not fully render the scale of the change under way or the extent to which some longstanding basic features of our financial systems are now being challenged.

The expression "blurring of frontiers" conjures up the idea of changes in the man-made administrative superstructures of an immutable physical geography. But what we are witnessing, I suggest, are important earth tremors, if not earthquakes. And, to describe what is happening, some countries have even drawn an analogy with the cosmic event of a "big bang".

I shall not redescribe or seek to interpret the rapid financial changes that are taking place worldwide. Inflation, uncertainty, progress in telecommunications and incentives to circumvent regulations have frequently been identified as the driving forces. Not only new instruments but also new intermediaries have emerged. Many of us have the impression of living through a period of parallel and interconnected change in financial markets and regulatory frameworks of an intensity not seen since the thirties.

Indeed, some of the pillars that were erected then are now being seriously questioned for the first time. October 19 has only strengthened a sense of urgency that was already there. Enthusiasm about deregulation has cooled not only among supervisors but also among market participants. Almost universally, the search is on for regulatory principles that will be consistent with the new shape of financial markets.

In Italy this process is taking several routes, all converging, I would say, on the objective of 1992. One is to contribute, as constructively as we can, to the drafting of the Community directives that will provide the legislative basis for a unified European financial market. Another is to use the ample room for manoeuvre allowed by Italian banking law to reshape our regulatory framework in line with the emerging Community legislation and the requirements of a continental market. Yet another is to modernize and complete our legislation to meet the need for a more efficient securities market and effective control of non-bank financial intermediaries. It would be hard, in this process, to disentangle the national from the international strands of the problem. This, in itself, is a sign of the times.

My remarks are based on two firmly held convictions. First, the process of financial change is such that we have to examine, and sometimes to re-examine, the very foundations of our financial systems and regulatory frameworks. Second, we have to do this together, i.e. at an international level, because one of the key aspects of the process is the blurring of national financial frontiers. This is why I will try to draw, albeit sketchily and tentatively, a comprehensive picture. I shall start by reviewing our conceptual framework and then address selected issues with which we are concerned in our work.

II. THE CONCEPTUAL FRAMEWORK

II.1 Contracts

To understand the blurring of financial frontiers and the problems it poses, it is necessary to start by considering the different categories of products that are exchanged in financial markets. This is because the blurring has its origins in the interbreeding of contracts that used to be separate and associated with specialized institutions.

Fundamentally, contracts signed on financial markets fall into three broad categories: insurance, equity, and debt.

Insurance provides for the transfer of risks from individuals to institutions that pool them with many others of the same kind. To some extent this risk-sharing function is, of course, performed by every contract spanning the future, but the unique feature of insurance is that, at least in principle, it allows the insured to shift all the risk-burden onto the insurer.

At the opposite extreme, equity typically involves uncertainty about both the flow of income that will accrue to the holder and the capital value of the investment. Such uncertainty exposes shareholders to the risk of incorrectly assessing the performance of the firms on which their capital and their earnings ultimately depend.

Finally, debt can be seen as covering an intermediate area, since the nominal value of the asset is certain. The holder of a debt contract nonetheless incurs both an interest rate risk, since its market value may fluctuate with general market conditions, and a credit risk, i.e. the risk of the debtor being insolvent. Depending on the difficulty of assessing the solvency risk, the debt may or may not be negotiable; in other words, a bond or a loan. Bonds are typically issued by medium-sized and large firms with well-established reputations, so that the solvency risk can be assessed by potential investors on the basis of general market indicators. By contrast, loans require a thorough and costly credit-evaluation process and their non-negotiability stems from the duplication of information costs that exchanges of such claims would entail.

If insurance, equity, and debt exhaust the basic taxonomy of financial contracts, the recent wave of financial innovation has extended the domain. By blurring the frontiers of the specialization of intermediaries, it has created new financial products that increasingly mix the features of the different basic contracts. NIFs, FRNs and options are examples of contracts that combine insurance and debt features. Convertible bonds stand mid-way between bond and equity financing. Loans are transformed into bonds, with securitization eroding the distinction between negotiable and non-negotiable debt. Finally, unbundling involves splitting the basic contract underlying bonds into different parts that circulate separately.

II.2 Institutions

The relationship between financial contracts and institutions is often less simple and straightforward than one might wish. This is true not only in fact, since the different categories of contract are often to be found together in the balance sheet of a financial institution, but also in principle, since the intermediation of a financial institution may be logically necessary for certain contracts, while for others an "impersonal" capital market may be a sufficient link between savings and investment.

Let me briefly elaborate on this point. Insurance and loans (non-negotiable debt) have to pass through the balance sheet of an institution in view of the nature of the underlying contract. Insurance contracts need specialized institutions, because their profitability for the insurer ultimately depends on economies of diversification rooted in the law of large numbers. Consequently, it is hardly possible to conceive of a <u>market</u> for insurance without specialized institutions providing services on a large scale.

In the debt market, by contrast, the role of financial institutions changes considerably according to whether the debt contract is negotiable or non-negotiable.

Loans are characterized by the very specific skills and credit-evaluation procedures lenders have to possess. Indeed, it is the costliness and confidentiality of the information on which lending is based that make loans a generally non-negotiable type of debt. One can even argue that, as lending is carried out on a strictly bilateral basis, information costs act as an effective barrier to the development of a wide and efficient loan market. Thus, there is a logical need for institutions specialized in collecting savings and channelling them, on the basis of a complex and relatively standardized credit-evaluation procedure, to the most creditworthy final borrowers, if lending is not to be an occasional activity, and develop into a well-defined and important economic function. Historically, this basic function has been performed by banks, which could draw on the technical expertise and confidential information acquired in making payments on the customers' behalf.

The "delegation" inherent in banking needs to be stressed. When savers deposit their funds with a bank, they entrust the final decision as to where they should be placed to the bank's management, confident of its superior credit-evaluation ability. As a result of such delegation, banks are able to direct funds towards financial uses that would otherwise have been neglected.

There is an essential element of financial transformation in both insurance and banking that makes the intervention of an intermediary indispensable. The funds received from depositors or from insurance policy holders are transformed into assets of a different kind, and the ability of institutions to meet their commitments to customers depends crucially on numbers being very large -- on each institution intermediating a substantial volume of funds.

II.3 Market Making and Delegated Investment

While insurance and loan contracts call for the performance of an intermediary to function, when one turns to negotiable assets, whether bonds or equities, the relationship between contracts and intermediaries becomes more complex and indirect. When the emphasis is on negotiability, the market naturally comes to play a central role. In other words, if such assets are to be widely acceptable, the first requirement is an efficient marketplace.

The efficiency of the market for negotiable assets primarily depends on the pricing system being able to send the appropriate "signals" to all market participants. In this regard, the importance of those specialized operators who supply market making services cannot be overstated, since they provide the market with their professional expertise in establishing the "right" prices of assets, thereby facilitating the completion of trades by individual investors. Nonetheless, it is worth stressing that such specialists are but one component of an impersonal capital market, and cannot be called "intermediaries" in quite the same sense as banks. They contribute to the efficiency of the whole market process, but do not receive a direct or indirect mandate from final lenders to choose either assets or final borrowers, nor do they change the nature of the funds received from investors, who remain entirely responsible for their investment choices and bear all the associated risks.

However, other institutions, such as unit trusts, pension funds and portfolio management companies, also participate in the market, though they are neither necessary for the smooth working of the market nor foreseen by the contractual forms underlying the assets traded. The economic rationale of such institutions is to be found in the economies of scale in gathering and handling information and the scope for risk diversification offered by large portfolios. The growing complexity of financial markets, and the application of new technologies to centralized information management, considerably enlarge the role of institutions of this type. What matters, for our purposes, is that, despite the significant differences, all institutions that collect funds for discretionary investment have a delegated investment power very similar to that of banks. Like banks, they are entrusted with the task of channelling the final investors' funds towards the most profitable uses the market can offer, performing in various degrees that transformation function which used to be the banks' exclusive domain.

The blurring of financial frontiers enhances the fiduciary role played by such institutions, while the blend of basic contractual into innovative assets makes it more difficult, not only for individual investors but also for institutions, to assess the risks involved.

The provision of market-making services and delegated investment are conceptually distinct activities, requiring different skills and involving different risks. Moreover, their association may give rise to conflicting interests, because the necessary neutrality as to the level at which securities prices are set may be threatened by the same institution acting as an investor, whether on its own or on the customers' account.

Thus, I think that the time-honoured distinction between insurance, banking and securities institutions - based on the now questionable assumption that the underlying contractual forms could be neatly and rigorously identified - should perhaps be treated as subsidiary to the more general distinction between suppliers of market-making services and institutions with a mandate to make investment choices and a transformation capacity.

Needless to say, drawing a clear demarcation line between the two fields may prove a difficult task. Examples of institutions engaged in market making and delegated investment at the same time can be easily found in each of our domestic financial markets. However, I do believe that by adopting the proposed binary scheme we can gain a deeper understanding of the phenomenon of financial conglomerates and its implications for the regulatory system and the stability of financial markets.

II.4 Instability and regulation

It may not be an exaggeration to say that the crucial role in a growing economy based on the division of labour is actually played by the financial sector. The efficiency of the allocative process and the stability of the economy are heavily dependent on the ability of this sector to combine efficiency and stability in the performance of its monetary, credit and payment functions. Efficiency and stability interplay in a complex fashion. While in the short run there may be a trade-off between the two, in the longer run they are mutually reinforcing.

This is true of all forms of financial activity and makes financial markets inherently unstable. If the "fundamental" values of assets, regardless of their contractual form, are unknown, rumours and misleading or false information from whatever source may cause "manias, panics and crashes".

Financial regulation is thus the authorities' attempt to achieve the maximum efficiency of the financial sector while averting the risk of its transmitting potentially uncontrollable shocks to the real economy.

The primary public interest, and hence the first task of regulation, is therefore to make the market efficient in managing information and pricing financial assets. This is the basic aim of all the forms of intervention regarding the market as such, the behaviour of its participants, the procedures for matching supply and demand, disclosure requirements and the setting of contractual standards. Such interventions take the form of "rules of conduct" and are concerned with the <u>transparency</u> of the market.

However, even a properly organized and efficient market is unlikely to be exempt from the danger of financial crises. Not only are standards and rules of conduct incapable of removing all market imperfections, but most economic systems adopt a policy designed to prevent the occurrence, and lessen the macroeconomic consequences, of severe financial shocks caused by the failure of a financial institution to meet its payments obligations or a sudden collapse in the public's confidence. Either of which could severely affect a large number of savers. Accordingly, regulations are put in place to enhance confidence in, and the stability of, institutions entrusted with the management of savings. Such provisions usually go under the name of "prudential regulation" and are concerned with the stability of the financial system.

It can therefore be seen that the concepts of entrusted funds and delegated investment or placing power are crucial if the domain of prudential controls is to be appropriately defined. From this standpoint, it makes little difference whether the institution to be shielded against financial instability is a "bank" or a "mutual fund". Ultimately, what matters is whether that particular intermediary does or does not have the power to allocate and transform funds on behalf of depositors or investors. (As I shall argue below, however, banks continue to hold a special place in this broader category.)

The growing complexity of financial markets and intermediation thus leads, somewhat paradoxically, to the need for greater generality and simplicity in the conceptual base of the regulatory framework. And I would suggest that this need can be satisfied by starting from a binary scheme that orders the vast array of regulatory functions and interventions into two main domains: market transparency and the stability of the financial system, respectively safeguarded by rules of conduct and prudential controls.

Two considerations need to be taken into account if regulatory functions are to be correctly organized along the lines of this binary scheme. First, in a sense both transparency and stability are indivisible social goods. Second, these social goods should be protected by two different authorities. Let me briefly explain these two points.

Stability is an indivisible social good not only because the danger of contagion would be greatly increased if the oneness of the financial system were not matched by an equally unique regulatory framework, but also because the blurring of financial frontiers means that any segmentation or loophole in the system of prudential controls could have perverse consequences. In this regard, for example, mosaic-type supervisory arrangements - whereby each company in a conglomerate is supervised by a different authority - is almost certainly undesirable. Similarly, just one responsible authority may be necessary to achieve efficient markets through general rules of conduct and avoid the risk of differences in contractual information and trading standards leading to undesirable arbitrage between the various parts of the financial market.

While indivisibility implies that each of the two domains should be covered by a single authority or by closely coordinated authorities, as a general rule, separation implies that the authority responsible for prudential supervision should not be the same as that in charge of market transparency. The task of ensuring the stability of the financial system and preserving the public's confidence requires confidentiality of information and discretion in dealing with individual cases, whereas such an approach could actually be counterproductive when the transparency of financial operations is the primary objective. However, the desirability of a system of "checks and balances" in no way implies that the two goals are in conflict; quite the contrary, they are basically complementary and must be pursued consistently by the authorities to which they are entrusted.

It is beyond the scope of this paper to analyze regulatory instruments and discuss how they should be assigned on the basis of their primary objective in line with the binary scheme suggested above. Further work is needed to reach such a stage. Tentatively, one can envisage a small set of basic instruments -- such as licensing, capital requirements, fit and proper criteria and prudential returns -- to be applied to all market participants. But this common framework would be supplemented for each type of institution by other provisions reflecting its peculiarities. For instance, actuarial reserves cannot reasonably be applied to anything except insurance companies; on the other hand, deposit insurance, discretionary supervision and lending of last resort would naturally be limited to banks. Conversely, market making institutions, such as brokers and dealers, should be subject to disclosure requirements, anti-fraud provisions, regulations governing selling practices, investor protection rules and others specifically designed to regulate activities not involving the allocation and transformation of funds on behalf of investors.

III. SELECTED ISSUES

An immediate implication of the foregoing analysis is that all institutions with a mandate from their customers to choose either assets or final debtors should be subject to a consistent set of prudential controls: authorization and monitoring by a supervisory body; solvency requirements; limits on risk concentration; managerial competence and integrity criteria, and so on. The regulatory frameworks of most countries were designed for a system of specialized financial institutions in which the bulk of intermediation was carried out by banks. They are no longer appropriate because the formation of conglomerates and the development of non-bank institutions managing large amounts of savings on the basis of customer mandates make it increasingly difficult to ensure the stability of the whole financial system by controlling only one category of institution, however important this may be. Moreover, the various parts of the financial system have become so interlinked that the mere fact of considering them as separate is a threat to control and stability.

Apart from this general conclusion, some specific regulatory principles can be identified that may help reduce the risk of systemic instability while financial innovation takes its course. The following is by no means an exhaustive list. The selection was made in the light of the main practical problems addressed by this Conference, but was also influenced by work under way at the Community level and institutional features particular to Italy.

III.1 The Special Nature of Banking

Banking should continue to be considered as a special business, requiring specific regulation.

The particular combination of mostly non-negotiable assets and monetary liabilities makes banking "special" in two ways. Firstly, it results in the banking system being the principal channel for the transmission of monetary policy, not only because deposits happen to be the main component of monetary aggregates but also because the low short-term substitutability of bank loans results in fluctuations in the volume of bank lending influencing aggregate investment and hence economic activity. Secondly, it means that banks play the key role in the payment system, since the book-keeping nature of deposits entails that banks themselves have to handle the complex process set in motion by their customers' payments.

The unique role of banks in the credit, monetary and payment systems is also the reason for the special systemic risks associated with banking. In particular, it exposes banks -- alone among financial institutions -- to the risk of "runs", that is to sudden and massive withdrawals of funds as a result of depositors losing confidence. Apart from threatening the solvency of the institution concerned, runs tend to be contagious, so that if the bank in trouble is large enough the run may well spread to other banks in the system, with the risk of a general disruption of banking activity and a deflationary impact on the real economy owing to the evaporation of a sizable part of the money stock. Moreover, even without a collapse in depositor confidence, the failure of a bank to meet its payments obligations, whatever the ultimate cause, may trigger a crisis leading to widespread disruption in the payments system as a whole.

Recognition of the special nature of banking not only implies that banks have to be subject to more thorough controls than other institutions with delegated investment powers, but also requires general prudential controls to be supplemented with more flexible and specific methods of intervention. Lending of last resort is of fundamental importance in this respect, since it not only provides monetary authorities with an effective tool for imparting macroeconomic impulses to the banking sector in normal times, but also enables them to inject liquidity into the financial system in the event of a crisis.

Newly created types of finance, such as leasing and factoring, based on a case-by-case assessment of borrowers' creditworthiness really belong to the field of banking, regardless of whether they are supplied directly by banks or by other institutions which raise funds by issuing bonds or borrowing from a bank. Such institutions are involved in "banking activities" and are thus exposed to the risk of illiquidity, which increases with the amount of maturity transformation undertaken. This is why legal provisions and supervisory procedures currently applicable to banks and designed to promote stability should be extended to all such institutions, as the new French banking law has done. This does not exclude graduating regulatory provisions according to the characteristics of each category of intermediary.

III.2 Finance and Commerce

The autonomy of banking is an essential condition, both for the efficient allocation of resources and for the stability of the financial system. Too tight a link between banking and commerce could give rise to instability and cause a potential conflict of interest between banks and their depositors. Historical evidence supports this general conclusion.

The separation between banking and commerce is usually enforced through provisions, often embodied in banking laws, regarding participation links or connected lending, or both. There are several examples of the former: the US Bank Holding Company Act; the Dutch law enabling bank supervisors to limit the voting rights of certain bank shareholders; and the Belgian "Protocol on the autonomy of the banking function", according to which the directors of a bank undertake to assure its autonomy vis-à-vis the interests of the controlling shareholders. The second type of regulation exists in almost every country, although it takes different forms: a typical example is the German provision requiring a loan to a shareholder of a bank to be unanimously approved by the Board of Directors.

In Italy, recent decisions taken by the competent Interministerial Committee have strengthened the regulations in this field. Non-financial companies will not be allowed to acquire, directly or indirectly, a dominant stake in the share capital of newly founded banks and the restrictions on connected lending have been tightened.

The blurring of financial frontiers has two important consequences for the relationship between banking and commerce.

The first concerns the informal role and the unwritten rules of bank supervisors when control in a bank changes hands. Both are crucial to maintaining the separation between banking and commerce, and derive their strength from the desire of all the parties concerned to comply with the behavioural rules of the club. The blurring of national boundaries undermines the effectiveness of such unwritten rules and makes it necessary for such informal provisions to be transformed into formal regulations. In so doing these provisions will have to be harmonized, if we are to avoid creating a serious source of distortion within the unified European market.

The second consequence, which is not related to the process of internationalization, is due to the emergence of non-bank institutions as major delegated investors of of savings. The conflict of interests affecting banks may also arise for such institutions. Accordingly, the issue of "banking versus commerce" becomes one of "finance versus commerce".

III.3 Banking and Insurance

Although most countries' legislation makes a clear distinction between insurance companies and credit institutions, the practical effect of this distinction has traditionally been diminished by two kinds of blurring: the development of products combining insurance and financial features and the establishment of ownership links between banks and insurance companies. While neither of these developments is new, both have acquired new impetus in the recent wave of financial changes.

The grafting of financial contracts onto insurance contracts is almost as old as the insurance business: indeed, it has been traced back to the 17th century. Recently, the share of mixed products in households' portfolios has grown and the marketing channels of insurance and financial products have increasingly overlapped.

The ownership link has its rationale in the analogies between the two categories of institution: both produce information about their customers, have liabilities that are fixed in nominal terms, and act as financial intermediaries, with highly-diversified portfolios.

However, neither of the two links is without its problems. When a bank enters into a commitment that does not result in a specific balance-sheet entry, it becomes difficult for both depositors and supervisors (and sometimes even for bank managers) to assess the riskiness of the bank's overall position. Similarly, the unrestricted production of financial instruments by insurance companies could distract them from their core business. On the other hand, the establishment of ownership links between banks and insurance companies may weaken certain prudential regulations concerning banks. As Professor Schneider points out in his report, the limits on banks' large exposures could be circumvented by a conglomerate in which the insurance company supplies the loans that the bank is not allowed to make. Thus, the blending of insurance and traditional banking, if not adequately monitored and regulated, could accentuate instability.

The banking and insurance sectors are by far the oldest components of our financial systems. Operations, customs, and prudential controls differ in the two sectors as a result of a historical process spanning several centuries. Today, it would be unwise to make radical changes in this institutional framework merely as a reaction to a market trend that is not yet consolidated. It would be preferable to reinforce the existing apparatus, by giving appropriate powers of intervention to the public bodies already operating in the two sectors and providing for closer coordination of their activities.

In Italy, the links between banking and insurance have recently been reviewed by a special Ministerial Commission and in a hearing of the Bank of Italy's Governor before Parliament. The emerging view is that, in principle, there are no objections to banks acquiring controlling interests in insurance companies and viceversa, as long as adequate provision is made for the managements of the two sets of firms to be kept separate and provided the relative size of the two companies is such that the link does not alter the nature of their business. The acquisition of controlling interests in banks should be avoided when the insurance company in question has substantial links with non-financial groups.

III.4 The Securities Market

In the aftermath of last October's stock exchange crisis, the regulation of the securities market has become a major cause of concern. It is now widely agreed that the matter deserves to be reassessed, both because the present legislation governing securities markets is generally more fragmented and heterogeneous than that applying to other forms of financial activity, such as banking and insurance, and because this lack of uniformity may be particularly costly in a segment of the financial system that is becoming "global" more rapidly than any other.

I have suggested that such a reassessment should perhaps lead to a sharper distinction between regulation aimed at the market as such and prudential requirements applying to institutions that, in the normal course of their activity, operate in the securities market predominantly on behalf of final investors. In a sense, regulating the narrowly-defined securities market should be seen as quite different from regulating institutions involved in the securities business. While I have so far dealt with the latter issue, let me now touch upon the former, which I called market-making regulation.

In a well-functioning market for negotiable assets two requirements have to be satisfied: one concerns the price setting mechanism, the other the publicizing of information regarding financial assets.

The process whereby the price of a negotiable asset is set is a highly complex one that requires technical infrastructures, clear procedures and specialized operators. To clear demand and supply effectively, and thereby perform their allocative function, prices should continuously reflect all the available information about the assets traded in the market. Consequently, there is an obvious public interest in improving the efficiency of the price formation mechanism. However, achieving efficiency in the sense defined above does not mean that prices will never jump, nor that the expectations of economic agents will always be fulfilled, even less that "widows and orphans" will never lose their money, nor even that those to whom they entrust their savings will always prove worthy of their confidence. There will always be events about which information is simply not available, or bits of relevant information that are withheld from the market, so that they cannot be discounted in the formation of prices. Indeed, the regulations and supervisory authorities governing the price setting mechanism should be neutral with respect to the interests of final borrowers and lenders, and aim exclusively at enhancing the overall efficiency of the process itself.

It should be a part of this regulatory function to ensure such neutrality among specialized market operators. In other words, rules should be designed that will prevent firms professionally involved in the price setting process from exploiting their privileged position to pursue aims that could conflict with their primary function. The risk of conflicting interests may increase as a result of the tendency for large brokerage houses to function ever more also as investment banks, by offering their customers securities in the form of mutual funds and other accounts. Security companies of this type, which in the United States and Japan have already yielded a considerable market share, provide their customers with both market making and delegated investment services; as a result, the appropriate regulation to which they should be subjected may become a matter of dispute. To my mind, it would be unwise to ignore the risk of instability that could result from an unregulated blurring of market-making and delegated investment. On the other hand, it would perhaps be unrealistic to deny the economic reasons that underlie this market trend and dispose of the problem through a wholesale prohibition to engage in both types of business. Rather, the rules that company managers should adhere to in their daily business should be carefully spelled out, while ensuring an effective coordination of activity between the various supervisory bodies involved.

The second task of securities market regulation is to ensure that access to the market is granted only to financial assets about which an adequate amount of information is made available to the general public. In principle, this function should also be basically neutral with respect to the quality and value of the assets exchanged; its main purpose should be ensure the transparency of the contractual terms offered to investors.

IV. CONCLUSIONS

Public authorities are facing a complex task. On the one hand, financial intermediaries can no longer be safely classified, as they often are in today's banking laws, on the basis of their primary functions. Consequently, it will be necessary to revise the institutional and normative frameworks of financial markets -- a task whose difficulty at the national level will be inversely proportional to the flexibility built into legislations. On the other hand, we must make sure that the process of re-regulation does not infringe the basic regulatory principles I have described.

The complexity of the task is in itself a warning against radical solutions. In my opinion, the idea of building regulatory "Chinese walls", i.e. of introducing a partition between intermediaries or even between different sections of the same intermediary, is no more viable than that of an outright return to "universal" banking. In policy decisions a solid conceptual scheme has to be combined with a large dose of pragmatism if we want to maintain control of a sector that by its very nature has vague contours and is subject to continuous change.

In a period in which the evolution of financial activity is sweeping away not only the barriers of specialization but also national juridical frontiers, it is essential that the effectiveness of supervision should be maintained. Although the "transnational" dimension of financial conglomerates is not yet fully apparent, there are already clear signals, which are bound to grow stronger as 1992 draws nearer, that the market is heading in this direction. The European Council's endorsement of the principles of "mutual recognition" and "minimum harmonization" of the regulations governing financial activity in the member states is a considerable step forward.

However, this may not be enough to ensure stability if supervisory practices are not also made more consistent -- in the first place by strengthening operational cooperation between national authorities. Disparities in such practices, particularly when rooted in differences in basic approach, may well result in cross-border supervisory gaps or inconsistencies. To mention only one example, the formation of conglomerates is prohibited at the moment in some countries, whereas in others not only is it permitted but the direct participations of the parent company alone have to be notified while those of subsidiary or affiliated companies do not. International supervision should clearly remain based on the principle of home-country control, but serious problems can clearly arise if the supervisory arrangements for conglomerates differ significantly from one country to another, especially if some group companies run into difficulties.

Discussion after Dott. Padoa-Schioppa's speech :

Mr. Fitchew

There is one question which I would like to ask, myself, perhaps a rather detailed one, relating to your proposition that there should be a clear separation between banking and commerce. Do you advance that as a two-way proposition, namely that it should imply a prohibition both on the ownership of banks by commercial interests on the one hand, and on the other the ownership by banks of equity participations, particulary in the non-financial sector.

Dott. Padoa-Schioppa

In the Italian system, separation is both down-stream and up-stream and this is also the case with other systems; as you know, it not so for, for instance, in the German banking system. Let me say that the links do not take only the form of ownership-links they take the form of credit-links as well. I am not suggesting that ownership-links should be forbidden in any circumstance both up- and down-stream, I think that to limit the possibilities of developing credit-links in a non limited way when ownership-links exist, may be a way to deal with the problem. I think at this moment the cases in which a bank is owned by a non-banking or non-financial institution are more relevant than those in which the bank itself holds shares of a non-financial institution, so I think that special attention should be devoted to that case, operating either at the level of credit-links or at the level of ownership-links.

Sir Kenneth Berrill

The speaker said that the worry was placing power, or one of the main worries, but of course the placing power is not confined to banks. Big securities houses have very large placing power and in theory one would have the same difficulty of worrying about commercial ownership of large security houses. In practice, one tries to solve that with very strict conduct of business rules in the placing power, in just as the same way as you were suggesting that you might solve the problem of lending to a holding company by the restrictions on lending to any one particular area. I wonder if you would like to develop your worries.

Dott. Padoa-Schioppa

I think what you said is very much in line with what I think myself; the problem exists not only between industry and banking, but also between industry and securities houses holding a large placing power. If an ownership-link exists, then I think, as I understand you do, that particular provision should be designed as to avoid the potential conflict of interest to develop fully and there may well be rules of conduct that help in this way, but I agree that conceptually the type of problem exists in the same way for the two types of institutions.

Dr. Knetschke

I just have one brief comment I would like to make on what Dott. Padoa-Schioppa has said. It is not so much that the introductory question has provoked me in any way; I think if I understood it correctly it simply confirms my view that the problem of conglomerates in banks and insurance companies is not perhaps such a serious problem as it may appear to be. But I may well have misunderstood. One other problem which I think is going to concern us rather more is the link with stock exchange supervision; it seems to us that maybe that should not be so serious either, but the problem for us may well be that in Germany we have the universal banking system, as has already been said, as opposed to countries which have a separation in that field.

Mr. Muller

I think my question goes a little bit on the lines of the remark of Dr. Knetschke, I think I also subscribe to the interesting remark made by Mr. Padoa-Schioppa that there is this problem of the blurring of financial services and therefore blurring of supervisory responsibilities. It is my conception, at least, that at the moment the problem is not so much a problem in the field of co-operation between the supervisors of insurance and banking, on one side, but more perhaps on the co-operation between supervisory authorities in banking, on one side and those responsible for the securities business on the other side. One wonders why should that be ? Maybe, and I would like to have the view of other speakers on this, one of the reasons is that for long it has been a fundamental element in the insurance business that it should be separately incorporated. Even I think that is enshrined in the Directives of the Common Market, so therefore the object of the prudential regulation is legally in a different angle from the banking industry and therefore perhaps it is easier and less problematic to co-operate. In the securities business more and more people are working from their responsibility for the stability of the market, they also realise that there is a fiduciary element in it if you want, because for the stability of the system very comparable questions have to be looked at, such as adequacy of capital, position risk, etc. So then, if a bank is dealing in securities, and it does, I think in most of the Member States as we have seen, or anyway in the important Member States, you see that the securities supervisor will come close to the banking supervisor, both from the fiduciary aspect and from the stability of the systems aspect, because both look to minimisation of risks. Do you have views on how we can avoid the kind of super-overlap of supervision? I would at least subscribe to Prof. Gower's thesis, that we should avoid making it by looking at the insurance business and saying let us incorporate it separately, because that is the ultimate remedy that will end a lot of the efficiencies for banks and so therefore we should look for other solutions, but perhaps our speaker can give us some views on this matter.

Dott. Padoa-Schioppa

I have more problems than solutions. If one could rethink things from the very beginning, I think that the modern equivalent to pure brokers should be identified again in markets that can fully use existing technologies and then define the figure, the institution, that performs as a pure market maker which has no function of handling savings entrusted to it by savers and have regulation for that function, including perhaps separate incorporation for it and this would belong to the regulation concering the securities market in a narrow sense. I would say that any other function that has to do with securities which are negotiable, whether it is performed by banks or by other investors, belongs to a different ward where the fiduciary element is the key and where regulation should be aimed at re-assuring, so to speak, the market that this fiduciary element is well founded. As this is not the case, because the two functions are de facto performed by securities houses or partly by banks together with other functions, I think that the only answer today is very close co-operation between the authorities supervising the securities market and the authorities supervising the banking business. The area of possible overlappings between these two authorities exists in most systems and is different from system to system, just because the national laws differ. Only a kind of pragmatic solution can be found, not necessarily separate incorporation, but probably a certain degree of separation in the accounting is desirable. The difficulty will inevitably explode at a Community level, because it seems to me that some common basis of regulation at the Community level is indispensable. It is in my view not conceivable that there is no Community doctrine whatsoever for this front that is now the most difficult one; this may be the discussion that will guide us to this minimum common philosophy.

MR. JOLIVET

First of all I would like to say that a meeting such as the meeting that we are having today is a very important event, because I think if you can get all these people concerned with supervision here today, this is something new and something which is very important. Secondly, I would just like to express my thanks to the the Commission and to Prof. Schneider for the work that they have done. I think that whatever discussions we can have and whatever thoughts we might have are bound to be based on the analysis of what is going on in the Community. The work that is being done on the banking side and amongst the insurance supervisers and the amount of research which has been done shows that there is a great deal of variety throughout our Community. I think it is much more diverse and much more fragmented, than I originally thought to be the case. Much more so than I could have imagined in the past. So it is important to have this opportunity to begin to think about the problems, it is an opportunity for everyone to find out what is going on elsewhere in the Community and it is an opportunity to consider the difficult matter of how to define a financial conglomerate. This is very important, it is something which is new and it gives us a great deal of food for thought. Obviously, we have got to consider conglomerates in general, and more particularly financial conglomerates, these are questions which concern us all in our various countries, at different levels. It is something we are beginning to become more familiar with and we are beginning to ask more questions about. I think that this is a good opportunity in this Conference to recall these facts, because it is quite clear that if the Internal Market, particularly the financial Internal Market, is going to run smoothly, this matter is of primordial importance. The questions that we have to ask here in this forum are perhaps different from the questions that we might ask individually back in our home countries, even if they are all interlinked.

The first thing I would like to consider, and I think it is very much the focal point of our whole discussion, is the idea that financial conglomerates have become a pretty much irreversible phenomenon. Particularly if we feel that this is something for the future, it is not something which involves us today, but we are taking here about specialisation. At the same time we have got to consider another phenomenon which is the progressive predominance of demand over supply in the financial field. First of all let me consider the question of specialisation. Obviously I will be referring more specifically to insurance here, but specialisation is a phenomenon which is very easily understood, it is very strictly dealt with by the European Directives in this field and we can understand why. Insurance activities, banking, securities trading these are all different things. In the field of insurance, it is very obvious that the insurance agent is doing something very special, he is entering into very specific commitments, whereas in other fields you could well imagine that it is the saver, for example, who is running the risk, but in insurance things are different. Obviously a lot more specific rules are necessary to cope with this, for example, the existence of technical reserves. We can understand why this is so and we can see that this is very solidly founded, and in fact European Directives are founded on this very principle. Indeed, a working party, chaired by Prof. Angerer, is dealing with this subject and we can see that at the moment this is something which is built on fairly solid foundations.

When we look at what has happened in other countries, we can see that a lot has still to happen. Let me take one subject which is very much at the confluence of savings and insurance, this is the so-called "universal life technique". We can see that this is something which is beginging to find its feet in Europe, but it is still much in the developing stages, therefore it is fair to say that specialisation is something which is still very much up and coming. Of course, if I can put it like this, specialisation justifies what I might call vertical control, vertical supervision, that is supervision of insurance companies and since they tend not to do very much apart from providing insurance then it is quite justified to have this vertical type of supervision. Unfortunately (if I may put it like this), we are now seeing that things are begining to get a little bit more complex, particularly where these insurance products are being manfactured and also distributed and on the distribution side, it is very much in the interest of banks for example to distribute insurance products and even commercial undertakings are distributing insurance products, this is something which is happening more and more now, in earnest. It is also in the interest of the insurance companies to distribute products other than insurance, for example other financial products. Therefore, it is clear that the conglomerate can meet a need here. Distribution is something which can involve a lot of financial operators and the conglomerate is one means of doing this job.

My second point is to stress that there are certain matters which are intrinsic in the development of conglomerates and maybe these are rather new. The most important point is, as I said earlier, that we are faced with a progressive predominance of demand over supply, which is very obvious in the case of insurance, at least in countries where insurance has been developing very rapidly in recent years. Up to now there have not been too many difficulties, for example the insurance market had been undergoing a very rapid development in various countries and that has meant that very often it was enough simply to manufacture your product and it virtually sold itself, where the products were "bought" rather than sold. We are begining to see now that that is no longer the case, certainly not to the same extent.

More important these days is the fact that the consumer of insurance products should have his needs met, so it is the needs that we have got to consider first and foremost. Now that idea converges with the fact that people are more in favour of having one single partner in this field, particularly in the field of assets. It is simply easier if you can have all your problems dealt with by one single firm, questions of credit, insurance, assets in general terms. Where that need can be met over a lengthy period of time, all the more reason for having only one place to go to to meet all your needs and conglomerates can fulfil this continuing need. This happens to coïncide with developments and technologies, these technologies are multipurpose and they make it possible to have quite a diversified form of management which uses specialisation in different products but with the same group of customers.

Of course, there are plenty of other reasons militating in favour of conglomerates, particularly financial ones. First of all, what I might call "synergy" and financial power, this is important, perhaps more important in countries where the markets are not heavily structured. In the case of the French insurance market, which at the moment may not have reached a structural optimum, companies are relatively smaller than they are elsewhere and in terms of financial power, they have to face up to an ever growing market. It is something which has to be viewed on a European and world scale these days and this means that they must obviously wait for developments to evolve. I do not have the answer to all the problems at the moment, you can try to diversify working on the insurance market as your basis, the market that you specialise in and therefore to grow by means of financial integration, or the other option is to diversify, to manage to form financial conglomerates which, in particular but not exclusively, involve banking and insurance. One other reason for developing conglomerates is the fact that banking, securities and insurance do not all grow at the same speed, so you can take things as they come, take things in order and use the various elements of the conglomerate to cope with the most immediate needs. Another very important factor, which has come to light, is the problem of distribution networks. I think that if you look at all the various financial elements which are involved the problem of the distribution network has to be seen as a most important one. We can see how this is important in the banking field, where you have got a banking network, which is perhaps rather too dominant, and when it comes to distributing another product like insurance, this becomes a means of making your distribution network more viable, but we are also seeing rather more polivalent distribution networks with all the problems which go with that, in particular questions of training which are very difficult ones.

Some other factors, which I believe are very important, arise out of the fact that markets these days are all interlinked. The primary markets used to be very much kept separate by rules and regulations, by authorities and by supervision. Now we can see that these markets are begining to interlink a lot more and that is another "raison d'être" of conglomerates and there are some more immediate reasons, for example, deregulation, which may well serve as a motive for forming conglomerates. If you have very heavy deregulation in a number of branches, or if you feel that some of the activities are being transferred at the moment, disintermediation as we call it in some countries, where banks move over to deal with securities for example, obviously this causes difficulties, people are going to want to move over from what they did in the past to the newer activities.

Obviously all this is going to involve very considerable and very difficult adaptations. So, how do we react to all of this ? Do we need to enact further rules and regulations, do we need more supervision ? Well that is a very difficult question to answer. I think, as Mr. Fitchew has said, pragmatism is of the essence. It is probably fair to say that there are different sorts of problems facing conglomerates. First of all it is true to say that conglomerates are not all that new, we had a lot of them even before the war, and perhaps that partly explains why we are rather worried today about conglomerates. It is clear that there are different scenarios involved, I am not going to go through the typology of what sort of conglomerates there are, as a lot of work has already been done on that, so I think we have got to stress some of the different aspects. When we look at the banking sector, or the insurance sector, I would say, they do not in themselves obviously lend themselves to changing into conglomerates. An insurance company is by definition involved in investing in other undertakings, and obviously it is subject to prudential supervision, which sets its own limits, but you already have there an embryonic conglomerate and with a commercial bank or a universal bank which deals with many different fields, we know more or less where we stand. The necessary supervision, whether it be over banks or over insurance companies or over the financial world as a whole, is very much in full working order and we do try to see to it that it remains in that position. As I said earlier, the vertical supervision system is perhaps creaking a little bit, there are problems of coverage which we have already stressed, but it may well not be all that difficult to deal with these if we have the proper co-ordination and dialogue. I think we know what problems are involved and I think they are not too difficult to solve. Things become rather more complicated when conglomerates are organised on the basis of financial companies, or companies holding various portfolios. Obviously we are not so familiar with these problems, because neither the monetary authorities, nor insurance supervisors, nor the stock exchange supervision outfits are in charge directly of this type of phenomenon. So there are new problems here and when the frontiers are opened up those problems are going to become more acute. These holding companies which are neither banks not insurance companies, they are likely to develop further and indeed some countries are going to be showing a particular interest in accomodating these holdings, and that is not going to make things any easier either. So we are going to have to answer all these questions.

I think that there are two questions which are of particular importance, and perhaps I could dwell at some greater length on these. One problem is that at national level we are familiar with the question of group law and if we have this, we have competition law after all, in some cases we have got laws on mergers, although there too, that causes a lot of difficulty across the border. But obviously if we had specific law dealing with groupings, then that might make things a bit easier. I have deliberately mentioned that example because in France we have had a number of public purchase operations which involve the banking sector and the insurance sector at the same time and we realise that in dealing with that kind of phenomenon we are a little bit in the dark and whatever ground rules you use, whether they are in the banking field, in the field of insurance, or in the field of other financial operations, although they are subject to supervision, they are not always suitable rules. Sometimes you have entities involved which are neither one nor the other. They might be holding companies of a type which we are not all that familiar with, so we have to think about them at national level and at European level. To some extent that is an element in replying to the question.

The other point which I would like to deal with specifically, and personally I think it would be very wise to think about it at greater length than we intended to do this afternoon, that is prudential problems. They are of ever increasing importance as you move away from specialisation. In other words, the less legal categorisation you have, the more of a prudential difficulty you are faced with. These matters have already been sketched out, but there are certain fields which are of particular importance, protection of the consumer, of savers, of insurance policy holders. If we have specific areas of control, with the result that the free market situation cannot entirely apply, this is precisely because we need to have proper consumer protection, or protection for savers and that is the kind of thing that we have got to think about. For example, if we can use own funds across the board, which I do not think one should be allowed to do, we would be undermining consumer protection. Another important point in the prudential field is clarity, transparency, that is absolutely crucial. Market operators and savers must both feel that the situation is more transparent. The conglomerate may be neither good nor bad in itself, but it must nevertheless be open, be transparent, so I think a great deal of progess needs to be made in the putting together of consolidated funds. All that work of course has been put on the Commission working programme, but it is very important, that cannot be stressed too much.

Finally I would say that, in general terms, co-ordination of supervision is perhaps even more important than systematic harmonisation, because systematic harmonisation and the inventory to which I was referring at the start, all of these things show that it a very complex field that we are talking about. I think perhaps co-operation and co-ordination in supervision is likely to enable us to make more progress than anything else. So, very briefly, Chairman that is all I wanted to say on this subject, it is quite clear that it is a very difficult and complex area and, of course, when you look at it at European level it gives rise to difficult problems and I have mentioned some of them.

There is one point I would finally like to touch on and it concerns the system of supervision by the country of origin. I think that this is a good system, but it is quite clear that if financial conglomerates are going to make much headway, it might become necessary to sit down and think about the matter again and see to it that this country of origin supervision tallies with the phenomenon of financial conglomerates. That is something which, no doubt, we will have to think about this afternoon.

Discussion after Mr. Jolivet's speech

Mr. Fitchew

May I ask Mr. Jolivet to expand a little bit on the point you raised about group law and the absence of group law. I had the impression, and I may not have understood correctly, that you were suggesting that supervision of a conglomerate might be easier with the existence of a law on groups. I was rather struck by the suggestion in Prof. Schneider's paper, which I thought rather went in the opposite sense, that if you have legislation on groups that normally carries with it the notion that the holding company of the group has full financial liability and responsibility for all the different components and that in a sense seems go in the opposite direction of the proposition that if you have a banking subsidiary which is part of the group or an insurance subsidiary, that it is rather important to keep their affairs separate and ensure that they have their separate end funds and that their accounts are kept separately. I wondered if you would like to expand a little more on this.

Mr. Jolivet

It is a difficult subject, I really wished to underline that there is a connection between the two phenomena, the major phenomena. What one can see emerging are groups involving all sorts of different categories of people. Concerning their legal status one finds common law groups, banking groups which come under the banking law, there are insurance companies which are governed by insurance laws, there are brokers, exchange agents with their own set of laws and basically all these groups could come under the aegis of just one holding company. You might have even more complex arrangements with mutual companies or ordinary companies, it is rather difficult to find your way through. When we have a control exerted as it is on the basis of one company, it is often not possible to see what precedes or what comes after. Generally it is easier to take a look at what precedes though even that is difficult in some cases. It is very difficult to separate the different areas of solvency, but this is a very vital issue, so there are different approaches to the problem. You can extend your controls and have them both before and after. As I said it is a little easier after, it is not quite so easy before, that is to say going back to the financial companies asking for documents, for commitments, and so on. People are not going to like that system and it is difficult to implement it. Sometimes it does not fit in with national traditions and customs nor even with the proper functioning of supervision, and it might even give rise to a conflict between different supervisory bodies, which is never a good thing. I would say transparency is a better solution. If you have transparency, this means that everybody, including the public and also the supervisory bodies, is going to be able to locate what he wants to locate and therefore make an overall assessment. I am not saying that there should be group legislation, but what I am saying is that transparency is a good thing.

Prof. Schneider

I would like to come back to this particular point, because as far as I am concerned, this is one of the essential points to which I have devoted my attention. We do not perhaps need a regulation which covers every possible detail, but we do need something which is not going to give rise to protest and allegation; and so supervision and the law of the company, contract law, criminal law, is not perhaps going to be completely consistent, but at least it should not be totally contradictory. Let me give you an example of what I mean. In company law we have worked upon a solution whereby the holding company is responsible for the developments which might occur within the group, this means that a lot of information has to be provided about the subsidiary. On the other hand, you have the secrecy of banking operations and the protection of certain amount of data, that is to say this is what happens in the financial conglomerate, if I could just follow up this question, do we think that bank secrecy would apply to the company, or a concern, when you are talking about relations between the holding company and the subsidiary ? Does that sort of confidential dimension apply when you are talking about insurance contracts between banks ? If you say yes to that question, you say you have to protect this sort of information, keep it confidential. Can you really than require, under supervisory law, that the holding company takes liability for the subsidiary. There has to be consolidation which means information is given concerning the persons involved in the negotiations. I wonder whether this is being dealt with in other branches of the Commission. I am not going to suggest that there is an answer to this question just yet, but perhaps this afternoon I will come back to this and point out how many contradictions there are at the moment between the laws which cover the different groups and I think that it is our task to smooth out these legal contradictions.

Mr. Jolivet

You have a great many contradictions to solve between competition, concentration and the specific law of different companies, that is the sort of thing one must concentrate upon, but the difficulty of the exercise is very clear, for example look at the draft directive on insurance accounting. This imposes consolidation except where you have a portfolio as a holding company, that is my point and there is the difficulty.

SIR KENNETH BERRILL

FINANCIAL CONGLOMERATES AND THE EEC

EVEN WITHIN A SINGLE COUNTRY, THERE ARE DIFFICULTIES IN REGULATING FINANCIAL CONGLOMERATES EFFECTIVELY AND EFFICIENTLY. THEIR ACTIVITIES WILL NEARLY ALWAYS FALL TO BE SUPERVISED BY A RANGE OF DIFFERENT AUTHORITIES - WHICH COULD BE A GOVERNMENT DEPARTMENT, THE CENTRAL BANK OF THE COUNTRY IN QUESTION, A REGULATORY BODY CONCERNED WITH THE SECURITIES INDUSTRY, AND PERHAPS ONE OR MORE OTHER BODIES. IN THE UK, THE SECURITIES AND INVESTMENTS BOARD (SIB) WAS SET UP UNDER THE FINANCIAL SERVICES ACT 1986, AS I AM SURE YOU KNOW, TO PROVIDE A COMPREHENSIVE AND UNIFORM REGULATORY REGIME NOT JUST FOR SECURITIES, BUT ALSO FOR MOST OTHER FORMS OF INVESTMENT BUSINESS. IT WILL DO THIS IN CONJUNCTION WITH THE SPECIALIST REGULATORY BODIES IT RECOGNISES (INCLUDING THE FIVE SELF-REGULATING ORGANISATIONS AND NINE PROFESSIONAL BODIES). THE SET-UP MAY SOUND COMPLICATED, BUT IN ANY COUNTRY NOWADAYS A NUMBER OF DIFFERENT REGULATORS ARE BOUND TO BE INVOLVED IN REGULATING INVESTMENT BUSINESS, AND WHERE THIS IS THE CASE, PROBLEMS CAN OCCUR.

MOST OBVIOUSLY, IT IS EASY IN SUCH CIRCUMSTANCES TO FIND THAT SOME AREAS OF ACTIVITY ARE LEFT UNREGULATED, LEAVING DANGEROUS LACUNAE BETWEEN THE DIFFERENT REGULATORY REGIMES. SECONDLY, IT IS CLEARLY EXTREMELY IMPORTANT THAT THERE IS GOOD COMMUNICATION BETWEEN THE VARIOUS REGULATORS: THE FORCE OF THIS POINT WAS HIGHLIGHTED DURING EVENTS LAST OCTOBER. THIRDLY, STEPS MUST BE TAKEN TO ENSURE THAT THE DIFFERENT SETS OF RULES ARE NOT INCOMPATIBLE WITH EACH OTHER. AND FINALLY, THERE IS THE QUESTION OF OVERLAP AND POSSIBLE DUPLICATION. IN COUNTRIES WHICH HAVE NOT HISTORICALLY BEEN SERVED BY 'UNIVERSAL BANKS' THE TRADITIONAL LINES OF DEMARCATION IN INVESTMENT BUSINESS ARE GRADUALLY BEING ERODED, WITH CHANGES SUCH AS THE RAPID DEVELOPMENT BY BANKS INTO AREAS THAT WERE PREVIOUSLY THE PRESERVE OF OTHER KINDS OF INVESTMENT BUSINESS. IN THE UK, FOR EXAMPLE, IT USED TO BE THE CASE THAT MEMBERS OF THE STOCK EXCHANGE COULD ACT ONLY IN A SINGLE CAPACITY; BUT FOLLOWING THE 'BIG

BANG' OF 1986 IN LONDON THIS DISTINCTION HAS GONE, AND BANKS HAVE BEEN FREE TO TAKE OVER STOCKBROKERS. WE ARE ALSO WITNESSING A CONSIDERABLE EXPANSION OF THE TRADITIONAL ROLE OF BUILDING SOCIETIES.

IN THIS INCREASINGLY COMPLEX ENVIRONMENT, CO-OPERATION BETWEEN REGULATORS IS ESSENTIAL. BUT THIS DOES NOT MEAN THAT THE VARIOUS REGULATORY REGIMES SHOULD BE IDENTICAL. REGULATORS IN THE DIFFERENT AREAS HAVE DIFFERENT TRADITIONS AND DIFFERENT PRIORITIES. THESE HAVE BEEN DEVELOPED, OVER A VERY LONG PERIOD IN SOME CASES, ACCORDING TO THE SPECIAL NEEDS OF THE PARTICULAR MARKETS, AND THE KINDS OF PRODUCT, FOR WHICH THOSE AUTHORITIES ARE RESPONSIBLE. TAKE, AS A CASE IN POINT, THE TYPICAL CONCERNS OF BANKING AND SECURITIES REGULATORS. CENTRAL BANKS HAVE AS THEIR MAIN CONCERN THE PREVENTION OF SYSTEMIC FAILURE - NOT TO THE EXCLUSION OF ALL ELSE, OF COURSE, BUT AS THEIR OVERRIDING PRIORITY. THIS MEANS THAT THEY HAVE LONG HAD DETAILED RULES ON CAPITAL ADEQUACY, TOGETHER WITH THE POWERS TO MONITOR IT AND THE POWERS OF INTERVENTION NECESSARY FOR THEM TO STEP IN WHEN A CRISIS OCCURS - IF NECESSARY WITH FINANCIAL SUPPORT. NATURALLY, CAPITAL ADEQUACY RULES ARE ALSO AN IMPORTANT ELEMENT IN THE REGULATORY REGIME OF A BODY CHARGED WITH SUPERVISING THE RETAIL INVESTMENT MARKET AND/OR SECURITIES; BUT HERE THEY FORM JUST PART OF THE NECESSARY WHOLE. FOR EXAMPLE, CONDUCT OF BUSINESS RULES - PARTICULARLY THOSE RULES ABOUT HOW A FIRM TREATS ITS CLIENTS - AND CLIENT MONEY REGULATIONS ARE ALSO ESSENTIAL FOR THE PROTECTION OF INVESTORS

THESE DIFFERENCES OF APPROACH AND EMPHASIS ARISE FROM THE ORIGINAL DIFFERENCES BETWEEN THE CORE ACTIVITIES OF BANKS AND INVESTMENT FIRMS, AND EACH HAS ITS VALIDITY IN THE CONTEXT FOR WHICH IT WAS DEVISED. NEVERTHELESS, BECAUSE OF THE WAYS IN WHICH BANKS IN PARTICULAR HAVE IN SOME COUNTRIES EXTENDED THEIR SCOPE BEYOND THEIR TRADITIONAL CORE ACTIVITIES, IT IS ESSENTIAL FOR THE REGULATORY AUTHORITIES IN EACH RELEVANT SPHERE TO CO-OPERATE.

IN THE UK, SIB AND THE BANK OF ENGLAND HAVE TRIED TO TACKLE THIS PROBLEM BY DEVELOPING 'LEAD REGULATOR' ARRANGEMENTS TO COVER THOSE AREAS WHERE BANKING AND INVESTMENT BUSINESS ARE NO LONGER AS DISTINCT AS THEY WERE. THE AGREEMENT REACHED INVOLVES THE BANK PERFORMING ANOTHER CALCULATION IN ADDITION TO ITS NORMAL RISK ASSET ASSESSMENT, WHICH IT IS OF COURSE OBLIGED TO DO UNDER B.I.S. CONCORDAT ARRANGEMENTS. THIS ADDITIONAL CALCULATION ENTAILS TAKING SIB'S INVESTMENT POSITION RISK AND COUNTERPARTY RISK REQUIREMENTS, TOGETHER WITH THE BANK'S RISK ASSET REQUIREMENTS ON OTHER NON-INVESTMENT ASSETS, AND MEASURING THE RESULT AGAINST THE CAPITAL BASE OF THE BANK, AS DEFINED BY THE BANK OF ENGLAND. IT WILL THEN REPORT ITS FINDINGS TO SIB. SIB, THOUGH, WILL BE RESPONSIBLE FOR ENSURING THAT BANKS OBEY THE SIB CONDUCT OF BUSINESS RULES, TOGETHER WITH OTHER INVESTOR PROTECTION REQUIREMENTS, IN THE COURSE OF THEIR INVESTMENT BUSINESS.

THE NEED FOR CO-OPERATION BETWEEN REGULATORS IS AS GREAT ON THE INTERNATIONAL FRONT AS ON THE DOMESTIC; BUT OF COURSE THE ISSUES HERE ARE EVEN MORE COMPLEX. ALL THE DIFFICULTIES ONE MEETS WITH ON THE DOMESTIC FRONT APPLY, AND THESE ARE SUPPLEMENTED BY VARIOUS OTHER FACTORS. TO BEGIN WITH, THERE ARE OFTEN LEGAL RESTRICTIONS ON THE PASSING OF INFORMATION TO A FOREIGN REGULATOR - PARTICULARLY WHERE THAT FOREIGN REGULATOR IS TECHNICALLY REGULATING A DIFFERENT AREA OF INVESTMENT BUSINESS. THIS ISSUE IS ALREADY BEING EXPLORED AT AN INTER-GOVERNMENTAL LEVEL BY THE WILTON PARK GROUP, BUT THERE ARE INEVITABLY CONSTRAINTS ON THE SPEED WITH WHICH PROGRESS CAN BE ACHIEVED: IMPORTANT POLITICAL AND MORAL CONSIDERATIONS ARE INVOLVED, AS WELL AS TECHNICAL ONES; AND IN ANY CASE, CHANGES IN PRIMARY LEGISLATION TAKE SOME YEARS TO GET ONTO THE STATUTE BOOK. ANOTHER COMPLICATING FACTOR ON THE INTERNATIONAL SCENE IS THAT DIFFERENT COUNTRIES WILL OFTEN HAVE DIFFERENT REGULATORY PRIORITIES AND TRADITIONS; FURTHERMORE, THEY WILL BE AT DIFFERENT STAGES IN IMPLEMENTING THEIR PARTICULAR REGIMES. UNIFORMITY IS NOT NECESSARY FOR CO-OPERATION, BUT REASONABLY EQUIVALENT STANDARDS OF INVESTOR PROTECTION ARE. WE AT SIB ARE ACTIVELY CONSIDERING HOW TRANSITIONAL ARRANGEMENTS COULD HELP TO COPE WITH THESE EXTRA LEVELS OF COMPLEXITY ON THE INTERNATIONAL FRONT.

IN THE EEC CONTEXT, THE MOVE TOWARDS CO-OPERATION AND HARMONISATION IS ALREADY UNDER WEIGH, BUT THERE IS STILL FURTHER TO GO BEFORE 1992, WHEN INVESTMENT BUSINESSES WILL BE ABLE TO OPERATE WITH HOME STATE AUTHORISATION THROUGHOUT THE COMMUNITY ON A SERVICES OR ESTABLISHMENT BASIS. THERE IS CONSIDERABLE MERIT IN THE HOME STATE REGULATOR REMAINING RESPONSIBLE FOR CAPITAL ADEQUACY ISSUES. HOWEVER, A BUSINESS WHICH CHOOSES TO OPERATE IN A COUNTRY OTHER THAN ITS HOME STATE SHOULD BE REQUIRED TO FOLLOW THE CONDUCT OF BUSINESS RULES OF THE FOREIGN STATE IN WHICH IT IS OPERATING COMPLIANCE IN THIS AREA CAN BE MONITORED MORE EFFECTIVELY BY THE HOST STATE THAN BY THE HOME STATE, AND IT WOULD IN ANY CASE BE IMPOSSIBLY CONFUSING FOR AN INVESTOR TO HAVE HIS OR HER RELATIONS WITH ELEVEN DIFFERENT INVESTMENT BUSINESSES GOVERNED BY ELEVEN DIFFERENT SETS OF RULES. GIVEN THIS DIVIDED RESPONSIBILITY, WITH THE HOME STATE GIVING AUTHORISATION AND MONITORING CAPITAL ADEQUACY, AND THE HOST STATE APPLYING ITS CONDUCT OF BUSINESS RULES TO A COMPANY WHICH IT HAS NOT AUTHORISED, MY EARLIER POINT ABOUT THE NECESSITY FOR AN ADEQUATE LEVEL OF CO-OPERATION AND EXCHANGE OF INFORMATION BETWEEN COUNTRIES APPLIES WITH ALL THE MORE FORCE. THE SUCCESS OF THE INTERNAL MARKET IN INVESTMENT BUSINESS DEPENDS ON OUR WORKING TOGETHER TO ACHIEVE THIS.

THE UK'S RECENT FINANCIAL SERVICES ACT IS IN PROCESS OF BEING IMPLEMENTED THIS YEAR. AGAINST THIS REQUIREMENT, DRAFT MEMORANDA OF UNDERSTANDING ARE ALREADY BEING DRAWN UP BETWEEN SIB AND OVERSEAS BANKING SUPERVISORS, PROPOSING THAT AN APPROACH SIMILAR TO THAT DEVISED FOR UK INCORPORATED BANKS COULD BE ADOPTED FOR OVERSEAS BANKS WITH BRANCHES IN THE UK. OUR AIM IS TO DISAPPLY OUR FINANCIAL RESOURCES RULES AND CERTAIN OTHER RELATED RULES WHERE THE OVERSEAS BANKING SUPERVISOR IS WILLING TO SHARE INFORMATION WITH US; WE WOULD THEN ASK THAT HOME SUPERVISOR TO MONITOR THE FINANCIAL POSITION OF THE BANK IN QUESTION NOT AGAINST OUR RULES, BUT AGAINST <u>HIS OWN</u> RULES, ON OUR BEHALF. THIS ARRANGEMENT, COMPLEX AS IT MAY SOUND, ACHIEVES THE NECESSARY LEVEL OF SUPERVISION WITHOUT TRESPASSING ON THE TERRITORIAL RIGHTS OF THE FOREIGN STATE IN QUESTION. IT ALSO ALLOWS FOR THE FACT THAT BRANCHES OF BANKS DO NOT HAVE

BANK REGULATORS DO NOT NORMALLY PLACE THE SAME WEIGHT ON THE AVAILABILITY OF LIQUID CAPITAL AS DO SECURITIES REGULATORS. NEITHER DO THEY ALWAYS TAKE ACCOUNT OF THE WIDE RANGE OF INSTRUMENTS AND OR RISKS WHICH ARE INHERENT IN INTERNATIONAL SECURITIES DEALING AND POSITION TAKING. DESPITE SUCH DIFFERENCES IN APPROACH, IT SEEMS LIKELY THAT SECURITIES REGULATORS WILL IN TIME FIND THAT, IN COMMON WITH BANKING REGULATORS, THEY TOO NEED SOME KIND OF CONSOLIDATED SUPERVISORY POWERS IN ORDER TO CARRY OUT THEIR DUTIES TO BEST EFFECT - ESPECIALLY IN THE AREA OF CAPITAL ADEQUACY. THERE CAN BE NO DOUBT THAT IN THIS FIELD THE OVERSEAS OPERATIONS OF BRANCHES OF FINANCIAL CONGLOMERATES WILL REQUIRE CO-OPERATION BETWEEN HOME AND HOST COUNTRY REGULATORS. BUT WHAT OF OVERSEAS SUBSIDIARIES? CAN THESE BE TREATED ENTIRELY BY THE HOST COUNTRY ON THE GROUNDS THAT THEY ARE SEPARATE LEGAL ENTITIES WITH THEIR OWN DEDICATED CAPITAL WHICH CAN BE SEPARATELY MONITORED? IN A LEGAL SENSE THIS IS CERTAINLY THE CASE. IN PRACTICAL TERMS PROBABLY NOT. IF A SUBSIDIARY GETS INTO FINANCIAL DIFFICULTIES CAN THE HOLDING COMPANY IGNORE THE PROBLEM? WILL NOT THE FAILURE OF THE SUBSIDIARY IMPACT ON THE CONGLOMERATE'S OPERATIONS WORLD-WIDE? DOES NOT THE HOME COUNTRY SUPERVISOR WISH TO BE INFORMED, IF ONLY INFORMALLY BY TELEPHONE, OF POSSIBLE CHANGES TO THE SUBSIDIARY? SIMILARLY, IF THE CONGLOMERATE IS FACING PROBLEMS, IT MAY WITHDRAW LIQUID CAPITAL FROM THE SUBSIDIARY AT SHORT NOTICE; AND ONCE AGAIN THE SUPERVISOR OF THE SUBSIDIARY WOULD BE GRATEFUL FOR INFORMAL WARNINGS FROM THE SUPERVISOR OF THE HOLDING COMPANY. (I STRESS THE WORD "INFORMAL" BECAUSE AT TIMES OF CRISIS IT IS THE INFORMAL PERSONAL KNOWLEDGE THAT SUPERVISORS HAVE OF EACH OTHER INTERNATIONALLY, THAT PERMITS THAT RAPID USE OF THE TELEPHONE WHICH IS SO ESSENTIAL.) INTERNATIONAL CO-OPERATION IN AREAS SUCH AS THE CAPITAL ADEQUACY OF FINANCIAL CONGLOMERATES WILL BE AN EXCEEDINGLY VALUABLE FIRST STEP TOWARDS THE GREATER LEVEL OF HARMONISATION THAT REGULATORS THE WORLD OVER WILL NEED TO AIM FOR IN THE FUTURE.

INDEPENDENT FINANCIAL RESOURCES: THEIR RESOURCES ARE THOSE OF THE OVERSEAS COMPANY, AND THAT COMPANY IS ALREADY ABIDING BY THE REGULATIONS OF ITS OWN CENTRAL BANK. SO, LET ME STRESS AGAIN THE TWO MOST IMPORTANT POINTS ABOUT SIB'S POSITION ON THIS SUBJECT. FIRST, THE PROPOSALS DO NOT REPRESENT ANY ATTEMPT BY THE UK TO INTERFERE IN THE RELATIONS BETWEEN AN OVERSEAS BANK BRANCH AND ITS HOME STATE REGULATOR: ON THE CONTRARY, WE ARE HOPING TO AVOID A SITUATION WHERE BANKS SUBJECT TO HOME STATE CAPITAL ADEQUACY RULES PROVIDING PROPER PROTECTION FOR UK INVESTORS ARE REQUIRED EITHER TO COMPLY WITH A SECOND SET OF FINANCIAL RESOURCES RULES, OR TO SUBSIDIARISE THEIR UK OPERATIONS. SECONDLY, THE PRINCIPLE ON WHICH THESE PROPOSALS HAVE BEEN DEVELOPED ARE PRECISELY THOSE OF THE REVISED BASLE CONCORDAT AND ALSO OF EUROPEAN COMMUNITY LEGISLATION - NAMELY, HOME STATE AUTHORISATION FOR BANKS OPERATING ANYWHERE IN THE EEC.

THERE IS A FURTHER POINT WHICH WE HAVE BEEN LED TO REFLECT ON FOLLOWING OUR CONSIDERATION OF THE POSITION OF BRANCHES OF FOREIGN BANKS. SECURITIES REGULATORS TEND TO OPERATE ON THE BASIS OF THE INDIVIDUALLY INCORPORATED COMPANY, OR OPERATING UNIT. INDEED, IT IS ONE OF THE MAIN FEATURES OF THE UK FINANCIAL SERVICES ACT THAT THERE IS NO SUCH THING AS GROUP AUTHORISATION. EACH REGULATED ENTITY MUST HAVE SUFFICIENT CAPITAL TO MEET ITS LIABILITIES TO CUSTOMERS, AND MUST ABIDE BY THE CONDUCT OF BUSINESS RULES. AND BECAUSE THERE IS NO CONSOLIDATED SUPERVISION, THERE IS VERY LITTLE RISK ANALYSIS OF CONGLOMERATES. IN OTHER WORDS, SECURITIES REGULATORS HAVE AT THE MOMENT ONLY SCANTY INFORMATION ON THE STRENGTH OR OTHERWISE OF CONGLOMERATES, BOTH DOMESTICALLY AND INTERNATIONALLY.

BY CONTRAST, BANKING REGULATORS DO USUALLY REGULATE ALL BANK HOLDING COMPANIES, AND UNDERTAKE CONSOLIDATED SUPERVISION OF THE ENTIRE BANKING GROUP'S COMPANIES. THIS PERMITS THE REGULATOR TO GAIN AN OVERALL PICTURE WITHOUT RELINQUISHING THE NECESSARY DETAILED APPRAISAL OF SEPARATELY INCORPORATED COMPANIES WITHIN THE GROUP - THOUGH IT HAS TO BE SAID THAT

Summary of U.S. based connected applicants who have applied for authorisation under the Financial Services Act

	TOTAL	TSA	AFBD	IMRO
Branches of:-				
- U.S. banks	16	13	2	1
- U.S. non-banks	50	38	3	9
	66	51	5	10
U.K. Subs of:-				
- U.S. banks	44	38	2	4
- U.S. non-banks	67	53	11	3
	177	142	18	17
Other non-U.S. branches	93	40	36	17

Discussion after Sir Kenneth Berrill's speech

Mr. Cooke

If we all take the view, perhaps a little bit contrary to Prof. Gower's introductory suggestion, that co-operation rather than uniformity is the essential process which at least begins down the road towards an integration of the financial services sector, then there remains the problem on the passing of information. This is an area where, for banking regulators, at least over the last decade, arrangements have been made in most countries, usually by the enactment of primary legislation, which ensures that banking regulators, dealing with their colleagues in other countries, have the possibility, within the law operating in their own countries, to pass information relating to institutions which operate accross national frontiers without constraint, where this is necessary for supervisory purposes. It seems to me one of the big problems in this whole area of financial conglomerates and the whole area of co-operatation between supervisors, cross-national frontiers in particularly, but also to some degree within national frontiers, is this question of what the law allows, as far as the passing of information in concerned. If we believe that the financial conglomerates are here to stay and that there is an increasing integration of insurance, securities and banking business in these large international conglomerates, then the question needs to be posed. Is it necessary for the law in each national centre, to provide for the free exchange of information, not only between banking regulators to those regulating banks in other countries, but between securities regulators, conceivably insurance regulators, and banking regulators to their colleagues in each of those three disciplines as it were in other countries ? Can the co-operative approach be fully effective, if at least that particular element of national law is not to some degree modified ?

Sir Kenneth Berrill

I feel that the law must allow, desirably the law would allow, pure discretion to the regulators to talk about what they wish between each other both domestically and internationally; that may be difficult to achieve. As a second best, you could imagine the law allowing certain classes of information of a more general kind being passed back and forth, which did not necesarily involve commercially sensitive data about lending to any particular borrower. An ideally complete discretion, with as a second best, discretion to exchange information affecting the overall financial position of any conglomerate operating in the market.

Prof. Gower

In view of the fact that Mr. Cooke has apparently thought I was advocating harmonisation, I was not advocating it at all; I was merely saying that that is what the Treaty, as amended by the recent Single European Act, says is going to happen by the end of 1992. All I was saying is, that if in fact one is going effectively to harmonise then, in my view, in particular areas, the harmonisation has got to amount as far as possible to unification, otherwise insuperable difficulties would be caused. Certainly, if the whole thing could be left to collaboration up to 1992 and beyond, I would not quarrel with that for a moment, but it is not what you chaps have said you are going to do !

Mr. Peter Cooke

I tried to use the word "suggestion" or perhaps I might have better used the word "proposition"; I entirely accept what you are saying. I still think that the process of collaboration as opposed to the process of unification, does pose this very particular problem, which actually needs to be addressed, if collaboration is going to be an effective route and it is a very important problem for a number of countries.

Prof. Gower

I just do not think you can have the needed collaboration if the bankers are going to insist upon reserving banking secrecy.

Mr. Padoa-Schioppa

I agree with the answer which Sir Kenneth Berrill gave to Mr. Cooke's question. I think that bank supervisors should remain responsible for the confidentiality of the information they have. They should be given the discretion to use such information when this is considered to be part of the necessary process of co-operation with other supervisors, including supervisors of say the securities business. An automatic access for information would be a satisfactory answer to the problem. The real danger is that if confidentiality is not kept, information in a way disappears. The access to information that bank supervisors have is very closely related to the confidentiality being preserved. This is why they should have discretion.

Mr. Jolivet

On secrecy between the different people in the financial sector generally this runs fairly smoothly, but the big problems arises when you start talking about taxation. Mr. Cooke is quite right to raise these legal issues, one should indeed look at this question, but also I think it is a question of degree between for example issuing a solvency certificate and other things. The telephone is quite practical in some cases, but it is a real problem; look at insurance, for example, what is going to happen when it becomes possible to provide services throughout the Community if a Japanese company sets up in France, with the right sorts of requirements and characteristics and if it operates properly in France, but perhaps badly in other Community countries ? Suppose they go in for dumping, though of course financial dumping is rather difficult to define, under those circumstances, I would invite them to revise their position, but of course the legal issue remains.

Mr. Muller

I would just subscribe to the answer of Mr. Padoa-Schioppa, vis-à-vis banking secrecy I think ways should be found so that the discretionary powers of the banking supervisors are used to convey information to other prudential supervisors. I think that is very important, that there is some kind of a clause and I think that the law must be changed. It should be only for prudential reasons and it can be done, and I think we all must be aware that often we pass on information received ourselves by colleagues from third Member States and in that case we could only do that with the consent of our colleague in the third Member State. Finally, I would just say to Sir Kenneth that I have appreciated very much his intervention, because there have been some worries also in our country and may I say the frame of mind in which this intervention was phrased gave us a lot of reassurance that we should be able to solve the co-operation problem and I think that is one of the merits of such a session.

Mr. Fitchew

May I just make two final comments. First on the question of exchange of information. I deduce from the interventions made on the floor from the central bank supervisors, that there is a wish on the part of the central bank supervisors to retain control over the "aracana imperia" but that they are willing to share some of the arcana where the need arises. In fact the solution that was suggested on the floor, that is, that the supervisors should be given the discretion to share their information with supervisors of the other financial markets, where the need arises, is precisely the solution which has been proposed in the Second Banking Coordination Directive. That does presuppose, however, that the supervisors of each of the three markets will have to be ready to use that discretion, when necessary. I would like to make one final comment arising out of the morning's discussion, because there is perhaps some misunderstanding of what the Commission means by "home country control". First of all, by "home country control" we certainly do not regard that as in any sense contradictory to the need for very close collaboration and co-operation between supervisors and I would very stongly endorse everything that has been said in the last two interventions on that subject. Second, although we may sometimes give this impression, we in the Commission certainly do not believe that "home country control" can apply to all supervisory rules or all the aspects of supervision that may be necessary. We are clear in our own minds that "home country control" should apply to the process of authorisation, the process of determining fitness and properness and also to the application of capital adequacy rules, because I think that everything that has been said in the last few minutes implies that anything other than "home country control" for capital adquacy is probably unworkable in the long run. At the other extreme, we also feel very clear that advertising and marketing rules should be left in the hands of the host country authorities, in particular for investment business, but I think that what we are increasingly begining to feel is that there is a grey area in between, where we are not quite sure what the right answer is. Two examples for that include one that was quoted by Prof. Gower, earlier this morning, namely the question of separation of clients' funds, whether that should be supervised by the home country or the host country. The other rather parallel area is the question of compensation or guarantee of funds and possibly a different answer may be required, depending on whether the business is being done by a branch or whether it is being done accross frontiers, but this is an aspect which I think we in the Commission would be interested to have explored in the discussions this afternoon and tomorrow.

PROF. DR. U. SCHNEIDER

I have the difficult task of summarizing the arguments put forward here today and the results of my own studies. I hope you will forgive me if I fail to deal adequately with any important point.

I propose, firstly to analyse the new developments in financial markets. Secondly, I intend to examine what new problems are emerging and whether current law is capable of meeting the new challenges. Thirdly, I propose to turn to considerations of a legal policy nature.

I

First of all, it should be stressed once again that in all Member States of the European Community the financial market is divided up into various market segments through the law relating to supervision, the law governing organisations of financial institutions (e.g. savings bank legislation and the law governing mutual insurance associations), stock exchange regulations, capital market legislation and tax law. Differences exist, however, in the classification of individual financial services, for example in the definition of financial services requiring authorization and those not requiring authorization and in the allocation of particular financial services to one or other market segment.

This different demarcation of market segments has two main implications for credit institutions. Firstly, the concept of banking business and thus also the scope of the law relating to banking supervision and the responsibilities of the bank supervisory authorities differ from one country to the next.

This means that in the Federal Republic of Germany, for example, securities business (i.e. the purchase and sale of securities for the account of others) also ranks as banking business. The Federal Banking Supervisory Office therefore deals also with cases of abuse in securities dealing and a securities house in crisis in the Federal Republic of Germany would be a banking crisis. In the United Kingdom, by contrast, securities business is not banking business; transactions in securities are therefore not subject to the law relating to banking supervision, and this had led, amongst other things, to the establishment of separate supervisory legislations. To sum up : in those countries in which certain financial services are not covered by banking supervision but used to be free of supervision, new supervisory systems have developed alongside banking supervision (e.g. in the United Kingdom and the Netherlands).

Secondly, supervisory legislation in the individual Member States in some cases permits the market participants concerned, in particular credit institutions, to operate only in part of the market. Other Member States impose no such limitations or only to a restricted degree. The 1984 French Banking Act, for example, contains numerous business restrictions on credit institutions, whereas credit institutions in the Federal Republic of Germany are also permitted to engage in non-banking business. A feature common to all Member States is the division, in the law relating to supervision, between enterprises which are engaged in banking business and those which are engaged in insurance business.

The frontiers which have hitherto existed between the separate markets are now increasingly being removed, firstly because national legal systems are easing business restrictions and, secondly, because of changes in practice, that is to say :

- firstly, the attempt to combine different financial services contractually (e.g. savings linked with insurance protection);

- secondly, the widening of the range of operations (e.g. the marketing of insurance services by credit institutions). These developments are not pursued further below;

- thirdly, new organizational forms, in particular the fusing of different financial institutions into groups (e.g. financial conglomerates). In most Member States there are participatory and group links between financial institutions which offer different financial services and which are subject to different supervisory legislation (e.g. in Belgium, the Federal Republic of Germany, Denmark, France, Greece, the United Kingdom, Italy, the

Netherlands and Spain) or between financial institutions and non-financial institutions, i.e. industrial and commercial enterprises (e.g. in the Federal Republic of Germany, France, the United Kingdom and Italy).

It must be borne in mind here that the term "financial conglomerate" differs in meaning from one Member State to another. In some countries with a specialist banking system, groups comprising deposit-taking institutions and investment banks are referred to as "financial conglomerates", while in other countries with an all-purpose banking system the term is used primarily to denote groups made up of credit institutions and insurance companies;

- fourthly, the penetration of new market participants into financial markets through subsidiary companies (e.g. commercial groups with banking subsidiaries);

- finally, the growing importance of financial subgroups of conglomerates.

II

The growing number of financial conglomerates, of manufacturing, commercial and services groups with financial institutions and of mixed groups with financial subgroups is regarded in some Member States as a new challenge in the field of supervision, which has led to intensive legal policy discussion (e.g. in Denmark, the United Kingdom and Italy). In other Member States, discussion of the supervisory implications has not yet begun in earnest (e.g. in the Federal Republic of Germany and Spain).

It is clear, however, that the creation of financial conglomerates and the incorporation of financial institutions into mixed groups pose many problems in such fields as regulatory policy, competition law, supervisory legislation, contract law and data protection law.

There is first of all the basic regulatory and competition law question of whether further concentration in financial markets is appropriate. The aim of the Dutch "structural policy" is to find an answer to just this problem.

The same questions are frequently analysed and dealt with at different legal levels in Member States. Typical conflicts of interest thus occur as a result of simultaneous activity in such fields as banking, investment, the sale and purchase of securities, stock exchange intermediation and organization of investment companies and advice on and the marketing of insurance services. Particular mention shall be made of the inappropriate use of information and conflicting contractual obligations.

National legal systems react differently to these conflicts of interest, that is to say through supervisory contractual and criminal legislation and through voluntary codes of conduct. What seems to me to be a somewhat oppresive trend in this connection is the growing criminalization of breaches of behavioural obligations.

Differences emerge primarily in terms of legal consequences. Typical legal consequences in the field of supervisory legislation (for example, activity restrictions, bans on participations, etc.) prevent conflicts of interest from arising. Typical contractual provisions and legal consequences are disclosure obligations, special interest-safeguarding obligations and rights of termination, claims for damanges, etc.

In analysing national supervisory legislation, a distinction has to be made between the formation of groups and prudential obligations and the supervision of the groups concerned.

National supervisory laws react differently to the formation of groups :

- In some cases, national supervisory legislation is restricted to notification obligations (e.g. the law relating to bank supervision in the Federal Republic of Germany).

- In some cases, there are supervisory restrictions of varying severity on the formation of subsidiary companies, on the acquisition of holdings and on the creation of groups by financial institutions (e.g. in Belgium, Denmark, France and Italy).

- In some cases, there are supervisory restrictions of varying severity on the acquisition of shares in financial institutions (e.g. in Belgium and the United Kingdom).

The supervision of financial institutions within groups is carried out differently under the various national supervisory laws. In no Member State, however, is the group the subject of supervision. In no country is there "group supervision" where, for example, financial services are supplied by only one company within a group.

There is also no uniform comprehensive supervisory legislation in any Member State where different financial services are supplied by individual enterprises within a group. Nor is there any uniform supervisory authority in any Member State for such cases. Only in Denmark were bank and insurance supervisory authorities merged to form a single authority on 1 January 1988. In many cases, obligations of confidentiality even militate against cooperation between supervisory authorities (e.g. in the Federal Republic of Germany, to some extent, also in Italy).

Even within a group, the basic focus of attention is simply the individual group enterprise. It is subject to the relevant type of supervision regardless of the areas in which the other enterprises within the group are active. There are three basic ways in which the prudential supervision of financial institutions belonging to groups is carried out :

- In some cases, only individual participation- and group-induced management and financial effects on the legally independent group enterprise are considered. Supervision is carried out on a consolidated basis (mosaic solution). No account is taken, however, of events affecting other affiliates or group enterprises. The other group enterprises are not included in the supervison (e.g. in the Federal Republic of Germany in the case of banking supervision and in Denmark and the United Kingdom in the case of insurance supervision).

- In some cases, an attempt is made to safeguard the entrepreneurial independence of a group institution from the other group entreprises (autonomy solution) (e.g. in Belgium in the case of banking supervision and in the Federal Republic of Germany in the case of insurance supervision).

- In some cases, attempts are made to treat the group as a unit and to include the other group enterprises in the supervision exercise in order to be able to take account of them when dealing with the financial institution belonging to the group (single unit solution) (e.g. in the United Kingdom in the case of banking supervision).

It is clear from close analysis that supervisory legislation is not adequate to cope with the new forms of group construction in the financial field. A number of problems have arisen, including:

- gaps in supervision;

- contradictory demands of different supervisory laws;

- multiple requirements imposed by supervisory legislation;

- multiple responsibilities imposed by supervisory legislation;

- serious evaluation inconsistencies.

I intend to cite only a few examples in support of this distressing diagnosis:

a) First example : group formation bans : where group formation bans exist, they are in some cases restricted to downstream group formation and neglect the upstream tyep, i.e. the holding company solution (e.g. Belgum and Denmark).

b) Second example : notification requirements : such requirements, for example those relating to holdings in a credit institution, are in some cases restricted to direct participations (e.g. Federal Republic of Germany), with the result that, in a multi-tier group, changes in the parent company's participation situation do not need to be notified; alternatively, they may be restricted to holdings in the ascending or descending line in the multi-tier group (e.g. United Kingdom). There is no guarantee, however, that information will be supplied concerning merely indirect holdings in foreign companies and concerning fellow group members (e.g. Denmark and the United Kingdom). As a result, the supervisory authorities may be denied an overall view of the building up of multi-tier cross-frontier groups (e.g. Ambrosiano; Neue Heimat/Bank für Gemeinwirtschaft/ Volksfürorge; Rumasa). This applies particularly to cross-frontier group situations.

c) Third example : limited consolidation : in a financial conglomerate the limited consolidation of large loans means that loans which may no longer be granted by a credit institution may be granted by an insurance company belonging to the same group.

d) Fourth example : reorganization and winding-up procedures : these procedures also vary widely between different financial institutions in crisis. They are dependent on what financial services are offered. The crisis and insolvency are frequently not restricted to the individual group enterprise but cover the group of financial institutions or the financial group as a whole. The supervisory authorities' powers of intervention, however, cover only the individual group enterprise and not the group as a whole. The freezing of payments thus applies only to the institution in question and not to subsidiary, parent or fellow group companies. Even the proposal of 31 December 1985 for a Community Directive on the reorganization and winding-up of credit institutions is restricted to improving cooperation between bank supervisory authorities. No account is taken of the need to improve cooperation between bank and insurance supervisory authorities. Ideas also differ among individual financial institutions on the objectives of the procedures (whether the aim should be reorganization, i.e. to safeguard the existence of the institution, or winding-up, i.e. to protect creditors), on procedural matters (whether there should be a free hand in reorganizing the institution or whether the reorganization should be organized by the State), on the necessity for funds to be established to provide subsidiary creditor protection, etc. In Spain, for example, a special ("Comisión Liquidadora de Entidades Aseguradoros"), whereas no such authority exists for credit institutions in crisis.

e) Fifth example : secrecy requirements. Although a financial conglomerate constitutes one enterprise for commercial purposes, there are in some Member States secrecy barriers between the supervisory authorities responsible for overseeing individual group enterprises. Only international cooperation (for example, between bank supervisory authorities) is safeguarded; cooperation between bank and insurance supervisory authorities is not provided for.

Examples of multiple requirements and responsibilities imposed by supervisory legislation are found in the case of an independent enterprise in countries in which the supervisory systems are not interlinked (e.g. United Kingdom) and in the case of groups which provide different financial services. There is no multiple requirement where risks increase as a result of a group situation.

The supervision of enterprises making up financial conglomerates involves a clash between the different standard solutions. This applies at national level where individual supervisory laws approach group supervision in different ways. It applies all the more at international level (i.e. for such multinational financial conglomerates as Citicorp, Assicurazioni Generali or the Aachen-Münchener Group), where there is the further problem of differences between national group liability and group risk rules. While an individual group enterprise is subject to the relevant national group supervision law of the country in which it has its head office, the differing requirements imposed on the various group enterprises lead to further supervisory evaluation contradictions : for example, in the case of a German insurance company with a subsidiary credit institution in the United Kingdom, United Kingdom bank supervisory legislation presumes parent company responsibility in the event of a crisis. The German insurance supervisory authority, by contrast, is empowered to prohibit continuance of the holding under Article 82 of the Insurance Supervision Law. And a further instance : parent company responsibility for subsidiary companies is appropriate only where the parent company is in a position to influence the management of the subsidiary company. However, this is ruled out, for example, by Belgian bank supervisory law.

What conclusions are to be drawn from all of this ?

The harmonization of supervisory legislation in the European Community has hitherto been carried out on the basis of sub-markets. Bank supervisory legislation, insurance company supervisory legislation, etc., are being harmonized. Member States remain responsible for supervising those group enterprises which have their head offices in their respective countries. The consolidation Directive of 13 June 1983 covers only the supervision of individual group credit institutions on a consolidated basis. It could therefore be concluded that the harmonization programme adopts the "mosaic solution". The emergence of financial conglomerates has not yet been matched in the harmonization process. The arguments set out in the Commission's second working paper of April 1987 on financial conglomerates (XV/49/87-EN) are therefore particularly welcome in this context.

The Basle Concordat of May 1983 organizes, with respect to international financial groups, cooperation between national bank supervisory authorities (particularly on the basis of reciprocal information); responsibilities are laid down and basic criteria for supervision are set out. National bank supervisory laws are to that extent relaxing the secrecy requirements imposed on bank supervisory authorities (e.g. in the United Kingdom). However, there is no overall agreement which provides for international cooperation between national bank supervisory authorities, capital market supervisory authorities, national insurance company supervisory authorities and other supervisory authorities in respect of financial institutions, with particular reference to financial conglomerates, and which guarantees reciprocal information, lays down responsibilities, etc.

An appraisal of the incorporation of financial institutions into manufacturing, commercial and services groups and of financial conglomerates requires :

- an appraisal of the general risks run by the institutions in question, with particular regard for the group situation;

- an appraisal of the typical risks arising from the grouping process; and

- an overall view of all relevant areas of law - namely, supervisory legislation, group law, balance-sheet law, competition law and tax law - and of public expectations.

These risks are analysed in detail in my study.

Consideration should then be given to adjusting the structural norms and behavioural requirements of credit institutions, as laid down by supervisory legislation, to the group situation. This also covers the coordination of consolidation requirements in the financial group.

The basic principles underlying the "mosaic solution", the "autonomy solution" and the "single unit solution" must be fused together. Where supervisory legislation premits the creation of centralized groups, including function-switching, and where it permits or requires letters of comfort, the supervision must cover all group enterprises. If the supervision is not to be extended to all group enterprises, the formation of centralized groups must be ruled out.

It is necessary to ensure that :

- subsidiary financial institutions are responsible for their own business decisions;

- financial institutions belonging to groups and conglomerates are independent in terms of their financial and liability situations where they are not operating in the same market segment (limits on intra-group lending and guarantees, etc.);

- account is taken of all important matters affecting the other group enterprises where they may have an impact on the group financial institution;

- account is taken of all significant group-induced financial effects (telescope effect, transmission effect, etc.) by means of supervision on a consolidated basis;

- supervisory authorities have comprehensive information on the participation and group situations, the legal structure of the group and the organization of the group's management.

Where the financial institution is a participating and/or controlling member of the group (holding company), consideration must also be given to :

- whether creditors' expectations that it will be responsible for its subsidiaries' liabilities apply only to subsidiaries which are active in the same business sphere and/or under the same name or apply to all subsidiaries; if the hypothesis is one of such dependent relationship, consideration would have to be given to permitting only such vertical subgroups which comprise financial institutions offering the same kind of financial services (principle of vertical category separation);

- how the own capital and liquidity endowment of the individual group financial institution should appear; consideration would have to be given to the adoption of a principle of decentralized capital endowment;

- whether and to what extent hiving-off operations and asset-switching for the benefit of group companies should be permitted, especially where these are active in other business spheres, since they run different risks and the problem of structural lower priority arises;

- whether and to what extent supervisory legislation can be circumvented through certain transactions being "parked" with other group enterprises (e.g. commodity futures trading, which is not permitted for the participating credit institution, with subsidiary companies, etc.);

- whether and to what extent controlled group enterprises can be compelled to comply with group-related obligations.

It is also necessary to ensure that :

- <u>reoganization and winding-up procedures are adapted to the group situation, that the supervisory authorities' powers of intervention are adjusted to the group situation and that supervisory laws (bank supervisory legislation, insurance company supervisory law, etc.) are interlinked within individual Member States. A balance must be achieved between the interests of depositors, policyholders, investor, etc. which requires that :</u>

- <u>supervisory legislation is harmonized and dovetailed at Community level;</u>

- <u>international cooperation between the various national supervisory authorities is arranged.</u>

Discussion panel, chaired by Prof. Schneider

Prof. Schneider

The first point that was touched on this morning, concerned the changes in the partial or sub-sectoral markets by overlapping distribution of financial services and secondly, as a result of the emergence of different forms of financial conglomerates. It was only on some occasions that is was not just a question of the bank securities houses and securities companies growing together, but we must also concern ourselves with the fact that we do have new market participants these days, banks, insurance companies as subsidiaries of trading undertakings. In other words, they are subservient to someone else or they are a company as part of a group. Thirdly, we are also concerning ourselves with banks and insurance companies which are subsidiaries in a conglomerate undertaking, such as British-American Tobacco, in other words a very multifaceted conglomerate. This morning, the Chairman sketched out the various jobs that we have to do here, we are dealing here with challenges to our legal systems. There is the question of supervisory law following the various sub-sectoral markets and we will have to consider which are the new risks which arise. Just the question of where to draw the line in determining what sort of conglomerate we are talking about and what sort of new jobs have to be done in terms of on-going supervision. What about managing crisis in financial conglomerates, but that is something which, up to now, has more or less been focused on the crisis in credit institutions. What is the position of the various bodies in the financial conglomerates ? I must concede that I was personally rather surprised to hear the stress that people were putting on the problems which might arise from the multiplicity of supervisory authorities. I could well imagine that we might wish to pick out some questions that have arisen in the discussions which up to now have not been dealt with sufficiently. There is the question of home country supervision and host country supervision, may be we should take that one a little bit further, I suggest that when we get to the next stage of our discussions we ought to consider the question of multinational financial conglomerates. Up to now to a very large extent the questions have only been raised in the national context, but I think it is important to remember that we do have multinational financial conglomerates and very often the parent company is situated in the United States or in Japan. Perhaps we ought to ask ourselves will this lead to even further and more far reaching challenges; perhaps this is the wrong place to discuss this kind of problem. We will have to go into the question of institutionalising international co-operation on supervision. I have simply sketched out the subjects we want to discuss here, but the next thing I would like to do is ask all of you whether there are any questions which you find particularly urgent in connection with the matters which we discussed.

Name unknown (German speaker)

Mr. Jolivet was saying that in France financial conglomerates have become increasingly more important and he said that this has given rise to problems. I would be very grateful if he could tell me how exactly these financial conglomerates he refers to are structured, how they are made up and maybe he could just touch on a few more specific problems by way of illustration, so that we can find out exactly where the problem lies. We heard a lot of theory expressed this morning, but I think we need to look at a few practical examples, so that we can determine exactly where the problems lie.

Mr. Jolivet

That is a little bit of a complicated question, if it requires a particular example to be quoted, but quite apart from the operations carried out by financial conglomerates it seems to me that Belgium is an ideal centre for financial conglomerates. A lot of phenomena are appearing in many countries, traditionally the financial companies, or what we call the "sociétés financières", have been involved in this kind of thing, that is to say holding companies which hold industrial equity as a priority, but also banking and insurance participations. When we were preparing our banking law in France, we had to address the problems, and in fact what we did was to recognise that there was a problem with the financial companies, in so far as the banking law was involved and we required certain points of information to be provided, but I think it is fair to say that the matter was not taken to the bitter end. In insurance, I suppose you could say that things are similar. There has just been a great deal of discussion in Paris recently about the Compagnie du Midi, which is a financial holding and underneath it it has groups of insurance companies and recently it is also an agency which has bought up insurance broking companies and so on. These are all part of the landscape these days and I would say that they tend to be rather welcome. In so far as we are talking about mainly financial operations, this is without too many difficulties, because the systems I was describing this morning involves a vertical supervision for each individual undertaking and that itself is in the form of, or is associated with specialisation, so that it more or less works. But it is quite clear that the problem of more across the board, horizontal supervision, is becoming ever more necessary with a view to supervising operations and protecting the consumer. These holdings tend to be predominantly financial in nature, but if they worked a little bit differently, we would have to ask ourselves, looking at each individual entity, what was happening at the top of the pyramid, in other words, who was taking the decisions and how financial policy was pursued, what are they doing about questions of solvency, all that would have to be examined. I must say that at the moment we are doing the best we can with this financial vertical system and we will have to think about doing things a little bit differently.

Name unknown (German speaker)

If I understand you correctly, this means that developments which arise in other undertakings in the conglomerate have to be taken into account in supervision, is that correct ? Secondly, can I ask you, are attempts being made to quantify these developments, these phenomena, so as to try to develop rules accordingly ?

Mr. Jolivet

For the moment we do not have any specific rules on this matter, we are simply trying to observe what is happening to consider the problem. The need for coverage and consolidation is important as well, the idea being that once you have got a clear transparent situation, clear information provided, then everyone benefits from that.

Name unknown (German speaker)

Mr. Jolivet said, if I understood him correctly, that he felt that an exchange of information between supervisory authorities, secrecy of banking operations could be ruled out, if there was a question of tax secrecy involved. As far as we are concerned in Germany, the two are certainly not linked up, they may be in France, I do not know.

Mr. Jolivet

I did not say that it was a problem that we could leave out of question or exclude. I think Mr. Cooke raised an excellent question; we do have extreme legal difficulties, because generally speaking, these matters are almost of constitutional importance, and sometimes therefore very difficult. The main problems in fact arise in connection with third countries in the context of reciprocal action and in the insurance field, of course, we also have difficulties. There are extremely serious problems of a formal nature, but within the Community at large, there is an open dialogue going on, and I think if we do want an increase in co-operation amongst supervisory authorities than we really have got to come to grips with this problem of confidentiality, which exists in the insurance field as well. For example, the confidentiality for the various commissions which follow stock exchange operations; so I think this is certainly one whole area which we must call attention to.

Mr. Zavvos

In some Member States banks hold participations, have got subsidiaries in the insurance company, and they follow the practice that when a client goes to get a loan from a bank, he is kindly advised that he should be insured with the insurance companies that constitute subsidiaries of its group. Some of the Member States have institutionalised this practice by means of law or other circulars and the question is the following. The Commission has taken decisions, condemning this practice, by virtue of competition laws and by virtue of the Treaty right of establishment and supply of services, but the dilemma is that in a period when the despecialisation, disintermediation and all the synergies are a common phenomenon, banks and insurance companies should collaborate and co-operate to a great extent, so what should be the position of supervisors for such a case ? From one side you have clear infringement of competition law, but from the other side you have got the phenomenon that these companies should co-operate amongst themselves and that is the real situation in the Community.

Dr. Angerer

If banks give credit to a customer and require this credit to be covered by insurance, that is a perfectly legitimate concern on the part of the bank. If the bank requires this risk to be covered, to be insured by the subsidiary, I think that is also legitimate. I do not see that that infringes competition conditions in any way; they are legally two separate institutions, but the customer is free to choose which bank and which conditions he is going to opt for.

Prof. Schneider

We have got to look at the same question from the point of view of supervisory law, but also from the point of view of contract law and from the point of view of competition conditions. I am sure that Mr. Boye-Jacobsen will have a position to adopt on that.

Mr. Boye-Jacobsen

I totally agree with Dr. Angerer. Before you can enter with a monopolies act it must really be extraordinary grave, because of course, a group may impose some conditions; otherwise you can go to another bank. My question concerns group law, because the very first meeting I ever attended in Brussels was a meeting to consult new Member States, in the epoch of Denmark, Norway, Ireland and the U.K., because of the near standing proposal of the Commission to the Council of the group law directive. The Commission said then it wanted to hear the new Member States before presenting the draft Directive to the Council, I think it was in March 1971. As we all know this important Directive has not seen the light of the day since. I would not say that I would agree to every bit of what the Commission would propose to us, but nevertheless, I think that many of us feel that we ought, at any rate, to know what the Commission thinks before we can think. After so many years it is a fair demand to the Commission that it tells us what it thinks on group law, because many things are so dependent on it. The problem of home office control depends to some extend on it. I have seen in the insurance law field the question being treated somewhat like a holy principle by the British or the Dutch, but what is the meaning of it. Part of the meaning is hidden in group law which is as important as most other matters. What does the Commission think about group law, because I think it is so very important, because there is another question which we mentioned. Multinational companies and some of them are really multinational, should be dealt with by group law. There are some multinationals which are just outside the Community but that is a fact of life. What are we to do about it ? We are to do something with it, we have proposals before our Parliament for the moment, from time to time people ask what do the Communities think.

Mr. Fitchew

I cannot tell you what the Commission, as an institution, thinks on this matter and perhaps Mr. Gleichmann, who is the author of the draft that you consulted on at an earlier stage, will forgive me if I speak rather frankly about it. We have said in the White Paper on the Internal Market that we were going to put forward a proposal on group law during the course of 1988, before the end of this year. I am not sure that we will do that at this stage, because we are still considering how to proceed on this issue. I myself was not entirely happy with the text of the proposal that was circulated at an earlier stage, which presented companies, not just in the financial sectors, but companies in the economy more generally, with two very constraining choices, they could either opt for group status, which involved taking on certain very strict obligations in return for which they would have the legal right to manage their entreprises as a single group, the alternative was to stay as they were, not opting for group form, but nevertheless to accept fairly stringent reporting requirements, in relation to the operation of subsidiaries. I was not convinced that that is in line with the current climate of deregulation, making life simpler, so far as possible for the company sector. I think it is unlikely that we will want to come forward with the proposal in the form that it was circulated earlier on. What we are doing at the moment, because we are conscious that there is a problem here in the diversity of practice in different Member States, is to have a survey undertaken by outside contractors to bring up to date our information about the way in which jurisprudence in different Member States on the group problem has been developing. We want to decide where to go from there when we have the result from that survey. I think that from the point of view of this Conference, and from the point of view of work on financial conglomerates, it is probably best to set the company law aspects of the treatment of groups on one side and to concentrate on how to ensure transparency and cooperation among the supervisors.

Mr. Biron

Are you restricting your information to the draft 9th Directive; are there not other possible approaches ? Might we not consider that in some cases the 7th Directive on Consolidated Accounts might deal with law on groupings in some way ? What about relations between affiliated companies, at European and international level, do they not constitute some sort of law on groupings. Would that approach be not more fruitful than perhaps trying to go too far, be too ambitious and try to solve everthing via the 9th Directive ?

Mr. Fitchew

In answer to your question about consolidation, that is an approach which we are pursuing in the banking sector. At the last meeting of the Banking Advisory Committee, we had a first discussion on the question of whether we should not try to extend the approach set out in the Banking Consolidation Directive, and to extend consolidated treatment. For example, to extend it to cases where a banking group, in the sense of a group which contains banking in it, but was headed by a non-bank, whether consolidation should not apply in that case as well. We are in the process of setting up a working party to try to deal with that and other questions which arise on the banking consolidation directive. I think the question does arise whether we may not consider a consolidated approach in the insurance sector as well, but at the moment we are pursuing it primarily in the banking sector.

Mr. Clarotti

Experience has shown, bit by bit, as we move to harmonising the different aspects of banking regulation, that the main directive which has a certain value, this concerns surveillance on a consolidated basis. This directive no longer quite fits the bill when it comes to dealing with all the problems relating to Community surveillance systems, solvency issues, delimitation of major risks, etc. So in fact we are going to set up a working group to see how it is going to be possible to extend the scope of consolidated supervision and see how we can, if not eliminate at least, attenuate the differences which have so far existed in the way in which the different authorities have approached the question of supervision. Mr. Biron has said of course that the group is very important, since we need to have a general solution; this may not be possible in the short term, but at least we can make progress moving towards specific goals. That is what we are trying to do, at least in the banking sector.

Name unknown (French speaker)

I think there are provisions in directives which are now in the pipeline and which are going to mean that we can advance very quickly. I am thinking in particular of the Directive on stock transactions for companies which are listed on the stock exchange; every time a given threshold is exceeded, public declarations have to be made to the authorities, which supervise these stock exchange activities. Then there is the Second Banking Directive, art. 9 in particular, where supervisory authorities may identify the main shareholders, we have that law in France too. The third text, which is really only at the drawing-board stage, makes it possible to define initial misconduct. This is the sort of provision which is going to help us to make rapid progress.

Mr. Fitchew

Mr. Padoa-Schioppa drew a distinction for the purposes of analysis between market makers on the one hand and intermediaries who had a fiduciary relationship with the clients, who were placing the client's money on the other. He suggested that there should be different sets of rules and conceivably even different supervisors for market makers on the one hand and for the second category of those in a fiduciary relationship with their clients on the other. I would like to ask the panel two supplementary questions arising out of that. The first is how far would they find that a useful distinction in drawing up supervisory rules in their own area of responsibility. The second question is : the concept of the market maker. Our impression in the Commission is that the market maker in the pure anglo-american sense of the term, does not exist in very many Member States, maybe at most one or two. If one takes the area of stock exchanges, quite a lot of stock exchanges operate on an auction basis rather than through market markers. I would like to ask the panel how far they feel that the same sets of rules can be applied to stock exchanges, which on the one hand work through the market maker system and on the other hand those stock exchanges which operate on an auction basis in which there are no market makers involved, where there may indeed be prohibitions on dealers in the market from having net open position going beyond certain fairly restricted limits. What kind of problems does that pose for us in our attempts to harmonise ? What are the implications for home country control of people who are carrying out the market making function, if there are these kinds of differences between different markets ?

Sir Kenneth Berrill

There clearly is a difference between somebody who is operating on his own account and somebody who is operating in a fiducary way for a client. One finds in today's conglomerates that inside the conglomerate you have both functions. If that is the situation you have to have very careful rules to see that the two functions are not brought into conflict. I don't myself see a very strong case for having two completely separate supervisors to carry out these two functions. But when it comes to the question of the form of the market, I think you have to look a little wider than the various ways of conducting a securities market. If you take a commodity market or financial futures markets - zero sum markets -, virtually everybody there is acting on his own account, not everybody but a lot of them; you will find the same problem in many countries in the way in which the prices of unit trusts, for example, are determined. That is to say the manager of the unit trust is operating on his own account sometimes and you have a problem of the interest of the manager of the unit trust or mutual fund as against the owners of the units. So my answer is yes, there is a great deal of the problem of the conflict between the person dealing on his own account, how you define the market maker is a separate issue, but once somebody is dealing to some extent on his own book, on his own account, you then have the problem of the relationship of that function, somewhere else in the conglomerate he is probably acting as an agent in a fiduciary relationship to clients.

Prof. Schneider

Last year I have been most busy with English law and it came as a tremendous surprise to me, to see that where there is a conflict between interests this can come under insurance supervision rules, rather than contract law. The mechanism of contract law would imply that where there is a given conflict of interests then the contract in null and void. Where there is a conflict of interest this can be solved by insurance supervision leading to prohibition, criminal proceedings, etc. Would one therefore draw the conclusion that contract law does not cover this area ?

Sir Kenneth Berrill

Prof. Gower is a commercial lawyer and I am certainly not a lawyer. I don't know that our contract law is that clear, I would not wish to rely as my only defence on the fact that I would have to go to the court and have the contract rendered void. There are many ways every day in practice, in which if you do not scrupulously obey the interest of your client, you can in fact disadvantage your client in a way in which one would rely on having the contract upset, but I would like Prof. Gower to respond.

Prof. Gower

When you say contract law, I think we English we would say there is a principle, not exactly a contractual principle, but a principle of the law of equity, which says that if you are acting as somebody's agent or trustee you must not put yourself in a position in which your interests conflict, or may possibly conflict, with his. The trouble is that although that is the law, the whole of the securities industry has been disregarding this principle for years and nobody, or very rarely, have they been taken to court about it. This is the problem that in our country, providing a civil remedy to small individuals as opposed to very wealthy corporations, particularly if they are American and therefore like litigation, is completely useless, because although there may be a remedy : a) they do not know they have got it and b) if they are told they have got it they have not got the money to bring an action in the court. The answer is certainly the fact that there may be a civil remedy under existing law, is not a sufficient protection a) because people do not realise that this is the law and b) because, when it is drawn to their attention, they probably disregard it in a way and c) because most people cannot afford, in our country, to bring an action to enforce it. Therefore, we have taken the view that one has got to have clearer specific rules laid down as a matter of professional duty and that is what the Securities and Investment Board is trying to do and here, as Sir Kenneth has said, it has drawn a distinction between those people who are acting purely as agents for others and those who are acting on their own account as market makers, but has provided rules which extend to some extent the fiduciary principle even to people when they are acting on their own behalf. It goes half way towards that, on the basis that if people are acting sometimes as agents and sometimes as principals, then they really cannot get away with that without fully disclosing and getting consent once they have started to act as agents.

Dr. Lanciotti

I can always try to place an authentic interpretation on the distinction which was drawn this morning. I do not think that the speaker was thinking of the technical implications which Mr. Fitchew mentioned in the second question. I think that the difference is more one of approach; by this I mean where you have placing power and delegation the problems which arise are very similar to those of a banking agent. Dr. Padoa-Schioppa has concluded that the type of supervision which is appropriate to this form of agency work is very similar to those appropriate for a banking agent, comprising not only the basic laws which apply to all operators on the market, rules of conduct, solvency requirements, and so on, and in addition to this a form of supervision involving to a great extent an assessment of the assets of the agent, as is done in the case of the banks.

Prof. Schneider

Perhaps we can turn our attention to these individual matters, that is to say the relationship between the host country and the country of origin and also the significance of the multinational dimension, particularly where the head authority is in a non-European country.

Sir Kenneth Berrill

I think I start from having to remember what are the realities of the markets in which we operate in the UK and which I suspect will become increasingly true of other European markets. The first reality is that most of the retail market is dominated by domestic firms. I know that that will change, but I think it will change only slowly. There are not many foreign European, or any part of the world, conglomerates which are effectively, as it were, operating in retail markets. That is being a little bit eroded in that some of our securities houses have been purchased by EEC banks - that will make a small hole, but nearly all our life-insurance and unit trusts are domestic. When you turn to the wholesale markets, the very reverse is true. They are only to a minority extent the province of UK firms. That is to say more than half will be in the hands of overseas conglomerates, including banks. That is true if you go down through the different sizes of markets from foreign exchange, Eurobonds, through swaps securities and commodity futures markets. Most of those international conglomerates, which play such a big part in the wholesale markets, are not EEC companies, or conglomerates. So you have the inter-EEC problem, but superimposed on that, you have an almost larger cross-border supervision conglomerate accounting and relations with overseas supervisors type of problem. I think we should bear that in mind and it will be surprising to me if 1992 made a great deal of difference to that, for a while anyway. We have to recognise that the cross-border services in wholesale markets tend to be extremely international. When you come to the question of which kind of issues should be looked after according to the rules of the home country and which according to the host country, I have said that I think that all the capital adequacy rules are best looked after on the basis of the home country. The more you move into business, conduct of business systems, the more difficult it is to imagine more than one set of conduct of business rules in one market. First of all at the most elementary level, you can only have on set of rules inside a given market, they have to be the local rules and everybody wishing to do business on those markets has to operate locally and that would go down all through the way in which they are market makers, agents, bookkeeping systems, etc. When it comes to the firms dealing with each other on a local basis, company to company, they must be clear what the relationships are and they must be the local rules. I cannot imagine trying to run a market on any other basis. When you come to the question of dealing with the public, then things are not so clear-cut. One of the most sensitive issues is any kind of a compensation scheme, that it to say when ordinary members of the public do business with a firm which is active in the local market, what can they assume if the firms goes bankrupt. If there is a situation in which it is highly uncertain, where it depends on which is the home EC country and one gets 100 %, one gets nothing, etcetera there will be problems. It will be alright in theory, but the first time there is a real crash there will be political difficulties in explaining just why this is so. When it comes to the keeping of the clients' money separate and whether he is entitled to interest on it, that is the heart of the matter, because there is a lot of money at stake on whether there is interest on your balances. If I have a positive balance and you have a negative balance, can the firm take my money and finance you with it without my permission ? One can go through a lot of these. When we get to the problems which were being discussed just a moment ago about contract law and agency law, the extent to which, if somebody is acting as your agent he really must act entirely in your interests, but what happens if he breaks it ? What are the disciplinary powers ? If you have very weak disciplinary powers in one country and quite strong ones in another, the extreme case being where if you break the rules the contract is not valid, you can see that I am doubtful about how the system will work if there are inside your own market, as it were, many variations, basically in the terms and defenses under which the general public or even professionals deal with people in the market place, depending on which country is their home EEC country.

Mr. Jolivet

I certainly would not wish to add anything to what Sir Kenneth has said. Two types of supervision, one on top of the other, might solve a number of problems. For example, first of all supervising in the country of origin checks on operators in a vertical axis and the main objective here is the proof of solvency. On the other hand, in the host country you would have a horizontal supervision of operations, as opposed to operators. The supervision of operations, where this takes place, is geared above all to consumer protection, or the protection of the saver, which means that you can solve a great many problems where you do not necessarily have very high solvency protection, for example, advice on investment, the problem of the distribution, etc. We started to talk about that this morning; if you combine those two systems, you have quite a good structure to deal with conglomerates. I should be interested to know what people think about this.

Dr. Lanciotti

I would just like to say a word about something which was implicit in what Dr. Padoa-Schioppa said this morning. This is also influenced by a comment made this morning by Sir Kenneth Berrill on the problem of the diversity of operators existing in the UK, for example. Here I am bearing in mind a country which is still working on its legislation in the field of share activities. When you set up regulation in our countries, what you want to do is organise the market and supervise operators in the field, so one should aim to simplify the powers that are used, this will be of a great advantage in international relations which have to be dealt with over and above controls within the country of origin. That I think is very important to bear in mind, controls in the country of origin would not be enough to guarantee a competent international supervision, there would have to be a number of understandings and international co-operation of an institutionalised form, such co-operation will be much more simple and much more efficient if our own domestic regulations are simple.

Mr. Muller

Just one remark, on the interplay between home and host country supervision.

We all agree the Basle line that the parent supervisor should in capital adequacy measures be playing first fiddle. The Belgian Banking Commission and the Nederlandsche Bank are on the eve of a very interesting exercise where we no longer know, with the Société Générale and Amrobank who is the home country supervisor - and we don't want to know, we are both ! They are both equal and both responsible.

Mr. Boye-Jacobsen

What do third countries think of this problem ? I was invited to the Swedish Institute of Insurance and they said this : it is very simple, we have now the Swiss agreement on insurance, and all others will have the same kind of agreement. This is what they think, but we know it will be discreetly buried. The third countries think that they will get an agreement with us.

Prof. Schneider

Mr. Boye-Jacobsen has just been calling on us to examine exactly where is the right place to think about and discuss the question of financial conglomerates. That is a question which I raised myself earlier and when I do it again it is in a rather hesitant way. I think we have all noted that in practice developments are taking place at a different rate and in a different way. First of all, we must consider the question of overlapping distribution, but we must also remember that groups and conglomerates are now emerging which involve banks, insurance companies and securities houses on the one hand acting together, and on the other hand banks, insurance companies and securities houses which have become parts of a larger conglomerate. Thirdly we have noted that these groups and groupings have certain multinational features, we have seen them in the area of multinationals but it it fair to note that this tendency is on the increase. We then also considered what challenges are posed, in terms of supervisory law and we considered the possibility of solving these problems in terms of contract law. I think my judgment of the situation would be rather different, at least with respect to the Federal Republic of Germany and I think there we have had excellent results in considering a solution by contract law and I put this in the form of a question. Are we not perhaps running the risk of pushing supervisory law too far, of extending it too much. In that way, we would be depriving those immediately concerned of the opportunity to look after their own interests. It emerged very clearly this morning that supervisory law pursues different objectives, in other words banking supervisory law was pursuing objectives which are different from those of insurance supervisory law and that is different from the objectives of the supervisors of the capital markets. However, since different undertakings will be coming together in financial conglomerates, we are going to have to consider the question of whether this will give rise to new risks and how can this on-going supervision be coordinated and institutionalised. How can co-operation amongst supervisory authorities, which works very well in the field of banks, once we are looking at this on an international plane, how is it going to work at that level ? We then attempted to pin-point the main areas of difficulty, there are certain individual Member States which do not see the problem of financial conglomerates as a legal problem, as a new challenge, and there are other Member States which are discussing the problem already in the field of the formation of financial conglomerates, they are considering what conditions should apply to the acquisition and the question to what extent banks may be taken over by non-banks, insurance companies or the subsidiaries thereof. I feel that that is very much a question of importance in Italy whereas in other Member States, which have different historical backgrounds, that is not so much of a problem. How can we make sure that we get the right information on the structure of these conglomerates, let us not forget that for the moment we do not know which undertakings belong to the conglomerate Banco-Ambrosiano. It is purely a question of information on the structure of the groupings. Have we had the necessary obligation to notify in the past, the information on the structure of groupings ? How are we going to organise on-going supervision of financial conglomerates ? And that in turn gives rise to the question : is it possible to single out certain component parts of the financial conglomerate and examine them individually or is that an absurd thing to do ? Do we have to view the conglomerate as an economic entity, although at the same time we would have to take account of developments in other parts of the conglomerate.

In our individual banking supervisory laws, and in our insurance supervisory laws, we have rules and regulations designed to manage crisis, but so far we do not have anything to cope with crises throughout conglomerates, even the deposit guarantee systems refer only to individual companies. To what extent can we see these deposit guarantee systems as appropriate to the conglomerate as a whole. Finally, there is the question of co-operation amongst the various supervisory authorities. To what extent the need for secrecy can be reconciled with the need for information. At national level within the banking supervisory authority, but also at international level where perhaps the Belgian supervisory authorities need to know was has happened in the past in an insurance company in Belgium and they need to inform say banking supervisory authorities in Denmark. Is that the essence, or must we remember that there is also the need for secrecy ? The question of notification arises as well, these question have all been raised and in subsequent statements I think we will have to take them rather further.

PART 2: QUESTIONS RELATING TO THE SUPERVISION OF CONGLOMERATES

Capital adequacy and consolidated supervision;
despecialisation and autonomy in different market segments;
conflicts of interest, intra-group transactions, etc.

PROF. H. BIRON

PRUDENTIAL SUPERVISION AND FINANCIAL CONGLOMERATES

The purpose of this report is to examine the problems raised for prudential supervision by the formation and operation of financial conglomerates. It goes without saying that the views expressed will be of a personal nature.

INTRODUCTION

The concept of "financial conglomerate" is not a straightforward one. Before attempting a definition, I should like to place it alongside a similar concept, i.e. that of the banking group. The last few decades have seen a multiplication, diversification and increasing sophistication of traditional banking activities. Several developments have played a key role in this. : the internationalisation of banking activity and the globalisation of financial markets, the rapid growth in the volume of transactions between the banks themselves and technological changes.

The result has been the emergence of banking groups which intervene worldwide, raise and reinvest funds in their own currency and in the major international currencies, operate permanently on exchange markets, buy and sell various types of commercial paper and securities and hold them on their own account, take considerable geographical risks and continually invent new financial techniques. In addition, these groups are closely linked to each other through the interbank markets and the extent to which they transfer funds between themselves.

How should we evaluate the phenomenon of conglomerates alongside banking groups as such ? What distinctive characteristics do they offer which justify our discussing them at this symposium ? I see two such characteristics. The first is that conglomerates operate beyond the traditional functions of banking activity. The second is that the companies making up a conglomerate may fall under the supervision of either banking or non-banking authorities, and that some of them may escape any form of supervision.

However, the distinction between banking groups and financial conglomerates must be seen as subtle. The growth of banking activity and the rise of conglomerates correspond to the same economic logic. The spontaneous development of banking operations is transgressing the boundaries drawn by law or the supervisory authorities between banking and non-banking activities, in the same way as it is ignoring national frontiers. The problems raised by conglomerates are, therefore, very similar to those raised by banking groups and have the same origins, i.e. the cohabitation of companies subject to different laws and supervisory authorities or even escaping any form of supervision, the need to reconcile group synergism with the autonomy of its constituent parts, and the risk of problems in one part of the group spreading to the others.

The traditional boundaries of banking activity are unclear and a wide variety of definitions exist. The authors of the Second Banking Directive drew up a list of "business which is integral to banking and shall be included within the scope of mutual recognition". This list covers business involving securities and excludes insurance. This leads the banking supervisor to conclude that the problem raised by financial conglomerates, as entities distinct from banking groups as such, is first and foremost the cohabitation of banks and insurance companies.

Any study of financial conglomerates comes up against an initial problem for which no completely satisfactory solution can be found. There is no precise definition of the term "conglomerate", and in practice it is used to mean a wide variety of structures. For the purposes of this report, and from the point of view of prudential supervision, we can distinguish four types of conglomerates. We will make the following two distinctions :

(a) Between integrated conglomerates having a central management which determines strategy and general objectives and conglomerates in which looser links exist between the constituent companies;

(b) Between conglomerates which limit their activities to the financial sector and those which go beyond that sector.

Our four types of conglomerate are therefore :

- Integrated mixed conglomerates;
- Non-integrated mixed conglomerates;
- Integrated financial conglomerates, and
- Non-integrated financial conglomerates.

It goes without saying that the situation is much more complex in reality and that, in practice, it is often difficult to be consistent in placing conglomerates into one or other of these categories. It is also clear that we will disregard conglomerates not involved in any financial activities and which are probably in the majority.

Principles of action for prudential supervision

1. Banking [1], like insurance, plays a central role in the economy. Consequently, it is subject to prudential supervision and a detailed set of rules. The constraints which result must, as far as possible, be flexible and adapted to changes within companies and on markets. They do, however, correspond to real life. A significant deregulation of banking activities is not possible, particularly in the difficult circumstances which we face. Banking stability is a matter of public concern and must be protected.

(1) This term refers here to all credit institutions, without making any distinction between banks in the strict sense, savings banks and public credit institutions.

2. This being said, banking supervisors must remain as close as possible to economic reality. Their action must be flexible and pragmatic. The diversification of banking activity and the formation of financial conglomerates are irreversible phenomena which reflect the normal growth of companies operating in the market economy. The same phenomenon can be seen in all other sectors of economic and social activity. Any out-of-hand situations and excesses must be prevented, but no attempt should be made to halt the development, which would in any case be impossible. Flexibility also demands that certain types of the conglomerates referred to above be dealt with according to their own characteristics.

A. Mixed conglomerates

The impermeability of the boundary between financial and other economic activities should, in our opinion, be maintained. This is obvious in the case of integrated conglomerates managed by a single body responsible for all activities and in which the principal company usually holds all the subsidiaries' capital. A bank should not form part of an integrated group in which certain components carry on non-financial activities. It should be neither the parent company nor one of its subsidiaries or sub-subsidiaries. If such a situation nevertheless arises, the bank should be withdrawn from the group.

The approach may be more flexible in the case of a non-integrated conglomerate. It is difficult to imagine how a bank could be at the head of such a group and assume responsibility for it, but it could form part of it if a number of precautions were taken. The requirements which must be formulated by the supervisory authority will relate in particular to the following aspects [1].

(1) It goes without saying that the supervisory authorities will have to treat each case on its merits. It is difficult in this field to issue general rules applicable to all cases.

- The shareholding structure

Banks (and insurance companies) should continue to have direct access to sources of risk finance outside the conglomerate. Therefore, the latter should not be the bank's sole shareholder. The bank must be free to determine its own financial strategy, reserve policy for strengthening its solvency and profit distribution policy for maintaining access to the market. Structures should be avoided in which a bank might be prevented from increasing its capital by calling on the market or placing its profits in reserve owing to developments in other units making up the conglomerate.

- The composition of the board of directors must reflect this situation. Representatives of the conglomerate must not be in the majority.

- Management must be made up of full-time officials offering the required independence.

- In its relations with the economic and social environment, the bank must appear to be an autonomous unit; it cannot present itself as the group's bank and it is preferable that it should not carry the group's name; in terms of accounting law, the links between the bank and the other members of the conglomerate should correspond to the relations which exist between companies linked by participating interest rather than those between combined companies; the bank should remain at arm's length from the other members of the conglomerate, and relations between them should be closely examined by the supervisory body and the auditor, and be made accordingly; the supervisory authority must interveneimmediately if there is the least sign of confusion [1]. The conclusion of "protocols" on the Belgian model between the supervisory body, the bank and its main shareholders might be a useful instrument for this purpose.

(1) Cf. Section 23B of the Federal Reserve Act which "prohibits any bank or non-bank affiliate from taking any action (including advertising) that would suggest the bank is responsible for any obligation of the affiliate".

B. Financial conglomerates

In arriving at conglomerates of a purely financial nature, we are getting to the core of the problem. Examination of the problems raised will therefore require a more detailed analysis.

(a) Financial conglomerates are, in principle, admissible.

(b) The existence of such conglomerates raises a number of difficulties. These are very much akin to those raised by banking groups proper, and the solutions which may be envisaged are similar.

(c) However difficult it is to define the terms "bank" or "banking activities", it is all the more so to pinpoint the meaning of "financial activity". Conglomerates may comprise local or foreign banks, savings banks, specialised companies carrying on activities likely to be carried on by banks themselves, companies whose activities are based on trading in securities, insurance companies, property companies and service companies. It is difficult, if not impossible, to set out general rules applicable to such a mixed bag. One has no choice but to make further distinctions.

- The cohabitation of banks, savings banks, other credit institutions and specialised companies carrying on activities which might be carried on by the credit institutions themselves is the leat of our problems.

- Trading in securities, in all its various forms (underwriting and investment, dealing, purchase and sale on behalf of third parties and on own account is part, in our opinion, of traditional banking activities. As stated, it will appear in the list of "business which is integral to banking" to be drawn up by the Commission. It is therefore admissible, provided two conditions are met. The supervisory authority must try to limit the risks likely to arise from such activity, as it does in the fields of credit, exchange rates and interest rates.

It does not seem appropriate that banks should, de jure or de facto, be the dominant partners of non-financial companies. The mixed bank is admissible only if the bank limits its participating interests in the financial sector and, moreover, restricts its holdings to investment shares.

- Insurance activities pose a particular problem. The affinities between banking and insurance are obvious, particularly at the level of mobilizing savings and offering guarantees. Nevertheless, they are different activities governed by different laws and subject to different supervisory bodies. Cohabitation between banks and insurance companies is admissible but it must be carefully controlled and be subject to detailed agreements between the respective supervisory authorities.

B_1. Non-Integrated financial conglomerates

The distinction between integrated conglomerates also applies to groups of a purely financial nature. Both forms are admissible. One might at first sight, think that supervisors would prefer non-integrated conglomerates since these make it easier to keep banks and insurance companies apart. However, this does not seem to be the case. The integrated group is a more simple structure enabling the responsibilities and risks to be more easliy identified and any necessary corrections to be made. The non-integrated conglomerate has the merit of flexibility. The link which exists between its various parts is ambiguous, however, and it is liable to be dealt with differently depending on the circumstances. The risk of contagion is more difficult to pinpoint, and the management and control of the group is hard to fathom. Consequently, the precautions referred to above for non-integrated mixed conglomerates also apply here (cf. pp. 6-8).

B_2. Integrated financial conglomerates

In order to be admissible, the integrated financial conglomerate must meet a set of conditions.

(a) It must be subject to a consolidated supervision of its entire structure. It would be unacceptable for one of its components to escape supervision. It would be even more so for the principal company not be to subject to appropriate supervision. If the company at the head of the group is a bank or insurance company, the banking or insurance supervisory authority, whichever is appropriate, will be responsible for supervision. If this is not the case, the principal company must somehow be placed under supervision, either by appropriate legislation or by the conclusion of a gentleman's agreement. If this does not happen, the structure must be revised in such a way as to become acceptable to the supervisory authorities.

(b) When banks and insurance companies are part of the same group, procedures for the cooperation necessary between the respective supervisory authorities should be established. Concentrating supervion within one body would have obvious advantages. In practice, it does not seem likely to be possible for the time being. If such a single body is not created, however, cooperation must be organised between existing institutions. In particular, the approach of the two bodies should be based on a number of common principles, which is not at present always the case.

It will not be easy to set up such cooperation because the two types of bodies have very different historical backgrounds. It will be even more difficult if the bodies are situated in different countries. The European Commission might play a useful role in this field by trying to develop principles for cooperation. To be effective, however, this presupposes a minimum harmonisation of laws and regulations applicable in the two sectors. To take just one example, the solvency of a bank and an insurance company are supervised according to different methods. How should bank ratios and solvency margins be integrated into a consolidated approach ? Should they simply be added together ? Should they gradually be reprocessed, but if so how ? The problem is not insoluble, but the solution will not be easy to find. I fear that, at present, dialogue between the various banking authorities is easier than it is between a banking authority and the insurance supervisory authority in the same country. Until such harmonisation is achieved, pragmatic solutions will have to be adopted and emphasis placed on the autonomy of the constituent parts of the group and the respective responsibilities of the existing supervisory bodies.

This pragmatic approach might involve the following aspects :

- representatives of the two bodies should meet at regular intervals and be able to exchange information without adhering to professional secrecy;
- auditing should be carried out by the same auditors;
- the principle of "home country control" could be applied in relations between the banking and insurance supervisory bodies. Depending on whether the principal company is a bank or an insurance company, responsibility for consolidated supervision would fall either to the banking supervisor or to the insurance supervisory body;
- the situation of conglomerates comprising banks and insurance companies should be examined jointly by representatives of both bodies at regular intervals.

The difficulties of integrated supervision

The consolidated supervision of a conglomerate raises two closely linked questions :

- what degree of integration is admissible ?
- to what extent does consolidated supervision dispense with supervision by the various individual bodies which exist, and, in particular, to what extent must it be ensured at both consolidated and non-consolidated level that legal statutory obligations are complied with.

These two questions are clearly not new. They also arise with banking groups made up of several banks or credit institutions, whether or not situated in the same country.

Here we are faced with a basic problem of company law and group law. The diversification of assets and liabilities resulting from the creation of different legal entities, is subject to compliance with a number of rules of substance and form. Where the interested parties (shareholders, creditors, staff members, public authorities) are the same in the various companies of the group, it is enough to observe the rules laid down by commercial law. The situation is made more complicated as soon as this identity of interest is no longer shared. The central management of the group will have to take account not only of the interest of the group and the principal company but also the interests of the various parts associated at the level of subsidiaries.

Banking groups and financial conglomerates will more often than not have considerable interests at the level of subsidiaries. In particular, and this must be a prime consideration for bank and insurance company supervisors, the various banks and insurance companies have, by definition, separate creditors. However, it is precisely these creditors which the supervisors are supposed to protect on the basis of precise legal and statutory constraints. Some of these creditors enjoy legal privileges. The banking supervisor cannot allow a bank to be drained of all substance or jeopardized for the benefit of other banks or insurance companies.

This does not mean the negation of a group policy, which would in any case be meaningless. The conglomerate or group will be able to be managed as a unit. A group policy is usually beneficial for all parties concerned. The profitability and solvency of the constituent parts depends on the financial equilibrium of the whole. If one of the companies within the group is in trouble, it is normal and necessary for the other companies of the group to come to its rescue. However, the group's managers will have to take account of the various interests at play and ensure that the flow of transactions between the constituent parts is balanced with regard to each of them. The role of supervisors (including auditors) will be to ensure that this is done properly. Several consequences ensue.

The first is that the integration of the group should never result in confusion of assets, liabilities and results. The personalisation of assets and liabilities and the resultant limitation of responsibility presupposes observance of the ground rules. Detailed procedures will have to be devised to determine the rights and obligations of the various parties concerned, the status of transactions carried out within the group and the method of identifying to which of the various entities assets, liabilities, profits and losses are attributable. Clarity, publicity and accuracy are major requirements in this area.

The second consequence is that certain basic rules of good management, relating to the activity of a bank or insurance company, will have to be observed at both consolidated and non-consolidated level. In particular, each bank and each insurance company will have to maintain, at its own level, an adequate degree of profitability and solvency. This requirement can only be dispensed with in the case of entities without minority holdings or where precise, unquestionable and published rules exist setting up complete legal solidarity between the various companies. Moreover, it will be necessary in each case to examine whether these rules are compatible with the legal status of the companies concerned.

The economic and functional approach, on the one hand, and the legal approach, on the other, lead at this level to different conclusions. The economic reality is that groups and conglomerates do exist. Examining the financial situation of the various individual companies has only limited significance. In many cases, companies can develop only under the shelter and protection of groups. The transfers which occur within the group, even if they are open to criticism from the point of view of one of the group's companies may still prove beneficial for the group as a whole. Effective managerial responsibilities are defined at group level. It may therefore seem unnecessary and annoying to subject the group and its constituent companies to two superimposed levels of supervision, i.e. the first at consolidated and the second at company level.

The legal reality is different however. In the majority of countries (with the exception of Germany), the law does not recognise groups as such. Attempts to issue a 9th Directive on groups of companies have not yet come to fruition. Our law makes provision solely for companies having a distinct legal personality. Supervisors must take account of this legal fact of life. As is often the case already, they will have to tread the difficult path between accepting the state of affairs (i.e. the existence of groups and conglomerates) and recognizing the legal structures (i.e. various legal persons) which exist, and this will never be an ideal situation.

The various types of transactions involving securities call for fewer observations. Such transactions may be carried out by the banks themselves. If they are carried out through the intermediary of subsidiaries, these must be subject to the same supervision as the parent company itself.

A particular problem might arise if the company specialising in the trading of securities is situated upstream of the bank and constitutes the principal company of the group. If the said company is itself subject to prudential control similar to that applicable to banks, the overall structure should receive the same treatment as advocated for groups of banks and insurance companies. If this does not happen, the banking supervisor must either extend his supervision upstream or see to it that the structure is modified.

Financial conglomerates do not necessarily limit their activities to banking, insurance and trading in securities. Without wishing to mention all the possibilities, we should like to indicate three developments at the frontier of financial activities.

(a) Transactions involving immovable assets. These extend from the management of housing stock and the financing of projects to buying and selling on own account and property development projects. They form a particularly important part of the business of insurance companies. It is not obvious that immovable assets should be treated differently to financial assets, and the boundary between them is not always impermeable. We do however believe that activities of this nature should continue to be limited in integrated conglomerates comprising a bank.

(b) Transactions involving raw materials for own account or on behalf of others. We feel that transactions on own account and statements (except on gold ?) should be prohibited.

(c) The exploitation, in various forms, of the experience accumulated by banks in the fields of telecommunications and information technology. The latter field is likely to be the one in which the most spectacular developments can be expected in the long term.

Transactions involving securities also come under the supervision of the stock exchange authorities or public bodies which, based on the model of the SEC, the COB or the Commission Bancaire Belge, are responsible for supervising public issue of securities and the quality of financial information. More often than not, the scope and procedures of the supervision offered by such institutions are different to those of prudential supervision. Close cooperation should however be set up between banking authorities and those authorities responsible for policing financial markets. In particular, it should be possible to exchange operations and information without restrictions. Several considerations favour such cooperation : the growing role of banks on financial markets, the fact that the boundaries between credit institutions and the financial assets they create, on the one hand, and the said markets, on the other, are becoming increasingly unclear, and the concern to avoid certain types of activity being subject to two superimposed forms of prudential supervision. This latter question is linked to the coordination necessary at international level between the various authorities responsible for supervising financial markets, a problem which is being studied at present by several bodies. The Commission might usefully make recommendations in this area to.

My conclusions are the following:

1. The diversification of banking activities and the formation of financial conglomerates are irreversible phenomena. Supervisors must allow this development and find a suitable framework for it. The impermeability of the boundary between financial and non-financial activities must be maintained.

2. The problems raised by financial conglomerates are comparable to those raised by banking groups (or groups of insurance companies) and they require the same types of solutions.

3. Activities involving securities form part of the traditional functions of banks. A close cooperation should be set up between the stock market authorities, the financial markets supervisory authorities and the banking and insurance supervisory bodies.

4. The main problem raised by the cohabitation of banks and insurance companies within conglomerates is related to the existence of different laws, regulations and supervisory organisations. Harmonisation and approximation seem indispensible in the field. In contrast, neither the nature of their activities nor the risks they assume are fundamentally incompatible. Consolidated supervision is vital and seems, in principle, to be feasible.

5. An integrated management of banking groups and financial conglomerates does not give rise to any major objections from a technical point of view. In as far as the various companies which make up the group have different shareholders or creditors, and in view of the existence of contrasting laws on the protection of depositors and insured persons, these companies must enjoy a sufficient degree of autonomy.

6. The extraordinary development of financial activities and markets seen in recent years is a source of both wonder and aprehension. It therefore seems that the central banks should be involved in the proposed alignment between the supervisory authorities. The massive scale and complexity of financial flows makes it vital for us to be prepared for any crisis scenarios. We must hope that such scenarios never occur. If they do, however, only the central banks will be able to intervene with the required effectiveness.

Discussions after Prof. Biron's speech

Mr. Halpin

Did Prof. Biron say that in the case of a mixed conglomerate, it will be conceivable that the overall conglomerate could be in difficulty, but the bank, which will be a small part of it, will be perceived as not being in difficulty ?

Prof. Biron

In a conglomerate, which was subjected to one central direction, it would not be conceivable and it would not be a good construction that a bank would be an integral part of such a conglomerate. But in a conglomerate which is rather loose it might be conceivable that a bank, if it is subjected to the proper precautions, could be insulated from the good and the bad fortunes of the conglomerate.

Speaker unknown (French speaking)

I do not think anybody ever thought that it will be possible to harmonise something for the banks and the insurance companies. As we said this morning, it would however, be of great interest if contacts could be established between the supervisory authorities, in order to inform themselves about these coefficients or margins, which in any case act as alarm bells in the case of a conglomerate involving banks and insurance. It should make perfect sense for such contacts to be established and for these coeficients or margins to avoid contamination where there is bankrupty or the risk of collapse, either in the bank or in insurance companies. It has been well understood that nobody has been thinking of changing the methods which have been set up to deal with solvency, nobody wants to place this on the altar of harmonisation. It is impossible, nobody would think of doing that. One can always use the same methods just as long as there is a link between the different supervisory authorities. What do you do when you turn up at a savings bank, or an insurance company, which has a banking subsidiary, how are you going to estimate a consolidated solvency, that is the real difficulty. I do not know how to solve that problem. We have cases of this, you have several insurance companies with subsidiaries which are savings banks and what do you do then ?

PROF. DR. AUGUST ANGERER

PROBLEMS RELATING TO THE SUPERVISION OF INSURANCE COMPANIES FORMING PART OF FINANCIAL CONGLOMERATES

Introduction : Financial conglomerates are defined as the grouping together under common management of companies or parts of companies which supply different financial services. Insurance business supervision is involved where the financial services include insurance products.

This paper discusses from a German viewpoint :

- the conditions under which insurance services may be supplied;
- the role which insurance companies belonging to a financial conglomerate may play;
- the requirements which must be laid down by the authorities responsible for supervising insurance companies; and
- the extent to which action on regulatory measures is needed.

I. The pursuit of insurance business

1. The pursuit of insurance business is reserved for insurance companies. All Community Member States make the taking up of the business of direct insurance subject to official authorization (1). Companies not duly authorized are therefore not entitled to engage in insurance business of any kind.

   While the concept of insurance business is not defined for Community purposes, the annexe to the Directive coordinating the legislation relating to life and non-life insurance lists the various classes of insurance, so that some guidance is available. Those in the industry would probably agree that insurance involves in essence the systematic underwriting of risks for payment.

In addition to the underwriting of risks, insurance business involves the investment of those parts of premiums which are necessary to cover the later payment of claims and also the investment of own resources. Insurance companies therefore invest capital. They operate in a similar manner to banks without becoming banks. For example, they grant mortgages and loans to firms in all areas of the economy, and in particular to banks. They invest capital in securities - shares, bonds and fund units - and dispose of them again. They acquire holdings.

Insurance companies are permitted to engage in investment activities only to the extent that such activities stem from their insurance business. They are therefore prohibited from borrowing in order to re-invest those resources at higher interest rates.

2. Insurance companies in the European Community specialize in the pursuit of insurance business. They may offer only insurance products for sale and may engage in other business only to the extent that such business arises directly from insurance activities [(2)]. There is sometimes doubt as to whether a product qualifies as an insurance activity.

In recent times, in particular, products have been developed which are difficult to classify. The question of whether an operation is directly connected with insurance has to be assessed on the basis of economic criteria. Market practices and historical developments play a key role in this. There are still varying views on both these questions within the Community. A working party set up by the authorities responsible for overseeing insurance activities is currently considering the subject. Its findings are not yet available. Among the many facets of a financial conglomerate, the following are of particular interest :

- products described as "Universal Life" products;
- fund-linked life assurance;
- the arranging of financial services which the insurance company itself does not provide; and
- holdings in companies which are not engaged in insurance business.

The term "Universal Life" is used to denote a special link-up between savings and insurance protection. There is as yet little experience of this in the Community. "Universal Life" products are to be classified as insurance products only if a risk is borne and free access to the assets saved (i.e. repayment during the lifetime of the contract) is ruled out.

The principle underlying fund-linked life assurance is that the savings portions of premiums are channelled to a fund and invested in securities. The level of the indemnification is based on the current value of the fund units. The investment risk is therefore borne by the insured. Fund-linked life assurance is recognized as an insurance product.

The arrangement of financial services for other companies clearly does not qualify as insurance business. However, certain activities are closely linked to such services. For example, it has been the practice in the Federal Republic of Germany for decades for insurance companies to arrange contracts for other insurance companies in classes of insurance which they themselves are not permitted to offer. This must be in the interests of the insured party. Similarly, building society business is so closely linked to life assurance that such operations may also be arranged by insurance companies. However, there is, generally speaking, no link between insurance business and bank services. Insurance companies may not arrange such services themselves.

A question of key importance is whether insurance companies engage in non-insurance activities when they acquire holdings in the share capital of firms engaged in other business fields. Were the answer to this question to be in the affirmative, insurance companies could acquire holdings in insurance companies but not in other financial institutions.

Their role in the financial conglomerate would thus be very restricted.

However, the question must be answered in the negative. A company which acquires an interest in another company - even to the extent of wholly owning it - does not yet pursue the business of that company. Management function, responsibility and business risk all remain with the management of the company in which the interest is held. The shareholder merely makes capital available and is naturally interested in overseeing the use to which it is put. In being represented on the company's controlling bodies, the shareholder is thus exercising that desire to oversee events. However, it is in no way pursuing the business of the company in which the interest is held.

The legal situation must be assessed differently where, under a company-interlinking contract, the insurance company acquiring the interest gains more extensive rights in the company in which the interest is held and is able to influence its management. In that way, key elements of the management of the business are transferred to the controlling company. That company is then also ultimately responsible for the business of the company in which the interest is held (3).

3. The security of an insurance company should be enhanced by its specialization in insurance business and related operations. It is the business of insurance companies to underwrite the risks run by others. They should therefore be spared alien risks.

A high degree of security for life assurance business is achieved through its separation from non-life insurance business. Life assurance companies may not provide any classes of insurance other than life assurance. Losses which may arise as a result of the hazardous nature of indemnity insurance do not affect life assurance companies.

Only certain forms of enterprise are permitted to engage in insurance business. A requirement common to them all is that the capital intended for use in transacting insurance business must be legally separate from the shareholders' capital. Moreover, full disclosure requirements are imposed on companies. This also helps to provide the necessary security for insurance companies.

Finally, insurance companies must at all times maintain a given minimum solvency margin. This is continually monitored by the authorities responsible for supervising insurance companies. This margin is available for use where, contrary to statistical expectations, an insurance company incurs unusual losses or there is a catastrophic fall in the value of its investments. The solvency margin should largely cushion an insurance company against the risk of bankruptcy.

Specialization, business category separation, prescribed legal forms of enterprise and minimum solvency margins - these are all requirements imposed on insurance companies. As these requirements are coordinated at Community level, they must be observed by all insurance companies which have their head offices in a Community Member State.

II. The role of insurance companies in financial conglomerates

The main roles of insurance companies in financial conglomerates are as :

- the partners of other financial institutions;
- the parent or subsidiary company of other financial institutions; and
- the subsidiary of a holding company which also controls other financial institutions.

This presents the following problems for the supervision of insurance business:

1. Where insurance companies and other financial institutions cooperate with the aim of marketing their partners' products together with their own products, the financial and organizational independence of the individual companies is fully maintained. The reciprocal agreement relate only to the joint marketing. Whereas banks - at any rate in the Federal Republic of

Germany - may arrange insurance, it is not permitted, as already pointed out, for insurance companies to arrange bank services. If they were to do so, they would be guilty of infringing the rule on not engaging in non-insurance business. Where it goes beyond the mere supply of addresses therefore, cooperation is permissible only if the partners market their products via a joint intermediary company. An insurance company is not prohibited from acquiring a holding in such a company. It is crucial that the intermediary company should bear the risk of acting as intermediary, and in particular assume liability in the event of faulty advice being given.

2. Insurance companies may acquire holdings in banks and banks may acquire holdings in insurance companies. Either is permissible in the Federal Republic of Germany.

   From a supervisory viewpoint, the identity of an insurance company's shareholders is irrelevant. Under German law, the board of managers is also responsible for the management of the company's business. It is responsible for ensuring that supervisory legislation is complied with. This also applies to arrangements conferring control on the parent company. They are not permissible where they go beyond the framework imposed by supervisory legislation. A bank with an interest in an insurance company - even a 100 % holding - could not give instructions to the board of managers. The authorities responsible for supervising insurance companies would refuse to approve any company-interlinking contract between an insurance company and its parent company under which the right to give instructions, insofar as it conflicted with supervisory legislation, was not duly restricted.

   Holdings acquired by insurance companies in other financial institutions constitute capital investments. As already pointed out, an insurance company does not engage in the business of the company in which an interest is held by virtue of that interest. Under German supervisory law, however, it is not possible to acquire holdings from the assets which must be available to meet obligations arising from insurance contracts. This means that holdings cannot be financed with technical reserves only with own capital and other borrowed capital.

Where an insurance company has a holding in another insurance company, it must meet the solvency requirements without taking account of that holding. In furnishing proof of its solvency, such holdings must be disregarded. The insurance company's solvency would be impaired if the own capital required for that were to be partly or fully passed on as a result of the holding to the other insurance company to safeguard its solvency. In order to avoid the so-called telescope effect, the German supervisory authorities require insurance companies to finance holdings in other insurance companies by means of additional own capital.

While it is in principle permissible for insurance companies to acquire holdings in banks and other financial institutions, such acquisitions cannot always be accepted without questioning. The insurance company's capital investments must be especially secure. Holdings in other companies are not only an investment risk; they also entail a liability risk. If the financial institution encounters payment difficulties, the insurance company must write off the holding. To that extent, the risk is limited and foreseeable. Because of the extent of the holding and the presumed influence on the company in which the interest is held, however, the insurance company may incur further financial obligations which it cannot escape. These are of an ethical rather than of a legal nature. The parent company is expected to be responsible for its subsidiary. In order to protect its reputation and not be discredited, the insurance company may be compelled to provide further injections of capital.

This ethical liability risk is hardly quantifiable in advance. As soon as a holding in a financial institution is acquired, therefore, the authorities responsible for supervising insurance companies examine whether, when measured against the total amount of capital investments, such a holding may constitute a risk for the insurance company. If it were to decide that such a danger did exist, it would have to prohibit the holding.

The acquisition of a holding must be notified to the supervisory authorities. A holding in this sense means a share of more than 10 % of the nominal capital of the company in which the interest is held. Any increase in the holding must also be notified to the authorities.

3. Insurance companies may be subsidiaries in a financial conglomerate which is controlled by a holding company. As the question of the ownership of an insurance company is immaterial for supervisory purposes, there are no objections to the holding company solution. The responsibility of the insurance company's board of managers for complying with supervisory legislation remains unaffected. The holding company is prohibited from giving instructions in this area. The interests of policyholders might be jeopardized if an insurance company were to invest excessively in other financial institutions belonging to the group. This is prevented, however, by the investment rules laid down in the supervisory legislation. Under German law, capital investments must be appropriately mixed and spread. The authorities responsible for supervising insurance companies do not therefore permit insurance companies to invest excessively in another company belonging to the same group.

III. Requirements laid down by supervisory legislation

1. The purpose of a financial conglomerate is to offer a package of financial services of different kinds. The services are supplied by different companies in the conglomerate. Insurance services may be supplied only by insurance companies. Each producer is responsible for its own product. Even where the customer is confronted with only one supplier, he must be able to know which supply has been provided by which company, since that is the only way in which he can make his decision to purchase correctly and can assert his rights against the company responsible. The authorities responsible for supervising insurance companies regard this transparency in the supply of insurance services as essential.

2. With the joint supply of different financial services, there is a tendency for products to be coupled with each other. the condition may be laid down that a customer can receive a service only if he at the same time enters into a contract for another service. Where one of the services supplied involves insurance, the German insurance supervisory authorities permit coupling only if the rights of the person insured are otherwise adequately safeguarded.

3. The interests of policyholders have also to be taken into account in the collection and transmission of data. Under German law, personal data other than such generally accessible information as names and addresses, may be stored and passed on only if the customer is in agreement. Such agreement is given to an insurance company in the case of life and health insurance to enable the necessary health examination to be carried out. The transmission of such data to other companies in the financial conglomerate is not permitted under any circumstances.

4. As already pointed out, insurance companies must ensure, when making their capital investments, that the principle of mixing and spreading investments is observed. They may therefore not invest more within the financial conglomerate than in outside companies. This is continually monitored by the authorities responsible for supervising insurance companies. They are provided with sufficient information through periodic returns on the composition of capital investments and continuous returns on new investment acquisitions.

   In this way, the "danger of infection" is largely warded off. An example from the past provides proof of this assertion. When, a few years ago, a bank became insolvent, the insurance companies belonging to the same financial conglomerate were only slightly affected. Their financial position was fully safeguarded. The insurance companies had not invested more in the bank than they were accustomed to do in outside institutions.

   The losses incurred were thus limited and did not jeopardize the insurance companies.

IV. Need for action on regulatory measures ?

1. The question has been posed as to whether insurance companies should continue to be restricted to insurance business and whether other companies should be excluded from that field. The answer to that question can only be affirmative. Insurance companies supply products of a particular kind. Such products are legally circumscribed; they require a high degree of

confidence and transparency. It is technically difficult to shape them. Special knowledge is required which is available only in specialist companies. Insurance involves the systematic underwriting of risks. These must always be visible and containable. If a company were to engage in business in addition to insurance, deficits arising from the non-insurance activities could have an impact on the insurance business. Policyholders' claims could then be jeopardized. This must at all events be prevented.

2. If insurance companies remain what they are, there is no reason to alter the supervisory arrangements for them. All insurance companies, with the exception of the very small, are subject to supervision. Only a very few have so far been incorporated into financial conglomerates. It would not be appropriate to create a new supervisory system on their account alone. Specialist supervision of insurance companies is essential if the current level of consumer protection is to be maintained.

   The expert knowledge and experience necessary for this can be found only in an authority specializing in such matters. If that authority had to supervise other financial institutions as well, the specialist knowledge of the insurance sector would probably diminish. I am therefore opposed to the setting up of a "super" authority which would be responsible for supervising all institutions in a financial conglomerate.

   This does not mean that "Chinese walls" should be erected between the separate supervisory authorities. Cooperation between the various supervisory authorities is absolutely essential, both on a day-to-day basis and especially in the event of a crisis. A joint financial council could achieve this by providing a forum for the exchange of experience, the notification of measures taken and possibly discussion of a coordinated approach. For that to happen, individual authorities would have to be relieved of their obligation to maintain confidentiality, as has already happened in the case of cooperation between supervisory authorities in the insurance field in the Community.

3. Supervision of the solvency of an insurance company must be carried out independently of the company's involvement in a financial conglomerate. The bases for calculating the necessary capital resources of the individual financial institutions are completely different. The bases for measuring own capital also differ. It is therefore not clear what benefits rules governing the overall solvency of a financial conglomerate would bring.

   For the same reason, there is also no need for a consolidated accounting operation covering the financial conglomerate and going beyond the rules already laid down concerning group accounts.

4. I do not consider there to be an acute need for action to be taken on regulatory measures in the field of insurance supervision. It seems to me to be more appropriate not to impede developments in the market in financial services through government measures. Where deficiencies appear, specific measures can be taken to deal with them. Means can always be found to do what is really essential. Should gaps appear in the supervisory system, they can quickly be filled in an appropriate manner.

Notes :

1) First Council Directive of 24 July 1973 on the coordination of laws, regulations and administrative provisions relating to the taking-up and pursuit of the business of direct insurance other than life assurance - first non-life insurance Directive - Article 6;

First Council Directive of 5 March 1979 on the coordination of laws, regulations and administrative provisions relating to the taking-up and pursuit of the business of life assurance - first life assurance Directive - Article 6.

2) First non-life insurance Directive, Article 8(1)(b);

First life assurance Directive, Article 8(1)(b).

3) See August Angerer, "Beteiligungen im Vermögen von VU", EfV 1983, p. 134

M. LE PORTZ

FINANCIAL CONGLOMERATES AND SECURITIES MARKETS

The ever increasing importance of financial conglomerates, and particularly the international ones, is a very important feature of the present structure of financial markets and it particularly applies to the securities industry. I would like to look at that aspect now. Perhaps I could just recall recent developments and then look at some theoretical solutions, at least to the problems which exist for the securities industry as a result of these recent developments and then I will finish with the international dimension and particularly the European one.

I. THE HISTORICAL CONTEXT

One particular feature of the securities industry is the extension of activity ofw firms to cover new areas. As we know in a lot of European countries, particularly the Latin countries and the United Kingdom, single capacity was the basis of securities markets, this system did not cause too many difficulties, everyone knew his place, you were either a dealer pure and simple or a direct or collective investor. This system was never completely unadulterated even in its original form, some countries never had it at all, and in many countries the banks were active in the securities market as dealers on the stock exchange floor or outside the stock exchange or direct investors as in Belgium or Italy. A lot of countries, like Germany, have had the universal bank for a long time, there is also the question of fiduciary management and that meant the banks, in particular in France, had an important role to play in collective management of assets. When conglomerates as such began to appear on our markets, as has happened relatively recently, very often it is not the product of a slow development, it is in fact the result of deliberate policy, pursued with the agreement of or as a result of pressure from the public authorities. In Europe it was particularly important to attract major American and Japanese firms to European markets and also develop market liquidity by increasing capitalisation of intermediaries. Two developments are characteristic, first of all, the developments in the United Kingdom characterised by the Big-Bang in October 1986, but also the developments in France which took rather longer but which principally involved the decision taken in March 1987 to authorise the taking over of stock brokers by other intermediaries, particularly banks. All this happened at a time when there were big changes underway in the securities market. At national level, private savings involved securities more and more for reasons of returns and liquidity. Then there were developments in collective management and also the creation of new financial futures. In the United States they are particularly important these days, where they exceed the importance of traditional markets and that success has been confirmed in Europe as well. These developments have meant that the same firms or groups of firms are becoming more and more important in national capital markets, even if that does not seem always to fit in. This development is just as important internationally, where major company shares are negotiated on the stock exchange floors or outside stock exchanges in several countries and we also have the emergence of the Eurobond markets and also Euro-equities and this has created a very active international market. This internationalisation is becoming even more important because subsidiaries in a host country can carry out activities authorised by the law of the host country, but prohibited in their country of origin. This international aspect means that we are getting the same financial multinational financial groups appearing more and more. These developments are fundamentally much in favour of market developments and better utilisation of savings, better allocation of resources, but we must accept that it is still rather difficult to regulate international groupings, since they pursue pretty uniform policy lines, but are faced with different types of national organisations and it is not always clear which doctrines are involved.

II. THE IMPLICATIONS OF MULTIPLE CAPACITY

The development of multiple capacity, particularly in conglomerates, increases market risks and causes serious problems from the point of view of investor protection and maintaining solvency among intermediaries. As far as protecting the investor is concerned, there is more likelihood of fraud or there will be if special precautions are not taken. Insider trading is more likely, since commercial banks know what is going on in all the fields of their clients' activities, and one single actor can play on several markets in different countries subject to different regulations where there is not enough coordination. Multiple capacity multiplies conflict of interest as well, as we know. As far as ficuciary management is concerned, this is linked with activities of commercial banking and financial engineering. There is also the function of brokers acting for other parties. The traditional solutions to conflicts of interest are moving in three directions. The most traditional of these is effective separation of incompatible managements, particularly in the field of commercial banking, market making and individual or collective fiduciary management. The important thing to note in this particular case is maybe not so much the actual legal separation which may be a kind of a smokescreen, but the actual autonomous effect of autonomous management by, for example, separation of accounts, separation of staff, complete delegation to the manager of decision-making powers, autonomous renumeration of those managers and various other pragmatic formulae of that type. In some cases it is impossible to separate functions, so you need to apply three principles. First of these is absolutely priority to be given to the customers' interests, in other words priority to the customer over the intermediary. The corollary of that is that the intermediary has to seek the best possible execution of orders on behalf of the customer, and then you also need diligence linked up to the concept of the financial mandate. In all these cases you need to guarantee transparency as the golden rule of the intermediary, you need a written agreement between the intermediary and his customers, setting out conditions for the intermediary's intervention, and for each transaction or group of transactions the customer needs to know if the intermediary is acting as a principal or as an agent and depending on the legal position involved you need a clear definitiion of the type of renumeration, brokers fees or the levying of a commercial margin. Another principle, which has to be observed in all cases, is that which prohibits the movement of confidential information which might have an effect on the prices of securities; Chinese Walls are certainly not always opaque within one single group, but at the same time that principle must be firmly adhered to.

Solvency of financial intermediaries

Although the question of solvency of financial intermediaries has to be seen against a new background, we must not exaggerate the risks involved. Bankruptcies in recent years in the United States have been the result of credit errors. On the contrary, no major investment bank has actually disappeared after last year's crash. Increases in market volatility as a result of concentration of institutional investors, has meant that the risks are more numerous and more acute, all the rules, or the longstanding ones have disappeared, as in France for example where solidarity amongst stock brokers in one single stock exchange was the fundamental rule which guaranteed the customers' interests. The diverse nature of intermediaries therefore means that solidarity is no longer the order of the day. Now there are rules fixing minimum capitalisation and ratio requirements, which are becoming more and more important in our countries. The principle should be that professionals carrying out the same activities should be subject to the same kind of requirement irrespective of their status. Banking status intermediaries probably make up the majority of intermediaries and stock exchange members in France and in each country they are subject to overall supervision organised by the Central Bank or bodies which depend on the Central Bank, such as Banking Commissions (Commissions Bancaires). They have the job of maintaining surveillance of a certain own funds ratio, compared with liability. Banking involvement in securities activities presupposes refinement of management ratios, it is not possible to make do with a global own funds liabilities ratio. Ratios need to be adapted to an analysis of risks involved in each type of operation and in that respect I think we can express satisfaction at the excellent work done in this field by the Cooke Committee. There it has been observed that bank supervision traditions lay down as a rule the fact that ratios have to be observed, but not all that frequently; however given the volatility of financial markets, I think that much more frequent surveillance of ratios is in order. As to bodies which do not have banking status, again management ratios are necessary as are requirements of a minimum capital level, these are necessary in all countries. There should be a close link between the bodies involved in doing this job and the Central Banks or the Banking Commissions.

The need for effective controls

It is also important to monitor the rules that exist, you need effective controls in all markets, first of all effective internal controls in the firms themselves or in the groups, this involves a control of accounts, but also and more particularly a control of procedural rules and professional codes of ethics which apply to the firms themselves and to their staff. The fact that you have internal control of procedures does not mean that you should not have external controls as well, carried out in some cases by professionals, inspecting, for example, stock exchanges and also the public authorities which generally speaking have a body of financial market inspectors available to them. In France external controls are done by the Commission Bancaire for the banks and the Commission des Opérations de Bourses for professionals in general. One more specific control requirement applies to operations on financial futures markets, because of the particular dangers involved here. On these markets a system of deposits and margins guarantees a day by day check on the safety of transactions. Given the plurality of markets consolidated supervision of open position of intermediaries is extremely useful and this is made easier by the unity of the "Chambre de Compensation" or the "Centrales des Risques" bodies, which in turn can also allow for supervision of consolidated positions amongst the major institutional investors and this may be particularly useful for these investors themselves. At all costs, though, it is absolutely crucial for these investors to organise their own strict and daily internal checks on their positions in the furtures markets as a whole, including the private or unofficial markets which normally speaking do not have this element of protection represented by the daily calls on margins.

Responsibility for regulation and control

It is very important to know exactly who is responsible for regulating and for checking that regulations are adhered to. Looking at the historical background of this, the specific nature and also the diversity of market techniques in securities led to autonomous regulation of these markets, by the professionals responsible for the organised markets, which were generally speaking groups in the securities stock exchanges. However, recent tendencies involve a more complex organisation here and we have the development of independent public bodies, like the Commission des Valeurs Mobilières, which rightly or wrongly represent the higher interests of investor protection. There is also a greater involvement on the part of the bodies which monitor the banks, because of the ever increasing importance of the role played by these banks and the possible repercussions on credit and currency. I am not sure that this is a bad thing as long as it fills all the gaps and guarantees sufficient contacts amongst the professionals and as long as we are sure that, if a conflict arises or if a crisis occurs then the rules of competence are made clear in advance.

III. THE INTERNATIONAL CONTEXT

In the international context, the heterogeneous nature of the organisation and rapid developments in the systems are making international coordination much more complex in the securities field than is the case in the field of credit and insurance. All the more so, since the international nature of the securities market makes it necessary to have a worldwide approach at the time same as a European one. We know that the emergence of an international authority and detailed agreements will apply to all of us, but it is something which is still in the distant future. Contrary to this situation with respect to banks, there is no national model which may be transposed to the international level, on the contrary there is the very great diversity which makes it very difficult to have proper coordination, and on top of that the markets themselves are far from having reached the same stage of development in the various countries. However, it does seem necessary to have some degree of harmonisation. For as long as we do not have it, national discipline is unlikely to have very much effect, particularly on the more risky transactions, and people are going to go for the systems which are most lax. That last point involves particular dangers for Europe, given the principle of mutual recognition, the internal market in Europe might be endangered and there would be increased risks of insolvency, so in the case of the securities markets, we need to go down the same path along which the banks have already gone, that is we need European coordination within the EEC and worldwide coordination as the banks have already demonstrated through the Basle Committee.

Existing bases for co-operation

There is, however, already some degree of international coordination amongst the various regulators of securities market. First of all I think it is very important to note that a lot of informal links already exist amongst the regulators in the different countries. Secondly, bilateral links amongst markets already exist and they continue to be crucial, particularly where one and the same product is being dealt in several markets. Thirdly, the international federation of stock exchanges has begun to examine a worldwide code of conduct, or at least some sort of body of principles. The international organisation on securities has created a technical committee on international transactions, made up of representatives of twelve countries, which make up more than 95% of world securities markets and they are more or less the same countries as appear in the Basle Committee. Some of the problems on that Committee's agenda include problems of solvency of multinational operators and these are being studied in liaison with the Basle Committee.

EEC implications

As far as the European Community is concerned, I am absolutely sure that closer cooperation is necessary. The unity of the financial market with 1992 on the horizon, involves a freedom to provide services, mutual recognition of national regulatory measures and the monitoring of those measures by the country of origin. I think it is inevitable, and it is absolutely crucial, that we have some harmonisation against the background of the minimalist philosophy to which Mr. Padoa-Schioppa referred this morning. I think, like Prof. Gower, that some aspects of harmonisation must extend upwards, partly in the field of cooperation. This kind of closer harmonisation, it seems to me, should apply to the rules which govern the qualifications of intermediaries, the Code of Conduct which should apply to them, prudential rules, particularly for the non-banking intermediaries, and finally, it should apply to control of entry requirements. In the field of cooperation, I think we need to develop exchanges of information and mutual assistance, particularly in the field of suspect transactions and in the relevant declarations needed for pinpointing the identify of the real owners of securities, even if they are fiduciary shares. This is something which must extend beyond the constraints of banking secrecy in cases where the regulators of the banking markets and the securities markets have a need to share these secrets. And it seems to me that all of this should at least accompany if not precede the institution of mutual recognition. The European Community has already considered these problems, when it published directives and when it prepared new directives ten years ago, and at that time it put together an initial European Code of Conduct on securities. I think that we can rely on the possibility of that work being resumed and taken further as a result of the new market conditions which will prevail when we will have a single market in financial services. For this reason I feel that when this Conference is over, we will have to take these matters further and indeed speed up the work going on in the European regulation of the banking and insurance sector and also, of course, in the field of securities. I hope that this Conference will be able in that way to lead to concrete progress for the future.

Discussion Panel

Mr. Cooke

Does Mr. Biron believe that when you are looking at consolidated supervision, it is necessary and appropriate to make a distinction between groups, financial groups, where the bank is the top company and where a bank is not the top company in the group, in terms of its structure ?

To me it seems important to make a very clear distinction, conceptually, between consolidated supervision and consolidated accounting. Consolidated supervision permits a form of consolidated view, without necessarily requiring consolidated accounting and therefore the application of precisely the same methods of calculation of solvency, for example, in different companies with different activities in insurance or securities, allowing for the short-term view of a securities intermediary or the long-term view of a banking intermediary or the special perspective of an insurance company. Does the panel accept that there is a difference between consolidated supervision and consolidated accounting for supervisory purposes and whether many of the problems, at least in the early stages of coordination of the regulation of financial service groups, can be handled through consolidated supervision, as opposed to consolidated accounting ?

Prof. Biron

Although the two concepts are related, they mean very different things. Consolidated accounting is a form of accountancy which is subject to a number of clear rules. Consolidated supervision goes much further, using consolidated accounts, but dealing with the general equilibrium of the group, its liquidity, its profitability, overall the exchange position, the risk situation, all this is a very broad concept. That is how I understood the 1983 Directive in conjunction with consolidated supervision.

It is difficult to talk about general principles which will apply to every case, but in particular for the supervisor the situation is going to be very different depending on whether the bank is at the top of the company, or is not, being just one of the component parts. When the bank is at the top of the whole, it shoulders part of the general responsibility for the group of the conglomerate, its responsibilities may extend further than a purely accounting responsibility. One can start talking here about moral responsibility which is difficult to quantify. When the bank is just part of the whole, it is easier for the supervisor to set up barriers and to enhance the autonomy of the bank. The idea being to isolate the bank as much as possible, using appropriate means to avoid the problems of the whole giving rise to serious difficulties in the bank.

Mr. Cooke

I accept that there is a difference between consolidated accounting and consolidated supervision. Mr. Biron said that consolidated supervision has to be undertaken on the basis of consolidated accounting. My proposition is that consolidated supervision can be undertaken not on the basis of consolidated accounting.

Prof. Biron

I would hesitate on that point; I think that consolidated accounts are the starting point of consolidated supervision. When you are before a group, or a conglomerate, you must try to have consolidated accounts and you must start from that.

Mr. Cooke

You must certainly have consolidated accounts, but you need not necessarily conduct consolidated supervision on the basis of those consolidated accounts. In other words you can deconsolidate the elements within the group, you need to supervise them all and certainly that is important that it is done. It need not necessarily be done on the basis of the single set of consolidated accounts.

Mr. Muller

As we have recognised in the Directive on consolidation, you cannot always use the accounting technique of consolidation for a group of companies, because it is just not so meaningful. One of the examples is that I have not seen many consolidated accounts of a banking group with an insurance company in it. The insurance company is not consolidated, because it has its own rules of arithmetic and reserves. I think that there should be a kind of technique and dialogue between supervisors where they do not necessarily have to consolidate fully in an accounting way, because it is just not meaningful and there are all kinds of devices for that, for instance, how do we deal with a participation of a bank within an insurance group. It should not be consolidated in the insurance group, because also there it is not meaningful. The technique is then just to isolate the capital endowment, of the capital invested in that area, and take it out of the capital base of the banking group or vice versa, for instance of the holding. There are all kinds of system controls where you do not necessarily have to go through the ordeal of a consolidation, because it is just not meaningful. There is a kind of system control in them which is more important than just accounting. Basic elements are the risk distribution, the capital adequacy and the liquidity position.

Mr. Biron

I agree with you that consolidated supervision goes much further than consolidated accounting, but I would express a certain preference for having consolidated accounts and these consolidated accounts can be made up on several assumptions. You can have a complete consolidation or you could have equity accounting, which is another way to evaluate their participation. But it would be always good for the controller to have before him consolidated accounts.

Mr. Fitchew

Taking in particular the case where there is a financial group, which is headed by a non-bank, are Mr. Cooke and Mr. Muller and Prof. Biron saying that over and above the need for the banking supervisors to look at the position of the banking subsidiary within such a group and at its specific position and for that purpose they would actually need to deconsolidate the accounts and look specifically at whether the capital adequacy of the banking subsidiary taken by itself was adequate. Is the proposition that over and above that there needs to be some form of consolidated supervision of the group as a whole, of the financial health of the group, looking at the tests that have been mentioned, such as liquidity, exchange rate exposure, etc. If so, if we are talking about a group which is headed by a non-bank, who is going to do it, which set of supervisors is to take responsibility ?

There is also a question I would like to put to Prof. Angerer : Does he see any need at all for consolidated supervision of this kind of group, because the presentation he gave of the German situation was one in which certainly the insurance companies are completely self-contained and there are very strict rules as to their degree of involvement with other members of the group. He mentioned that one might need to have co-operation between supervisors if there is a crisis, but there is no need for any continuing consolidated supervision of groups of this kind.

Prof. Angerer

I did mention that there would not be any point in having consolidated accountancy. Quite rightly somebody has said that solvency requirements in different branches are highly different and of course have different aims, for example, we have a holding at the top of an industry and this holding masterminds an insurance company; what sort of a consolidated account would give you useful information here ? It would tell you about the capital structure, but this is very different indeed from the information you would expect of a bank. If you have a consolidated account for this sort of a group, I am not going to get the sort of information which I need at all. The important thing is, and of course this is something which you can get via consolidated accountancy, is the sort of obligation that is worked out according to own capital. I have said that insurance companies provide a programmed approached to capital investment and this must be spread. We have learned from our experience that more than is usually the case, where you have a parent company or a subsidiary, dangers might arise and this is the sort of thing one must rule against. Similarly the bank supervisory authority might keep a very close eye upon the bank in that respect, because the risk of infraction, which we have mentioned several times, must be very carefully warded against. If we did not do what I just said, then I do not think that there really would be a risk.

Mr. Boye-Jacobsen

I entirely agree with what Dr. Angerer has said, because whether the insurance company is the parent or the subsidiary, it does have a very special role to perform within the group. The insurance company can pay, the other companies do not have money, they have a great many activities, but one can always milk the insurance company and unfortunately this sort of process escapes unnoticed and is not discovered as quickly as one would discover in the case of the bank. This is why we feel that our problems are very much geared to the life-insurance companies. One must do one's best to make sure that there is consolidated supervision, even though legallly speaking this is not necessary since there is specialisation, one must nevertheless make sure that the law is properly implemented. One must also have consolidated accounts, although we all know that it is almost impossible, still I think that one must do one's best because otherwise you run the risk of having bank or insurance companies which are only partially healthy. An insurance company very rarely goes bust, but the bonus drops to floor level, so one really must make an effort here.

Mr. Lanciotti

The point which seems to be questioned here is the lead regulator arrangements set up in the UK. These would not seem to be very meaningful in the case of an insurance company, which is part of a group.

Mr. Russell

This is somewhat tentative in the UK experience and the arrangements in the UK depend on the legal responsibility of the regulator for the particular sector. So that in the case of a conglomerate the fact that one regulator is taking the lead, does not mean that the legal responsibility is passed on by the regulator; for example in the case where the Bank of England is the lead regulator they will collect information and check for example the question of capital adequacy on behalf of the insurance regulator and on behalf of the securities regulator, but the legal responsibility will continue to be borne by the insurance regulator in respect of the insurance operation and the securities regulator in respect of the securities operations. It is, at least in the first instance, a question of minimizing the burdens for the provision of information and making sure that they are handled with the least intrusion on the financial institution. How that develops in the future remains to be seen.

Mr. Fitchew

Could I ask Mr. Lanciotti whether what he had in mind is maybe this, a theme which has come out of the discussions today. That insurance is somehow different, that the main area where there are borderline problems of supervision and borderline questions as to who should be the lead supervisor, is in the area between banking activity and securities market activity, rather than in the areas between insurance and the other two sectors ?

Prof. Schneider

Perhaps there has been a misunderstanding here. It is my feeling that so far this particular concept, this very unusual British concept, is not very well known for other Member States. A distinction between supervision on the basis of consolidation and consolidated supervision on the other hand. Two years ago, the Bank of England, in the quarterly bulletin, published a paper in which this distinction between supervision on a consolidated basis and consolidated supervision was very clearly defined and described in detail. Looking at things now from the viewpoint of a German lawyer, it occurs to me that this very much concerns bank supervision in respect of different forms which might occur within the conglomerate in the shape of different financial undertakings. This would apply to a given credit institution, but there is nothing specifically catered for when it comes to insurance companies and it was not very clear to me exactly what relation existed between the bank supervision and the consolidated supervision. I am not quite sure that this has been made very clear, I think this is really something we are not familiar with.

Mr. Barnes

The paper to which the previous speaker referred was a paper which related to the consolidated supervision of banks and was aimed at improving our understanding and our supervision of the capital adequacy of the bank. We have taken powers in our new Act to obtain information, not only from companies which are subsidiaries of the bank, but also from the holding company of the bank and also from sister-associate companies of the bank, in circumstances where that information is required in the interest of the depositors. So in terms of being able to get, in order to protect depositors, a wide spread of information from the group, upward, downwards and sideways, we have now considerable powers. The question then arises and that is where this business to which Mr. Cooke refers to of the difference between supervision on the basis of consolidated accounting and consolidated supervision, becomes important, is what is the most helpful method as a banking supervisor to exercise those powers. What I think he was arguing was that in certain circumstances you do better to obtain information on a single entity basis, but not necessarily to consolidate it in accounting terms before you do your capital ratios. We would argue that there can be times when it is better to get a lot of information which enables you to take a global view of the risks in the group, without tying yourself into the very difficult knots of consolidating the information on an accounting basis and than having to work out whether you understand what you are looking at, because the capital ratio tests that you would then want to apply on a consolidated group basis would be irrelevant tests, because you would be adding apples and pears together.

The concept of the lead regulator in relation to a complex group really is an extra-statutory coming together of the supervisors of the individual bits, enabling them to share information, which is relevant to their bits, and thereby improve their overall understanding of how the group is operating. So there is no question of the banking supervisor having his autonomy over the bank taken away from him, or the insurance supervisor having any diminution of his authority, but if they sit together round the table periodically under the chairmanship of the lead regulator, they will then be in a position to share information and to note whether there are things happening to the group overall which may call for concern and which none of them have noticed in relation to their observation of the bit for which they are responsible. I stress it is extra-statutory and its main function is to provide a better overview which will inform the individual supervision and make that, hopefully, qualitatively more acute.

Mr. Bröker

Mr. Le Portz mentioned the international conglomerates, Japanese, American securities conglomerates, which can conduct operations in foreign countries to a larger extent than they can do in their home country. From a Community point of view, third country firms that operate in the Common Market area, how does Mr. Le Portz see the application of the principle of home country control and supervision. This morning it was said that in the area of solvency contol, home country supervision was probably applicable, but in areas such as codes of conduct (Mr. Le Portz mentioned conflicts of interest), I just cannot see how this can be done in a meaningful way. Codes of conduct, conflicts of interest are concepts that refer to the market place in which these firms operate, if a securities firm operate in the London market in a wide range of securities activities that may give rise to conflicts of interests, that is from my point of view impossible to be properly supervised from the Japanese supervisory point of view. How do you see these problems and the concept of home country control in a global market is just not applicable in a smaller area such as the Common Market.

Mr. Le Portz

I share Mr. Bröker's concern. The idea of country of origin controls is a Community concept and it is still a vague one. We are still not quite sure what the Community technique of controls will involve. I am quite convinced of the fact that, even within the Community, this kind of rule could only be accepted if we have minimum harmonisation in parallel so that Community Member States as a whole, have a guarantee of investor protection irrespective of whether it is the host country or the country of origin that is involved. Otherwise, I think this is something which would not apply outside the Community, no principle of this type has been established. For as long as corresponding guarantees are not available it will be up to the national authorities in each of our countries to guarantee investor protection on the basis of the national rule. We need a Community-wide rule, or indeed a rule which applies throughout the world, but that is a longer way away.

Mr. Poveda

I think that the answer to whether one consolidates the banking and insurance sectors or not depends on a number of factors that can differ between countries. Until a couple of years we would have suscribed to the generally accepted idea of not consolidating. Banks and insurance companies in Spain ran sufficiently differentiated business for there to be a separate treatment with no need for consolidation. Since then, however, a new type of life insurance policy, with many common features with a medium term deposit, has been developed by some saving banks, and subsequently by other insurers affiliated to commercial banks. A huge transfer of money has taken place from ordinary term deposits to those policies, amounting to more than one trillion of pesetas, or about half of the annual increase of the money supply. This transfer, coupled with the corresponding transfer of covering assets, between departments of a saving bank (that share commercial and administrative services), or between affiliates of a financial group, makes utopic the separated supervision of the two activities. We do not have a legal solution for the problem, but it is a serious one, that needs an early solution.

Dr. Angerer

If it is the case that an insurance policy has been transferred to a bank, I do not think that is admissible in terms of Community law. I have already pointed out that insurance companies may only conduct insurance business, banks may not go in for insurance business and if the products in an insurance service, it cannot be conducted by anybody but an insurance company; that solves the problem, doesn't it ?

Mr. Fitchew

It seems that the problem is one of transfer of funds that has taken place between the business rather than a bank actually carrying out insurance or vice versa.

Mr. Poveda

In Spain there are types of life insurance policies which are limited within a given period of time and the savings banks offer this service to their customer at the same time, so the customer can choose a life-insurance or else an investment which is clearly defined over a period of time. The transfer from one to another was very considerable last year.

PART 3: THE COMMUNITY DIMENSION

The blurring of frontiers between financial sectors
and the rise of conglomerates on Community level;
the significance of financial conglomerates for the harmonisation
of supervisory legislation and policies in the EC;
conclusions

G.E. FITCHEW

Completing the Internal Market for financial institutions in view of the blurring frontiers between the financial services sectors

As everyone at this Conference knows, we are trying to create a unified market for trade in financial services on the basis of the following trinity:

- harmonisation of essential rules of supervision;
- mutual recognition of each others' financial supervisors;
- home country control and the "single licence".

At the risk of substantial oversimplification, the Commission's view on what needs to be harmonized in the financial sector in this process are the following:

in all cases

1) criteria for the granting of licenses or authorizations:
   - fitness and properness
   - training and/or experience

2) financial solidity:
   - minimum own funds
   - a solvency standard (banks and insurance)
   - effective internal audit and accounting rules
   - matching rules for insurance claims

in some cases

3) certains types of measure for the protection of depositors, investors and policy holders:

   e.g. - deposit guarantee schemes
   - separation of investors' funds
   - guarantee funds for insurance

4) arrangements for cooperation between supervisors (not exactly harmonisation but a rule)

Everything else can be dealt with by the host country.

This approach is already a difficult enough one because of the problems of agreeing on what are the essential rules of supervision which need to be harmonized and on how they should be harmonized.

It is clear that at least some of these areas of supervision are made more complicated by the problem of conglomerates. I should like to pick out a few examples in order to stimulate.

WHO CAN OWN WHOM?

Some countries or some supervisors in some countries take the view that banks should not be owned by industrial companies - presumably on the grounds that they could be managed in the interests of the industrial companies. Some countries, including some Member States, take the view that insurance companies should not own banks or vice versa. Italy - to take a specific case takes the view that an insurance company can own a bank, but not vice versa.

It is clear that potentially this could create problems within a unified European market. For example, if in Member State A a bank can own an insurance company but in Member State B cannot, does it pose any problems if the insurance subsidiary in A can branch or sell onto country B? More difficult, can the bank from Country A buy an insurance subsidiary in B? and, if not, why not? Can a bank in country B be prohibited from having an insurance subsidiary at home, own one abroad?

On the whole, the Community legislation, which we have in place or are preparing is pretty agnostic and provides that differences in structure of this kind and should not be an obstacle to the exercise of the rights of establishment and freedom of services. It follows equally from this agnosticism that we have not allowed these structural issues to pose problems so far as mutual recognition is concerned. The line we have taken in our banking and insurance Directives is that any properly authorized bank or insurance company can benefit from mutual recognition as a basis for setting up branches and supplying services irrespective of whether or not they are parts of larger conglomerates. But this does not answer the above question about whether crossfrontier conglomerates should always be permitted or whose rules should apply in these cases.

We have not included the possibility of banks acting as agents for insurance companies. This does not mean that they cannot do so; but merely that they cannot do so by virtue of a banking license on the basis of mutual recognition. Non-banks can, for example, lend, but not take deposits. Non-banks can also engage in leasing, safe custody, ect.

There will no doubt be other problems of the "who can do what" variety which arise as our work develops. For example, in the area of investment services, there is the U.K.'s so-called "polarization" rules. On the whole we are rather inclined to duck this issue - by leaving pure investment advisers out of our legislative proposals at this stage. But we should be interested to hear your views as to whether there are either any general principles or criteria which can help in answering the question "Who can do what?".

FINANCIAL STABILITY

I mentioned financial stability as one of the main aspects on which we have thought it necessary to lay down common prudential rules as a basis for mutual recognition and home country control:

- minimum own funds and a solvency ratio for banks;
- a solvency ratio, matching requirements and some degree of harmonization of technical reserves for insurance companies;
- no doubt some capital adequacy rules for providers of other investment services;

How far is or should this kind of rule-making be affected by the financial conglomerate phenomenon? If all these rules are well conceived and properly applied, and of course supervised, then why should the possible activities of subsidiaries or holding companies have a negative effect? If financial institutions and their groups are individually and in group fashion, regulated and supervised, then - it might be argued - the activities of parent, subsidiary or affiliate companies could be considered irrelevant. Irrelevant, because no different from any other transaction or investment in the sense that all the usual rules affecting that financial institution (e.g. a bank or insurance company) and its assets and liabilities (e.g. rules on large exposures, solvency margins, technical reserves, limits on participations or deductions from own funds, etc.) will have to be respected.

Of course, our legislation provides that the shareholders and managers have to be "fit and proper". Moreover in the new Second Banking Coordination Directive we have included a requirement that the supervisors should take corrective action if the major shareholders of a bank seem to be engaging in policies which are inconsistent with the "safe and sound" management of the bank. But otherwise we have not at this stage thought it necessary to lay down rules regarding acceptable structures for financial conglomerates. But we should be interested to hear of any other views.

WHO CAN DO WHAT? (Specialisation)

A related but not identical problem is who can do what? Here there is one Community rule of some importance. Insurance companies can only do insurance (and operations "directly arising there from"); and only insurance companies can do insurance. The immediate reason for the adoption of this restriction into Community law is a historical one, in that all of the then Member States maintained more or less strict requirements of specialization. Indeed, some went further, in requiring the corporate separation of life insurance from non-life insurance activities and Community law reflected this philosophy, in its requirements for companies formed after the directive's entry into force, subject to a grandfathering clause. This rule does not, however, prevent an insurance company owning or being owned by a bank or indeed a non-financial company. Should this prohibition on insurance companies stay in force? In favour of such a continouation is the idea that the separation of business is necessary, because of the high sensitivity of the insurance sector. However, against is the fact that some products are 90% savings versus only 10% insurance.

In the case of banking we have, on the other hand, in the Second Banking Directive taken a very liberal view of what contitutes banking. In particular as most of you will know we have included in the list of core banking activities all forms of securities transactions. Moreover, we have proposed that "home country" rules should apply in this case, i.e. where a bank is authorized to carry out any of the activities in the list in its own Member State, then it must be permitted to carry out the same activities in any other Member State, whatever restrictions the host Member State may impose on its own banks. Even here, however, we felt we had to draw the line somewhere.

And, in theory the argument could be perhaps more easily made in relation to insurance companies as there is perhaps less debate about what the activity of insurance essentially consists of, so that it should be less contentious to distinguish insurance from non-insurance actitivites.

However, the weakness in this argument arises out of the fact that companies in groups are not in practice regarded or treated by the business community, or indeed the public at large, as being separate economic entities. Mr. Angerer recognized this kind of moral responsibility yesterday even in the special case of insurance companies' sector. A bank's non-bank subsidiary may have to be rescued by its parents even if it is a non-financial company; a conflict will then arise between the banking rules referred to above (which at a certain point will obviously prevent further financial support) and the unwritten rules of the market which will downrate the bank if one of its group companies is seen to be failing. A vicious circle then comes into play, at any rate for a bank, forcing its cost of funds upwards, as these costs are of course very sensitive to reputation.

The conundrum arises from this distinction between the legal theory of separate existence which implies individual corporate responsibility to creditors on the one hand, and the generally accepted standards and behaviour of the market place on the other, in which reputable groups are not expected to allow their subsidiaries to fail. In practice, this means that they do not in fact, allow those subsidiaries to fail. Indeed one could go so far as to say that there may in some cases be almost an unlimited commitment of the parent to a subsidiary company which is closely identified with a financial institution, a commitment (whether one calls it a moral one or a practical one) which can only be brought to an end by disposing of control, in other words selling it. Such a course is naturally not an easy one to take in what will be, by definition, the difficult circumstances of a financial crisis in that subsidiary.

If one accepts this latter reasoning which highlights the group as an economic entity in preference to the former which emphasises the legal separation of its parts, it becomes clear that the financial health of the whole group, or conglomerate, in which a regulated institution is situated must at the very least be of major interest to both its creditors and to regulators. But the relationship between the supervisors authorities - particularly banking supervisors - and <u>mixed</u> financial conglomerates clearly needs to be handled with great care. It is bad enough that the central bank should be the lender of last resort to banks.

In the case of banking groups we have introduced rules on consolidated supervision and the aim is that own funds and the solvency ratio should be applied on a consolidated basis. But if consolidation is appropriate for banking groups, why not for insurance groups also?

Mixed financial conglomerates, however, would seem to require special consideration. If a bank owns all or part of an insurance company, both must separately meet their separate solvency requirements. It is clear that any double counting of capital would have to be avoided. But should there be any supervision of the financial health of a conglomerate as a whole? The EC banking supervisors have recently endorsed the view that consolidated supervision should apply to cover conglomerates headed by a non-bank holding company. Does this extension go for enough? As Professor Schneider's paper notes the management of crises poses these questions in a particularly acute form.

CONFLICT OF INTEREST

One of the Commission's working documents mailed previously to the participants (Second Working Paper, XV/49/87, pages 16 and 17) raises questions pertaining to conflicts of interest in some detail. Wherever financial activities of various types (e.g. broking and dealing for the institution's own account, lending and issuing securities, investing the reserves of insurance companies and managing investment funds) are carried out "under one roof", conflict situations will inevitably arise.

Some Member State have introduced fairly elaborate rules to govern such "conflicts of interest", "chinese walls" and so on. Should there be any harmonization of such rules at Community level? We have proposed a Directive on insider dealing which is of some relevance here. On the other hand, we have certainly not thought that conflict of interest rules are necessary, for example, in the Second Banking Directive. It is fairly easy to invent examples where at least in theory problems could arise if different jurisdictions are applying different rules. But how does one apply conflict of interest rules to a cross-border conglomerate, in particular if transactions are done across frontiers. And who takes the supervisory load (home or host country).

PROCEDURAL ASPECTS

Finally, the cooperation of supervisory authorities, which is obviously required, calls for certain arrangements, not only at national but also Community level. The least one will have to do is to ensure that the necessary flows of information are not hampered by rules on professional secrecy, but without neglecting the necessary confidentiality of supervision. But consideration of these matters could potentially go much further. For instance, if one is planning for a rôle of "lead supervisor" to be given to one of the authorities concerned within a Member State, one might raise similar questions with regard to supervisors from different countries and with a leading role for the home country authorities of a conglomerate, under the proviso, of course, that such home country can be identified for an entire group.

THE DISCUSSIONS AND THE PANEL DURING THIS PART OF THE CONFERENCE WERE CHAIRED BY MR. McGOWAN, CENTRAL BANK OF IRELAND

Discussion after Mr. Fitchew's speech

Mr. Benelbas

Mr. Fitchew has talked of the notion of what is fit and proper to the profession and that seems to be an appropriate approach. To try to put this into a tangible form, one would have to look at a number of different possibilities. For example, suppose one has not actually commited a crime which would be thought of as serious in some other field. That being the case, if one looks beyond that question of the basic definition, from which it is fairly easy to establish a rather clear general area, one can always assume that there are going to be major conflicts between the national controlling or supervisory authorities on the one hand and on the other hand any discretionary powers. Suppose you required previous experience in the financial sector, you might be conservative and consider that prior experience is necessary if people are to do their business properly. However, if so, we would prevent people who come from outside stepping into the financial sector and taking initiatives. There would in fact be an obstacle set up to the entry of outsiders and the financial sector would be a closed circle, a club. I realise that a country may have discretionary powers when it comes to criminal proceedings or a criminal definition of a given activity. If we move beyond such criteria I think we can say that there are tremendous concerns and worries, because different countries see things differently.

Mr. Fitchew

It is actually extremely difficult to lay down detailed criteria for fitness and properness. We attempted to do so most recently in drafting the Second Banking Coordination Directive and we ran into exactly the problem that you have described, once we had written down the proposition that no one who had been convicted of a criminal offence could be regarded as fit and proper. We found it really impossible to be more precise about any other criteria and in the end the proposition, that no one who had been guilty of a criminal offence should be regarded as fit and proper, seemed so widely accepted that we decided that it was not worth actually saying that in the legislation itself, since everybody clearly follows that approach. I think that in the end we are left with having to rely to a considerable extent on the discretion and judgment of the supervisors in the different Member States themselves. We have included in some of our Directives requirements for appropriate training and experience for management. Laying down requirements of appropriate training and experience for management does not necessarily seem to me to preclude new capital being brought in from outside interests, so in that sense it should not result in a closed shop.

Mr. Clarotti

It is true to say that in 1977 with the First Coordination Directive we did try to bring in a number of concepts relating to the integrity of the person and his professional experience. When we worked on the Second Coordination Directive, more recently, all the proposals which we made with a view to drawing up some very objective criteria, all these attempts have failed. Some criteria fitted the situation in some countries, other did not and the minimum demoninator was fit and proper, but it was very difficult to say more than that. The rest has to be left to the discretionary power of the supervisory authority. At one point we thought we had reached an agreement more or less when we talked about some form of failure in the form of a bankrupty. Then people said you really cannot demand that particular criterion for ever, so we stated looking at time limits and so on, in other words it was impossible to reach an agreement. We decided that that point would be left to the discretionary powers of the national authorities. It is a pity, but situations do diverge considerably in some countries, in Italy for example in the implementation of the First Coordination Directive, a number of very precise criteria were added in order to define the honourable reputation of people involved in banking. This notion of fit and proper has been inserted into their law, but as it is still a discretionary matter, it was not possible to go further.

Mr. Boye-Jacobsen

In our system the notion of fit and proper, which I only know from the Danish description, I do not know whether they are correct but that is a thing which you cannot simply transpose into our law because the penal code has quite another starting point. It says once you have been punished and are released then you are a free man and you can be integrated into the society and until you have a conviction you are free to do whatever you want. There you have this conflict again and it is thought to be a fundamental principle. We cannot be the only country in Europe that has such a principle.

Dr. Knetschke

How is the Commission to proceed in an agnostic sort of style. I think we have to be pragmatic and put out pragmatic feelers. Looking at yesterday's discussion, I would say that we have more or less three aproaches to a whole set of problems, but the common denominator is certainly the protection of the consumer. But I do not think it is quite enough when you start talking about the supervisory authorities. Insurance is probably the branch where consumer protection is still important, because that is a very specific aspect and then there are credit matters, credit policy being masterminded by the central bank and then of course another approach would be the stock exchange approach. It seems to me that there are three approaches and the idea is to put all this under one hat, if we want to harmonise. We are certainly going to have to do a lot of intellectual spadework.

Mr. Fitchew

When I referred to the Commission being agnostic, I had in mind solely the question of structure as to who can own whom. I certainly would not want it to be thought that we were agnostic about the need for consumer or investor or policy holder protection.

Günther Bröker
Head of Financial Markets Division
OECD, Paris

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SOME REGULATORY ISSUES PERTAINING TO FINANCIAL CONGLOMERATES*)

(Conclusions from Discussions on Ownership Linkages in Financial Services held at the OECD Committee on Financial Markets in 1987)

1. Introduction

Ladies and Gentlemen, first of all I wish to thank Mr Fitchew for inviting the OECD Financial Markets Division to attend and speak at the present most interesting Conference on Financial Conglomerates. I welcome such an intensified contact between the Secretariats of the two Organisations as I believe that this will be beneficial to the work being carried out both in Brussels and in Paris on subjects of common interest such as financial services.

Although -- in contrast with most other participants in the conference -- I am neither a regulator nor a supervisor, I hope to be able to make a useful contribution by reporting on work on the question of ownership linkages in financial services that was recently (in 1987) carried out by the OECD Committee on Financial Markets. The subject of ownership linkages in financial services, which includes the subject of financial conglomerates, was put on the agenda of the OECD Committee on Financial Markets because of the special attention that this question has received in quite a number of countries, not only within the EC but also in countries such as Canada, Finland, Norway, Sweden, and last but not least, the United States. The question of ownership linkages in financial services has become of topical interest in so many countries for the same reason that has been brought out so well in both Commission papers serving as a basis for the discussion at the present Conference: namely, the general trend towards the blurring of demarcation lines between previously more specialised and separated sectors of the broad and complex markets for financial services. This trend has often been referred to in terms of a general diversification process in financial services.

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*) As an appendix to Mr. Bröker's speech an OECD Staff Paper on "Conflicts of Interest in Banking an Finance and their Control and Management" is presented in Annex 3.

2. Some conceptual and definitional considerations

The OECD Committee on Financial Markets considered four types of ownership linkages in financial services which, in practice, may be combined in various ways, inter alia, via a holding company structure:

a) Ownership linkages between financial institutions of the same category, e.g. interbank participations, mergers, acquisitions, etc;

b) Ownership linkages between different categories of financial institutions, e.g. between banks and insurance companies, banks or insurance companies and securities firms, etc;

c) Financial institutions holding participations in non-financial enterprises;

d) Non-financial enterprises holding participations in banks or other financial institutions.

In discussing regulatory issues pertaining to financial conglomerates, any of these types of ownership linkages in financial services may receive attention depending on the circumstances prevailing in a given country. One basic question for financial policy in this regard is whether and to what extent policymakers should support the general trend towards diversification in financial service activities by allowing financial or non-financial enterprises to move into previously prohibited financial service activities directly or via ownership linkages (participations, mergers, partially- or wholly-owned subsidiaries). The formulation of the question suggests that policy issues pertaining to financial conglomerates should be discussed irrespective of the corporate structure within which financial conglomerate activities are being conducted. In other words, from a regulatory and supervisory point of view, a universal bank operating in a wide range of financial services through different departments of the same institution should be considered as a financial conglomerate in the same way as a holding company that owns a number of legally-separated entities operating in the same wide range of financial services.

3. Factors affecting the scope for the formation of financial congolmerates and their corporate structure

The scope for the formation of financial conglomerates and their corporate structures is essentially determined by the following factors:

a) The large number of activities that constitute the financial service sector as a whole;

b) Legal frameworks applying to financial service activities:

-- The degree of specialisation within the financial service sector that is legally imposed by different legal frameworks applying to different categories of providers of financial services;

-- The scope for "circumventing" any such legal barriers between different sectors via ownership linkages;

-- Recent reform measures designed to support the general trend towards diversification of financial service activities.

As legal frameworks applying to financial institutions are of key importance as regards the scope for the formation of financial conglomerates and the corporate structure they may take, it follows that because of considerable country differences in such legal frameworks, the problems raised by financial conglomerates differ greatly from country to country, although the basic considerations and concerns guiding financial policy may and are likely to be the same. To give two extreme theoretical illustrations: in a country with a legal framework that imposes a relatively high degree of specialisation on different types of financial institutions, the regulator may be faced with the problem where and to what extent he should deregulate, i.e. harmonize the different legal frameworks or, alternatively, allow different categories of financial institutions to move into each other's territories via ownership linkages, i.e. via acquiring, or setting up, partially- or wholly-owned subsidiaries.

By contrast, in a country with a widely tailored legal framework which allows banks to operate in a relatively wide range of financial service activities without having to set up legally separated entities specialised in one or the other activity, the regulator may increasingly be faced with the question whether and to what extent different types of financial services do not require different sets of prudential regulations and different supervisory practices. To give a few more practical examples of current issues for financial policy raised by financial conglomerates: In the light of the 1987 stock exchange crash experience, the question may arise in countries with universal banks whether and to what extent the securities-related activities of these banks should not be made subject to more specific prudential regulation and special supervisory arrangements. Another example: In some countries in which there is a trend towards an increasing interpenetration of banking and insurance, regulators may be increasingly faced with the question whether and to what extent this process should not be controlled by way of re-regulation. Final example: Canada is a country in which the legal frameworks applying to different types of financial institutions have become subject to fundamental review and reform. Under the new financial policy that has been formulated in "New Direction for the Financial Sector" (December 1986) the traditional "four pillar" system -- banking, trust and loan companies, insurance and securities firms -- has been deregulated in the sense that institutions from each of these four sectors are now allowed to enter the other three sectors via ownership linkages or to some extent also via broader in-house powers. Thus, banks -- as well as federal trust and loan companies and federal insurance companies -- are now allowed to conduct directly all government securities activities including underwriting, all money market activities including commercial paper, all activities in their own debt instruments, secondary market operations in corporate bonds, as well as a certain portfolio management, mutual fund and other securities trading activities. Other securities-related activities, such as new issuing activity in corporate equities and bonds and secondary market activities in equities, and certain portfolio management functions need to be conducted via a separate subsidiary.

4. Some controversial conglomerate situations

Although it is difficult without further study to provide a full picture of government attitudes towards financial conglomerates it can be said that some conglomerate situations, or combinations of financial services, are of particular interest or of a controversial nature in some OECD countries. The following conglomerate situations may be mentioned in this context:

a) Combination of banking and insurance;

b) Combination of banking or insurance and securities business;

c) Non-financial activities of banks or other financial institutions;

d) Non-financial enterprise ownership of banks or other financial institutions.

While in a number of countries legal frameworks require a strict separation of insurance and banking (Denmark and the Netherlands, for example) there are other countries in which ownership linkages between these two sectors and the sale of insurance products via the banking network are tolerated or -- as far as the latter is concerned -- actively encouraged (Australia, France, Germany, the United Kingdom may be mentioned in this context).

As far as the separation of banking and securities business -- or some aspects of the latter -- is concerned, the situation is in a state of flux. In Japan the securities "powers" of commercial banks have gradually been widened, notably as far as foreign branches and subsidiaries of Japanese commercial banks are concerned. The same applies to commercial banks in the United States where the Glass-Steagall Act is under intense discussion and attack. Canada has already allowed commercial banks to move fully into the securities business via increased in-house powers and subsidiaries as has already been mentioned. In addition, there is now a more general trend towards breaking the monopoly position of stock exchange brokers by allowing banks and other financial institutions to take participations in such broker firms or set up new stock exchange member firms (France, Italy, Spain and the United Kingdom may be mentioned in this context in addition to the Canadian case just mentioned).

As regards non-financial activities of banks and other financial institutions there is a striking split of views between OECD countries. While a number of countries adhere to the principle of separation of "banking and commerce/industry" (Belgium, Sweden, the United States), other countries pursue a relatively liberal policy in this field (Austria, Germany, Luxembourg, Spain, Switzerland, Turkey and the United Kingdom), although it needs to be mentioned that several of these latter countries impose limits on participations in industry and commerce (or any other participations) via specific capital ratio requirements.

Relatively little is known about government attitudes towards the question of bank ownership, in particular as regards participations in banks held by non-financial enterprises. It seems that only countries such as Australia, Canada, the Netherlands and Norway have formulated a specific policy in this field although in a number of other countries changes in bank ownership are closely controlled on an ad hoc basis through corresponding reporting requirements (Belgium, France, Italy and Luxembourg may be mentioned in this context). In fact, there seems to be a more general trend towards increased sensitivity on the part of policymakers as regards the issue of bank ownership.

5. Basic policy concerns

I am now turning to the more fundamental question of the reasons for which policymakers or regulators are, or should be, concerned about the trend towards diversification in financial services, the blurring of demarcation lines within the financial services sector and the related trends towards the formation of financial conglomerates. In this regard, the following three broad objectives of financial policy are relevant:

a) Ensuring efficiency in the financial services markets through an adequate level of competition (efficiency meant in the broad sense of adequate supply of financial services);

b) Ensuring the stability, safety and soundness of the financial system as a whole (protection against system failure);

c) Ensuring adequate protection of the demanders of financial services against fraud and malpractices and losses that may arise from insolvencies of individual providers of financial services;

Whether, to what extent, and in what sense there is a need for regulation and supervision of ownership linkages in financial services and of financial conglomerates ought to be judged against these broad financial policy objectives. Does a given financial conglomerate, or combination of financial services activities, increase the efficiency of the system in that it widens the range and improves the quality of services offered? Is there a danger that the conglomerate, or the combination of financial service activities in question, reduces the scope for competition in the financial services markets and increases the concentration of financial power so that ultimately the efficiency of the system may deteriorate? Does the formation of a particular conglomerate, or a particular combination of financial service activities, tend to increase the overall risk exposure in the system? Finally, does the formation of conglomerates, or a particular combination of financial service activities, increase the danger of malpractices through abuse of conflicts of interest situations and self-dealing, i.e. intra-concern operations which are potentially harmful to the extra-concern client? These seem to be major questions that need to be considered in an effort towards designing policies towards financial conglomerates.

Guided by the three basic concerns, or objectives of financial policy just mentioned, regulators have to deal essentially with the following more specific issues:

a) Conflicts of interest;

b) Self-dealing (i.e. intra-concern operations);

c) Insulation of risks within a conglomerate or concern;

d) Concentration of power, dominant market positions.

Canada, France and the United Kingdom are examples of countries in which questions relating to conflicts of interest and self-dealing receive particular attention as regulatory systems are being reformed in the direction of a further blurring of demarcation lines between previously separate financial service sectors. Further detail on the issue of conflicts of interest is given in the Annex which is a reprint of a Special Feature published in "Financial Market Trends" No 38 (OECD, Paris, 1987).

Discussion after Mr. Bröker's speech

Prof. Angerer

There is one rather important question of structure which has turned up very clearly. Mr. Bröker asked what conditions should apply to participations. It seems to me that we are not taking sufficient account here of the fact that we have now learned that there are very different forms in which groups and conglomerates are put together. It is not a question of who can be authorised, we know when we look at the legal situation that these things exist in different forms. First of all there is the question of simple participation, even if it is majority participation, which is not used in order to exert direct influence on business policy. Secondly you have the situation where you get the decentralised grouping where there is some influence exerted perhaps on staffing policy and financial policy, but otherwise the individual companies in the conglomerate are given a pretty large measure of freedom in pursuing their business policy. For example, the BAT conglomerate allows its subsidiary Eagle Star a pretty wide ranging room for manoeuvre in determining its policy. Thirdly the very highly concentrated conglomerates where the subsidiaries are really only conducted as a local establishment, but they are kept on pretty tight rein neverthless. It occurs to me that the fact that you have these different forms in which conglomerates are put together, means that these will have to be dealt with differently in our various legal systems. In the case of co-determination the conglomerate is considered as one unit and when accounts are being put together in part the conglomerate is regarded as one unit. In supervisory law in part the decentralised conglomerate is of the essence. In individual countries, for example in the Federal Repulic of Germany, there are differences in the case of insurance law. This kind of centralised position is not allowed, but the opposite is the case in banking, in fact the question has not even really been discussed. Therefore, I would suggest that an undifferentiated view of the question of whether participation is possible or not, it is really going to depend, to a very large extent, on the level of centralised conglomerates, or decentralised conglomerates and one can draw further distinctions as well.

Mr. Bröker

These distinctions within the different types of concern in the formation of conglomerates is also important for the question of the contagion effect whether the concern of the holding company feels responsible to bail out one of its subsidiaries. One can easily see different examples where in some cases a big bank just coldly drops a subsidiary that does not make any profit, while, in others, they say "we must come to the rescue" and they help out. It is not a one sided affair, one can see all forms, both highly centralised formations and highly decentralised formations where one piece after the other may be sold off.

Mr. Jonkhart

Question to Prof. Schneider. I fully agree with the analytical distinctions, but maybe there is a practical problem involved. Suppose that for supervisory purposes we make a distinction between the different types of participation and the different types of conglomerates. Suppose that among those different types of participations there are certain types that the supervisor would not like to see, would like to forbid them. Once you have given permission for a type of participation that you can go along with, how do you prevent the company or the conglomerate from evolving in such a way that it makes abuse of your permission and shifts towards an undesirable form of participation ? You are just taking three different types, but you could also make ten different types, it is a matter of refinement and where do you draw the line between one type and the other type.

Mr. Fitchew

In the particular Belgian case where a closely controlled participation by a bank in a non-banking institution is not permitted, is the distinction between a closely controlled conglomerate and a losely controlled conglomerate one which is a matter of law or is it a matter of fact. If it is a matter of fact, what are the criteria for determining that ?

Prof. Schneider

First of all we are talking here of questions of fact. The fact whether a conglomerate is organised in a centralised or a decentralised fashion. Since there are certain legal consequences, attempts have been made to try to draw these distinctions between what is centralised and what is decrentralised, because of the legal consequences. There are certain legal markers which have been laid down in order to draw this distinction. Secondly, if we are to stick to the mosaïque-type theory, in other words we only have supervision of one individual undertaking in the conglomerate and not of the whole conglomerate, you do not have a conglomerate-wide supervision, you can only defend that theory if you do not believe that the concentrated conglomerate is acceptable. Mr. Jonkhart's question is perfectly justified. How do you provide guarantees for the decentralised conglomerate. If you look at, for example Danish law, very interesting provisions exist there; if I understood correctly there is a prohibition against there being a personal identity in the members of the particular bodies in question, in case of the parent company and in the case of the subsidiary. I know that there are some countries where the identity of members is prohibited, so that the subsidiary can make up its own mind. Our British colleague pointed out to me that the supervisory authorities feel that personal responsibility of the members of the board of the subsidiary could be reinforced, their own responsibility, their independance vis-à-vis factual influences. It is not so much the question of the legal implications, it is the de facto influence exerted by the parent company. If you compare the different legal systems you realise that each legal system has different rules, or in part they have rules on guaranteeing independence, but they are put together in very different ways and they are also listed separately.

Prof. Biron

I tried to draw a distinction between companies or integrated groups and those which are not intregrated. One has to adopt a pragmatic approach basically, because groups can be organised in all sorts of different ways and our experience has always been that the group does not always tally with the image which they themselves project. They might be very closely integrated, but that does not appear. This is why the Belgian authorities adopted an essentially pragmatic approach, taking account of any contingency which might occur. We have a protocol on the banking function and the banking autonomy and sometimes we have required the bank, or we have required the conglomerate, to increase the bank's capital. We do not have precise rules at all, we do not say this must happen or that.

On policy instruments with respect to the structure of the financial services industry

by prof. dr M.J.L. Jonkhart *)

paper presented at the EC Conference
on Financial Conglomerates, Brussels,
Borschette Center, 14/15 March 1988

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1. Introduction

1. As financial conglomerates emerge, the question arises how to control them; previous speakers at this conference have made this sufficiently clear. From the place in the program some of you may be expecting me to answer this question. To start with a dissapointment: I will not do so, if only because I don't know the answer either. What I will do, however, is to address some elements of the question of which I think that they may be relevant. I will do so in the light of the Dutch experience with some legal instruments that came into force in 1979 and which were particularly designed to control the structure of the financial services industry. To the best of my knowledge the Dutch legislation is rather unique in having created such instruments exclusively to control the financial industry; the only country with similar specific instruments I am aware of, is Norway. Most of the countries today base their policies on general merger rules and general antitrust legislation.

2. The general outline of my presentation will be the following. First of all I will give you a brief summary of the system currently into force in the Netherlands, including its history and its reasons for being in existence. In the second part of my presentation I will address the issue whether or not it would be a good idea to introduce such a system on a European level. Here a clear distinction must be made between the instrument itself and the way it has been used in the Netherlands during the past decade. This is an important distinction, because my conclusion will be that the instrument itself may be useful on a European level, but the way it has been used sofar in the Netherlands should not be copied along with it, not because it was a poor use of the instrument, but simply because of a difference in basic conditions in the environment.

2. The Dutch experience

3. Let me start by describing the current legal situation in the Netherlands. From thereon I will picture the actual policy presently pursued and I will try to provide you with some insights in the reasons behind this policy. I will conclude this part of my speech with some remarks on the future of the system.

4. Under the current Act on the supervision of the credit system it is required to obtain a so-called 'declaration of no-objection' both in case a bank wishes to obtain an interest in excess of five percent in any other corporation (bank or non-bank, financial or non-financial) and in case somebody wants to be able to exercise a voting power in excess of five percent in a bank. Note the difference between 'ownership', which is relevant in case the bank is the controlling party and 'voting power' in case the bank is the party to be controlled. I will come back to this difference later on, when the lessons that can be learned are to be discussed. A rather similar provision is embodied in the Act on the supervision of insurance companies. The major difference is that in the latter case the provision sees only to the situation where an insurance company wants to obtain an interest in a bank. As such it is complementary to the provision in the banking legislation.

5. The declaration of no-objection as meant by the Act on the supervision of the credit system is given by (or, on behalf of) the Minister of Finance after having consulted the Nederlandsche Bank in its role as the supervisor on the credit system. However, the Minister can only grant a permission in the case of a positive advice of the Central Bank; hence both the Minister and the Central Bank have a vetoing power. Likewise the declaration of no-objection on the basis of the insurance legislation is given by the Minister of Finance after consultation of the Verzekeringskamer and here again he needs a positive advice.

6. Both acts give explicit considerations on which applications for a declaration of no-objection are to be judged. In the case of the banking legislation these grounds are a) sound banking practice and b) whether or not the proposed action would or could lead to an undesirable development of the credit system. The Central Bank judges the application on both grounds, the Minister of Finance only on the latter. Similarly applications in the context of the insurance legislation are judged on the basis of 'sound insurance practice' and 'undesirable development in the insurance industry'.

7. Sofar for the facts. At least as interesting, of course, is the policy that governs the use of these legal instruments. The central idea is to avoid an undesirable concentration of financial power and to ensure sound banking practice. In the past decade the political emphasis has been on the first criterion. During this period the three main policy rules have been as follows:

1. a strict separation between banking and insurance,
2. domestic take-overs of any importance by any of the top-5 banks were not favoured,
3. no banque-d'affaires.

Originally the separation between banking and insurance was not limited to mutual ownership but it included limitations in the commercial cooperation as well; the latter limitations however where lifted at the end of 1986. With respect to banques d'affaires one should think of banks having permanent and substantial interests in, for example, industrial companies, or, more general, in any non-related area. Normal investment bank activities are, of course, permitted (of course within the boundaries of prudential supervision).

8. As mentioned before, the major force behind the separation policy tradionally has been the fear for a concentration of financial power. A number of Dutch banks rank among the largest banks in the world, as do a number of Dutch insurance companies. At the same time, however, the domestic (guilder) market is relatively small. A further concentration between those largest companies could result into too dominant a party in the home market. This applies, of course, only to the largest companies. However, if large banks and large insurance companies have to be kept separate, considerations of avoidance of a distortion of competition force towards a policy where all banks and insurance companies are to be kept separate.

9. The roots of the policy just described are in the seventies, which came after a periode that had shown a series of substantial mergers in the financial industry. Ever since, conditions have changed. First of all a large number of foreign banks and foreign insurance companies have entered the Dutch market. In such an environment with enhanced competition, the fear for monopsonistic behavior diminishes. Secondly,

in the meantime also the balance in relative strength between banks and insurance companies had been improved. Moreover, the role of other institutions such as pension funds had increased substantially thus also adding to an increased competition. Thirdly, the awareness of the fact that the top financial groups from the Netherlands can only maintain there international position (and hence their meaning for our own domestic economy) if they have sufficient growth opportunities increased. Fourthly, the Dutch financial markets have increased substantially during the past decade, which is yet another reason why the fear for dominating financial power has diminished.

10. The developments just described have led to the wish at the side of the monetary authorities to liberalize the regime. Accordingly the discussions with the parties involved - i.e. the banking industry and the insurance industry - where opened in the Summer of 1985. For this wish to liberalize there was yet another reason. It had turned out that in practice a policy of complete separation leads to very detailed regulation at the level of the individual institution. The reason for this is, that there are many forms in which a financial group can organize itself. In each and every case it becomes necessary to accompany the declaration of no-objection with a set of permanent conditions that aim to avoid a violation of the complete separation rule by what may be called a 'back-door construct'. To give just one example, it is perfectly feasible that an international financial group based in, let us say country X, wishes to obtain the shares of a Dutch bank. Suppose that for tax reasons it wishes to do so through a holding company on the Dutch Antilles and a Dutch subholding. In that case it becomes necessary to require all parties involved - i.e. the parent group, the holding company and the subholding- to abstain directly and indirectly from any insurance activity in the Netherlands if one wishes to maintain a complete separation. The regulatory burden then soon becomes increasingly troublesome.

11. The discussions started in 1985 led to the conclusion that although the regime could be relaxed on a number of issues, there still was a considerable fear, both political and in a large part of the financial industry itself, that a complete opening up on a rather short notice would have a number of undesirable consequences. As a results only a limited number of steps were taken and it was agreed upon that by the second half of 1988 the discussion would be continued. The major steps set at the time were

- a complete freedom of all commercial relations,
- the freedom to obtain a mutual shareholding interest for investment purposes with a maximum of 15% (where the voting power is limited to 5%),
- the freedom to own or to establish capital market institutions (in particular: mortgage banks), which abstain from deposit taking.

The general separation between credit institutions and insurance companies, however, was maintained.

12. Since the first steps agreed upon in 1986 developments have continued, the major new element being the 1985 White Paper by the EC Commission. At the time of the discussions all parties concerned were, of course, familiar with the existence of the White Paper. Nevertheless I think that it is fair to recognize that only recently most people start to realize the far reaching consequences as well as the fact that 1992 no longer is a myth. And indeed, those consequences are far reaching. In the fast majority of European countries banks and insurance

companies can be part of the same financial group, for instance under a common holding company. A similar development is notable in Canada, whereas also in the U.S. the system is under consideration. To refuse access to either the bank or the insurance company of such a group to the Dutch market because of the fact that they are in the same group clearly would violate the idea of freedom of establisment and of rendering services in a truly Internal Market. Without any doubt this shall be a serious consideration in the domestic discussions yet to come. By the way, note the striking similarity with the discussion on the access for banks from countries where general banking is allowed and countries where commercial banking and investment banking are separated.

3. Lessons that can be learned

14. Does the foregoing mean that explaining the Dutch structural policy towards the financial sector at an EC Conference on financial conglomerates in the nineties is an excercise of mere historic and/or curiosity value? Clearly I hope it is not, but I believe that indeed something can be learned. From the current situation in Europe it is clear that there would be no majority to establish a complete separation between financial subsectors - be it between banking and insurance or, for instance, banking and investment - on a European level. And indeed, I do not know any valid reason why one would like to do so. The Dutch policy clearly emerges from a situation where there was a fear that large financial groups would dominate a relatively small home market. Considering Europe as one market, there is no reason at all for such a fear, on the contrary. What are considered large institutions in a small home market are still relatively small institutions on an international level, rightly seeking for more co-operation to maintain there international position. Last month's announcement of the co-operation between the Belgian Generale Bankmaatschappij and the Dutch Amro Bank is just one example. Opening up the coutry-by-country barriers will on the contrary increase competition and provide opportunities for greater efficiency from which ultimately we will all benefit.

15. Recall, however, that the policy instrument of a 'declaration of no-objection' was not only created to counter an undesired concentration of power in banking and insurance: it was also created to give room to considerations of sound banking practice and sound insurance practice. In other words, the declaration of no-objection is also a prudential instrument, particularly designed for the emergence of financial conglomerates.

16. Considering the instrument as a prudential one, the question arises as to what benefits may be expected from it. In my opinion, based on the Dutch experience, the benefits may be in three different, albeit interlinked areas:
- ex ante testing on sound banking (and/or insurance) practices,
- ex ante testing as well as permanent testing afterwards of 'fit and proper ownership conduct',
- information on and control of the group as a whole.

Let me explain each of these items.

17. Whenever a financial institution - or, for that matter, a financial group - is planning to participate in any other corporation the first concern from a prudential point of view obviously is whether or not such a participation could endanger the creditors' interest. In other

words, one would like to verify whether or not the financial institution is solvent enough to participate and, maybe even more important, whether or not the organization is sufficiently well equipped. A system of a declaration of no-objection in this respect works as a 'nihil obstat' and - if the proper sanctions go along with it - can insure that no irreversable action can be taken until the supervisor is satisfied.

18. Likewise the supervisor has the opportunity to judge the 'fitness and properness' of the ownership in advance in case anybody wants to excercise any substantial voting power in a financial institution. Note that the concern here is not directly one of financial solvency, but rather indirectly. The direct concern is one of undesirable influence on the management of the financial institution by other parts of the group, also in the best interest of the creditors. A construct of a 'declaration of no-objection' in advance is superior to a requirement that the institution should provide the supervisor with the names of its shareholders, because in many cases shares are to bearer, as a result of which shareholders can remain anonymous, even to the company itself. This expecially may so in the case of a financial institution listed at the stock exchange. Linking the declaration of no-objection to excercising voting power has the advantage that the shareholder himself has an interest in revealing his indentity and in observing the conditions eventually set at the time of the declaration. Attaching conditions to the declaration of no-objection moreover turns out to be a very effective instrument to ensure that the behavior of the shareholder remains 'fit and proper' after the initial permission. The ultimate sanction may be that the votes are legally ignored in case the conditions are not met.

19. The conditions attached to a declaration of no-objection also provide an opportunity to monitor the totality of the conglomerate to which the financial institution belongs. For one thing it provides an opportunity to require financial information on a permanent basis. Clearly, another possibility would be to control the financial relationships such as lending, borrowing and paying dividends between the institution and other parts of the group. Yet another possibility is to require that actions by other parts of the group such as take-overs or mergers, which are considered potentially influencing the soundness of financial institutions are referred to the supervisor in advance.

4. Conclusion

20. Financial conglomerates can take many forms and the supervisory issues involved can be very complex indeed. The foregoing by no means pretends to have solved these problems or even to have addressed them all properly. For one thing the difficult question of co-ordination between the different types of supervisors - banking, insurance, securities - was not even mentioned. The same is true for the co-ordination between the supervisors in different countries. However, whatever system eventually will emerge, it is my feeling that making take-overs by financial institutions and excercising voting power in financial institutions subject to explicit approval may turn out to be a useful element of it. It may do so especially if the occasion of the approval gives the opportunity to specify conditions tailored to the situation at hand. The experience in the Netherlands at least makes it clear that the instrument is capable of supervisory guidance of the formation of financial conglomerates in albeit not a perfect, but still a sufficiently helpful way.

Perspective of cooperation among the competent authorities.

Christen Boye Jacobsen, Deputy Permanent Secretary, Ministry of Industry and Trade, Copenhagen, Denmark.

Denmark has the strictest statutory restrictions on other business in the financial sector. Most "other activities" are prohibited, not only in the bank or the insurance company itself, but equally through affiliated daughter companies.

It may thus seem a paradox to you that we were the first EC-country to merge the banking and insurance supervisory authorities. In logic - alas, the worst legislator of all - we were to be the last. But well is it written that the first shall be the last and the last the first.

The explanation to our paradox is that the merger was primarily decided upon due to factors other than the intermingling of banking and insurance in practice. This does not mean that this problem is unknown - on the contrary. But financial coglomerates in Denmark are outside my subject. I just mention that in Denmark the insurance companies took the lead in the 80'ies.

The main motive for the merger was a general health control leading to a complete reorganization of the Ministry of Trade and Industry. With budget problems, with already the highest taxes in the world, and with an unstable political situation that renders budget cuts in the big areas of social welfare, unemployment alowances, or education a tabu, a strict system for what rests is a must. This requires an effecient administration, and in the wake of this the Ministry of Trade and Industry was totally restructured. It was the biggest reshuffle ever made in the central administration. 19 agencies were merged into 8, e.g. in maritime shipping 7 into 1. Among the merged were also the supervisory authorities for banks and insurance.

During the same period there sat under the chairmanship of our permanent secretary a comittee dealing with the new activities of banks and insurance companies. The committee was informed of our merger, but had no right to discuss this albeit most important development because it formed part of a grand scheme for the whole ministry. I will at this point make on excursion about a scism that arose between us and those who represent a background of theoretical economy. They have grown in influence in our administration as a natural consequence of our economic distress. But they tend to think that the Banking and Insurance Acts primarily form part of economic and monetary politics and tend to underrate the needs for investor protection. Often they are hampered by lack of legal knowledge and of experience in practical administration and tend to look at financial sectors isolated from the rest of business. Nothing is, we think, more detrimental to the financial sectors as if legislation and administration were to regard them as an extention of political and regulatory burocracy. Indeed the coglomenrate question illustrates the importance of subjects like company and monopolies law and practical "Fingerspitsgefühl" as more relevant than economic theory. This showed an- admittedly strange - ancillary need for strengthering the systems, including a new appeals board, in order to keep our system efficient <u>and</u> respectable and thus being able to treat the sectors as what they are and ought to remain, business forming part of private economic life albeit under control mainly for solvency reasons.

This also illuminates that the merger forms part of a more active industrial policy.

An active industrial policy is relatively recent. But in the 80'ies we experienced a need to infuse new dynamism into the economic life. As cheaper capital in scale is needed the financial sectors suddenly became more interesting to the political thinking (also as a tax object) and conversely took greater interest in investing in shares themselves. Equally important is that the financial world forms part of the growing services sector. But the frequent political discussions require a strong "sparring partner" and "knowledge bank" for our minister, and thus the need for a stronger supervisory authority manifested itself anew.

A frequent argument an favour of the merger was that in case of a crash of a big company or a sector the combined personel gives a bigger "masse de manouvre" to direct to the area in question. Of course it means that other areas are depleated. But the answer to this is that the old intense control will end anyway because we cannot afford it. The supervisors are thus forced to invent new and modern controls imbracing the auditors, actuarians and internat controls of the individual companies.

Thus, gone are the days of the cartesian maxime: "Je depense, donc je suis haut fonctionaire".

I shall now turn to another problem. What can we learn for general use from the Danish experience.

First of all I submit that you shall - before setting out - clearly realise what you want, do not want, and what cannot be achieved. It was intended that the system should work more smooth. We hope it will, but there will be then no saving in the form of reductions in personel. Generally speaking we hoped to avoid dilluting both the effeciency of the supervisory legislation and the competitive abilities of companies.

But then the real problem arises. To what extend are insurance and banking alike. 3 times in two years there had been debates in parliament, an argument in favour of merging being that financial sectors, and thus controls, are alike. The government repulsed this idea convincingly. In coping with new activities we must not forget, under the impression of new producets and new magic words, that **the core of banking and the core of insurance are, shall and will for a foreseeable future remain different.** The short term nature of much banking business, and in consequence a kind of liquidation accounting in banking illustrates this when compared with the excessive long term natur of life insurance business. It is clear that in frontier areas can there be a usefull overlapping such as extending actuarian control to the many pension schemes offered by banks and marketed in an often unfair comparison with insurance schemes and mixed schemes. It is possible clear that a so-called "synergy"effect can arise in areas such as the control of the annual accounts out of an intellectually more demanding work. In this area I think that our collegues in the other countries have a potentially greater advantage of common control due to less strictness - or greater laxness, according to tastes. But theoretically the opposite can happen through the phenomen known in science as resonance or coherence which also applies to public administration.

This calls for the absence of too much optimism and a nearly excessive virgilance in the genesis phase of the new authority vis á vis a well qualified personel with a great mobility. I guess that we are all aware of the scarcity of actuarians available at public wages. This required with us reliance repon modern organization and management theory in order to retain an attractive and efficient organization.

In the proces of merging I observed the importance of adapting all statutory instruments. It was a huge work to bring all the big acts into the new harmony. Indeed it required many hundred amendments. I think we managed it, but there remains one illustrating problem. Before the merger the Insurance Supervision had a director, a board and an appeal bord. The banking authority had its director under the responsibility, direction of and appeal to the secretary of state. Now the Insurance Bussiness Act states: "The Financial Services Authority consists of a directorate and the Insurance Board". There you see an imbalance. It is illogic, and the further question of a Banking Board - so far undiscussed - springs to the mind, whether politically desired or not. Thus the merger in itself will foster some change in future, e.g. in group law.

This leads me to discussing whether the merger should lead to a kind of cover organization for two departments for banks and insurance respectively, or whether a real new integrated structure should be created. For many reasons, I think the latter solution should be aimed at as far as possible. Otherwise the cost/benefit ratio will deteriorate, and you will have neither a common culture for all employees nor any "synergy"effect. As mentioned above you will, however, at the same time have to respect the differences in business of banking and insurance. Otherwise you may hamper a development of new products and competition.

On the whole the picture till now is a fairly rosy one. One problem I can see is if insurance company has invested in a sick bank or vice versa. If there are separate authorities, overtures from the banking supervision to the insurance company to save the bank through a bad investment can be countered by its sister authority. But under a merged authority, what then ? My fear is that the long term interests (i.e. insurance) can be jeopardized in order to accomplish the political short term gain of saving a bank.

Another grey area is the confidentiality. Those working with insurance accounting shall keep their knowledge secret to outsiders, and equally those working with banks. But what to do, if the persons are the same? This has not been clearly solved, but it is a problem under the lst banking directive. It will at some later stage call for technical amendments. This is all the more required as a positive cost/benefit requires investment in the best data equipment and the storing and comparing of much information.

So far, I have not described any cooperation among authorities except in its most integrated form.

What about old fashioned cooperation ? During my term as Director General in the Insurance Supervision I was bemuzed to find it quasi non existing in a formal or systematical sense, though the problem of blurred frontiers is 25 years old.

The need continues to exist because two relevant authorities work alongside the merged supervision of banks, Stock Exchange, and insurance companies. First there is the office for protection of consumers and fair trading, also under our own minister. Secondly there is the authority supervising the mortgage credit institutions under the minister for housing. Your know that this is relatively the most important in the world, essentially an oligopole of 3 institutes, with a total balance of 725 billion D.kr.

The first formal cooperation among all the authorities in the financial market took place in the summer of 1986. It is likely to grow, but not in a formal way.

Advertizing for long term saving notably pensions, has led to a war between companies, and between banks and insurance companies. It will incease cooperation to ensure fair competition and a reasonable level of consumer protection. Market developments, individual contracts, coglomerates etc. will in themselves increase the need for consumer protection.

Another need for coorperation arises from new activities in mortgage credit. The first banking directive opens the market, and forms of "wild west" transactions can affect the banking system and the Stock Exchange, supervised by the Financial Services Supervision Authority, and this generates cooperation.

In concluding I will just mention that in order to simplify I "forgot" two important areas. First the Stock Exchange that has been semiindependant under Banking Supervision for more than 50 years. Secondly monopolies legislation which also is under the competence of the supervisory authority. Thirdly how the merger affects the increasing cooperation relations to the authorities in other countries which, in theory, it should facilitate.

Discussion Panel

Chairman (Mr. McGowan)

There were three things running through this discussion. One was banks; from time to time I was disappointed that I did not see "credit institutions" used rather than banks, because I felt that we were trying to identify those institutions which guarantee their liabilities, but on the other hand not the value of their assets. That is one sort of area that ought to be identified and there are special responsibilities relating to it. As a central banker I got worried this morning when I heard Mr. Fitchew talking about the extent to which the central banks might have to stand behind the whole financial sector. I think that is one area which has been coming through and there is a message in it; perhaps it has been developed well in recent years and we ought to continue down that road. I do not think it is as simple as that, because the ownership issues comes up. Should banks own various institutions or who should own banks ? I have a feeling that the insurance business is quite unique, it is difficult to see whether there is much scope for co-operation in the areas between the banks and the insurance sector, although perhaps more emphasis should have been put on the separation of the life and non-life business. I do not know where the securities people come into the discussion, should they come closer to banks, closer to insurance or are they quite independent ?

Mr. Jolivet

The discussion which we have heard about different experiences, in particular the OECD, show that if we start discussing structural harmonisation, we are going to come a cropper over some serious issues. The structures we are talking about are very much rooted in our policital and legal backgrounds, for example, the mechanism concerning anti-trust makes it very difficult. Another example which makes things more complicated, we have always concerned ourselves with the notion that you have shareholding companies in conglomerates or mutual societies, but this is only a very small part of the picture. The fact is that we are operating in an open area, an open financial zone, thus we cannot just stand in isolation from that space. The fact is that the multinationals find that our rules are pretty amusing, the big American banks when they operate in Europe, forge ahead with insurance, they are very glad to do so, because it gives them experience should the market ever be open to them back home. If we were to start harmonising, I would be rather disinclined to find this of much interest, speaking at least in a supervisory capacity. There are many problems which are linked with the legal structure of conglomerates and I do not think harmonisation is going to solve those problems. A number of supervisory authorities are worried because there are perfectly fit and proper persons about, who purchase insurance companies. Since the solvency level in Europe is rather low and since in some companies there is considerable added value in insurance companies, it is very tempting to buy them up so that you can do some asset stripping and then it goes on to the market. That is a conglomerate problem which we are very worried about as supervisory authorities and I do not think harmonisation is going to help us there. I am not saying that we do not have any difficulty with structures, but I think that one must pinpoint a number of specific problems.

In banking one can say that competition prerequisites in different branches of activity are one and the same. This is something which I think was very clearly demonstrated in the speech given by the Dutch speaker. So my point is, it is important for us to take a very careful look at the question of competition.

Mr. Muller

The phenomenon of the conglomerate is there, we have to take it as it is. We should not have any ambitions in saying it should be centralised, it is just there in a very competitive world market. We have to tailor our supervisory intervention to their structure, not force them to change their structure. What is actually binding us together here ? It is primarily the worry about the stability of those institutions that are under our different supervision, that is our common root. We will maintain our responsibility as an insurance supervisor, as a security supervisor, as a banking supervisor, but we have to recognise, although we will all retain our own primary object, that as soon as our institution works in a conglomerate, that will have an influence on its stability. I felt that in Mr. Angerer's speech, and he is very clear on the philosophy of insurance supervisors, that they would like to maintain as long as possible chinese walls, also there they take into account the possibility of contagion risk, moral responsibility and others. We all share that, perhaps to different degrees, and I think the banks are perhaps more exposed by their names and have more tradition, but we all share that. Firstly, I would say that we should try to find instruments that will help us to be aware of what happens in the conglomerate. Secondly, that we can co-operate with our colleagues and that has to be translated into instruments. In the first place we should have an instrument to be aware what happens in the holding or in the other area of the group. I would subscribe to Mr. Jonkhart's proposal for a kind of technique which is not so loose, but to have an instrument to intervene. I wonder whether Art. 9 in the Second Coordination Directive for Banking is already tailored for that ? We should strive that throughout the machinery of the Commission, the three supervisory groups should have instruments to know what is happening in a group, so that later on they can discuss between the different areas of supervisors and that requires a relaxation of the secrecy provision.

Mr. Boye-Jacobsen

We came on a natioal level to the same conclusions as those which Mr. Muller just mentioned, because what matters is that we know what is going on, the transparency question. The Norwegian report, with all its prohibitions is a long list of all things that should be avoided at national level and at European level, because we cannot guess what are the abuses of the future. Behind this there is even a more fundamental question. Is it up to us, supervisors, to lead the evolution in economic life, is it us who are the economic life and the others are just our executive officers ? We think that we should stand away, control the solvency, but leave to economic life what is their part of the job, namely to lead us into the future. We should come in, if something goes wrong, but we should not try to structure the future. If we try to structure banks and insurance companies, why not the other industries, for example the textile industry ?

Mr. Jonkhart

What is so special about the financial industry, what is common to insurance, banking and securities, this is probably best caught in the word "trust". If you buy a product of a textile company, you do not need any trust, you pay once you have seen the product. With those three industries it is the other way, you give away your money and then you have to expect what will happen. That is also the very reason for supervision. Do we need a sort of structural policy for financial conglomerates on a European level, I tried to explain that at the time we had good political reasons in the Netherlands why we wanted such a policy on a local level, but I also tried to explain that you never should adopt such a policy on a European level. That is something different from the question of being informed on a financial group. I think that the intervention of Mr. Boye-Jacobsen disregards that aspect. How many supervisors are there here in this room, who actually know who owns their banks, insurance companies, brokers, what are their particular relations within groups ? If those groups are managed from out of one single point, particularly outside your country, then you get the feeling that you want to know a little bit about it and you would like to have an instrument to get that information one way or the other. As a regulator you would like to rule the world and manage all those institutions as if they were your executives. Between that and knowing nothing is trying to know a little bit and trying to get an instrument to guide the developments away from what you think is evil and towards what you think is a more reasonable development.

Mr. Boye-Jacobsen

In Mr. Jonkhart's presentation one of the advantages of the Dutch system was that you would find out what was happening to a conglomerate, wherever its headquarters were, and you would say yes or no to this development or that development. First of all the problem is how good are you at guessing, but the more you say yes or no, the more you are taking on the responsibility for success or failure. I think the failure of part of a group, for which you had taken on the direction of development, would leave the people who would have lost their money coming back to the authorities to say, why don't you bail it out ? This problem of the extension of the responsibility of banking supervisors accross these groups is something that has to approached with great care.

Mr. Lanciotti

I will start off from the position which the Commission seems to be taking, that is to say the agnostic position. I should like to ask whether this word means the same thing when it is applied to relations within the financial sector, the three sectors represented here, or between those sectors and the industry or the trade, which is outside those three segments. It is my view that perhaps this agnosticism should take on a rather different field, depending upon whether it applies to the first or the second of the cases I described. In my country, we were rather worried about agnosticism in the relations between the financial sector on the one hand and the other aspects of the economic world on the other. I should also like to say that even within the financial sector, the more agnostic we are about structures, the more we should feel worried about prudential issues. Many speakers have already pointed out that should agnosticism mean absence of information, it would be the worst of all worlds if one were not able to do anything about structures and if one did not have the necessary equipment to process information, to co-operate with the authorities. If we did not have the right instruments for the collation of information and co-operation with the authorities. Would agnosticism not imply information in the case of conglomerates too, that is to say the consolidated vision of the group in which we would co-operate in supervising the different branches of their activities and here I would refer to what Mr. Cooke has said about supervising the conglomerate. Could co-operation not take on a very tangible form in the case of the financial sector supervision ?

Name unknown (French speaker)

In the light of our discussion I would just like to refer to a couple of provisions which we have in French law. The first of these rules, which we had traditionally since the 1940's, is control on the shares in the banking system. I turn to Mr. Jonkhart, he gave us an excellent description of the system which applies in the Netherlands, but I would like to point out that that is a system that we are very accustomed to. Since the 1940's, we have had a provision which compels credit institutions regularly, on an annual basis, to declare where their shares are. Obviously this does not apply to companies quoted on the stock exchange, but in the case of the others we have a complete knowledge of what the situation is. We also have a prior authorization procedure for certain thresholds to be breached and indeed that was reinforced last year, because we introduced new thresholds where authorisation was necessary in advance for investment or dis-investment. I think that these provision taken as a whole would meet the points of prudential concern that Mr. Jonkhart mentioned and our experience is that these provisions are not only familiar to the banking community, but they are very acceptable to them. The second type of provision, which we have in our banking law in France, which may well be important as a reply to the questions that have been asked, was introduced into the new banking laws in 1984 and they give the inspectors in the bank of France the right not just to verify which establishments are subject to banking law, but also their subsidiaries or their shareholders. This is what in our usual jargon we call "des droits de suite" the right to follow-up. I think that that meets Mr. Cooke's concern. It is clear that supervision on the basis of consolidated accounts is probably not enough and that, where appropriate; the person doing the verifying in the banking sector needs to make up his mind on the financial soundness of some non-banking subsidiaries of credit institutions and he would also need to make his mind up about the financial soundess of some of the shareholders. For the shareholder to be accepted as a significant shareholder in the credit institution, he needs to have a sound financial basis and if appropriate we need to be able to verify the existence of that sound financial basis. You have loans granted to a shareholder, it is not always a good thing if it is clear that there isn't that sound financial basis.

Prof. Gower

It must be some consolation to Mr. Fitchew to know that on one matter we appear to be unanimous, namely that increased collaboration between various regulators is a good thing and must take place particularly in view of the problems of multinational and other conglomerates. It is perhaps interesting that, if this was a similar meeting in the USA, I do not think there would be unanimity on that basis. One of Sir Kenneth Berrill's senior colleagues was explaining to the American investment bankers in London that there would of course be constant collaboration between the Bank of England as the banking regulator and the Securities and Investment Board as the securities regulator, to which all the Americans said no, certainly not, there must not be any collaboration. What the banking regulator is doing is to protect the interest of the depositors. If we are really going to achieve this friendly collaboration, I somewhat share the view of Mr. Boye-Jacobsen, that it is unlikely to happen if they are not really brought into one body. It is very nice to see all the UK regulators sitting together in apparent harmony, but if you think that they have always behaved as if they were friends, you would be deceiving youselves. If it were practicable I do agree with the observations of Mr. Boye-Jacobsen. But probably the only way to get constant, proper and friendly collaboration is to bring everybody together, it may be impracticable, but I certainly think that it will not happen in practice to the extent that it ought, unless there is a body of this sort. You cannot prescribe precisely what is meant by fit and proper, it obviously depends on the discretion of the supervising body, it has got to make a value judgment, but what you can prescribe by instrument is what information the supervisor shall get, or try to get, before he decides whether the person concerned is fit and proper. That is the philosophy which is adopted under the new British legislation; anybody applying for authorisation has to fill in an elaborate questionnaire, which is designed to list the information about who really owns it and so on, not only a questionnaire about the existing situation, but a business plan indicating how the body proposes to operate. That I think can be done by an EEC instrument and if it is to be meaningful, it seems to me it is essential that it should be done by an EEC instrument. We cannot have a situation in which the UK takes this elaborate method of ascertaining whether someone is fit and proper or not, if some other country, Denmark for example, is simply going to ask "what is your name and address, are you still in prison" ? If it is impossible under present Danish law to ascertain details about the applicant's former criminal record, then all I can say is that the EEC instrument will compel Denmark to change that and if Denmark does not, I think the European Court will hold it is directly inforceable. The Commission should prescribe in some detail what a country has to do about getting information before it accepts somebody as being authorised to undertake this type of a business, which is distinguished from buying goods.

Mr. Cooke

Agnosticism does carry with it the importance of transparency and of information and also of co-operation and collaboration. We are in a situation where the current thinking is towards the integration of financial services. I wonder how long this particular phase will last, how far isthe need to pursue particular Community objectives in the context of this particular phase appropriate, or whether we do not run some risk that if we try to pursue some Community legislative proposals in this general area does not run the risk of falling into the trap that others referred to of constraining the national economic evolution and development. In relation to the problem of conglomerates as a whole, the need to move to some early piece of Community law is perhaps a question still at the moment. The most important element is in fact to ensure that the transparency is there, to ensure that the co-operation can actually be pursued and conceivably it might require a European initiative to achieve that. For the rest, what we may actually be talking about in practice over the period immediately ahead, is the manner in which co-operation is in fact undertaken, the form of co-operation is actually quite difficult, when one looks at the diversity of organisations that are represented around this table, no doubt this is something the Commission has got very much in the front of their mind. In the UK, in looking at the whole question of financial conglomerates, what are we talking about and what is the problem, you actually need to look at what the actual institutional groupings are in your country and we certainly, in the context of lead regulation arrangements, need to be aware how many groups are there actually in this situation. There are perhaps about a hundred of them, of which about fifty are perhaps significant in economic terms. It is not a bad approach in an area where you are probably not going to be structurally purest to hold up to the light the actual institutions that are presenting the problems that you will be having to deal with. I am not sure whether it would enlighten a great deal, but I think it might be worth looking a little more closely in each country as to the nature of the particular groups that present the real problems and see where that took one in relation to the need for co-operation with other authorities.

Mr. Fitchew

It seems to me that there was a broad consensus that the Community and Community legislation should not seek to harmonise structures, we should not try to control at a Community level, to lay down rules as to who could own whom, who could own what. That is certainly my own view. There was equally a broad consensus that it was desirable that there should be greater transparency, both within Member States and between Member States, about the structure of financial groups and about what the shareholdings actually were. Again that is certainly something that I would tend to agree with, I think agnosticism about the question of who should be allowed to own whom certainly should not be taken to imply ignorance about what the structures of shareholdings and of groups actually are. In fact, as Mr. Muller pointed out, in the Second Banking Coordination Directive we have said something on this subject and indeed we have gone a little way further than simply providing for transparency. We have said first of all that there should be a regular annual provision of information about who the shareholders are in credit institutions, that is dealing with the upstream problem, but we have gone beyond that, in Art. 9, in saying that the Member States should ensure that the influence exercised by the important shareholders has to be compatible with the safe and sound management of the bank. Moreover, we have proposed, and this is clearly going to be more a controversial area, a rule relating to down-stream participations in proposing a limitation on the extent to which banks can hold participations in non-financial companies in the commercial and industrial sector. I think the question which we may have to ask ourselves in the light of this Conference is whether banking is a special case, as Mr. Padoa-Schioppa suggested, because of the particular importance of banks in ensuring the integrety of the payment system, the money transmission system and because of the very important macro-economic consequences of systemic failure in the banking system, that one needs to have greater transparency and to the extent that we have proposed and I have just described in the Second Banking Coordination Directive, some measure of control by the supervisors over the influence exercised by the major shareholders. What I think we perhaps need to look at is whether, at least a requirement for transparency about major shareholdings, should be introduced in the other two sectors, in insurance and in securities markets.

The second topic that I wanted to come on to is consolidated supervision. There I very much agree with the comments made by both Mr. Lanciotti and Mr. Cooke, that if we are to be agnostic on the question of structures, then that should imply more emphasis being given to prudential supervision. I think there is certainly general agreement among the banking fraternity that we should try to deepen and extend the arrangements for consolidated supervision, in particular to extend the arrangements of consolidated supervision to cases where a banking group may be headed by a non-bank institution. I think again, perhaps we will need to ask ourselves whether that approach is one which is needed in the case of banks only, or whether a similar approach for consolidation may not need to extend to the other two sectors, at any rate where there is a conglomerate structure. Under the same general heading of supervision, there is of course the question of solvency; the banking supervisors present will know that we are starting work now on the treatment of position risk, or market risk as it affects the banking sector. That same problem presumably needs to be dealt with in the case of non-bank operators in the securities markets as well as banks.

The third topic : conflicts of interests which we have not discussed a great deal. The paper which was circulated arising from the work done under Mr. Lanciotti's chairmanship by the Groupe de Contact, suggests that actually quite a large number of Member States, perhaps the majority, do have rules relating to the treatment of the avoidance of conflicts of interest in banking groups. In some cases the rules are laid down by legislation, in some cases they are laid down by the supervisors, in some cases they may be in the formal rules adopted by the industry itself. We will certainly need to look at the question of conflict of interest and whether we should seek to ensure some degree of harmonisation in the investment services directive, that we are currently preparing; if that is the case, then such rules on conflict of interest will probably need to cover both bank and non-bank operators in the securities markets.

Fourth and finally the question of exchange of information between the supervisory authorities. I think there was certainly a consensus that this is the subject which we should look at at a Community level, that the proper supervision of financial conglomerates, perhaps particularly in any crisis situation, is going to require exchanges of information between the three different set of supervisors and it does appear that, at least in some Member

States, the secrecy imposed on the individual sets of supervisors can be a barrier to those exchanges of information. I think we will want to look to see whether that is a subject that should be tackled, perhaps by a legal instrument at a Community level and presumably, if that is the case, it would be a legal instrument covering all three sectors. I am not sure whether I interpreted Mr. Cooke's question rightly as to whether he was asking whether the Commission envisaged some form of institutional arrangements for co-operation between the three sets of supervisors. That is a subject we have not thought about at the moment, I think in the first instance what is needed is to ensure that there are no barriers to the bilateral exchanges of information. Dealing with any specific problem cases, it will normally be bilateral exchanges of information that are required. That brings me to the question of how we propose to carry out future work in this area, within the Commission. First of all, following this Conference we will be circulating both all the papers that have been received, the texts delivered by all the participants, and as soon as the translations have been done, Prof. Schneider's report and we will be very interested to have any comments that anyone is moved to send us when they see these in print. Apart from that, we do not at present want to propose any formal working party comprising representatives of each of the three sectors, I think it would be a mistake to set up a working party which just operated in a vacuum as a talking shop. I think however that in the areas that I have mentioned, the arrangements for exchange of information between supervisors, the question of consolidated supervision, occasions will arise, as we come forward with specific proposals when it will be useful to bring together, at least two and in some cases three of the different market sectors concerned. We would like to retain flexibility to deal with that on an ad hoc and pragmatic, if not totally agnostic, basis. I think that is all I have to say about our future work at this stage.

A N N E X E S

1. Conference programme

2. List of EC Commission documents available

3. Appendix to Mr. Bröker's speech (see page 151):
   OECD Staff Paper on conflicts of interest

4. List of participants

CONFERENCE ON FINANCIAL CONGLOMERATES

Borschette Centre, Brussels, 14th-15th March 1988

PROGRAMME

MONDAY 14 MARCH 1988

9.30 a.m.	Registration and Coffee
10.30 a.m.	Opening of the Conference by Mr. Geoffrey E. FITCHEW, Director General for Financial Institutions and Company Law, EC Commission
10.45 a.m.	Introducing the topic : Prof. L.C.B. GOWER, author of the White Paper on Investor Protection in the United Kingdom

PART 1 General overview of the problem : General presentations on recent history of and perspectives for the development of financial conglomerates and the breakdown of frontiers between different types of financial institutions and products.

11.15 a.m.	Dott. Tommaso PADOA-SCHIOPPA, Vice Direttore Generale della Banca d'Italia, Rome
11.45 a.m.	Mr. JOLIVET, Directeur des Assurances, Ministère de l'Economie, des Finances et de la Privatisation, Paris
12.15 p.m.	Sir Kenneth BERRILL, Chairman of the Securities and Investments Board, London
12.45 p.m.	Buffet Lunch in the Borschette Centre
2.15 p.m.	Summing up of part 1 and short analysis: Prof. SCHNEIDER (University Mainz/Darmstadt)
2.45 p.m.	Panel Discussion with speakers
3.30 p.m.	Coffee

PART 2 Questions relating to the supervision of conglomerates, in particular capital adequacy and consolidated supervision; despecialization and autonomy in different market segments; conflicts of interest, intra-group transactions, etc.

4.00 p.m.	Mr. BIRON, Premier Directeur, Commission Bancaire, Brussels
4.30 p.m.	Prof. Dr. ANGERER, President of the Bundesaufsichtsamt für das Versicherungswesen, Berlin
5.00 p.m.	Mr. LE PORTZ, President de la Commission des Opérations de Bourse, Paris
5.30 p.m.	Panel Discussion with speakers
6.15 p.m.	Cocktail
7.30 p.m.	Dinner at the Borschette Centre

TUESDAY 15 MARCH 1988

Part 3 The blurring of frontiers between financial sectors and the rise of conglomerates on Community level; the significance of financial conglomerates for the harmonization of supervisory legislation and policies in the EC; conclusions.

9.00 a.m.	Mr. FITCHEW, Director General, EC Commission, on Completing the Internal Market for Financial Institutions in view of the blurring of frontiers between the financial services sectors
9.30 a.m.	Mr. BRÖKER, Financial Markets Division, OECD, on work of the Organization for Economic Co-operation and Development concerning international cooperation in the field of financial conglomerates and in particular of securities.
10.00 a.m.	Coffee
10.30 a.m.	Mr. JONKHART, Director, Ministry of Finance, The Hague, on perspectives of policies acting on the overall market structures
11.00 a.m.	Mr. BOYE JACOBSEN, Deputy Permanent Secretary, Ministry for Trade and Industry, Copenhagen, on perspectives of cooperation among the competent authorities
11.30 a.m.	Concluding Panel Discussion
1.00 p.m.	End of Conference

ANNEX 2

List of documents which can be made available to the participants
of the Conference on Financial Conglomerates

Doc. No.	Subject	DA	DE	EL	EN	ES	FR	IT	NE	PO
XV/100/85	1st Commission Working Paper on the definition of "Financial Supermarkets" (1985)				X		X			
XV/49/87	2nd Commission Working Paper: a reflection document on "Financial Conglomerates" (1987)	X	X	X	X	X	X	X	X	X
XV/192/87	3rd Commission Working Paper: a summary of the conclusions of Prof. Schneider's study (1987/88)		X		X		X	X		
XV/53/87	Groupe de Contact Links between banks and insurance companies	X	X		X		X	X	X	
GC/87/15	Groupe de Contact Banks and Securities related activities				X					
XV/17/88	Possibilities for and legal limits on multibranch activities in the financial sector, with particular reference to co-operation between banks and insurance companies and the formation of financial conglomerates		X							
XV/113/87	Draft Report on further harmonisation of consolidated supervision	X	X		X		X	X	X	

Liste des documents disponibles pour les participants
de la Conférence sur les Conglomérats Financiers

Doc. n°	Objet	Disponible en								
		DA	DE	EL	EN	ES	FR	IT	NE	PO
XV/100/85	Premier Document de Travail de la Commission concernant la définition des "supermarchés financiers" (1985)				X		X			
XV/49/87	Deuxième Document de Travail de la Commission : document de réflexion sur les "conglomérats financiers" (1987)	X	X	X	X	X	X	X	X	X
XV/192/87	Troisième Document de Travail de la Commission basé sur les conclusions de l'étude du Prof. Schneider (1987/88)		X		X		X	X		
XV/53/87	Groupe de Contact Liens entre les banques et les sociétés d'assurance	X	X		X		X	X	X	
GC/87/15	Groupe de Contact Banks and Securities related activities				X					
XV/17/88	Possibilités et limites juridiques des activités multibranches dans le secteur financier, notamment en ce qui concerne la coopération entre banques et assurances et la formation de conglomérats financiers		X							
XV/113/87	Projet de Rapport sur un approfondissement de l'harmonisation sur la surveillance sur base consolidée	X	X		X		X	X	X	

ANNEX 3

Appendix to Mr. Bröker's speech:

CONFLICTS OF INTEREST IN BANKING AND FINANCE AND THEIR CONTROL AND MANAGEMENT

FOREWORD

The OECD Committee on Financial Markets and its Expert Group on Banking have, in recent years, carried out considerable work in the field of banking regulation. While this work has culminated in the publication of the study by Mr. R.M. Pecchioli, the Expert Group's secretary, on "Prudential Supervision in Banking" (OECD, Paris, 1987) some special regulatory issues addressed in that study have been followed up in more detail because of their topical nature. The assessment, control and management of conflicts of interest in banking and finance has been one of these issues. Problems raised by conflicts of interest have been gaining in importance as banks, securities firms and other financial institutions have increasingly diversified their activities not only in countries in which commercial banking has been legally separated from the securities business or some important securities-related activities, but also in countries with universal banking systems. This development has been often referred to as the trend towards universal banking. It should be noted, however, that conflicts of interest do not only arise for commercial banks moving into the securities business or vice versa; they also exist within securities firms operating in a wide range of securities-related activities such as the brokerage business, new issuing business, portfolio management, investment research and investment advisory services.

Net provisions generally include, in part or in full, charges for value adjustments in respect of loans and securities, recoveries from such adjustments, losses on loans, and transfers to, and from, reserves for possible losses on such assets.

For technical and methodological reasons not all countries submitting data on financial statements of commercial banks for publication in the "OECD Bank Bulletin" have been covered by the present Special Feature.

INTRODUCTION

Conflict of interest considerations play an important role in the context of policies towards the structural organisation of countries' financial systems, notably as regards the desirability of separating certain areas of financial service activities such as, for example, commercial banking and securities-related activities, by legal arrangements. In this sense, policies designed to handle conflict of interest problems in banking and finance have an important bearing on competition policies in this field as a separation of functions introduced on conflict of interest grounds may represent limitations on market access and hence on the scope for the working of competitive market forces. There is another relationship between the conflict of interest issue and competition policies insofar as reliance on adequate competition is often seen as an acceptable approach towards dealing with certain broader conflict of interest situations such as may arise for universal banks, for example, as regards the respective promotion of deposit taking business on the one hand and selling securities to small investors on the other.

In recent years, the discussion on conflict of interest problems in banking and finance, which has a long history, notably in the United States, has seen a considerable revival in a number of countries such as Canada, France, Germany, the United Kingdom and the United States. In Canada and the United States the conflict of interest issue receives particular attention in connection with policies towards, or discussions on, structural and regulatory reforms of the financial system which are strongly influenced by the general trend towards the blurring of demarcation lines between formerly separated sectors of the financial system.

In the United States the ongoing debate in this field includes a critical review of the Glass-Steagall Act of 1933, which, largely on conflict of interest grounds, introduced a separation of commercial banking and a large number of securities-related activities. In France efforts are being made in connection with comprehensive securities market reforms to deal with conflict of interest problems, inter alia, by the introduction of a legally binding code of conduct applying to market operators. In Germany, questions of conflicts of interest were discussed in considerable detail by the Gessler-Commission whose report on "Basic Questions of the Credit System" was published in 1979. The Gessler-Commission looked into this question mainly in the context of a critical review of the universal banking system and reached the conclusion that the latter system had functioned satisfactorily and should, therefore, be maintained. Any necessary reforms dealing with conflicts of interest could be taken care of by the banks themselves within the framework of the universal banking system. In the United Kingdom, where important securities market reforms, often referred to as the "Big Bang" of 27th October 1986, paved the way for the formation of large capital market groups operating in a wide range of securities-related activities, the question of an appropriate management of conflicts of interest received particular attention in connection with the implementation of the new Financial Services Act. The importance of this question is highlighted by the following paragraph of the White Paper on "Financial Services in the United Kingdom" issued by the Department of Trade and Industry, London, in January 1985:

"Conflicts of Interest

The rapid increase in the number of firms engaging in more than one type of investment business and the blurring of demarcation lines (for example, between brokers and jobers) have made it more important than ever that investors are adequately protected against abuses arising from conflicts of interest within investment business."

DEFINITION AND PRACTICAL EXAMPLES

Definition

Stated in an abstract way, a conflict of interest situation arises for a bank -- or any other enterprise -- dealing with a client if it has a choice between two solutions for a deal, one of which is preferable from its own interest point of view while the other represents a better deal for the client. A conflict of interest situation arises also for a bank or another financial institution if it carries out activities involving two different groups of customers and if it has to strike a balance between the respective interests of the two customer groups. A practical example of the latter case is the new issuing, or underwriting, business which always requires a compromise between the interests of the issuer and those of the buyers of the securities. As soon as a financial institution -- or any other enterprise -- offers two or more technically or functionally unrelated services leaving scope for certain choices, it is faced with the problem of how much effort to put into the promotion of each of these different services.

As financial institutions often operate in a wide range of different financial services they are bound to be confronted with a relatively large number of conflict of interest situations. This explains why conflicts of interests in banking and finance generally receive more attention than in other sectors of the economy.

Practical examples and related concerns

The practical examples of conflict of interest situations listed below are, apart from the general conflict between banking and non-banking activities, grouped under two headings: first, conflicts of interest considered as typical of universal banks; second, conflicts of interest between different types of securities-related activities. The list is not intended to be exhaustive; nor is it intended to discuss the pros and cons of the arguments put forward.

Banking activities versus industrial and commercial activities

The principle of separation of "banking and commerce" which is applied in most countries to varying degrees in the sense that bank participations in industrial and commercial enterprises are either prohibited or severely restricted, is essentially based on conflict of interest considerations. A typical concern in this regard was expressed by the U.S. Congress in a House Committee Report of 1955 on the extension of the Bank Holding Company Act:

> "If banks were permitted to own non-banking businesses they would be compelled in many instances to extend credit to such businesses to the detriment of other competitive businesses in the community and possibly also to a degree which would be unsound from a banking point of view." (U.S. Congress, House Report 609, 84th Congress, 1st Session 1955.)

Conflict of Interest Situations Considered as Typical of Universal Banks Combining both Banking and Securities-Related Activities

Deposit business versus securities brokerage and related investment advisory business

It is sometimes feared that banks might promote deposit taking for balance-sheet growth reasons to the detriment of promoting household savings in the form of securities. The argument may, however, be reversed if banks were particularly interested in promoting their securities underwriting business.

Deposit business versus fund management (trust business i.e. the management of mutual funds, pension funds, and private securities portfolios on a discretionary basis)

Banks should not be allowed to use managed funds for strengthening their own deposit base.

Combination of corporate credit business and securities brokerage and investment advisory services and security trading on own acount

Banks should not be allowed to influence their securities business with clients (brokerage and investment advice) or their securities trading business (on own account) through company information obtained in connection with lending activities.

Corporate credit business versus new issuing (underwriting) business

Critics of this combination of activities fear that universal banks would unduly favour their credit business with corporate clients for profit and balance-sheet growth considerations to the detriment of the development of an efficient corporate bond and equity market.

Combination of credit business with private customers and securities brokerage and investment advisory services, security trading on own account and underwriting business

Banks should not unduly encourage private securities purchases via imprudent lending to private customers to finance such purchases.

Conflict between the banks' involvement in industrial and commercial enterprises via participations, proxy voting rights and mutual interlocking membership on supervisory boards and their securities business with private customers

Banks should not abuse their relationships with industrial and commercial enterprises against the interests of small and minority shareholders.

Conflicts of Interest Between Different Types of Securities-Related Activities

Combination of securities brokerage (agency) business and dealing on own account (jobbing, market making)

Securities firms or securities departments of universal banks should not unduly benefit from serving client orders from their own books.

Combination of security dealing on own account (jobbing, market making) and trust business (fund management for pension funds, mutual funds and discretionary portfolio management for private persons)

The market making function should not be based on security holdings managed under trust business. Undesirable own holdings of securities should not be dumped into funds under management.

Combination of new issuing (underwriting) business and trust business (fund management for pension funds, mutual funds and discretionary portfolio management for private persons)

The new issuing departments of securities firms or universal banks should not be allowed to demonstrate their placing power by dumping low-quality issues or not adequately priced issues into funds under management. Conversely, funds under management should not unduly benefit from the pricing of new issues to the detriment of issuers.

Combination of investment research and securities trading on own account (jobbing, market making)

Securities trading on own account should not benefit in an unfair manner from early information on purchase recommendations to be released by investment research departments.

Combination of investment advisory services and securities brokerage business

Investment advice should not be biased in favour of overtrading ("churning") i.e. unnecessarily high turnover of the securities portfolio of private clients intended to generate high fee income.

OVERVIEW OF BASIC CONCERNS

Public policy concerns about conflicts of interest are essentially motivated by three types of basic considerations: efficiency considerations, investor protection considerations and prudential i.e. stability and soundness considerations. In addition, it should be mentioned that, in practice, discussions about conflicts of interest have often been closely related to fears about concentration of power in banking and finance, or in the economy as a whole, and measures intended to deal with conflicts of interest by a separation of functions have often been motivated also by considerations regarding the prevention of undue concentration of power and financial resources.

As far as the efficiency aspect of conflicts of interest is concerned it has been argued that a financial institution operating in different broad areas of financial services such as retail banking, corporate financial services, securities-related activities etc. cannot be expected to be equally efficient and competitive in all these services at the same time and will, hence, tend to offer less than lowest cost and highest quality services in areas of activity which are less profitable or in which the institution in question has less experience or less qualified staff. In other words, according to this argument the financial service needs of particular customer groups or of the economy as a whole will be better satisfied if more specialised institutions were responsible for offering particular types of services or for dealing with particular customer groups instead of allowing multi-function institutions to operate in all these areas at the same time. Policy makers can deal with this problem either by imposing a certain degree of specialisation between financial institutions, or setting up special institutions dealing with particular financing problems; or they can take appropriate measures designed to improve the efficiency of less developed sub-markets for financial services by increasing the scope for competition and, in particular, facilitating market access from inside or outside the country. This latter approach has generally become the preferred way of dealing with this aspect of conflicts of interest as the authorities have accepted, and often supported, the general trend towards despecialisation and diversification of activities in banking and finance. It is increasingly realised that universal banks tend to be more flexible to adjust to new needs of market participants and structural changes in the financial services markets than specialised institutions that are legally prevented from moving into new areas of business.

The second type of concern about conflicts of interest which is motivated by investor protection considerations goes a step further than the efficiency concern. It is argued that in certain conflict of interest situations the quality of service offered may suffer to such an extent that investors need special protection against intentionally bad service and malpractices. This applies mainly to securities-related activities in which a securities firm, or the securities department of a universal bank, has a fiduciary function vis-à-vis clients which, moreover, may have little experience with securities transactions. It is feared that professionals which may have various choices for doing securities business with clients may unduly weigh their own interests against those of their clients. In some of these cases the authorities go beyond reliance on market forces and market discipline and handle conflict of interest situations by codes of conduct, rules of practices or conditions for doing business, the supervision and control of the observation of which may be left to self-regulatory bodies.

The third type of concern about conflicts of interest is motivated by stability and soundness considerations. It is argued that in extreme situations a conflict of interest can lead to mismanagement and unacceptable risk-taking in business areas in which a given financial institution has little experience and for which it is not "fit and proper", and that in order to protect the general public against undesirable failures and losses appropriate precautionary measures need to be taken. This concern played, for example, a major role in the United States in the debate leading to the introduction of the Glass-Steagall Act of 1933 which approached the underlying conflict of interest problem by a separation of commercial banking and a wide range of securities-related activities. Today, the prudential aspect of conflicts of interest, like other risk aspects of banking and securities-related activities, is generally being dealt with by prudential regulation and supervision rather than by a separation of functions.

CONTROL AND MANAGEMENT OF CONFLICTS OF INTEREST

Conflicts of interest in banking and finance can be handled in many ways depending on their nature and the severity of concern that the authorities attach to them. In principle, the following approaches are available:

- Separation of functions by separating the institutions which operate in conflicting types of financial services;
- Disclosure of information necessary for recognising and judging conflict of interest situations;
- Ensuring effective competition by providing sufficient choice as regards the institutions with which consumers may wish to do business;
- "Chinese Wall" arrangements inside financial institutions designed to separate departments carrying out conflicting types of operations;
- Codes of conduct, rules of practices and conditions for doing business prescribing how professionals should deal with conflict of interest situations;
- Arrangements for in-house and external monitoring of the handling of conflict of interest situations;
- Effective complaints procedures for consumers who have become victims of abuses of conflict of interest situations.

An extreme solution to dealing with conflicts of interest is to seek their avoidance by a strict separation of institutions operating in conflicting financial service activities. This approach could even go as far as requiring also separate ownership of such institutions which would prevent a financial institution from operating in conflicting business areas via separately capitalised subsidiaries. Examples of this approach are: the separation of "banking and commerce" which applies to varying degrees in most OECD countries; a full or partial separation of commercial banking from securities-related operations traditionally applying in Canada, Japan and the United States although there are at present strong pressures in these countries for reducing this separation; and the separation of the jobber and broker functions which until the 1986 "Big Bang" applied to members of the London Stock Exchange. As it is now widely accepted that financial institutions often see an entrepreneurial advantage in combining a wide range of financial services for the benefit of the general public, it is also increasingly recognised that conflicts of interest are bound to occur in banking and finance more frequently than in other sectors of the economy and that public policy should mainly focus on the avoidance of abuses of conflicts of interest rather than on the avoidance of their occurrence.

One widely accepted broader approach towards protecting investors and consumers against abuses of conflicts of interest by providers of financial services is based on the principles of adequate disclosure requirements and effective competition. According to this approach the clients of financial institutions should be fully informed about all aspects of the business they are doing with financial institutions (nature of the transaction, capacity in which the institution is acting -- as agent or principal --, risks, return and costs involved etc.); any such information should be readily available in understandable form. In addition, there should be an adequate level of competition providing sufficient scope for consumers to choose amongst financial institutions with which they wish to do business. This approach generally applies to broader conflict of interest situations in which a given financial institution may promote one line of business, for example, deposit taking to the detriment of another line of business, for example, securities brokerage and investment advisory services with private savers.

In a number of more specific conflict of interest situations the authorities attempt to avoid their abuse by requiring that multi-function institutions apply "Chinese Wall" arrangements by which different departments are functionally separated in the sense that information giving rise to conflicts of interest cannot be exchanged between them neither on a personal contact basis nor via in-house information flow arrangements or access to files. Such separations of functions often apply in multi-function institutions to the corporate finance department, the trust, i.e., fund management department, securities brokerage, trading and investment advisory services, and the investment research department.

Chinese Wall arrangements are, however, often seen as requiring complementary codes of behaviour, rules of practices and conditions for doing business which need to be respected by providers of financial services with a view to providing further investor and consumer protection against abuses of conflicts of interest. This applies in particular to the profession of securities dealers. In the London market, for example, securities dealers acting as principals i.e. on own account, have to respect three principles:

-- The principle of fair dealing which implies that unfair practices are avoided and that deals are executed in accordance with the rules governing the London market;

-- The duty of skill, care and diligence when investment advice is given which should correspond to the needs and the level of experience of the client; or when orders are executed;

-- The duty of disclosure of information on the capacity in which the dealer is acting, the interest he may have in a particular transaction and the fees he is earning.

Securities firms acting as agents of clients for buying and selling securities have to respect the principles of "best execution" and "subordination of interests", which includes that client orders must be given priority over the execution of own transactions and that orders must be executed in the client's best interest.

Furthermore, public policy dealing effectively with abuses of conflict of interest situations needs to provide a basis for effective monitoring arrangements at three levels: first, at the in-house level of the institutions themselves so that the management can control how any conflict of interest situation is actually handled; second, at the level of any self-regulatory organisations responsible for setting up rules and procedures applying to their members; and, third, at the level of the authorities.

Finally, there need to be effective complaints procedures for clients who have become victims of abuses of conflicts of interest. The importance of this latter point is highlighted by the fact that in Canada, the Technical Supplement to the Green Paper on "The Regulation of Financial Institutions: Proposals for Discussion", published in June 1985, contains a proposal for a new public body dealing with conflicts of interest in banking and finance: the Financial Conflicts of Interest Office. It may be noted in this context that some countries go so far as to provide bank customers with legal rights against the supervisory authority itself whereas other countries implicitly refer them to their banks as legal counterparts.

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