

THE PRUDENTIAL SUPERVISION OF FINANCIAL CONGLOMERATES IN THE EUROPEAN UNION

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ABSTRACT

Around the world, the formation of financial conglomerates is gaining importance. In the United States, the provisional agreement between Congress and President Clinton's administration to break down the barriers between banking, insurance, and securities firms by repealing the Glass-Steagall Act is no less than revolutionary. Meanwhile, in the European Union (EU), where the establishment of financial groups working in all three sectors has long been permitted, the Financial Services Action Plan (COM 1999),¹ as endorsed by European Heads of State at the Köln Council, identifies the further development of prudential rules for financial conglomerates as a top priority for EU financial services legislation in the coming years.

The focus of EU prudential legislation is on individual financial services undertakings, that is, on the bank, insurance company, or securities undertaking and not on the position and operation of the conglomerate as a whole. From this angle, the potential danger is one of a growing mismatch between the prudential approach, which looks at the individual legal undertakings separately, and the business approach, which manages and controls the conglomerate as a whole in different product and geographic areas. For this reason, the basic EU prudential framework has been supplemented to address the conglomerate dimension.

This paper presents an overview of financial services prudential legislation in the EU. It explains the role of the European Commission and gives a summary of the basic prudential framework for financial services, focusing on the single passport concept and the principle of mutual recognition. It examines the recent history of financial concentration and conglomeration in Europe and discusses general prudential issues arising from financial conglomerates. The paper also examines existing EU prudential legislation on financial conglomerates and how this might be developed in the future. Finally, some conclusions are drawn. It is hoped that this brief overview of how the European Union has tackled and is tackling the difficult issue of financial conglomerate supervision might be of interest to North American readers at a time when the United States is changing its prudential legislation to permit the development of financial conglomerates.

1. THE EUROPEAN COMMISSION

The European Commission is composed of 20 members who provide its political leadership and direction. They are obliged to be completely independent of their national governments and to act

only in the interests of the EU. The Commission is responsible for initiating legislative proposals, acting as guardian of the treaties, and managing and executing EU policies and international trade relationships.

In the financial services field, the Commission consults with three important regulatory committees: the Banking and Advisory Committee (BAC), the Insurance Committee (IC), and the High Level Securities Supervisors Committee (HLSS). These committees comprise experts from each member state. Before the Commission adopts a proposal for a directive, the appropriate committee discusses it comprehensively. Subsequently, the draft directive

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¹COM(1999)232, 11.5.99, as described in the Commission communication *Financial Services: Implementing the Framework for Financial Markets Action Plan*.

is examined and debated further by the European Parliament and the Council before it is finally adopted as EU legislation. This process is sometimes long but ensures that all member states and interested parties can provide input into the legislative process. This is important because once a directive has passed, the member states must implement it into their national legislation, normally within a period of 12–18 months.

The Commission also ensures that EU legislation is applied correctly by member states. If member states breach their treaty obligations, the Commission can begin proceedings at the Court of Justice. In certain circumstances, the Commission can fine individuals, firms, and organizations.

2. THE BASIC EU PRUDENTIAL FRAMEWORK FOR FINANCIAL SERVICES

The cultural, linguistic, administrative, legal, and tax differences of the member states and the absence of a common currency, until this year, presented many barriers to individuals and businesses seeking opportunities outside their home states.² To create a true internal market for financial services and to promote growth, stability, and employment the Commission has developed a prudential framework for financial services based on a single passport system and introduced the Euro.

Establishing a common approach to prudential regulation was an essential preliminary step to creating a market that would permit financial organizations to be established in any member state and to trade products, either by branch establishment or by cross-border provision of services, in the 14 other member states. To accomplish this approach, the EU established common minimum standards, called harmonized standards, that must be respected by all member states. It also applied the principle of mutual recognition for other prudential aspects. This is the heart of the single passport system. Supervisors in the host country cannot invoke their own prudential rules;³ they are obliged to recognize the equality and validity of the prudential supervision that the authorities exercise in the home country of the financial services provider.

²Note that Belgium and Luxembourg already shared a common currency.

³There are certain exceptions but these must be applied restrictively.

The economic rationale for the single passport system was to improve efficiency and to provide consumers and businesses with a wider choice of innovative products at competitive prices. While some barriers to a fully integrated market still remain, the advent of the Euro eliminated tremendous barriers for market integration. For participating member states, cross-border investment and transactions are stimulated by increased price transparency, reduced money transfer costs, and the removal of foreign currency risks. The future development of e-commerce can only reinforce this competitive impact, although it too will raise new issues and challenges.⁴

Although the basic prudential framework and ground rules are in place today, the creation of a single financial services market has not taken place overnight. It has required a series of Commission directives establishing harmonized core standards. It is perhaps best illustrated by the three generations of insurance coordination directives that were adopted over a 20-year period.⁵

These directives required harmonized standards relating to matters such as detailed rules for the solvency margin requirement, the establishment of technical provisions or reserves, the valuation of assets, the “fit and proper” nature of managers, and the identity of the shareholders of an insurance company. What is particularly important in the context of conglomerate supervision is that the directives required the establishment of a system permitting close cooperation and exchange of confidential information between the different national supervisory authorities.

The two banking coordination directives,⁶ the investment services directive for securities,⁷ and the undertakings for collective investment in transfer-

⁴It is not possible to analyze the impact of e-commerce within the scope of this paper. It will highlight existing difficulties with the balance between home and host country for cross-border sales, that is, consumer protection, contract law, and jurisdiction legislation. It will also raise new issues such as contract validity, electronic signature, e-money, and so on.

⁵First nonlife Directive 73/239/EEC, OJ L 228 16.8.73 and first life Directive 79/267/EEC, OJ L 63 13.5.79. Second nonlife Directive 88/357/EEC, OJ L 172 4.7.88 and second life Directive 90/619/EEC, OJ L 330 29.11.90. Third nonlife Directive 92/49/EEC, OJ L 228 11.08.92 and third life Directive 92/96/EEC, OJ L 360 9.12.92.

⁶First Banking Directive 77/80/EEC, OJ L 322 17.12.77. Second Banking Directive 89/646/EEC, OJ L 386, 30.12.89.

⁷Investment Services Directive, 93/22/EEC, OJ L 141 11.6.93.

able securities (UCIT) directive for the sale of cross-border mutual funds⁸ developed a corresponding system and approach. Although there are many other directives in the financial services field, these directives lie at the center of the single passport system and characterize the prudential framework for financial services in the EU.

It is worth pointing out that financial services providers have pricing and contractual freedom. National authorities in the host country cannot, in principle, control the tariff and policy conditions of an insurance company that is approved in another member state. Moreover, even the home member state cannot exert ex ante control as long as the solvency of the insurance undertaking is not threatened.

Under community law, there is no equivalent of Glass-Steagall and no legislation forbidding financial conglomerates. Banking and securities activities might even be combined in the same legal entity, but life and nonlife insurance undertakings must always be established as separate legal entities within a financial group.⁹

Before examining the specific supervisory problems posed by financial conglomerates, it is perhaps appropriate to consider the phenomenon of concentration and financial conglomerates within the EU.

3. FINANCIAL CONCENTRATION AND CONGLOMERATION

There has been substantial concentration in EU financial markets during the 1990s, spurred by the completion of the 1992 single market program, and more recently by the advent of the Euro. The numbers of banks, life insurers, and nonlife insurers have all decreased by more than 20%. Table 1 indicates that the reduction has been particularly marked for life insurers.

To respond to the increased competitive pressures, financial institutions increased their size through mergers and acquisitions. Firms have sought economies of scale by reducing overlapping branch networks or by saving on information technology systems, asset investment, head office administrative functions, and marketing and distribu-

⁸Directive 85/611/EEC, OJ L 375 31.12.85. (Note: UCIT is an acronym for undertakings for collective investment in transferable securities.)

⁹There is a grandfather clause for existing composite offices (that is, life and nonlife offices).

Table 1
Number of EU Bank, Life Insurers, and Nonlife Insurers in 1990 and 1997

EU Institutions	1990	1997	Percentage Reduction
Banks	8,979	7,040	21.6%
Life Insurers	1,409	948	32.7
Nonlife Insurers	3,426	2,626	23.4

tion arrangements. These savings were most easily realized in acquisitions within the same sector and member state. On the other hand, conglomerate mergers provided economies of scope by cross-selling different financial products or by brand extension across different financial sectors.

Of the 50 largest mergers falling under the EU Merger Regulation in 1997 and 1998, 28% (14 mergers) involved financial services organizations. Table 2 presents an analysis of these mergers. Eleven of the 14 mergers were within the same sector and ten were within the same member state or region.¹⁰ Three mergers joined business in different sectors and four were cross-border.

To date, most financial conglomerates are found in the banking/investment sector. However, conglomerate mergers involving all three sectors are becoming more common and more important. In some member states, financial conglomerates hold a predominant position in the financial services. For example, in the Netherlands and Belgium, the combined market share of financial conglomerates is approximately 90% for banking, 80% for securities, and 70% for insurance.

Bancassurance or *allfinanz*, whereby banks distribute insurance products, is also very important in some member states. In 1995, the percentage of life assurance distributed by banks in France was 52%; in Italy, 31%; and in Spain, 38%. Today, the percentage share of bancassurance in France probably exceeds 60%. Table 3 shows the importance of bancassurance as a percentage of the distribution of all life assurance in six EU countries.

As levels of concentration rise, additional within-sector mergers will become more difficult and ultimately impossible for antitrust reasons. In such cir-

¹⁰Benelux and Scandinavia were taken to be single geographic regions.

Table 2
**Analysis of the Financial Services Mergers Out of the 50 Largest Mergers
 in the EU in 1997 and 1998**

Activity of Target Acquired	Number of Mergers	Mergers within Same Sector	Mergers within Same Member State or Region
Banking	8	6*	8
Insurance	5	4**	2***
Asset Management	1	1	0****
TOTAL	14	11	10

*Fortis/Generale de Banque and ING/BBL can be considered conglomerates.

**BAT/Zurich can also be considered a conglomerate.

***The cross-border mergers were: BAT/Zurich; Generali/AMB; Allianz/AGF.

****The cross-border merger was Merrill Lynch/Mercury Asset Management.

cumstances, continued consolidation in financial services will lead to more conglomerate mergers.

3.1. Product Offerings

Financial conglomerates increase consumer choice by providing products that better match customer needs. EU financial markets have seen the introduction of complex, composite financial products. Examples are unit-linked life insurance (combining insurance and securities); investment mortgages (combining securities and banking—products where the mortgage is repaid out of the investment proceeds of share investments); and products providing a mortgage, share investment, and life assurance, thus bringing all three sectors together. Figure 1 illustrates the differences between traditionally separate and modern product mix combinations.

Consumers might be concerned that the emergence of financial conglomerates will restrict competition because of the obligatory bundling and tied sale of various financial products. This has not become a major issue in Europe. Perhaps this is a reflection of the fact that individual financial conglomerates do not possess sufficient market power. However, if this were to change, then under either national law or, failing that, EU competition law,

legal action could be taken to prevent tied sales and to restore effective competition.

4. THE PROBLEMS OF FINANCIAL CONGLOMERATE SUPERVISION

As mentioned earlier, the basic difficulty in supervising a financial conglomerate is that it is managed as a whole. Traditional supervision focuses on the individual sectors making up the conglomerate without necessarily looking at the big picture.

As financial conglomerates grow, they often develop increasingly complicated corporate structures that, in turn, produce complex internal management arrangements. As such, financial conglomerates can be organized across global business lines with management responsibilities cutting across different legal entities in a complex matrix. The danger is a growing discrepancy between the broad management of the business and the focused prudential supervision that looks at specific legal entities that exist at the narrow sectoral level within a given member state.

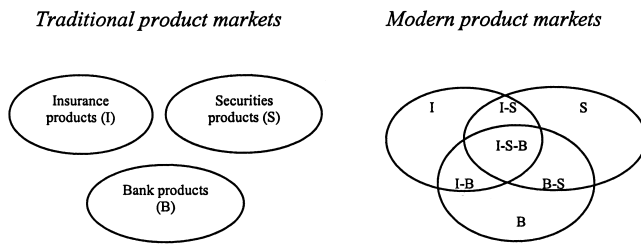
The proper management of financial conglomerates requires the development of adequate internal procedures and accurate information systems for

Table 3
Life Assurance Distribution: Percentage Importance of Bancassurance in 1995*

Life Assurance	FR	DE	IT	NL	ESP	UK
Bancassurance	52	2	31	8	38	11
Intermediaries	23	94	52	79	51	42
Direct	25	4	17	13	11	47
Total	100	100	100	100	100	100

*includes pension products

Figure 1

Traditional Versus Modern Product Mix

managing and controlling risk. This is a challenge not just for the managers of the conglomerate but also for the many different supervisors involved. There might be numerous supervisors.¹¹ In such an environment, the need for proper systems to share supervisory information is evident.

The next section covers various types of prudential concerns that can and do arise. However, before listing potential problems of financial conglomerates, it seems only fair to make one positive remark in their defense. It is important to realize that financial conglomerates can reduce and diversify risk due to the wider range of business they conduct; that is, a combination of different financial activities or even the addition of nonfinancial business in a mixed-activity financial conglomerate can sometimes be beneficial.

4.1. Prudential Concerns

The Difficulty of Calculating a Coherent Solvency Requirement for a Financial Conglomerate

In principle, it is relatively easy to add the usual risk requirements for the separate individual banks, insurance companies, and securities firms within the group. We can simply add the various credit risks, market risks (counterparty, settlement, interest rate, foreign exchange, and commodities risks), liquidity risks, insurance solvency margin requirements, and so on across the conglomerate. However, the specific risk capital requirements for each sector have

developed separately and are not necessarily coherent when taken together in a conglomerate. Two examples may clarify this. For banks, capital adequacy is determined in relation to the asset side of the balance sheet, while, for insurance, the focus is on the liability side with the technical provisions. Second, the eligibility of different items toward regulatory capital can vary by sector; that is, non-paid-up capital or future profits might be acceptable for insurance but not for banking supervisors. So it might not be very meaningful to look at consolidated accounts for a banking insurance conglomerate in this context.

Double or Multiple Gearing

One of the predominant supervisory concerns is the problem of double or multiple gearing. By moving capital elements up and down the structure of the financial conglomerate, the same capital can be used more than once to cover different regulatory requirements. At the same time, a dense web of capital links within the conglomerate increases the contagion risk so that when one part of the conglomerate runs into problems, the financial problems can be transmitted rapidly, like a row of falling dominos, throughout the whole conglomerate.

Concentration of Risk/Large Exposure Risks

Generally, banking supervisors look for a bank's excessive exposure to a single client or group of connected clients, whereas insurance supervisors are concerned that assets backing the technical provisions should be soundly diversified. In a financial conglomerate, both aspects can be combined and masked from the respective supervisors. Risk exposures and assets may be passed from one financial institution to the other or even to an unregulated entity within the group in order to deliberately circumvent prudential restrictions on the individual regulated entities.

Intragroup Transactions

Intragroup transactions can become a prudential concern in a financial conglomerate if they are not carried out at arm's-length or are not based on market conditions. For example, profits and losses can be transferred within the group structure, which impairs the capital strength of supervised entities.

¹¹Mr. Howard Davies, current chairman of the UK Financial Services Authority, wrote in the *Bank of England Quarterly Bulletin* in 1997: "In a discussion with one large clearing bank here recently, we established a list of over 150 different regulators in the different jurisdictions in which they operated, before we gave up counting and went to bed."

Systemic Risk

The classic banking danger is that the demise of one major bank can imperil the entire banking system with effects being quickly transmitted through the whole system via the interbank market and payments systems. This gives rise to a systemic risk for the whole economy. A financial conglomerate, or a mixed activity financial conglomerate with an important financial services arm, can become so big and powerful that, in the case of a failure, major parts of a national and perhaps an international economy can become seriously affected. This leads directly to the next problem.

Lead Supervisor or Coordinator

When a major financial conglomerate sells many different financial products and operates in many national jurisdictions, especially in a time of crisis, there might not be a natural choice of supervisor to take the lead. If there were, the host of different supervisors involved could make rapid and effective communication impossible. In a financial crisis, speedy action is essential.

Information Exchange

In a world that is increasingly integrated and where information and money transfers take place at the speed of light, there is a paramount need for effective communication between supervisors. In particular, the lead or primary supervisor needs a rapid and effective flow of information. If this flow does not exist, no one will be able to understand what is really going on inside the conglomerate. The importance of this issue was identified by the G-7 Finance Ministers when they adopted the Ten Key Principles for Information Sharing.

Fitness and Propriety Criteria

Another critical issue is the fitness and propriety of managers. Clearly, to protect consumers and the wider economy against the dangers of systemic risk, as well as to maintain confidence in the financial system, there is a primordial need for financial institutions to be managed in a sound and prudent manner. Moreover, good managers will be able to identify and correct problems long before the supervisory authorities ever hear about them. Prevention is better than remedy.

At the level of the individual financial undertaking, the fitness of managers can be monitored by examining their competence (that is, formal quali-

fications and experience). Similarly, propriety can be checked by looking at the integrity and suitability of the manager. You might look specifically for financial position or the absence of criminal records, civil actions, or the use of questionable business practices. The potential problem in a financial conglomerate is that fully acceptable managers downstream can be influenced by unsuitable executives or directors in upstream undertakings, which might or might not be regulated. This can give rise to information difficulties, which again reflects the general need to exchange sensitive information across borders and jurisdictions. In some cases, data transfer may be rendered difficult by the obligation to respect individual privacy.

Opaque Structures

Linked to the last concern are difficulties caused by opaque structures. Lack of transparency in the group structure or the distant location of upstream holding companies may make it difficult to obtain satisfactory information about top-level managers and the ultimate shareholders. In such an environment, effective supervision might be nearly impossible.

Reporting Obligations

While the situation in supervised financial undertakings within the conglomerate can be satisfactory, there might be a need for information about the possible negative impact of other group undertakings on regulated entities.

While this paper identifies the additional difficulties of supervising financial conglomerates, it does not imply that financial conglomerates are intrinsically unsound. Indeed, the very great majority of EU financial conglomerates have operated in a highly satisfactory manner. However, the structure of financial conglomerates gives rise to new issues and challenges for supervisors. Many of the above issues have already been addressed by existing EU legislation.

5. EXISTING EU REGULATIONS ON THE SUPERVISION OF FINANCIAL CONGLOMERATES

As long ago as 1988, the commission and the member states started looking at the supervisory issues raised by financial conglomerates. A tripartite working group (composed of bank, insurance, and secu-

rities supervisors and regulators working under a mandate from the BAC, the IC, and the HLSS) finalized a comprehensive report in early 1996 that contained a detailed analysis of the prudential issues and formulated specific policy recommendations. However, this work was put on hold because it was considered inappropriate to develop rules on financial conglomerates at the EU level, which might preempt those adopted later as a result of the wider international efforts taking place within the Joint Forum.¹² The Joint Forum released its recommendations in February 1999 and the commission has now picked up its previous work on financial conglomerate supervision as a top priority.

This very brief history does not mean that no legislation has been adopted at the EU level that is relevant in the field of financial conglomerate supervision. Over the last decade, four important directives have been adopted, which, taken together, remedy or alleviate many of the problems described above and provide a solid basis for further work. These directives are:

- Directive 92/30/EEC on the Supervision of Credit Institutions on a Consolidated Basis (OJ No. L110/52, 28.4.92) (the Consolidated Banking Supervision Directive),
- Directive 93/6/EEC on the Capital Adequacy of Investment Firms and Credit Institutions (OJ No. L141/1, 11.6.93) (the CAD I Directive), Directive 98/78/EC on the supplementary supervision of insurance undertakings in insurance groups (OJ No. L330/1, 5.12.98) (the Insurance Groups Directive), and
- Directive 95/26/EC, (OJ No. L168/7, 18.7.98) (the so-called Post BCCI Directive).

Together, the first two directives provide the framework for the conglomerate supervision of banks and investment firms. The third addresses the prudential supervision of insurance undertakings within financial groups composed of insurers and reinsurers, while the last is a horizontal directive reinforcing the prudential supervision of regulated financial undertakings (such as banks, insurers, investment firms, and UCITs) in financial conglomerates.

¹²The Joint Forum on Financial Conglomerates, which was established under the aegis of the Basle Committee on Banking Supervision (Basel Committee), the International Organization of Securities Commissions (IOSCO), and the International Association of Insurance Supervisors (IAIS).

5.1 Directive 92/30/EEC, the Consolidated Banking Supervision Directive

The focus of this directive was on establishing a system for the effective supervision of credit institutions where they form part of a wider financial group. This directive can be considered as the start of conglomerate supervision at the EU level, at least as far as banks and securities firms were concerned.

Under this directive, every credit institution that has a subsidiary bank or financial institution or has a participation in such institutions must be supervised on the basis of its consolidated financial situation. It is important to stress that the definition of a *financial institution* does not include insurers. Subsidiaries and participations of 20% or more are consolidated.

Consolidated supervision covered the solvency ratio for credit risks, the adequacy of owned funds to cover market risks, and the control of large risks. Clearly, to carry out their responsibilities, the competent authorities required adequate information, and the directive effectively obliged banks to establish adequate internal control mechanisms for the production of data and information needed for consolidated supervision.

5.2 Directive 93/6/EEC, the CAD I Directive

Since the Consolidated Banking Supervision Directive required the presence of at least one bank, where the financial group was composed of only investment firms, there was a gap and no consolidated supervision was carried out. This was remedied by the CAD I Directive. Essentially, the directive replicates the approach taken in the consolidated banking supervision directive and applies it to investment firms so that there is a basic symmetry in the consolidation treatment given to banks and investment firms.

As the name suggests, the primary purpose of CAD I was to establish common rules for the calculation of the regulatory capital required by investment firms and for the market risks incurred by banks in connection with their "trading book." Common rules for the credit risks of banks had already been established by the solvency ratio rules under Directive 89/647/EEC.¹³

¹³Capital adequacy requirements for banks and investment firms is an extremely complicated subject and is addressed by a variety of other directives, for example, Directive 98/31/EC and Directive 98/33/EC. For the purposes of the present paper on conglomerate

Taken together, the Consolidated Banking Supervision and the CAD I directives produce a comprehensive basis for the application of risk-based supervisory rules to financial conglomerates composed of banks and investment or securities firms. In fact, nearly all the prudential rules that have been specifically adopted in view of the single passport for banks have become applicable to investment firms, so the same rules apply to both types of financial institutions. Both have to be supervised on a consolidated basis according to the rules of the Directive on the Supervision on a Consolidated Basis in conjunction with the Capital Adequacy Directive. This risk-based consolidated supervision in the EU should cover at least the credit risks, the market risks, the concentration or large exposure risks, and the limitations for participation in nonfinancial undertakings.

Considering banking and securities is the most important element in most financial conglomerates, the EU situation can be considered relatively satisfactory, at least by current international standards.

5.3 Directive 98/78/EC, the Insurance Groups Directive

This directive has the same basic objective (elimination of double gearing in insurance groups), but there are some differences in the approach as compared with the two previous directives. It is also somewhat more extensive with regard to certain other aspects.

In contrast to the case for banks and investment firms, this directive is not based on the consolidated accounts but on the individual insurance company accounts that are examined in a group context. This is the so-called “solo-plus” supervision method. The directive covers parent companies and subsidiaries as well as participations exceeding 20%. Whereas in the case of banks and investment firms, the group dimension was addressed by the preparation of consolidated accounts, in the insurance groups directive, an adjusted solvency margin is calculated for the insurance undertaking under review. In the annex to the directive, three methods

supervision, it is not necessary to enter into these intricacies, except to note that any complexity in the calculation of capital adequacy requirements at the level of individual banks or investment firms is obviously carried through when determining capital adequacy at the group or conglomerate level.

of calculating the adjusted solvency requirement are described, which take into account the individual company's financial relations with other group companies.¹⁴

Although reinsurance undertakings are not supervised and not subject to a solvency requirement at the EU level, a notional solvency requirement is calculated and taken into account for the purposes of determining the adjusted solvency requirement.

Furthermore, unlike the Consolidated Banking Supervision Directive, there is a specific article dealing with intragroup transactions. National supervisors are required to exercise supervision over transactions covering, among other things, loans, guarantees, off-balance sheet transactions, eligible elements for the solvency margin, investments, reinsurance operations, and agreements to share costs.

This directive, as in the other directives, also has provisions for facilitating the collection of information and organizing cooperation between competent authorities.

5.4 Directive 95/26/EC, the So-Called Post-BCCI Directive

This directive was written to remedy the regulatory gaps highlighted by the collapse and failure of the Bank of Commerce and Credit International. BCCI was a financial conglomerate, primarily in the banking area, whose demise caused much suffering and financial loss to many investors and depositors throughout the world. When the group ran into difficulties, effective prudential supervision was handicapped by a lack of information, an opaque conglomerate structure, and the difficulty of all the various regulatory and other official bodies to exchange information and cooperate satisfactorily.

The existence of close links with natural persons had posed specific problems in the BCCI affair. The directive required national regulators to refuse authorization if the financial undertaking had links with other natural and legal persons that would prevent the effective exercise of their supervisory functions.

Furthermore, it obliged competent authorities to refuse authorization if the laws, regulations, or administrative provisions of a non-EU country that governed one or more natural or legal persons (with

¹⁴Method 3 in the annex uses consolidated accounts.

which the undertaking had close links) could prevent the effective exercise of their supervisory functions.

The directive considerably widened the scope of information exchange with other official bodies (within the EU) not responsible for prudential supervision. The detailed provisions are extremely complicated and are set out in full in the article. Essentially, the extension included:

- Bodies involved in the liquidation and bankruptcy of financial undertakings
- Authorities responsible for overseeing auditors
- Independent actuaries and their governing bodies
- Bodies responsible for the detection and investigation of breaches of company law
- Central banks and monetary authorities
- Public authorities responsible for payment systems
- Bodies responsible for clearing or settlement services.

There were also specific rules on information disclosure, and these too are extremely detailed:

- The information received had to be used for the specific purpose referred to.
- The information was subject to the conditions of professional secrecy.
- Where information had originated in another member state, it could not be disclosed without the express agreement of the competent authorities that disclosed it, and it must be used solely for the purpose for which those authorities had agreed.

These provisions permit information exchange much more widely within the EU and extend the scope to enable the exchange of information with third countries to include UCITs.

The last major provision of the directive was the reporting obligation on external auditors. This requires auditors to report to the competent authorities any fact or decision of which they become aware, while carrying out their statutory responsibilities. Auditors must report a material breach of the laws, regulations, or administrative provisions connected with the conditions for authorization or anything that affects the continuous functioning of the financial undertaking. These actions could lead auditors to refuse to certify the accounts or to express a reservation.

Particularly relevant in the context of financial conglomerates was the additional duty for the auditor to report any such facts or decisions during the

course of his duties in an undertaking having close links resulting from a control relationship with the financial undertaking being audited.

This places a clear duty on auditors to act as whistleblowers and to thereby improve and facilitate proper prudential supervision. However, to protect the auditor from possible litigation or reprisals by his client, the directive provides that such good faith disclosures shall not constitute a breach of any restriction on information disclosure.

6. FUTURE EU LEGISLATION

Although the EU is relatively well endowed with an appropriate legislative framework for the prudential supervision of financial conglomerates, the status quo isn't entirely satisfactory. The situation is dynamic and obviously legislation needs to be adapted to market developments.

Currently, most financial conglomerates in Europe are composed of banking and securities groups. The number of major financial conglomerates spanning all three sectors (banking, securities, and insurance) still remains relatively small, although this number is growing rapidly. In the next phase of consolidation, financial service providers who can meet the full range of customers' needs are likely to emerge. At the same time, the pace of the globalization and consolidation process will continue and probably accelerate. The Internet can provide the technical means for niche suppliers to cherry-pick the most profitable customers. By way of example, last year, the Prudential, which is the UK's largest life insurer, launched an Internet bank called Egg. This has attracted a large number of customers away from traditional banks. So the need for an overall supervisory framework embracing both banking/investment groups, on the one hand, and insurance/reinsurance groups, on the other hand, is likely to become more pressing.

For these reasons, the European Commission is establishing a work program. It will include a comprehensive review of the current EU prudential framework and bring together the three financial sectors. This review will build on the papers and recommendations of the Joint Forum adopted earlier this year.

The logistical difficulties of the exercise should not be underestimated. Supervisors from each of the three sectors (banking, insurance, and securities), as well as regulatory experts from the national finance

ministries and some officials from other ministries, such as the justice area, must all be involved. All of this has to be multiplied by a factor of 15, corresponding to the 15 different member states, plus a complement is needed to cover the corresponding representatives from the EEA member states. Clearly, the complexity of the exercise is extensive.

7. SUMMARY AND CONCLUSIONS

The basic EU prudential framework for the supervision of banks, investment firms, and insurance undertakings is in place. This provides for each sector a set of harmonized core rules, mutual recognition, home country control, and the EU single passport for business. Each sectoral system is based on common requirements, including solvency and capital adequacy, fit and proper criteria, and close cooperation between national supervisors.

Financial conglomerates are expected to grow in number and size. Currently, most are mixed banking/investment groups. Major conglomerates spanning all three sectors, although important in some member states, are limited but growing rapidly. Internationally, financial conglomerates are also expected to gain importance.

The EU has addressed financial conglomerate supervision by expanding the focus on the individual financial undertaking to include the conglomerate dimension. In the banking/investment sector, conglomerate supervision is carried out on the basis of consolidation.

In the insurance sector, an adjusted solvency margin is calculated for combined insurance/reinsurance groups. Information exchange between the different sectoral supervisors and with other public and professional bodies is facilitated by Directive 95/26/EC.

Although the EU framework for conglomerate supervision is relatively advanced by international standards, it still needs further attention to reflect the integration of financial services throughout Europe. In fact, prudential supervision of financial conglomerates is a top priority for the Commission for 2000, as it builds on the valuable work of the Joint Forum recommendations.

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DISCUSSION

LARRY D. WALL*

The U.S. has enacted a variety of rules to limit the affiliation of commercial banks with other providers of financial services during the 1900s. Over the last several decades, competitive pressures from the marketplace have been exerting increasing pressure to relax the rules. Commercial banks, investment banks, and insurance companies have all been using advances in information technology and financial technology to develop products that were functionally equivalent to products in the other industries. Sympathetic regulators recognized that many of the barriers had become obsolete and agreed to relax the barriers via reinterpretation of existing legislation. However, the process of identifying and ex-

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exploiting loopholes has proven to be costly and time consuming; ultimately, this process was unable to remove some crucial barriers.

The passage of the Gramm-Leach-Bliley Act (GLB Act) sweeps away the remaining barriers preventing commercial banks from affiliating with the full range of financial services while reinforcing the barriers separating commercial banks from nonfinancial firms. Financial services firms will have more freedom in choosing how to best serve their customers, albeit that different combinations of financial services might entail varying amounts of government regulatory taxes and subsidies. These new combinations pose a variety of difficult issues for financial regulators. Michael Thom's excellent paper highlights the most important and most difficult of these issues: how to resolve the conflict between regulators organized around products and firms organized around serving customers' needs for diverse financial products.

If the GLB Act had been enacted in the 1980s or the early 1990s then structuring, managing, and regulating the resulting combinations might have been the dominant issue facing U.S. financial firms and their regulators for many years. However, rapid development of financial services provided over the Internet is threatening to reshape the financial services industry in a way that is far more fundamental than the GLB Act. The provision of financial services is ultimately about obtaining, processing, and transmitting information. The existing structure of financial services providers is premised on the idea that information is costly, especially for consumers of financial services. The development of information technology (IT), and especially the growth of the Internet, is dramatically reducing the costs of information. While the issues associated with financial conglomeration are likely to be important in the short-to-intermediate run, the issues associated with IT and the Internet can be critical over the intermediate-to-long run.

This discussion starts by summarizing the changes contained in the GLB Act in terms of both permissible combinations of financial firms and the structure of the financial regulatory agencies. Then the discussion briefly reiterates concerns discussed in the Thom paper, such as how to regulate financial conglomerates, and it discusses a related issue. The third section discusses how changes in IT and the Internet could impact both financial conglomerates

and bank regulators. The last section provides a summary.

1. GRAMM-LEACH-BLILEY ACT CHANGES

When Congress considers revisions to the financial system, it rarely starts with a blank sheet of paper and a goal of producing a simple and streamlined set of rules and supervisory structures. Parliamentary systems of governments might facilitate such fundamental change, but the U.S. legislative system does not. Instead, Congress typically focuses on resolving the problems, real or perceived. The GLB Act follows this pattern. The GLB Act removed the statutory barriers between different financial services providers and established new rules for the oversight of financial conglomerates with commercial banking affiliates, but it left largely intact the rules and supervisory structures overseeing the activities of commercial banks, investment banks, and insurance subsidiaries.

1.1 Changes in the Limits on Operations of Financial Holding Companies

Most of the constraints on affiliation prior to the GLB Act focused on the affiliation of commercial banks with other financial services providers. Accordingly, some of the biggest changes due to the GLB Act are in the area of commercial banks' affiliations with nonbank financial firms.

The Rules Prior to the GLB Act

A number of different statutes limited the affiliation of commercial banks with firms in other industries. Among the most important of these are (1) the Glass-Steagall Act, and (2) the Bank Holding Company Act of 1956 and its 1971 amendments.

The Glass-Steagall Act prohibited commercial banks from being affiliated with firms that are "engaged principally" in services such as the issue, floatation, underwriting, public sale, or distribution of securities.¹ It did not completely ban commercial banks from all types of securities services. For example, banks could continue to underwrite municipal (state and local government) general obligation bonds and to offer some investment services through their trust department. Various other openings developed, such as allowing U.S. banking or-

¹See Section 9.02 of Fein (1998) for a discussion of the Act.

ganizations to offer in foreign markets the range of products offered by their competitors.² This change allowed U.S. banking organizations to develop significant experience in investment banking in foreign markets, most notably London.

Although commercial banks obtained explicit authorization to provide a limited range of securities services, the Glass-Steagall Act effectively kept banks out of the mainstream of domestic investment banking until bank lawyers reexamined the text of the law.³ The big break occurred in the 1980s when a careful reading of the Act found that its limitations applied only if the subsidiary was "principally engaged" in the prohibited activities. An implication of this provision is that a subsidiary could engage in the banned activities so long as it was not "principally engaged" in the activities. The Federal Reserve Board agreed with this interpretation in 1987.⁴ These so-called Section 20 subsidiaries were initially subject to highly restrictive limits on what they could underwrite and the extent to which they could engage in otherwise banned activities (stated as a proportion of revenue). These security activities were also subject to substantial "firewalls" that limited the potential for the securities affiliate to put the commercial bank at risk, and it possibly limited synergies between the securities affiliate and the commercial bank. However, all three types of restrictions have been relaxed as commercial banks and their regulators gained experience with Section 20 subsidiaries.⁵

Banks have entered the insurance industry more slowly. The federal government has granted banking organizations limited authority to enter at least some aspects of the insurance industry both through affiliates of bank holding companies and through national banks. Most of the recent action in this area has been with regard to the ability of national banks

to provide insurance services. A 1916 federal law permits national banks to act as an insurance agent in any community of less than 5,000. The regulator of national banks, the Office of the Comptroller of the Currency (OCC), gave this interpretation: the insurance activities are to be located in communities of no more than 5,000 but the insurance can be marketed nationwide in communities of all sizes.

Many in the insurance industry regarded the offering of insurance products by commercial banks as providing unfair competition, especially given the potential for banks to link loan application approval to whether the borrower obtains insurance from the bank. Consequently, some insurance trade groups fought against bank expansion into insurance. In many states, they asked for limitations to be placed on banks' ability to sell insurance. However, these limitations have generally been rejected in a series of federal court cases. Insurance trade groups also lobbied Congress to pass unambiguous changes to the statutes that either limited bank's participation in insurance or made banks subject to the same rules as insurance companies.

The ability of commercial banks to affiliate with other types of financial services was subject to the control of the bank regulators. The Federal Reserve had been the most important regulator in its capacity as the sole regulator of bank holding companies (BHCs) under the Bank Holding Company Act of 1956 and its amendments. However, banks could have subsidiaries, and the activities of these subsidiaries were limited primarily by regulations from the bank's primary supervisor. In particular, the OCC had reviewed its rules and concluded that national banks have substantial authority to engage in financial services through their subsidiaries. The OCC had formalized its interpretation of the statute in its Part 5 rules.⁶ Although OCC's Part 5 rules might have ultimately allowed national banks to be affiliated with a wider range of activities, relatively few applications had been approved under Part 5 prior to GLB.

The ability of commercial banks to affiliate with commercial activities is also restricted under the BHC Act. The BHC Act of 1956 restricted the

²See Section 12.01 of Fein (1998) for a discussion of U.S. banking organizations' ability to engage in securities activities outside the United States.

³See chapter 9 of Fein for a discussion of banks' authority to engage in securities activities in the U.S. See also section 1.04 of Fein for a review of the key administrative rulings authorizing banks to engage in additional securities activities and section 1.05 for the relevant court cases.

⁴See the Federal Reserve Board's decision in Citicorp/J.P. Morgan & Co. Inc./Bankers Trust New York Corporation in the *Federal Reserve Bulletin*, starting on page 473 of volume 73 published in 1987.

⁵See section 9.05 of Fein (1998) for a review of the original firewalls and the subsequent modifications.

⁶See the Testimony of Eugene A. Ludwig Comptroller of the Currency before the Subcommittee on Finance and Hazardous Materials of the Committee on Commerce of the U.S. House of Representatives July 17, 1997.

ability of commercial firms to own a bank holding company. Subsequent amendments to the BHC Act in 1966 and 1970 and the Competitive Equality in Banking Act in 1987 closed several loopholes in the restriction.⁷

One important point to note about the prior discussion is that the limits applied primarily to commercial bank affiliation with nonbank activities. Similar limits applied to thrift holding companies that own more than one thrift charter.⁸ No restrictions applied to affiliation between securities and insurance firms. Moreover, holding companies that own only one thrift charter may be affiliated with any other financial or nonfinancial service. At one time, Ford, the automobile manufacturer, owned a thrift charter, and State Farm Mutual Insurance recently chartered a thrift.

GLB Act Changes

The GLB Act amends the BHC Act to allow commercial banks to be affiliated with a wide range of financial services. In an effort to break down the barriers between financial services companies, the Act repeals the Glass-Steagall Act's limits on the affiliation of commercial and investment banking. However, the Act also seeks to reinforce the barriers separating banking from commerce.

The GLB Act adopted the bank holding company model for structuring new activities in which different activities are organized as subsidiaries of the holding company. I do not think that Congress seriously considered authorizing new activities structured along the lines of universal banking in which the bank itself engages in the full range activities, an organizational form that is common in many European countries. The GLB Act also permits many financial services to be provided through subsidiaries of the bank; however, the Act also imposes several limitations and requirements on bank subsidiaries that are not imposed on BHC subsidiaries.

BHCs that choose to provide a wide range of financial services may elect to become Financial

Holding Companies (FHCs).⁹ The only requirements for becoming an FHC is that all of the holding company's subsidiary banks and thrifts must be well capitalized and well managed and have at least a satisfactory Community Reinvestment Act (CRA) rating. FHCs have explicit authorization to engage in a laundry list of activities including: (1) lending, trust, and other banking activities; (2) insurance activities; (3) financial or economic advice or services; (4) pooled investments; (5) securities underwriting and dealing; (6) any other activity already authorized by the Federal Reserve for BHCs; and (7) engaging in any other activity in the U.S. that is currently permissible for BHCs to engage in outside the U.S. The Federal Reserve, with the approval of the Secretary of the Treasury, may also expand this list of activities to include other "financial" or "incidental" activities. The criteria for approving additional activities include considering (1) the purposes of the GLB Act; (2) changes or reasonably expected changes in the financial services marketplace and in technology; and (3) whether an activity is "necessary or appropriate" for FHCs to compete with, or to use technology in the provision of financial services.

While the GLB Act follows the principal of separating banking from commerce, the Act recognizes that investment banks, merchant banks, and insurance companies can acquire controlling interests in companies in the ordinary course of business. Thus, the Act permits FHCs to own a controlling interest in any company, provided that the interest is acquired in the ordinary course of business and that the FHC is acting as a passive investor rather than actively running the company.¹⁰

The GLB Act allows national banks to provide a wide range of financial services through their subsidiaries.¹¹ A national bank may have a subsidiary that engages in any activity authorized directly for the bank or any financial activity except insurance underwriting, insurance investments, real estate investment, or development and merchant banking. The Act provides for the Secretary of the Treasury to expand the list of permitted activities subject to Federal Reserve approval. The Act limits the total

⁷See Heller and Fein (1999), chapter 4.

⁸The so-called unitary thrift charter is discussed in Ellen Seidman, Director, Office of Thrift Supervision, testimony before the Committee on Banking, Housing and Urban Affairs of the United States Senate on June 25, 1998.

⁹Section 103 of the GLB Act lays out the requirements for a bank holding company to become an FHC and the range of permissible activities for a FHC.

¹⁰Section 103 of the GLB Act.

¹¹Section 121 of the GLB Act establishes the limits on national bank provision of financial services through affiliates.

assets of all financial subsidiaries to the lesser of 45% of the bank's assets or \$50 billion.

The GLB Act closes a loophole in previous law that allowed holding companies without bank charters and only one thrift charter to be affiliated with commercial activities.¹² The Act grandfathers in any holding company that owned a thrift charter on May 4, 1999. However, this authorization to continue owning a thrift is not transferable. This closure of the unitary thrift holding company loophole was necessary if the policy of separating banking and commerce was to remain viable.

1.2 Regulatory Structure

Arguably, the most contentious parts of the GLB Act relate to the structure of the regulatory agencies. The basic philosophy underlying the Act is one of functional regulation; that is, specialized regulatory agencies should oversee each of the various types of financial services. Adopting functional regulation in the Act neither eliminated any existing agencies nor created any new agencies. However, the Act had to address several bitter disputes about exactly where the boundaries between the different agencies should be placed.

The Structure Prior to the GLB Act

The U.S. regulatory system is more complicated than that in many countries, most notably the United Kingdom, which recently adopted a single financial regulator. I think the U.S. system is best seen as the consequence of two aspects of our political system: a federal government in which states are granted substantial authority under our constitution, and a system of checks and balances at the federal level that separates the legislative, executive, and judicial system.

The federal government's authority to exercise regulatory influence over the financial sector is largely a result of its authority to "coin money" and "regulate commerce . . . among the several states." Our constitution explicitly reserves for the states all powers that are not either granted to the federal government or denied to the states by the constitution. Thus, the states can and do have regulatory authority over the intrastate provision of financial services. They exercise this authority in the bank-

ing, securities, and insurance areas. In practice, this authority is greatest in the insurance area where the McCarran-Ferguson Act specifically grants all regulatory authority to the states, unless a federal statute "specifically relates" to insurance.

The U.S. system of checks and balances has contributed to the development of the so-called independent regulatory agencies (agencies independent of the executive branch). The only regulatory agencies that are part of the executive branch are the OCC and the Office of Thrift Supervision (OTS). The Federal Deposit Insurance Corporation (FDIC), the Federal Reserve, the Securities and Exchange Commission (SEC), and the Commodity Futures Trading Commission (CFTC) are all independent agencies. Whether the existence of independent regulatory agencies is "good government" has been debated since independent agencies were first created. One justification for making agencies independent of the executive branch is these agencies often exercise some judicial power. A practical explanation for the existence of independent agencies is that Congress sometimes establishes goals that might have different policy implications and the structure of the regulatory agencies has an important effect on which goals take priority (Wall and Eisenbeis 2000). A purely political explanation for their existence is that Congress may exercise greater influence over independent agencies than it does over agencies in the executive branch.

Regulatory Structure under the GLB Act

Two major issues of regulatory structure arose during the writing of the GLB Act. First, should an agency, called an umbrella regulator, have oversight over the entire FHC for safety and soundness purposes and, if so, where would the boundary be between the umbrella regulator and the functional regulators? Second, if a bank subsidiary is engaged in the provision of securities or insurance services, then where should the boundaries be drawn between the bank regulatory agencies and functional regulators of securities and insurance?

The first issue was resolved in favor of extending the Federal Reserve's umbrella regulator responsibility over BHCs to the new FHCs. This expansion of the FRB's role does not give the agency authority over holding companies that do not own banks.

The creation of an umbrella regulator raises the question of how the Federal Reserve can meet its responsibilities without usurping the position of the

¹²Section 401 of the GLB Act imposes restrictions on holding companies that own only one thrift charter.

functional regulators of the individual bank, securities, and insurance subsidiaries. In terms of obtaining information, the Federal Reserve is given authority to require reports and conduct examinations of FHC subsidiaries. However, under the so-called Fed-Lite formulation, the Federal Reserve is directed to obtain needed information from the functional regulators to the maximum extent possible. The FRB will conduct an examination only if it needs more information on the riskiness of the subsidiary or if it must enforce any other law where the board has specific authority.¹³

In terms of setting standards and taking enforcement action, the Act sets a variety of boundaries between the FRB and the functional regulators. The FHC precludes the FRB from imposing capital regulations on the regulated subsidiaries of a FHC, but it is silent on the FRB's ability to impose such regulations on the consolidated FHC. The Federal Reserve's authority to take action against functionally regulated subsidiaries is also limited. In general, the FRB may not take action against such subsidiaries unless the action is necessary to address a "material risk" in the safety and soundness of a depository or the payments system, and unless it is not possible to guard against the risk solely through requirements imposed directly on the depository.¹⁴ Furthermore, the Federal Reserve's ability to direct holding company affiliates to aid distressed banking affiliates is limited. The FRB may not require a broker/dealer or insurance company that is a BHC to infuse funds into a troubled depository if the company's functional regulator determines that doing so would have a material adverse effect on the broker/dealer or insurance company.¹⁵

Congress was also under pressure to establish the boundary between the national bank regulator, the OCC, with both the regulators of securities (SEC) and of insurance (state insurance commissioners). The SEC has had authority to regulate broker/dealers, but the definition of broker/dealers contained an exemption for banks. Historically, this exemption existed to allow banks to engage in a limited set of activities, such as trust operations, without SEC oversight. However, this exemption became significantly wider as the bank regulators refined their

reading of the Glass-Steagall Act. The GLB Act repeals the general exemption of banks and replaces it with a limited set of exemptions such as trust activities, sweep accounts, derivatives, and identified bank products.¹⁶ Congress recognized the ongoing development of "new hybrid products" and that the boundary line between new securities (which come under SEC authority) and extensions of banking products is fuzzy. Thus, the Act provides for the SEC to first issue a regulation defining a new hybrid product as a security before it uses the security as justification to require the bank to register as a broker/dealer. The SEC is required to consult with the Federal Reserve Board before issuing such a regulation, and the FRB may seek judicial review.¹⁷

Setting a boundary between the OCC and state insurance commissioners was also critical to the passage of the GLB Act. The rules set by the Act appear designed to address the concerns of both sides, and it reaffirms that the business of insurance is subject to state regulation.¹⁸ However, the Act also requires that such state regulation may not discriminate against the insurance activities of depositories.¹⁹

2. CHALLENGES POSED BY BREAKING DOWN OF BARRIERS

Thom highlights one of the fundamental challenges of supervising financial conglomerates:

4. As mentioned earlier, the basic difficulty in supervising a financial conglomerate is that it is managed as a whole. Traditional supervision focuses on the individual sectors making up the conglomerate without necessarily looking at the "big picture."

His discussion provides an excellent explanation of why prudential supervision of the individual pieces of a financial conglomerate is inadequate.

One response to the calls for consolidated supervision was that important affiliates, such as government-insured commercial banks, could be protected by erecting "firewalls" between the bank and its affiliates. In particular, regulators could protect the

¹³Section 111 of the GLB Act.

¹⁴Section 113 of the GLB Act.

¹⁵Section 112 of the GLB Act.

¹⁶Section 201 of the GLB Act.

¹⁷The regulatory treatment of hybrid financial products is established in Section 205 of the GLB Act.

¹⁸Section 104 of the GLB Act.

¹⁹Section 304 of the GLB Act.

bank by limiting its financial transactions with affiliates. The banks could not transfer excessive capital out directly via dividends or indirectly via mispriced transactions with affiliates.

Whether firewalls could absolutely prevent the parent from using bank resources to help troubled affiliates is questionable. I think that firewalls can significantly slow the drain on a bank's resources but they could not eliminate the drain. Whether a bank will remain safe behind its firewall while fire is raging through its affiliates depends crucially on the relationship of the bank to its affiliates. If the parent manages each of its subsidiaries as a stand-alone operation, with no connections to other affiliates, then firewalls may work well enough to give regulators time to save the bank. However, if conglomerates are to add value, then it must be that they obtain some synergy from combining different financial services in a single entity so that the value of the whole is greater than the sum of the parts. This synergy could take the form of efficiencies of scope in the production of services leading either to lower costs of production of individual services or greater value to customers. Yet, if important synergies exist between the bank and its affiliates, then the failure of an important affiliate might have a significantly adverse impact on the bank's competitive position. In terms of the firewall analogy, how valuable are impenetrable firewalls if important supports for the ceiling are collapsing as affiliates fail?²⁰

The U.S. has used firewalls to help protect depositories from problems in affiliates and the GLB Act reinforces these firewalls. For example, existing statutory limits on transactions between BHC subsidiaries and insured depositories are being extended to cover transactions between insured depositories and their subsidiaries. However, in recognition of the need for consolidated supervision, the GLB Act also establishes the Federal Reserve as an umbrella regulator for U.S. holding companies that own a commercial bank.

Despite differing stands on the effectiveness of firewalls, U.S. bank regulators have recognized that banks, especially large banks, have become engaged

in increasingly complex activities. These complex activities pose a very substantial challenge for traditional bank supervision, and one response of the bank supervisors has been to look for ways to enhance market discipline. The case for enhancing market discipline of banks becomes even stronger if one believes that complex financial conglomerates are "managed as a whole" so that the health of a bank cannot be judged in isolation from its affiliates. Exactly what form these calls for increased market discipline will take remains to be seen. The GLB Act opens up one possibility—greater reliance on bond markets to evaluate and discipline risk. The Act requires large banks that engage in certain activities through bank subsidiaries to issue highly rated bonds with a maturity of at least one year. The act also instructs the Treasury and Federal Reserve to conduct a study of the potential use of subordinated debt to discipline bank risk-taking.

3. CHALLENGES POSED BY DEVELOPING INFORMATION TECHNOLOGIES

In many markets for financial services, consumers have historically found comparison shopping was time consuming, costly, and impossible. Someone seeking a loan from a bank needed to provide financial information to a lending officer, who would evaluate both the new information and his prior knowledge about the customer's character. In most cases, comparison shopping at banks that lacked a local branch was pointless because banks would not consider making small loans unless they had a local presence from which to obtain information about the borrower. Similarly, someone seeking information about insurance prices needed to go to an insurance agent to request information; the buyer, ultimately, must pay a handsome commission for the agent's services. In perhaps the extreme case, investors in corporate bonds may lack access to the prices paid in recent secondary market transactions. Investors that want to buy or sell a corporate bond can obtain quotes from several dealers, but the dealers are generally unwilling to publicly disclose recent transaction prices.

The continuing development of technology for transmitting and analyzing information (IT) is creating profit opportunities for those seeking to exploit the inefficiencies in the existing financial system.²¹ Lend-

²⁰The idea that conglomerates manage their affiliates in a way to obtain the benefits of synergy is implicit in Thoms' Sec. 4 ¶2 remark that "financial conglomerates can be organized across global business lines with management responsibilities cutting across different legal entities in a complex matrix."

²¹See Morgan Stanley Dean Witter Equity Research (1999) for a recent analysis of the implications of the Internet for financial services.

ers are entering new geographic markets by using information technology to model consumer behavior and evaluate loan applications. Insurance firms may follow the Dell model of selling direct, allowing customers to obtain customized insurance packages and pricing via the Internet. IT-based firms are working to develop computerized markets for corporate bonds that allow investors to buy and sell directly without trading through investment banks.

The ongoing development of IT, including the Internet growth, is transferring power to the consumers over all types of products. Consumers are in a better position to get the combination of product pricing and characteristics that maximize their utility. The increasing power of the consumer is forcing firms in all lines of business to reevaluate what they do. Firms are increasingly unable to subsidize inefficient parts of their operation with profits earned due to consumer ignorance. If a firm wants to succeed in this environment then it must: (1) determine what is its core competency, that is, what it does better than potential competitors; (2) find ways to reinforce and build on its strengths; and (3) either improve its inefficient operations or obtain the needed services from outside.

The pressure that IT is exerting on all business has two important implications for financial services firms and their regulators. First, the gains from forming conglomerates that were available when information was costly to consumers may no longer exist. Consumers may choose to obtain a package of transaction accounts, investment accounts, and loans and insurance from a conglomerate, if the conglomerate is among the very best providers in each of these services. However, the consumer could purchase each of these services individually, perhaps through a Internet portal such as Yahoo. Yahoo might help both to identify the best firms in each product category and to provide integrated reports summarizing the consumer's financial position. Thus, while a financial conglomerate might succeed in this environment, it cannot have any weak links, and it might not be able to command premium prices for merely providing consumers with one-stop shopping. If conglomerates are to provide added value, they will need to find a way to obtain synergies in the production of financial services.

So does this mean that financial regulators need only survive a temporary period of complexity before we return to the world of well-defined banks, insurers, and securities dealers? No. If the above analysis of the role of IT is correct, then regulators

might face questions that are even more difficult in the future. One of the problems that regulators might need to face is that the existing boundaries we draw around "financial services" bear little resemblance to how corporations define their core competencies in the future. Indeed, the concepts of a commercial bank, an investment bank, and an insurance firm may become obsolete. Instead these functions may be split up and fit into firms with core competencies arranged around very different concepts. Those with superior data-mining abilities may dominate credit-granting decisions for retail and small business lending, insurance sales, and the marketing of a host of nonfinancial products. For that matter, marketing firms can pay consumers to process their credit card transactions and payments in order to obtain additional data for their databases. Moreover, the firms that provide transactions processing need not be the same firms that manage the transactions accounts or other assets, and neither of these need be the same as the firms that pool smaller loans for sale. Firms with superior skills running on-line auctions might replace existing financial markets.

As the boundaries between financial and nonfinancial services continue to blur, financial regulators may be forced to ask some tough questions about their own roles. Exactly what financial services are vital to the operation of an economy, and in which of these would the failure of important providers pose a threat to the economy? How are these vital functions to the best protected and important firms to be supervised? Furthermore, how do we prevent firms from expanding the safety net's coverage to new financial activities?

The other problem that regulators face is that national boundaries are becoming even less important than they had been in the past. In the past, most consumers of financial services needed the ability to physically interact with their providers. The Internet is rapidly eliminating this need. To be sure, national boundaries are important to the extent that the laws governing financial transactions can be very different across countries, and these boundaries may be important to the extent they correspond with cultural differences. However, national boundaries might not prevent consumers from obtaining financial services from providers in other countries, but they can raise the cost of obtaining services from other countries. This cost barrier associated with national boundaries will provide

a level of protection for local financial firms and regulators that are inefficient, but it will also set a ceiling on the level of viable inefficiency.

The increasing threat of competition from foreign financial services providers will certainly pose a challenge to the managers. However, it will pose at least as much of a challenge to regulators. Regulation that is costly and provides little benefit to consumers can drive domestic market share from providers supervised by local regulators to foreign providers over whom the local supervisors may exert little influence. Does this imply that the only sustainable level of regulation in a global financial marketplace is no regulation? It is possible, but improbable. While regulators are often berated for raising the costs of doing business, regulators also play a vital role in lowering the costs of doing business. In particular, regulators can lower costs by producing an environment in which parties can confidently contract. For example, regulators can reduce information costs by conducting periodic reviews of otherwise confidential information, by providing a fair and transparent legal system, and by providing for the quick and efficient resolution of failed financial firms. We in the developed countries tend to underappreciate this dimension of regulation, but the experience in many developing countries suggests that this governmental function is essential to the operation of an efficient free-market economy.

4. CONCLUSION

The GLB Act makes many important changes that were needed for the U.S. financial regulatory system

to meet the challenges of the late 1900s. It sweeps away many of the statutory barriers on affiliations between different types of financial services. The mergers likely to follow the Act may challenge the U.S. regulators' ability to oversee large, sophisticated financial firms that offer a variety of products. Yet, as we look out toward the horizon, the biggest challenges that regulators in the U.S. and around the world may face are coming from possible changes in the market. The ongoing revolution in IT, especially Internet growth, will challenge regulators' ideas about both the business and geographic boundaries of financial services firms.

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