



ASSOCIATION OF SUPERVISORS  
OF BANKS OF THE AMERICAS

# **Best Practices Guide and Recommendations for the Regulation and Supervision of Financial Conglomerates**

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December, 2011

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for the Regulation and Supervision of Financial Conglomerates**

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## CONTENTS

<b>I</b>	<b>Introduction</b> .....	<b>7</b>
<b>II</b>	<b>Recommendations and Best Practices for the Regulation and Supervision of Financial Conglomerates</b> .....	<b>9</b>
II.I	On the Legal and Regulatory Framework .....	9
II.II.	On Supervisory Powers .....	13
II.III.	On Corporate Governance .....	16
II.IV.	On Risk Management .....	20
II.V.	On Intra-group Operations .....	21
II.VI.	On Concentration Risk .....	23
II.VII.	On the Consolidation Process .....	24
II.VIII.	On Capital Requirements .....	25
<b>III</b>	<b>Approaches and Tools for Consolidated Supervision</b> .....	<b>28</b>
III.I	Lead Supervisor .....	28
III.II	Supervisory Colleges .....	29
III. III.	The Use of the Memorandum of Understanding (MOU).....	30
<b>IV</b>	<b>Main Supervisory Challenges</b> .....	<b>32</b>
	<b>Annexes</b> .....	<b>37</b>
	Annex 1 – Regional assessment on the supervision of financial conglomerates .....	37
	Annex 2 – Memorandum of Understanding .....	48
	Annex 3 – Bibliography .....	53
	<b>Discussion Group Members</b> .....	<b>54</b>



# I

## Introduction

In recent decades an important change has been witnessed in the development of the financial system at the global level. Said change has been characterized by an increasing movement toward consolidation as well as by the internationalization of operations and a high level of innovation in the financial system. During the eighties and nineties, Latin America experienced a liberalization process in its financial and capital markets, resulting in the access of foreign banks to the Region<sup>1</sup>, as well as the participation of banking entities in activities related to securities and insurance markets, asset management, and equity participation in non-financial entities<sup>2</sup>. This process echoed what was happening in industrialized countries, such as the United States, where the Gramm-Leach-Bliley Act was approved in 1999, thus allowing the integration of entities that offered a diversity of financial services. In like manner, in Europe there was a strong consolidation movement between banking and insurance companies in answer to the intense competitive environment and to fewer legal barriers to mergers and acquisitions in the financial sector.<sup>3</sup>

As a result of the changes described, there are a significant number of financial conglomerates (FC) that offer a wide range of financial products under the same umbrella. This concentration and linkage of the traditional financial sector leads to significant challenges for regulating and supervising financial conglomerates. On one hand, conglomerates can take advantage of the regulatory differences to which various entities of the same group are subject to. On the other hand, it is considered that this type of structure also promotes the emergence of new risks or, at least, increases existing ones. Beyond the traditional risks faced by a FC, the risk of contagion and the reputational risk represent risks that are particularly related to this type of entities. Finally, the recent financial crisis bespeaks the increasing interconnection among the different sectors of the financial system. Thus, risks could arise from banking entities, from investment banks such as Lehman Brothers, or insurance companies such as American International Group (AIG). Based on this analysis, countries in the Region should have a robust regulatory and supervisory structure for financial conglomerates.

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1 Region is understood as the geographical area covered by the Member countries of the Association of Supervisors of Banks of the Americas.

2 Moguillansky, Graciela; Studart, Regoerio and Vergara, Sebastián. Economic Commission for Latin America and the Caribbean. "Paradoxical behavior of the Foreign Banking in Latin America," ["Comportamiento Paradójico de la Banca Extranjera en América Latina"]. April 2004

3 Lown, Cara; Osler, Carol; Sufi, Amir and Strhan, Philip. "The Changing Landscape of the Financial Services Industry: What Lies Ahead?" New York Economic Policy Review, Vol.6, No.4, p.39-55. October 2000.

Considering the challenges presented above, the Association of Supervisors of Banks of the Americas (ASBA) created a Discussion Group in order to assess the strengths and weaknesses of the regulation and supervision of financial conglomerates in the Region and to identify necessary changes. Therefore, this paper presents a compendium of recommendations and best practices for the effective regulation and supervision of financial conglomerates. These recommendations are the result of a joint effort of the Discussion Group members, the consultant, and the assistance of the ASBA's General Secretariat.

Section II gathers recommendations and best practices that allow authorities to guide their efforts toward effective consolidated regulation and supervision. This section includes recommendations that cover features and requirements for the legal and regulatory framework, as well as the main supervisory powers needed to develop their functions. This section also provides guidelines on the supervisory process at the consolidated level for areas such as corporate governance, risk management, intra-group operations, concentration risk, consolidation processes and capital requirements.

One of the main supervisory challenges for a FC is the accessibility to information and the timeliness in obtaining such information. Given the importance of an efficient exchange of information and proper coordination among the different supervisors participating in this process, the third section presents the main approaches and tools that can be used to facilitate and promote an adequate communication process. These include the Supervisory Colleges, the Lead Supervisor, and the use of Memoranda of Understanding (MOU).

Section IV introduces a brief account of the challenges faced to date by the supervisory authorities in the Region in regard to FC regulation and supervision. Some of the main challenges identified include the need for changes in legal and regulatory frameworks in order to introduce the concept of integrated FC supervision; a review of barriers that discourage the exchange of information and promote regulatory arbitrage; the lack of human resource training in regulatory and supervisory authorities; the lack of an adequate legal protection for the supervisor, and the need for accounting convergence to support the comparison of financial information at the international level, among others.

Finally, the annex section provides an assessment of the present situation of supervisory practices in place in the Region; this also served as the basis for drawing up recommendations and identifying best practices. The second annex presents a model of a Memorandum of Understanding (MOU) that can be used by supervisory authorities to design their own mechanisms for the exchange of information and cooperation.

# II

## Recommendations and Best Practices for the Regulation and Supervision of Financial Conglomerates

The supervision of a financial conglomerate (FC) involves, among other processes, the collection and analysis of relevant information on the different conglomerate units in order to analyze unique risks and the mechanisms for their mitigation. In order to develop this task, there is a wide range of regulatory and supervisory tools. Such tools gain more or less importance, depending on the particular characteristics of the FC under evaluation, where the supervisor must choose the most suitable tools to achieve his/her target.

The following include a series of recommendations and best practices identified by the Working Group, comprised by bank supervisors from the Region, the consultant, and ASBA's General Secretariat with the objective of conducting an effective consolidated regulation and supervision:

### II.I On the Legal and Regulatory Framework

#### i. Definition of Financial Conglomerate

*The legal or regulatory framework should include a broad definition of what constitutes a FC, expressed in such a way that it not only encompasses all existing entities that comprise a conglomerate, but also contains the flexibility to include institutions that may be incorporated in the future or that can be assumed as belonging to it ("umbrella type" definition). In summary, the FC definition should be able to adapt to changing situations. In order to achieve this, it is recommended that the more precise definition of supervisory powers be incorporated at the regulatory framework level.*

On the other hand, *the definition of control to establish a FC should be expressed at the conceptual level of the law*, leaving the more precise definitions in the regulatory framework. Another recommendation is to incorporate within the legal framework the concepts of control through stock ownership, control exercised through operational control, and control implemented through ordinary members of decision making bodies (committees).

*The legal framework should grant the supervisor a presumption capacity to define a FC or to establish linkages of the FC with outside units.* In this sense, the law should establish the

types of linkages in a conceptual manner. The presumption capacity of the Supervisor allows him/her, based on reasoned argumentation and considering the control elements or linkages typified in the corresponding law, to define the existence of a FC or to incorporate economic units to the FC.

*The legal framework should also include the obligation of conducting consolidated or integrated supervision of FCs, so that the regulatory framework incorporates risks not covered at each unit's sectorial level regulation.* The main objective of consolidated supervision is to allow supervisors to understand the FC's strengths and risks, so that any financial, managerial or operational deficiency can be addressed before it affects the rest of the FC components. Therefore, the Supervisor should have the authority to regulate and supervise the FC's activities, as well as to apply corrective measures or necessary sanctions.

The FC's inherent risks comprise reputational and contagion risks, the risk of concentration, and the risk of insufficient capital at the consolidated level, which can be caused by intra-group operations or by cascade capitalizations.

Finally, *the supervisor should have the legal capacity to demand information from entities linked directly or indirectly to the FC in order to define the FC's perimeter.* Such information should be requested from the holding company's management, if it exists, or from the dominant company in the FC. Ultimately, the Supervisor should have the legal power to force the FC to cease operations with an entity (or unit) that does not provide the required information or deny such entity's incorporation into the FC, if there is a request for incorporation.

## ii Types of Financial Conglomerates

In some countries in the Region, FCs are restricted to performing financial-banking activities exclusively; in other countries activities related to the real economy are allowed (commerce, industry, agriculture, and others). For the purposes of this paper, a FC is considered to be a group of institutions that participate in predominantly financial activities in at least two market segments (i.e. banks, securities, insurance, or pensions). On the other hand, financial conglomerates that include real economy activities are known as "mixed conglomerates."

The opinion of most of the Region's supervisors is that real economy units that belong to a FC can potentially entail higher risks. Therefore, *the supervisor should be able to demand any information deemed necessary (balance sheet, income statement, cash flow, etc.) of any of the non-regulated entities that belong to the FC*, for the purpose of understanding the unit's risks, financial as well as reputational, and thus perform an assessment of the risks that these entities pose for the FC and to its various units. Also, the supervisor should evaluate the existence of risk correlations between non-financial operations and the FC. In case this information is not available, the supervisor should have the power to prevent the bank from carrying out operations with the unit in question.

Based on the analysis presented above, *it is prudent for FCs to perform exclusively banking and financial activities*. Financial activities are sufficiently complex and require exclusive dedication and a profound degree of specialization on the part of managers and supervisors. Adding real economy activities to this process would entail an even higher degree of dedication and specialization.

The above premise does not imply a limitation to the scope of the Supervisor's authority: if the Supervisor considers that the supervised entity has real economy activities, he/she should have the power to incorporate such activities into his/her analysis. Supervisors in countries where "mixed conglomerates" are a reality should consider the specific challenges posed by this type of structure, including:

- Higher risks, including contagion and reputational risks, that tend to concentrate in the FC units dedicated to activities in the real economy.
- Difficulty to establish capital requirements at the FC level when the real economy units do not have their own capital requirements.
- Use of risk mitigation measures for "mixed conglomerates," such as the prohibition of intra-group transactions between the regulated entities and those of real economy.
- Need of specialized knowledge to assess the risks of real economy units and their impact on financial units, as well as how to evaluate risk at the consolidated level.
- Difficulty in consolidating accounting for the economic group, given that the accounting standards in the finance department of a FC do not necessarily adapt to the reality of entities participating in real economy activities.

In these countries –though it might be impractical to modify legislation in order to achieve greater control over this type of structure– it would be advisable to implement amendments that define the FC as having an exclusive banking and financial vocation.

### iii. Legal Structure

As an essential part of consolidated supervision, *the supervisor should have a broad understanding of the overall structure of the conglomerate and its main activities*. The importance of understanding a conglomerate's legal structure arises from the need to avoid an underestimation of the risk exposure of the entity, as well as an overestimation of the consolidated regulatory capital or non-compliance with legal or regulatory requirements<sup>4</sup>.

Occasionally, FCs adopt forms of legal organization that hinder the efficient supervision of all the risks assumed by the conglomerate. This could be due to the existence of FC

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<sup>4</sup> Superintendencia de Banca, Seguros y AFP del Perú. Financial Conglomerates Supervision Guide. [Guía de Supervisión de Conglomerados Financieros.]

units operating in jurisdictions where the Supervisor does not have access to information or where there is difficulty in establishing counterpart risks or the existence of ownership schemes in which some subsidiaries are the owners of other units, either wholly or in part, thus making it difficult to establish the proper consolidated capitalization level. In those cases, *the regulatory framework should give the supervisor the power to change the FC legal structure if there is evidence that the structure inhibits or prevents the correct supervision of the FC.* Such powers could include the suspension of domestic or international operations, as well as the temporary or definitive closing of offices and/or subsidiaries.

The following include some of the documents required as a minimum that the Supervisor can demand from the FC in order to understand its structure:

- Information on the economic group, the units it comprises and main activities.
- Organization charts of the companies composing the FC.
- Minutes of the meeting of shareholders and the board of directors.
- Report on intra-group transactions.
- Report on permanent investments, including the participation percentages.
- Financial statements of the main companies composing the FC, particularly those from unregulated units.

Based on regional experience, *it is beneficial for consolidated supervisory purposes to have a legal requirement to establish a holding company within the country.* Likewise, said holding company should be regulated and supervised by the competent authority.

The presence of a holding company legally established in the country simplifies supervision given that:

- The accounting consolidation is simpler to execute because a reference for consolidation is clearly established, given the mandatory existence of a company that owns the various units of the FC.
- There is certainty about the highest-ranking contact person in the FC.
- When a FC has subsidiaries abroad, it is important that those subsidiaries belong to a local holding company, to be able to demand from the local holding company any required corrective actions in its foreign subsidiaries.
- If capital requirements at the FC consolidated level are established, or the capital requirements for a subsidiary abroad are inadequate, the holding company structure is important in order to demand from it said capital requirements.

Some countries do not demand the presence of a holding company. Instead, the banking entity in the home country acts as holding company, while the remaining FC units, either directly or indirectly, are considered subsidiaries of that bank. If a home supervi-

sor operates under a deficient regulatory framework that does not provide supervisory powers at the consolidated level, having the holding company constituted in his/her jurisdiction allows the supervisor access to information on all FC units, given that these would be established as the bank's subsidiaries.

## II.II. On Supervisory Powers

As noted above, it is important that the legal framework allow for the consolidated or integrated supervision of the FC, and not only the sum of its parts. Thus, the necessary requirements can be established to cover the risks that transcend sectorial supervision. In this regard, the law or regulatory framework should establish the power to supervise all FC units, including the FC's holding company. Furthermore, the supervisor should have the same powers to supervise each of the FC units, as he/she has for the FC as a whole.

The following section introduces recommendations on supplementary powers that the Supervisor for financial conglomerates should have:

### i. Determination of the Majority Interest

*The law should grant the supervisor authority to know who the ultimate owner of the FC is, and to demand compliance of the “fit and proper” requirements established in the regulation. Special requirements should be established for the majority shareholders that directly or indirectly control a significant percentage of a FC's social capital.<sup>5</sup>*

Requirements for integrity, capacity and financial position should be demanded from the largest shareholders, as well as from the members of the Board of Directors and senior managers. (For further details see section I.III subsection iii, “Suitability of Corporate Government Participants.”)

Therefore, *regulation should give the supervisor unrestricted access to all the information needed to identify the linkages of the FC owner or its subsidiaries with other legal or natural persons.* It is important that the information submitted to the Supervisor be presented in the form of a sworn statement to ensure greater reliability and accuracy of the information.

### ii. Requirements and Exchange of Information

*The supervisor should have the authority to demand that the FC provide periodic reports on its structure, corporate government, business strategies, risks, operations and risk control systems in a timely manner<sup>6</sup>.* The supervisor should have the power to require financial

5 Some countries in the Region establish a threshold between 5% and 10% to represent a significant holding of FC's capital.

6 Association of Supervisors of Banks of the Americas. “Consolidated Supervision” 2008

statements (i.e. income statements, balance sheet statements, off-balance sheet transactions, intra-group transactions, etc.) at the consolidated level, taking into account all units belonging to the FC. Likewise, the supervisor can request qualitative reports regarding significant changes in policies or business strategies, thus allowing the supervisor to effectively carry out his/her duties.

*The supervisor should also have the legal power to sign agreements with other supervisors for the purpose of exchanging information to advance joint supervision.* The unrestricted exchange of information among supervisors in the same locality and with supervisors abroad is fundamental for effective supervision. (See section III Approaches to Consolidated Supervision, for further details).

Basel Core Principle No. 25 provides guidance on the relationship between the home supervisor and the host supervisor. Said principle implies that the information exchanged between supervisors should be appropriate to develop the tasks and responsibilities of each supervisory agency. Likewise, emphasis is placed on the use of formal or informal agreements with the objective of promoting the timely exchange of information (See section III.III Memoranda of Understanding).

Therefore, it is advisable to promote a “face-to-face” relationship among all supervisors involved in assessing the same FC. As a way to foster this relationship, supervisors should establish a meeting schedule throughout the year or whenever a supervisor requests a meeting, depending on the nature and importance of the FC under review. This practice promotes trust and facilitates the process for the exchange of information needed for the proper supervision of a FC.

*The exchange of information should be systematized or organized to cover the entire regulatory cycle* and not only specific questions on the FC. There is consensus among the members of the Discussion Group regarding the importance of systematizing<sup>7</sup> the information exchange among the various supervisors. The main benefit of systematizing the information exchange is that it forces supervisors to analyze the FC’s risks in an ongoing manner, not only when specific issues or doubts arise. This allows for proactive actions rather than reaction when FC difficulties become evident.

Furthermore, it is important to establish agreements on technical cooperation with other Superintendents (Supervisory Authorities) in order to learn about the assessment processes developed at other jurisdictions. A clear example is the exchange of know-how regarding the methodology for credit quality ranking and investment valuation practices, in order to attain a better understanding of the information that is exchanged and thus perform more accurate evaluations on the risks such portfolios entail.

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<sup>7</sup> For further information regarding this systematization of information, please refer to the document “Home-host information sharing for Basel II Implementation” (June, 2006) and “Good Practice Principles on Supervisory Colleges” (Consultative document, March, 2010), both from the Basel Banking Supervision Committee. The Mexican experience, described in this document, is illustrative of the systematization process.

For those countries where there are several superintendents, it is very important that the law contemplate establishing coordination among supervisors and legally assign the main responsibility to a specific supervisor. It is difficult for a two-layer FC supervision to work adequately (i.e. the first layer being the sectorial supervision for each FC unit, and the second layer in charge of consolidated FC supervision) without the presence of a coordinating body with clearly defined functions and sufficient authority to enforce them.

### iii. Capital Requirements

*The law should grant the supervisor the power to require a FC to hold more capital, based on the risks that the FC is facing or could face in future.*

When the law does not allow such power, an alternative –through risk-based supervision– consists in establishing special categories for FCs in regulatory frameworks that will operate with capitalization levels above those legally required based on their risk, thus allowing them to conduct activities that otherwise would not have regulatory approval.

### iv. Intra-group Operations and Risk Mitigation

*The legal framework should grant the supervisor the authority to impose limits on FC intra-group operations.* Based on the above, *the supervisor should have the power to prohibit specific intra-group transactions* when he/she considers that such transactions are carried out under conditions that are not in keeping with market practices or that prevent the detection of all relevant risks.

It is essential to identify all risks related to non-regulated entities belonging to a FC. Given the nature of transactions among related companies, there should be a strict regulatory framework in place to regulate this type of transactions. For this purpose, it is important to request the FC to provide a list of all transactions with related entities and intra-group operations. The information received can be verified by establishing an exclusive ledger account to record these transactions or to compare these operations against the elimination sheets of the consolidated statements. Supervisors should verify that the risk limits for the bank's capital with related entities are strictly met. This is one of the most vulnerable areas for a FC.

*The legal framework should authorize the supervisor to provide for measures to contain risk* as concerns operations among groups associated with the FC through ownership. The definition of related entities through ownership deserves a specific regulation. Nevertheless, it is worth mentioning that association through ownership can occur through the FC units, the FC Board of Directors membership or through ordinary members of senior management.

In like manner, although not a common practice, *the supervisor could have the authority to set up exposure limits for related loans.* Said limits can be applied to loans with individu-

als related to the financial entity, among these influential shareholders, directors and close relatives.

In order to enforce risk mitigation measures established by the supervisor, it is important for the *supervisor to have the necessary powers to impose sanctions related to his/her supervised sector and through coordination mechanisms at the consolidated FC level.*

#### v. Risk Concentration

*Regulation should include among its consolidated supervisory functions the requirement for FCs to monitor and control large exposures.* Some of the tools available for this task include establishing limits to concentration or exposure to a single counterpart or related counterparts, as well as limits on the exposure to specific sectors in the economy or geographical areas. In addition, limits can be set up for the loan amounts.

#### vi. Legal Protection for the Supervisor

It is important that the *supervisor have adequate legal protection to address claims or complaints against him/her for actions or omissions performed in good faith in compliance with his/her duties*<sup>8</sup>. In this sense, supervisors should not be subject to undue pressure in performing his/her assigned functions, so that supervisors are not forced to modify their assessment conclusions based on the pressure exerted upon them. Supervisors should be able to perform their duties without fear of facing civil or criminal reprisals or trials instigated by third parties and/or supervised entities<sup>9</sup>.

### II.III. On Corporate Governance

Good corporate governance is fundamental in the context of FC regulation and supervision because it entails the analysis of whether or not the organizational structure and managerial practices are sufficiently robust. The supervision of corporate government at the FC level should be performed thoroughly since regulatory compliance may lead to a false sense of security whose fragility may be exposed in a crisis situation.

Moreover, corporate governance supervision provides an ideal opportunity for the supervisor to discuss the risks to which the entity is exposed with the FC's most senior executives as well as any future strategy that they plan to implement. Corporate governance discussions should take place at the highest possible level. In those cases where members of the FC's highest executive level are not available, discussions should take place at the highest management level of the FC's most significant entity.

8 Basel Committee on Banking Supervision. "Core Principles Methodology", October 2006.

9 Association of Supervisors of Banks of the Americas. "Corporate Government in Bank Supervisory Agencies", March 2008.

## i. Specialization of Corporate Governance Supervision

Experience tends to indicate that given the complexity of adequately assessing the robustness and suitability of an FC's corporate government – beyond the simple verification of regulatory compliance with the various regulatory requirements – it is necessary to have specialized staff perform this task. If this degree of specialization in assessing corporate governance is not exercised, the evaluation generally ends up being a mere verification of compliance with the established rules instead of a deep analysis of matters.

Due to the complexity of emitting proper judgment resulting from said assessment, *it is advisable that supervisors consider the creation of a specialized unit for the evaluation of corporate governance*. Said unit could not only appraise the FC corporate governance practices, but also train other staff to do so in order to expand knowledge on the subject.

## ii. Best Practices for the Assessment of Corporate Governance

*Expert judgment is an essential element for the evaluation of corporate governance; however, corporate governance supervision requires clear rules to guide supervisors in this task*; otherwise, such evaluations could eventually degenerate in mere unsubstantiated opinions. Moreover, in the absence of clear rules for the evaluation of corporate governance, each supervisor would apply his/her own criterion to the best of his/her understanding, creating differences in valuation among supervisors. In this sense, there should be good corporate governance guidelines for all FC units and FCs to meet.

While off-site supervision serves to numerically evaluate compliance of limits contained in the corporate governance framework, *on-site supervision is vital in making a qualitative evaluation of the status of the FC's corporate governance*. The differences between mere regulatory compliance and good corporate governance can only be perceived during on-site visits. These visits allow supervisors to assess whether or not formal controls are applied in practice, key positions in the organizational structure have sufficient autonomy to act, weaknesses are corrected in timely manner, and whether or not the organization has truly internalized its corporate governance guidelines.

Developing good corporate governance supervisory practices can take years to implement fully given that time and practice are required for specialist supervisors to develop such expert judgment.

A way of initiating the corporate governance evaluation process is by collecting the basic elements to build a database that over time will support the supervisor's expert judgment. Without being extensive, a list of basic information to initiate such evaluation should include:

- A detailed description of the FC's organizational structure, infrastructure, and its information systems.
- Any necessary information to gain an understanding of the FC's strategic, operational, and business plans.

- Identification of the executives that comprise the FC's corporate government and their corresponding biographical information or curriculum vitae, as well as the fit and proper requirements for the positions they hold.
- A list of corporate governance policies and procedures approved by the FC's highest authority.
- Detailed declarations on each FC unit regarding compliance of policies and procedures, detailing their corporate governance structure and providing internal and external audit reports.
- Description of the internal control system, including key internal controls, as well as internal and external audit processes.

### iii. Fitness and Propriety of Corporate Governance Participants

Good corporate governance is enhanced when an adequate balance among shareholders, the Board of Directors, and senior management is achieved. Excessive concentration of power in one of these groups is an indication of future excesses that could generate a crisis in the FC. Each one of these groups has important requirements to meet.

*Fit and proper requirements should be established for shareholders whose direct and indirect share of FC capital exceeds a certain threshold* given that shareholders holding a greater share exert influence on important FC decisions that can negatively affect the FC through image contagion or reputational problems.

Even if the FC ownership lies in just a few hands, there should be a Board of Directors whose members enjoy technical suitability, independence, and sufficient time to fully perform their functions. The fit and proper requirements for members of the Board of Directors should be strict enough to guarantee the quality of its members. It is also advisable for fit and proper criteria to be applied to members of the FC's senior management, since they are in charge of properly implementing any necessary actions to meet the objectives of the entity, based on the policies approved by the Board of Directors.

The main objective of fit and proper requirements is to determine if the person has the qualifications needed to perform the responsibilities demanded by the position. Generally, such requirements are grouped in three categories: integrity, capacity, and financial position. The integrity requirement covers the person's reputation and character, including not having participated in fraud, or having been subject to adverse results in relevant civil or criminal trials, and not having participated in an action countering the prudential principles of a bank, among others.

The second set of requirements relate to capacity. Under these requirements, the evaluation focuses on whether the person has sufficient skills, knowledge, experience and soundness of opinion to perform the responsibilities and obligations accompanying the position. Finally, an assessment should be made of the economic capacity of the

shareholder or member of the corporate government to guarantee that the decisions being taken are not influenced by conflicts of interest or by his/her own financial situation. The requirements should be strict enough to limit possible image contagion risks between the shareholder and the FC.

When an individual participates in several Boards of Directors within a FC, a concentration of power could be perceived or the individual might not have enough time to adequately meet his/her director functions in several boards. However, the participation of an individual in several Boards of Directors of a FC should not be seen *a priori* as something negative. The ordinary members of the boards within the FC support the existence of necessary internal coordination and the creation of a homogenous corporate culture, among other benefits.

On the other hand, key management positions (principal executives, staff in charge of areas of control, risk and audit) should have the sufficient experience, capacity and independence to perform their responsibilities.

#### iv. Corporate Governance Homogeneity

*The corporate governance assessment at the FC level should verify whether each FC unit conducts its corporate governance according to the FC corporate governance framework.* This evaluation allows the supervisor to detect corporate governance inadequacies in the FC units. Different ways of managing risks among FC units is an indication of weakness in the application of the corporate governance framework.

In cases where the FC headquarters is located abroad and it is not possible to comprehensively assess its corporate government, it is recommended to request the headquarters office policies to compare them against the local policies and evaluate their compliance. Regular meetings with the home supervisor are also fruitful in order to exchange views on corporate government practice and other issues regarding the FC.

#### v. External Auditors

Supervisors should analyze how to build on the work of external auditors. Regarding the functions that external auditors should perform, it is good practice to require external auditors to issue an opinion on the risk of relevant events and on the risk of accounting and/or control systems not detecting these. Furthermore, external auditors can report on relevant issues that may require corrective measures, including: violations of laws and regulations, inadequate provisioning of loan portfolios, and the uncertainty of cashing assets for their recorded value.

Although this implies additional expenses for the supervised entities, the additional effort provides the supervisor with valuable information. The supervisor's challenge is to implement changes in the requirements of FC external auditors, which will result in the enhancement of the financial system.

## vi. Public Disclosure of Relevant Information

A practice that introduces discipline in how a FC conducts its corporate governance is to require public disclosure of various aspects of the FC. In addition to financial information, disclosure about the organizational structure is advisable, as well as the frequency of Board of Directors meetings and main committees where members of the Board participate; also important are any relevant facts affecting the FC, concentrations with related parties and others. In this sense, it is recommended that the FC's highest authorities uphold a philosophy of transparency, providing information that could be relevant for the public and the financial community, beyond that which is mandatory to disclose.

## II.IV. On Risk Management

*The first line of defense against capital shortfalls at the FC level is the existence of adequate risk management systems (credit, market, operational and liquidity).* The correct assessment of these risks, through ongoing monitoring by the FC management and supervisor, as well as the review of financial solvency indicators and the evaluation of the corporate governance in general, are vital to avoid a crisis in the institution under review.

*The risk management supervisory process' main objective is to evaluate the FC's capacity to effectively identify, manage, control and monitor risks facing the FC at the consolidated and unit level.* As part of this process, the supervisor evaluates the organizational structure, the policies and the implementation of risk management practices at the consolidated as well as unit levels. Furthermore, the supervisor verifies that these aspects are in line with the FC's risk appetite, size, and complexity. Another aspect to be considered includes the communication channels through which the Board of Directors and senior management are kept informed of the risks that the FC faces.

The following is a list of minimum information required to initiate the risk assessment process for a FC:

- Business plans and/or strategic plans for the conglomerate. Any other information needed to identify the risk appetite of the FC can also be requested.
- Organizational structure of the risk management area and its corresponding functions and responsibilities.
- Minutes from the Risk Committee and the Audit Committee at the FC level.
- The FC Risk Manual, including all internal risk management policies.
- Financial statements by unit and on a consolidated basis, together with the elimination sheets for intra-group transactions.
- Management reports on the conglomerate's risk management practices at the consolidated level.

- Details of all significant risks over a pre-determined percentage of capital and the actions taken to monitor and mitigate these risks.
- Details of all transactions by the financial intermediation entity, to be a member of the FC, with its respective holding company, affiliates or subsidiaries.
- Details of the regulatory capital estimation at the unit level and at the FC consolidated level.

Furthermore, *it is important to request that the FC submit its risk management methodologies at the consolidated FC level for the supervisor's evaluation and approval.* The risk management model should be tested periodically with the larger loans, verifying concentrations in economic groups and the exposures that each FC unit has with the rest of the FC units (intra-group operations). Equally important for the supervisor is to periodically request FCs operating in several countries for a consolidated detailed list of the main FC debtors.

Risk ratings given to a single client by several banks represent an important element to detect weaknesses in controls at specific banks. When two or more banks change the credit rating for a client, the rest of the system should be forced to modify their ratings for that same client.

It is important to acknowledge that many times the supervision of large and complex FCs requires permanent on-site supervision<sup>10</sup>. Permanent *on-site* supervision allows supervisors to constantly assess risks facing the FC as key decisions are being made, and not only once a year when *on-site* visits generally occur. Besides, permanent on-site supervision provides the most adequate way to form a deeper evaluation of the quality of the FC's corporate governance. Although this requires significant supervisory resources, the relative importance of the FC within the banking system, as well as the quality of its risk management practices, justifies such investment.

## II.V. On Intra-group Operations

Intra-group operations are defined as those that take place among the various units of the FC, whether these are financial or real economy entities. Such operations also include those involving the main FC shareholders, members of the Board of Directors, senior management and key personnel, as well as those individuals with direct or related interests and their close relatives.

In the financial sphere, intra-group operations can include, but are not limited to:

- Granting loans or similar transactions, such as factoring, installment purchases and leasing.

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<sup>10</sup> It is not feasible to establish a "large and complex" FC definition that would be applicable to all countries in the Region, given that each country faces different realities. In spite of this, as a general feature, large and complex FCs are those that would generate severe impacts in the financial systems in which they operate, if they were to experience financial problems.

- Transactions related to asset procurement, sale, exchange or leasing.
- Providing guarantees for a related party.
- Purchase or sale of securities of a related party.
- Professional services rendered among FC units.

With the objective of ensuring that the FC understands the risks generated or transmitted through intra-group operations, *regulation should require the FC to have a policy to guide the development of transactions with related parties and that processes be established to monitor and evaluate compliance of said policies*. As for the supervisor, he/she is in charge of evaluating the adequacy of such policies, their level of implementation, and the controls and reporting system to senior management and the Board of Directors.

The supervisor should ensure that intra-group transactions are not being used to hide the FC's real financial situation. For example, through the transfer of bad quality assets to FC entities that are not regulated in exchange of quality assets or by recording fictional services with the sole purpose of transferring income from one entity to another <sup>11</sup>.

Among the regulatory tools identified by the Joint Forum<sup>12</sup> for the regulation and supervision of intra-group transactions, the following can be mentioned:

- Requirements for intra-group transactions to be developed under market conditions, that is, in similar terms to those that would arise between two unrelated parties.
- Prohibition of transfers of capital or income.
- Requirements to have guarantees or collateral to back this type of transactions.
- Limitations on transfers.
- Requirement of the supervisor's prior approval.
- Requirement for prior Board approval for any intra-group transaction above a material threshold determined by the same Board of Directors.
- Restriction of certain types of transfers.
- Requirements for public disclosure that promotes sound management and increases market discipline.

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11 Superintendencia de Banca, Seguros y AFP del Perú. Financial Conglomerates Supervision Guide. [Guía de Supervisión de Conglomerados Financieros].

12 Composed by the Basel Committee on Banking Supervision, the International Organization of Securities Commissions and the International Association of Insurance Supervisors, who published in December 1999 the "Intra-Group Transactions and Exposure Principles" paper.

As part of the consolidated supervision process, the *supervisor should require periodical reports detailing intra-group transactions*. This requirement will allow the supervisor to verify that these transactions are carried out under market prices, that they meet the established limits, and that the eliminations of such transactions are appropriately recorded.

The supervisor should also consider the optimum way of establishing limits to regulate intra-group transactions. An example of this is to ensure that the consolidated FC's investment portfolio does not provide financing to the FC's economic units by acquiring these units' securities, since this would compromise the consolidated capital.

During the recent financial crisis, certain FC risks that were apparently detached from the FC through special purpose vehicles (SPVs,) to avoid capital requirements were frequently returned to the FC. While active trading in the stock market is a practice that favors the market and the FC, it is necessary to ensure that there are no legal, financial, image or reputational links that can affect the FC's capital requirements. If linkages like those mentioned exist, the supervisor should force the FC to establish accounting provisions or require accounting consolidation of such entities.

## **II.VI. On Concentration Risk**

Concentration risk is particularly significant in FC supervision, given that the evaluation covers risks that are not necessarily apparent or have not been identified during the sectorial or individual supervision of the FC units. Moreover, risks at the consolidated level as a result of concentration in a single FC unit or the interaction among risks might be transmitted to other conglomerate entities, since the FC components are linked through reputation and/or intra-group transactions and exposures.

In the first place, *the supervisor should understand the business model and the strategy followed by the FC under analysis*. This is because certain concentrations or large exposures, in geographical areas, products or markets, could be the result of the FC global strategy and do not necessarily represent an excessive risk. Likewise, the supervisor should consider risk concentrations within the same risk, as well as across the different types of risk.

In general, concentration risk has been associated to credit risk. For this reason, financial institutions usually establish exposure limits for transactions with a single counterpart or related counterparts, as well as limits for counterparts that belong to the same economic sector, geographical area or similar activity. However, concentration risk can also arise from significant exposures to an entity's assets or liabilities, which can in turn threaten the FCs solvency. For example, there could be concentration exposures related to funding sources, specific products, off-balance sheet positions or exposure to factors related to the investment portfolio.

*The supervisor should verify that the FC has an adequate risk management framework that allows management to identify, monitor, manage and report concentration risk at the FC level*<sup>13</sup>. The FC should be able to manage risk at the individual level of each of its units, as well as at the consolidated level. It is also paramount that the FC have an information system robust enough to aggregate the information of the various units composing the FC and to monitor concentration risk situations.

Among the tools used by the supervisor in regard to concentration risk, one can include the requirement for each entity to have an internal risk structure in line with the FC's strategy and risk tolerance level, as well as being approved by the FC's Board. Likewise, the supervisor could establish minimum limits, request additional provisions establish legal restrictions to certain investment types and restrict the use of certain assets in the regulatory capital calculation<sup>14</sup>.

Banking regulations should not only establish the limits to the risks that a FC may assume with third parties, but it is equally important that the regulator establishes limits to intra-group risk concentrations.

## **II.VII. On the Consolidation Process**

As mentioned earlier, periodic access to the FC's consolidated financial statements constitutes the basis for FC integrated supervision. For this purpose, it is necessary for the supervisor to be aware of and understand the consolidation process that the FC goes through to arrive at the consolidated figures.

To ensure that the information used during the supervisory process is reliable and has been drawn up under the guidelines established by accepted accounting standards, *the supervisor should evaluate the reasonableness of the policies, manuals and procedures used by the FC to prepare the consolidated financial statements and their corresponding notes*. For this purpose, information requirements may include the following documents:

- The FC consolidation manual, which identifies the areas responsible for the consolidation process, the flow of information, the frequency of information, and the description of the systems and controls used in this process.
- Consolidated financial statements, as well as the notes to said statements.
- Trial Balance
- Individual financial statements of the units composing the FC.

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<sup>13</sup> Committee of European Banking Supervisors. "CEBS Guidelines on the management of concentration risk under the supervisory review process". September 2010.

<sup>14</sup> Basel Committee on Banking Supervision, the International Organization of Securities Commissions, and the International Association of Insurance Supervisors. Joint Forum. "Risk Concentration Principles" Basel, December 1999.

- Elimination sheet, including the corresponding adjustments and the necessary support to explain adjustments.

In a similar manner, *for exclusive banking-financial conglomerates, the recommendation is to establish a single accounting code which would cover the entire process from information gathering to its consolidation at the FC level.* This facilitates accounting consolidation since data from the various FC units is comparable; this, in turn, expedites access to specific consolidated information by the supervisors. In the case of a mixed conglomerate, it is not practical to use the same accounting code that is used for the banking-financial group for the real economy units.

In this sense, *countries in the Region should accelerate the adoption of the International Financial Reporting Standards (IFRS) as a basis of convergence of the accounting practices.* This would facilitate the accounting consolidation of the FCs that operate across borders and help supervisors advance towards regulatory convergence. Once IFRS are adopted by countries in the Region, certain geographical sub-regions where FCs operate across their borders could consider adopting a unique accounting code for the entire sub-region.

With regard to external auditing services, hiring a unique external auditing company for the FC may provide advantages regarding the exchange of information and coordination among the audit firm representations in all jurisdictions where the FC operates. However, it becomes more practical *to promote a unique auditing standard setting up similar quality terms and minimum requirements* to perform such process. This way, reports would be obtained and disclosures would be made in a uniform and comparable manner, across the globe.

## **II.VIII. On Capital Requirements**

*In establishing capital requirements, it is paramount to identify all material risks that could affect the FC and to introduce capital requirements to include such risks within the capital adequacy calculation.* For this purpose, the FC should have policies on capital adequacy at the consolidated level, as well as processes for the identification, control and reporting of such capital levels to the Board of Directors and senior management. Such mechanisms should be evaluated by the supervisor to determine their reasonableness with regard to the risk level that the FC is facing, as well as the size and complexity of its activities.

*The supervisor should verify the FC's capital adequacy according to the risks it faces at the individual level as well as in a group basis.* A way to establish the solvency or capital adequacy requirements at the FC level is by adding the capital requirements for each of the units; it is recommended to coordinate this procedure with those responsible for individual supervision. This process determines compliance of the capital requirements for each FC unit, constituting the first defense barrier for sol-

vency problems. For the calculation of capital at the consolidated level, any sum invested in the capital of another unit should be deducted from the regulatory capital. In a similar manner, intra-group operations should be eliminated not to duplicate capital requirements.

In the Region, there is no trend towards demanding additional capital at the FC level beyond the requirements established for the individual units and the consolidation mechanisms described in the above paragraph. Nevertheless, taking into account what is established in sections II.IV and II.VI, regarding risk management and the calculation of regulatory capital at the FC level and concentration risk respectively, it is desirable for the *supervisor to have the legal power to establish capital requirements at the financial conglomerate level* considering the incidence of the concentration effect, as well as the diversification effect.

*As part of the supervisory process, the supervisor should assess the quality, origin and evolution of the effective consolidated capital used in the calculation of capital adequacy.* This evaluation seeks to determine the proper application of current regulations at each jurisdiction with regard to the regulatory capital calculation. Some aspects to be evaluated include: ledger accounts that comprise effective consolidated capital, minority interest calculations, provisions and deductions. Also, the supervisor should perform an analysis of the origin of the effective capital to ensure consolidated capital does not come from cross financing or debts among FC units. Finally, in cases where significant changes can be seen in the effective or regulatory capital, the causes and origins of such changes should be investigated in order to dismiss possible mistakes in the calculation of capital adequacy.

The following include information requirements that could be useful for the evaluation of the FC capital adequacy:

- Minutes of Shareholder's Meetings determining the capitalization of profits.
- Financial statements at the consolidated and individual levels.
- Elimination sheets.
- Report on the composition of the FC's effective capital.
- Report on individual capital requirements for the entities that make up the FC.
- Report on consolidated limits, including financing for related parties, for a single counterparty or to related debtors.
- Work sheets used for the calculation of the effective consolidated and regulatory capital.

There is a trend in the Region for FC units in each country to ensure their own compliance with capital requirements. This is important to take into account when assessing consolidated capital at the FC level. The supervisor should evaluate the flexibility of

transferring capital surpluses from one FC unit in a given country to another country, especially during a crisis.

For FC units that do not have their own capital requirements (i.e. real economy entities), the supervisor may require these to hold a capital amount similar to the one required for the FC unit with the largest similarity in terms of its line of business. If the recommendation above does not apply, the supervisor could establish the most conservative capital requirements that are applied to some of the FC units. When the supervisor does not have legal powers to impose capital requirements to unregulated units, the regulator/supervisor can establish exposure limits for transactions with unregulated units, force the FC to provide capital for the unregulated entity or prohibit transactions with unregulated units.

# III

## Approaches and Tools for Consolidated Supervision

The effective supervision of conglomerates requires appropriate coordination and information exchange among the different supervisors. Depending on the characteristics of the FC under analysis, supervisors may need to exchange information across sectors, across borders or both. In particular, one of the main challenges of consolidated supervision is to design mechanisms to facilitate and allow for the timely exchange of information.

Some countries will prefer a single unified Superintendence, instead of several Superintendencies by sectors. Other countries will prefer the form of the Lead Supervisor, while others will seek higher coordination levels that are equally effective. Circumstances in each country will determine the use of one supervisory model over the other, and each one will have to choose its own coordination formula. Regardless of the formula adopted, supervisors should acknowledge the need to integrate sectorial supervision schemes and use them as the basis on which to build the FC integrated supervision.

The “pure and simple” coordination among supervisors on the basis of the best effort usually does not provide the results needed for an effective consolidated supervision. In this sense, in order to transcend from the individual supervision of the FC units towards an integrated FC supervision, a special coordinated effort is necessary, which cannot be left to the good will of the parties.

The following section covers different approaches and tools used to perform a consolidated supervision.

### III.I Lead Supervisor

The absence of a formally appointed coordinator –with the implicit authority and responsibilities– weakens the possibilities of successful coordination. Integrated FC supervision cannot be effective over time if there are no strong coordination elements among the relevant supervisors. The presence of a Lead Supervisor or Coordinator, with clear legal powers to perform supervisory functions, contributes to the appropriate coordination of the FC supervision process.

Sector supervisors will always feel pressure to meet their primary obligations, and this could threaten the overriding obligation of monitoring the FC as a whole. Some of the functions that the entity in charge of coordinating the supervision of the conglomerate are noted below:

- Coordinating the collection and dissemination of relevant information, including dissemination of information that might be necessary for the supervisory tasks of competent authorities following sector supervisory guidelines.
- The overall supervision and evaluation of the FC's financial situation.
- Evaluating compliance with the obligations established in the previous bullet, as well as the policies in place.
- Evaluating the structure, organization and internal control systems of the FC.
- Planning and coordinating supervisory activities when needed to attain additional supervisory objectives and, in any case, in extreme situations.

The practice of having a Lead Supervisor implies an integrated supervision defined in two layers:

- The first layer corresponds to the supervision of banking, securities, pensions and insurance sectors by their corresponding supervisors.
- The second layer is comprised by additional supervisory measures for the FC as a whole, carried out by the Lead Supervisor.

The concept of two-layer supervision should be adapted according to the circumstances in each country. In countries where first layer supervision is not as strong as it should be or where the FC is largely diversified among its units, the second supervision layer and the additional requirements for the FC are elements that add great value. In this sense, coordination needs among supervisors for the FC integrated supervision acquire greater importance. Furthermore, in countries where the first supervision layer is robust and, above all, where the FC activity is strongly concentrated in only one entity, it is advisable to assess whether there is an aggregate value to the additional requirements to the FC. Nevertheless, this does not mean that the reception of information from the FC should be stopped, nor should the coordination functions for the FC supervision.

The proper execution of a two-layer supervision program necessarily entails having a larger number of qualified human resources and vast experience. It is recommended to avoid using the same human resources that participated in the first layer of supervision in the second layer as well. This weakens the two-layer supervision process and negatively affects adequate specialization of the technical teams.

### **III.II Supervisory Colleges**

Supervisory Colleges, under the coordination of the holding company supervisor, can be an effective mechanism for international coordination. This mechanism is especially valuable when the functions and responsibilities of the College members are well defined.

It is important to consider that the fundamental difference between a Lead Supervisor and a Supervisory College is that the former leads to binding decisions, while decisions from the latter are usually not binding. Decisions made by Supervisory Colleges are not necessarily binding given that they could represent a conflict with each country's legal framework.

Supervisory Colleges should not operate solely in times of crisis. It is precisely during ordinary times that Colleges have more room to maneuver in order to suggest measures to ensure the financial soundness of a FC. These Colleges should require the FC to have detailed contingency plans that will be useful to address crisis situations. Furthermore, Supervisory Colleges should serve as a mechanism for dialogue between the team of supervisors and the FC senior authorities.

Finally, these Colleges can help supervisors advance towards joint action protocols in the event of a FC crisis or a systemic type crisis.

### **III. III. The Use of the Memorandum of Understanding (MOU)**

When it comes to cross-border conglomerates, the exchange of information and cooperation among supervisors of the various jurisdictions in which the FC operates, are crucial for effective consolidated supervision, pursuant to the Basel Core Principles. The relationship among supervisors may be informal, including an informal exchange of letters, or may be formalized through the use of Memoranda of Understanding (MOU). It is advisable that the use of MOUs be based on the principles of cooperation, mutual trust, reciprocity, confidentiality, and transparency.

Supervisors across jurisdictions should develop an appropriate work relationship leading to a more efficient and timely exchange of information, which in turn ensures the solid performance of the entities that make up the cross-border conglomerate. Based on the “Essential Elements of a Memorandum of Understanding” paper issued by Basel15, MOUs should cover four areas:

#### **i. Exchange of Information**

It is the responsibility of each supervisor to inform his/her counterpart supervisor about the existence of legal or administrative restrictions in the process for the exchange of information. The exchange of information between supervisors should take begin in the authorization process, and continue in an ongoing manner. During the authorization process, supervisors will discuss issues related to the entity's skills to manage: cross-border operations; regulatory compliance of the entity in its home country; the suitability of Board members, senior management and main shareholders; and, the scope of said supervision for both supervisory agencies. In ongoing manner, the super-

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15 Basel Committee on Banking Supervision. “Essential Elements of an MOU between Banking Supervisors.” May 2011.

visory agencies should exchange relevant information on the evolution of operations, significant changes in the environment, the enforcement of sanctions, and any other relevant information to support the supervision process.

The following includes a list of minimum information that can be exchanged:

- The conglomerate and the local entity's organizational structure, including the main shareholders, members of the Board, and senior management.
- Strategic policies.
- Data related to the financial situation, including capital levels, profitability, intra-group operations, and concentrations.
- Organization, risk management, and internal control information (mainly with reference to intra-group transactions and concentrations).
- Procedures for the collection and verification of information.
- Record of enforced sanctions.

## ii. On-site inspections

On-site inspections could be conducted at the request of the home supervisor and with the knowledge of the host supervisor. It is advisable that the results of said inspection be discussed with the local supervision team.

## iii. Information Protection

The supervisor receiving information from another agency should ensure that all necessary measures to ensure the confidentiality of the information received have been taken. The MOU should also include a reference to the circumstances that may obligate the supervisor to disclose the information received to a third party.

## iv. Ongoing Coordination

Cooperation among supervisors can be promoted through a meeting schedule, regular or as needed, for the discussion of relevant issues, as well as internships or exchange of officials in order to understand the regulation and supervision environment of the supervisory agency.

Annex 2 includes an example of a MOU designed to facilitate supervisory tasks among international jurisdictions.

# IV

## Main Supervisory Challenges

Based on a survey conducted among ASBA member countries, the supervisory authorities of these countries identified key challenges and risks posed by consolidated supervision in the Region. These are presented below:

### I. Legal and Regulatory Framework

The main challenge reported by supervisors involves making changes to the legal framework to facilitate effective FC supervision. This is a significant challenge, but it is essential to overcome it in order to reach an adequate level of control of the FC's risk exposure and management practices.

Within the legal changes required to achieve an effective FC supervision, the following were mentioned:

- To achieve changes in legal definitions, such as the concepts of related parties and consolidated group, in order to broaden the supervision scope.
- To authorize the exchange of information among supervisory authorities with the purpose of conducting consolidated supervision.
- To introduce the concept of FC integrated supervision and move away from single sector supervision.
- To grant the supervisor the authority to request information about all FC units, including the holding company.

### II. Supervisory Techniques

The complexity posed by FCs compels supervisors to concentrate on the analysis of material risks rather than regulatory compliance. Consequently, a risk-based supervision approach becomes essential. Although several countries declared they were immersed in the process of transition to risk-based supervision (risk matrix), less than half of them use this approach completely. The rest of the countries still maintain approaches –wholly or partially– based on regulatory compliance.

All countries reported that their FC supervision methodologies are based on the periodical analysis of off-site information, on-site inspections and the work done by external auditors. Notwithstanding this, the fact that fewer than half of the countries declared that their supervision relies on risk matrices implies that others still conduct supervision based on regulatory compliance. This transition poses an important challenge.

Another supervision technique that shows significant differences in the region is the role of external auditors. In most countries, external auditors are limited to issuing an opinion over the reasonableness of financial statements and the verification of certain regulatory aspects. However, external auditors are not used in the identification of relevant risks, non-compliance with laws and regulations or inadequate provisioning of credit portfolios, among others.

### III. Information Exchange

All countries reported the existence of cooperation agreements with Central Banks or Superintendencies of the FC home country. However, more than half of the countries declared having legal limitations for information exchange with supervisors abroad. Moreover, close to half of the countries surveyed reported that their supervisors have obstacles to share information with other supervisors in the same jurisdiction.

Although few countries reported inefficient cross-border information exchange as a key challenge, more than half declared that banking secrecy regulations obstruct the exchange of information, mainly because these regulations do not take into account the need for an exchange of information for FC supervisory purposes.

The obstacles generated by banking secrecy stem from the protection of the right of individuals to the confidentiality of their private information, as well as the possible abuse of said information by intermediaries or governmental bodies. Banking secrecy laws are valid for protection purposes and there is no intent to modify said protection, rather to authorize the relevant exchange of information among supervisors of the same country and abroad with the sole purpose of assisting them in performing their duties within a framework of strict confidentiality.

To promote the exchange of information, most countries have signed agreements (MOUs) containing similar reciprocity definitions on the exchange of information exchange, the suitability of the information requested and information confidentiality. In practice, such agreements tend to focus on specific exchange of information rather than on generating permanent support among supervisors for the proper supervision of transnational FCs.

## Continuous Information Exchange - Mexico

The approach used by **Mexico** is interesting because it attempts to cover the entire regulatory cycle of a cross-border entity through the ongoing exchange of information throughout the various regulatory phases. This exchange of information begins in the authorization or license-granting phase, through exchanging information with the supervisor abroad on the person that is seeking an authorization or license, including information to verify and learn about the person's background.

In the same way, once the supervised entity is operating, a process of exchange of information on the supervisory process is performed with the supervisory authorities abroad, including regular telephone conferences to exchange know-how and information, as well as cross-border inspection visits. The information that is shared includes information on the trends that could affect a cross-border entity, a financial system, and information on sanctions and corrective measures imposed on the holding company or the entity abroad.

## IV. Regulatory Arbitrage

Regulatory arbitrage is frequently present in most of the surveyed countries. This phenomenon arises when entities performing a similar activity are subject to different regulations issued by different government agencies in the same country or a third country. Regulatory arbitrage is difficult to control because of barriers to the exchange of information and the different perceptions of risk held by supervisors in different jurisdictions.

This situation creates advantages for certain entities and prevents regulators from adequately evaluating risk; these distortions, in turn, can affect the provisions and capital requirements for the financial entities comprising the FC. In order to mitigate the risks of regulatory arbitrage, it is essential to have access to the monthly accounting consolidation statements of the FC. In this regard, supervisors must focus on the quality and timeliness of the information received, as well as the comprehensiveness of the on-site inspections of the FC's management practices.

Different types of regulatory arbitrage can be introduced; for this reason, the supervisor should evaluate the purpose of "satellite" entities within a conglomerate. For example, regulatory arbitrage can occur between unregulated companies and regulated units of a mixed conglomerate. In a similar manner, it may develop through a cross-border transfer of assets in order to take advantage of the differences in regulatory frameworks, or through the sale of portfolios from one banking entity to another or through securitization. In spite of regulatory arbitrage being a commonly observed practice, few countries have specific regulations in this regard.

Moving assets from one unit to another in order to benefit from more relaxed regulatory frameworks or taxation differences takes place within the same country or between units located in different countries. In this sense, supervisors should have the legal power to identify intra-group transactions and establish relevant measures, when needed. When transactions are conducted with the intention of taking advantage of regulatory requirements for loan loss provisions, the holding company could be required to record an additional provision for the remaining amount. An extreme solution would be to prohibit such transactions, although very few countries in the Region have reached this extreme.

Another type of regulatory arbitrage can occur through the transfer of assets from the FC's economic group to regulated units to gain tax advantages or government coverage for supervised entities. The supervisor should have the legal capacities to prohibit such transactions if he/she can assume that these are not operations carried out in an open market, based on their characteristics.

Transfer pricing among FC units may constitute another form of regulatory arbitrage if the intra-group transactions are not conducted at market prices. It is advisable to request the external auditors to evaluate transfer prices as part of their opinion. This opinion would establish that related party transactions are carried out according to the market prices, which would have been used with independent parties in comparable operations.

## V. Human Resources

Another issue identified as a challenge is the improvement of human resource teams, namely, ensuring that staff members have access to better training and are exposed to broader experience. It is a well-known fact that, in relative terms, supervision advances at a slower pace than supervised entities do. This gap will get smaller as long as supervisory teams are better prepared and experienced. Perhaps those countries that mentioned the need to improve their supervisory techniques as being a challenge also acknowledge the improvement of their human resources to enhance their supervisory efficiency.

## VI. Budgetary Independence

Frequently, Superintendencies are functionally and administratively dependent on the Central Bank or fiscal budget; consequently, their own budgets will be dependent on the issuer's budget. More often than not, the issuer exerts budgetary control with the objective of containing monetary expansion, thus limiting the ability of Superintendencies in obtaining enough financial resources for the proper professionalization of its staff.

The above becomes critical when it is necessary to implement a two-layer FC supervision. This method of supervision requires a larger quantity of qualified staff; however, many jurisdictions may lean toward utilizing the same resources in both supervisory layers. The challenge is for legal frameworks to ensure adequate financing, so that supervisors may perform their tasks effectively.

## VII. Supervisor's Legal Protection

Consolidated FC supervision is partly based on the presumption capacity of supervisors to establish the groups subject to supervision, on the ability to identify risk at the FC level and the power to establish sanctions that require FCs to change their business practices. The foregoing exposes the supervisor, leading said supervisor to have to deal with the FC in a manner different to established practice. In some cases, FCs might try to coerce the supervisor not to act according to what the circumstances demand, given that the supervisor does not have due protection to allow him/her to fully exercise his/her functions without external pressure.

## VIII. Possible Conflicts of Interest in the FC Supervision

In situations implying exacerbated risk levels in a FC, each jurisdictional supervisor faces conflicts of interest between what is most convenient for the depositors in his/her own country versus what is most convenient for the FC community of depositors. Most supervisors stated that in these cases the priority resides in the protection of local depositors and compliance with local regulatory framework.

The supervisor's primary responsibility resides in compliance of his/her local regulatory framework and the promotion of the stability of the financial system and gaining the trust of users regarding the system. As consolidated supervision is not enacted above the main regulatory requirements of the jurisdiction, supervisors face an important challenge on how to advance solutions when a cross-border FC experiences a crisis.

## IX. Accounting Standards

Most countries have implemented a specific set of accounting standards for all financial entities, while others are in the process of achieving this convergence. For countries that do not have a unique accounting standard for financial activity units, the challenge is to achieve this as soon as possible.

A major challenge for convergence in accounting is related to cross-border FCs that operate in jurisdictions with different accounting standards. Although it is unlikely for all countries to adopt an identical accounting standard, a first step would be for them to embrace International Financial Reporting Standards (IFRS). A second challenge is to achieve convergence –or at least a clear understanding– of the methodologies that supervisors of other FC jurisdictions use to assess loan and investment securities portfolios.

## Annexes

### Annex 1 Regional Assessment on the Supervision of Financial Conglomerates

This assessment was performed on the basis of a survey conducted among supervisory authorities in ASBA's member countries in order to gain a better understanding of the Financial Conglomerates (FC) present in the region and detect inadequacies in the current supervisory practices. Sixteen countries participated in the survey<sup>16</sup>. The data obtained in the surveys served to draw up the regional assessment, which in turn was used as a point of reference to determine just how far the Region is from achieving an ideal framework for supervising financial conglomerates. Furthermore, this assessment supported the discussion and the establishment of best practices and recommendations to attain an ideal and consolidated supervisory and regulatory framework.

The following assessment was complemented by the opinions and suggestions of a specialist in the matter so as to fill in gaps of information in the survey.

#### I. Significance and Key Characteristics of FCs in the Region

Financial conglomerates have a strong presence in ASBA's member countries. All survey respondents declared having a FC in their country. In most countries, the market participation of FCs within the banking sector is high. The survey shows that FCs manage around 80% of total assets in the banking systems in the Region (this figure only considers countries responding to the survey)<sup>17</sup>.

Nearly half of the FCs have established their headquarters abroad. Considering that banks in the Region have historically had local ownership, it can be inferred that there is a recent trend towards regionalization and globalization of the financial entities, especially during recent years.

On the other hand, the survey brought to light that there is no established trend on permissible activities for FCs, whether these are restricted to purely banking-financial activities (banking, securities, pensions and insurance) or are allowed to undertake activities corresponding to real economy (commerce, industry, agriculture and others).

As concerns the ownership of the three largest FCs in each country, ownership is almost equally distributed between national and foreign parties. In Brazil, Costa Rica and Spain the three largest FCs are nationally owned, while in El Salvador, Nicaragua and

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<sup>16</sup> Brazil, Cayman Islands, Chile, Colombia, Costa Rica, El Salvador, España, Haiti, Mexico, Nicaragua, Panama, Paraguay, Peru, Dominican Republic, Surinam and Uruguay.

<sup>17</sup> Using a simple average, not weighted by the relative size of the different countries' economies.

Mexico the three largest FCs are foreign owned. In Central America, there are financial groups whose major operations are developed in one country, but whose headquarters are located in another country. These cases could be classified as foreign ownership for having their headquarters abroad, but in practice they operate as national groups.

Regarding the use of special purpose vehicles (SPVs), only five countries reported that some FC utilize such vehicles in order to securitize risk operations, effectively separating such risks from the risk scope of the FC. It is clear that if the separation of risks is well done, those should not affect the FC. However, during the recent financial crisis, it was seen how the supposed risk separation through the use of SPVs, did not always work in practice and the risks returned to the FC. This possibility may seem not to generate worries among the supervisors in the Region, who indicated that the effects of the SPVs over the FC are limited in crisis events.

## II. Regulatory Framework

### II.1 FC Definition

Twelve surveyed countries stated that their regulatory frameworks have a FC definition, establishing sufficiently consistent criteria as concerns the linkages that lead to a FC. The following examples show some FC definitions that are used in the Region. A financial conglomerate is:

- "... one where there is common control based on a relationship of ownership, management or shared risk assumption and use of a corporate image, or, where these relationships do not exist, the involved parties determine control based on mutual agreement<sup>18</sup>."
- "...a set of financial entities with direct or indirect linkages, either through the participation of shareholders or through effective operational control, characterized by a common administration or management, or by actions in the market under the same brand or commercial name<sup>19</sup>."
- "...constituted by an owner of banking shares and its subsidiaries, whose predominant activities consist in providing services in the banking or financial sector, including the non-banking subsidiaries of the latter that, in the judgment of the Superintendencia, operate under common management, either through the owner of banking shares or through different participations or agreements<sup>20</sup>."

The linkages to establish a FC used by countries in the Region are conceptually similar. The linkages mostly mentioned were: significant shareholding participation, operational control or significant influence, and common members in the Boards of Directors.

18 Superintendencia de Bancos y Otras Instituciones Financieras (Nicaragua). Resolution CD-SIBOIF-678-2-May 25-2011. May 2011.

19 Banco Central do Brasil (Brazil). Accounting plan for national financial system institutions (Cosif). December 1987.

20 Superintendencia de Bancos de Panamá (Panama). Executive Decree No.52 of 2008. 2008

The definition of FC used in nearly half of the countries requires that these be of an exclusively banking-financial vocation. However, there is a similar number of countries whose FC definitions allow financial units to coexist with real economy units. Therefore, the FC does not adjust to only one definition. However, the opinion of most countries surveyed is that the real economy units belonging to the FC potentially contain greater risks.

The survey also revealed that there are no material differences concerning the type of regulation or supervision that is applied to different types of FCs<sup>21</sup>, beyond those relative to the accounting consolidation. In mixed conglomerates, consolidation is carried out separately for the economic group and the financial group.

## II.II FC´s Organizational Structure

The existence of a holding company is not an extended practice in the Region. Only regulations in Mexico, El Salvador, Nicaragua, and Costa Rica demand them in every case. The Spanish regulation provides that option when the supervisor considers it convenient to locate the holding company within the European Union. Meanwhile, the Dominican Republic demands the presence of a holding company when more than 50% of the consolidated capital of the Group comes from the group's regulated entities. Other countries consider the banking entity to be the holding company. Also, there are “de facto” FCs, which are those that without being formally constituted and regulated as FCs, operate as such. In these cases it is of the utmost importance for the supervisor to have the legal power of presumption to mandate the accounting consolidation, regulation, and supervision of such FC.

Although there are other forms of legal organization that may give form to a financial conglomerate, the regional assessment focuses on FCs that include banks because these have a significant market presence and are able to undertake non-banking financial activities or real economy activities.

## II.III Regulatory Authority at the FC Level

In the region, less than half of the countries state that their legal and regulatory framework allows them to identify all FC risks and to impose the corresponding risk mitigation measures.

Similarly, nearly half of the surveyed countries state that they cannot supervise all FC units. In this regard, the legal inability to supervise a holding company is a major hurdle. This means –according to the survey– that half of these countries have significant risks not being detected given that risks at the FC level tend to gravitate toward unregulated units or those subject to less demanding regulatory schemes. In practice, maybe a greater number of countries face this type of issues.

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<sup>21</sup> Different types of FCs in terms of the location of their holding company (national or foreign), jurisdictions in which they operate, activities permitted (purely financial or mixed conglomerates), etc.

Regarding access to information, nearly half of the surveyed countries mention not having the legal power to demand information with which to determine linkages between an entity and a FC.

On the other hand, in most surveyed countries there are no additional capital requirements at the FC level. The only country that establishes risk-adjusted solvency requirements for the FC, beyond the levels required for each unit, has opted for excluding additional supervisory measures considering that under the present circumstances they do not add any value.

In summary, the major limitations and inadequacies that were mentioned in regard to regulatory frameworks are presented below:

- They do not grant the power to perform consolidated FC supervision.
- They do not cover the risks at the FC level (only the risks of the different entities comprising the FC).
- Capital requirements are non-existent at the consolidated level.
- Legally impossible to require additional capital in relation to the material risks that FCs present.
- Limits are not established at the FC level for credits and investments.
- They do not include the power to supervise the holding company.
- They do not contribute to prevent regulatory arbitrage between subsidiaries.

Additionally, there are other limitations that were not mentioned in the survey, but are worth considering. For example, legal integrity –understood as a uniform and effective application of the judiciary systems in certain countries of the Region– is often precarious. This fact represents a special challenge when the regulator quantifies liquidity or solvency risks that can be generated by assets of dubious recovery or negative sale expectations.

A second limitation not mentioned in the survey refers to a FC that operates in several countries and whose loan portfolios are subject to different risk rating methodologies. In these cases, the home supervisor finds it difficult to reach realistic conclusions about the risk levels of the FC subsidiaries that operate in other countries.

A third limitation is the diversity of methods to determine fair value for investment securities portfolios. ASBA member countries have a variety of accounting standards and guidelines for fair value calculation. In countries where there is no market to set up prices or that is not deep enough, securities are valued according to their historical cost or on the basis of valuation techniques with a high degree of judgment. While countries where market prices are available allow for certain categories of securities to maintain their acquisition cost, yet others require all securities to be valued at market prices

(fair value). This situation poses additional risk valuation difficulties for a FC operating across borders.

### III. Supervision Framework and Practices

FC supervision is a complex process given that FCs are generally based on structures that transcend not only geographical borders but also economic sectors. Additionally, FC supervision can reveal risks that are not necessarily detected in the analysis of the group's separate units. Therefore, integrated FC supervision should include not only that of each FC unit but also the supervision of all the FC risks seen as a whole.

Based on the survey results, it is evident that there is a weakness in the supervision of conglomerates in the Region, given that more than half of the countries surveyed stated that not all of the FC units are supervised. Furthermore, nearly half of the surveyed countries do not have a legal or regulatory definition of FC that would allow for its effective supervision. The following section covers a series of FC supervision practices in the Region, organized in two main categories (approaches to consolidated supervision and corporate governance):

#### III.I Approaches to Consolidated Supervision

The complexity of FC mandates a close coordination among supervisors –of the same jurisdiction and international sites- in order to achieve an effective supervision. ASBA member countries have designed a variety of structures to conduct FC supervision. However, a third of the surveyed countries stated that local authorities do not coordinate among themselves during the process of FC supervision.

Supervisory structures are presented below. These structures are not mutually exclusive, but rather may be combined among themselves depending on each country's reality.

##### *i. Lead Supervisor or Lead Coordinator*

In the region, slightly over half of the countries stated they have a Lead Supervisor that coordinates the conglomerate supervision functions and demands compliance of additional requirements for solvency, liquidity, and mitigation of exposure at the FC level. However, the remaining countries mentioned that no single responsibility is formally assigned to a given Superintendence or to a Lead Supervisor to coordinate the supervision tasks of the FC in their countries.

Although the consolidated FC supervision concept based on two supervision layers is a priority for quite a few countries in the Region, only few declared having already implemented it. It would seem that –with few exceptions- ASBA member countries are still in early stages in this regard.

## Lead Coordinator – Spain

Spain has several sector supervisors, and the Lead Supervisor plays a crucial role in conducting effective FC supervision. The Lead Coordinator is usually the supervisor in charge of reviewing the holding company of the FC. If the holding company is not a regulated entity, the Lead Supervisor would be that of the largest financial sector unit within the FC. The Coordinator does not replace the sector supervisors, but rather promotes consensus on the rele-

vant measures in every case. The Lead Supervisor's functions include coordination of the supervisory measures at the conglomerate level, including the collection and diffusion of relevant information, the evaluation of the structure, organization, and internal control systems of the FC, as well as compliance with limits for intra-group operations, risk concentrations and solvency limits adjusted to the FC level.

### ii. Single Supervisory Entity

The survey shows that in half of the cases that reported the existence of a Lead Supervisor, his/her presence is due to the existence of a single supervisory authority in the country. Thus, close to one-third of the countries surveyed have a single supervisory entity, resolving the vital issue of coordination among supervisors.

The figure of a single supervisory entity presents a solution to achieving coordination among supervisors in the same country, an indispensable element to achieve adequate FC supervision. This structure represents another option that should be analyzed based on the particular characteristics of the country to achieve higher levels of cooperation.

## Single Supervision Entity – Uruguay and El Salvador

As a result of the No. 18.401 Act, enacted on October 24<sup>th</sup> 2008, an amendment was established to change the Charter of the Central Bank of **Uruguay**, wherein the financial supervisory bodies would have to merge, including: the Superintendence of Financial Intermediation Institutions (SIIF), the Superintendence of Insurance and Reinsurance (SSR), and the Division of Market Securities and Control of AFAP (DMVCA). This law provides for a more integrated and homogenous regulation and supervision of the financial system.

As for **El Salvador**, in January 2011 the Legislative Assembly approved the Supervision and Regulation of the Financial System project, which proposed the unification of the Securities, Pensions and Financial Superintendencies in only a single entity. Among the motivations for the approval of such Act was, among others, the importance of having the necessary mechanisms, structures and procedures to implement supervision on a consolidated basis. This would allow the supervisor to monitor and evaluate risks which non-consolidated supervision would not permit.

### *iii. Specialized Unit for the Supervision of Conglomerates*

The survey indicates that very few countries mentioned the existence of a specific unit to supervise the major FCs. Two of the most representative cases are presented below:

#### **Specialized Unit for Conglomerate Supervision – Brazil and Colombia**

**Brazil** has a specialized unit for FC supervision. Said unit not only evaluates the traditional risks (credit, liquidity, operational, market), but also contagion risks within the FC. In order to perform this supervision, it has three specialized teams:

- Legal and taxation risks, data processing, corporate governance, and the application of the International Financial Reporting Standards (IFRS);
- Application of Basel II norms (internal models);

- Consumer banking, consumer protection and foreign exchange transactions.

Likewise, **Colombia** presents a scheme of multiple supervisors. Even though they state not having a Lead Supervisor within the structure of the financial Superintendence, there is an area called Delegation for Conglomerate Risks and Corporate Governance. This area is in charge of conducting the FC supervision, as long as the FC comprises financial intermediaries and entities that perform non-banking financial activities.

### *iv. Regional Initiatives for Consolidated Supervision*

The following boxes introduce regional initiatives to enhance and promote a greater exchange of information and cooperation on cross-border FC supervision:

## Regional Initiatives for Consolidated Supervision – Central America

In 2007, the Central American Council of Superintendents of Banks, Insurance and Other Financial Institutions established the creation of the **Liaison Committee** with the objective of conducting effective consolidated supervision, as well as coordinated action around financial conglomerates. This Committee comprises the supervision directors of the Superintendencies of Honduras, Guatemala, El Salvador, Nicaragua, Costa Rica, Panama, and the Dominican Republic. This is a permanent Committee that meets several times a year to join efforts in the supervision of financial groups that operate in several Central American countries.

Among the main functions of the Liaison Committee, the following may be mentioned:

- Planning, identifying material risks, and coordinating the annual consolidated and cross-border supervision of regional financial conglomerates.
- Sharing relevant information regarding significant events or concerns related to the operations of cross-border conglomerates, including changes in shareholder ownership.
- To request of the relevant supervisor, when necessary, a brief summary on the performance of the FC, developing issues in reference to its management and compliance with rules and requirements, among other aspects.
- To exchange information as soon and as far as possible on events that could negatively impact the stability of financial groups.

## Regional Initiatives for the Consolidated Supervision – The Caribbean

The Caribbean Group of Banking Supervisors (CGBS) has created a Technical Working Group with specific mandates related to consolidated supervision. These mandates include:

- The harmonization of regulatory and supervisory standards in the Region.
- A harmonized approach to the restructuring of financial groups.
- A standard accounting framework and the submission of reports.
- Information exchange among regional regulatory agencies.
- Essential training for bank inspectors in the Region.

### III.II. Corporate Governance

Corporate governance defines how a FC manages its business, controls its risks, and discloses relevant information to the public. This issue is critical in the scope of FC regulation and supervision, since it involves analyzing whether or not the FC's structure and risk management practices are robust enough.

### i. Approaches to the Supervision of Consolidated Corporate Governance

ASBA member countries acknowledge that the evaluation of the FC's corporate governance is a specialty. Notwithstanding, there is no consensus on whether a specialized unit should exist within the supervisory authority for the evaluation of corporate governance, or whether said function should be undertaken by supervisors specializing in the subject. This disagreement might result from the fact that corporate governance is a relatively new issue in several countries and countries have not had enough experience in assessing the different structure schemes.

In line with the above, survey results show that, except for very few notable exceptions, the evaluation of the quality of the corporate governance of FC's is performed by the same staff that reviews the accounting reports and the most relevant risks of an entity, such as credit and liquidity risks.

Supervision of corporate governance in the Region is beginning to take shape, although not with the degree of specialization and experience that supervisors need to perform these functions more thoroughly.

## Corporate Governance Supervision in Conglomerates – Colombia, Costa Rica and Peru

**Colombia** is an interesting case since the Superintendence has a specific unit for the specialized supervision of corporate governance in regulated entities. At the Superintendence, there is an area in charge of supervising financial conglomerates' risks and assessing the quality of the FC's corporate governance.

**Costa Rica** opted to issue guidelines on good corporate governance to be implemented by each regulated entity as part of their own policies, leaving the responsibility of drawing up its own policies to each supervised entity. Such policies are then reviewed by the supervisor and later approved by the Board of Directors; these are also uploaded to the entity's website and updated at least once a year. The Board of Directors approves an annual report on the compliance of corporate government regulations.

**Peru** established corporate governance supervision as a permanent process. The *on-site* visits contem-

plate, among other aspects, the verification of:

- Technical suitability and due diligence in conducting business;
- Risk management systems that allow business objectives to be achieved within a controlled risk level;
- Financial soundness,
- The reliability of financial information and regulatory compliance;
- The existence and updating of policies and procedures for risk management at the individual and consolidated levels;
- A proper separation of functions;
- The role of the Risk Unit and the Internal Audit Unit to conduct ongoing follow-up and monitoring of the quality of management and risk control;
- Corrective measures being directly reported to the corresponding committees and the Board.

## ii. Internal Controls

Internal controls are an essential part of the FC corporate governance framework. The way in which a FC manages its risks implies risk mitigation within certain parameters, consistent with the level of risk tolerance and the FC's business strategy. An inadequate risk control system leads to assuming risks beyond expectations.

### Supervision of Internal Controls in Conglomerates –Peru

**Peru** has a well developed scheme of supervision and assessment of internal controls, performance of the internal audit function and corporate governance, which are supervised *off-site* as well as *on-site* as part of a permanent process. Such schemes verify the compliance with rules issued on risk management, where at least the following aspects are assessed: internal environment, establishment of objectives, risk identification, risk evaluation and its corresponding treatment, control, information, communication and monitoring activities.

The supervisor also establishes certain examinations that should be conducted on a periodic basis by the internal audit unit and the external auditors in relation to the entity's integrated risk management practices. The purpose of such examinations is to verify technical suitability and due diligence in conducting business, as well as the existence of a risk management system that allows objectives to be achieved with controlled risks, financial soundness and reliability in the financial information, in addition to regulatory compliance.

## iii. Contingency Plans

Contingency plans establish actions to be taken when certain adverse events affect an entity. Such adverse events may include unforeseen interruptions of data processing systems, losses not contemplated in the value of credit and investment portfolios, bank runs due to unfounded rumors on the liquidity or solvency of the financial entity, and total loss of buildings and facilities.

It is important for financial entities to have contingency plans that are updated and internalized by senior management, allowing for precise and rapid actions in case of an adverse event. When such catastrophic events have significant impact on the capitalization level of a bank or FC, contingency plans to recapitalize the bank take on vital importance.

Out of the countries surveyed, few of them demand contingency plans for the main risks that a FC may face. Neither have procedures to recapitalize the entity in case the current level of capital is deemed inadequate in light of the risks.

#### *iv. External Auditors*

The external auditors' function supplements the supervision performed by the corresponding authorities. External auditors do not only validate or reaffirm the accounting information, but are also empowered to detect violations to laws and regulations, identify important material risks and the lack of provisions for doubtful loans, among other issues.

### Use of External Auditors – Brazil

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**Brazil** presents an interesting case with regard to the tasks that supervisors entrust to external auditors. The function of external auditors goes beyond the issuance of an opinion over the reasonability of financial statements.

Auditors could also issue an opinion over the risk of relevant occurrences, the risk that accounting and

control systems might not detect relevant risks, as well as the obligation to report on relevant issues that may require corrective actions: violations of the law, inappropriate provisioning of credit portfolios, uncertainty regarding asset realization, etc. This additional effort provides valuable information to supervisors who may have not detected such risks.

## Annex 2 – Memorandum of Understanding

### MEMORANDUM OF UNDERSTANDING ON BILATERAL COOPERATION ON FINANCIAL SUPERVISION

#### AMONG:

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#### PRINCIPLES:

- Cooperation
- Mutual Trust
- Reciprocity
- Confidentiality
- Transparency

#### PURPOSES:

- To promote the sound and safe operation and development of financial institutions that operate in both countries
- To exchange and maintain up-dated information related to the banking systems of both countries. This will allow banking supervisory agencies of signing countries to perform better assessments of the financial condition and performance of banking institutions within their jurisdictions
- To ensure that consolidated supervision is executed, as well as enhanced cooperation among banking regulators.
- To ensure transparency of information exchanged at the international level.

#### GENERAL FRAMEWORK

This Memorandum of Bilateral Cooperation is established within the framework of the Association of Supervisors of Banks of the Americas (ASBA), with the purpose of promoting closer cooperation among the banking supervisory agencies of the American Continent.

Therefore, both parties endorse the principles that have been produced and released by

the Basel Committee on Banking Supervision (Basel Committee), the “Core Principles for Effective Banking Supervision”. These Principles comprise the regulation of banking supervisory practices, information requirements, the formal powers of bank supervisors and cross border banking supervision.

Thus, considering the endorsement described in the previous paragraph, both signing banking supervisory authorities agree and approve the role allocated by the Basel Committee to the home country bank supervisor (the banking supervisory agency of the country where the parent of the banking group is located, also called “country of origin”). Signing parties also approve the role allocated by the Basel Committee to the host country bank supervisor (the banking supervisory agency of the country where affiliates of this banking group have established operations, also called “country of reception”).

## **INFORMATION EXCHANGES**

Both banking supervisory authorities commit themselves to cooperate and exchange information. Cooperation shall include contacts during the authorization process (which includes license granting or license denial to any affiliate), as well as during the ongoing supervision of the activities those affiliates are carrying out.

Therefore, signing authorities specifically commit to the following:

- To promptly answer information requests on any aspect related to the regulatory framework of each country.
- To notify each other, as soon as it is possible, of any applications for approval, by the corresponding banking supervisory authorities, for banking organizations of one country to establish affiliates or operations in the other country. Also, signing authorities shall inform whether the applicant bank is in total compliance with all current rules and regulations, and if it is expected to orderly manage its international branch or any other cross border establishment given its administrative structure and internal controls.

On other issues, banking supervisory agencies are entitled to exchange information related to those persons that perform managerial responsibilities in the international branches that are to be established in the country of reception.

Signing banking supervisory authorities will notify each other and will provide information related to the following:

- Any relevant banking supervision event or concern regarding the local operations of any central office of a banking organization.
- Any relevant change or modification, particularly those that have a significant influence in the activities of international branches and other cross border establishments of banking organization with operations in other countries.

- Any situation that could potentially endanger the stability of banking organizations with cross border establishments that have operations in the other country.
- The sanctions, either administrative or of any other nature, that are to be applied to any cross border financial organization. This information shall be provided either by request of the banking supervisory authorities of the country where the banking organization has cross border establishments, as well as if the request is made the banking supervisory authorities of the country where the parent of this banking organization is located. It must be noted that the information might prove relevant for the supervision of the transnational financial organization, notwithstanding the country where it has operations.

Information to be exchanged shall be subject to those legal restrictions typically associated with confidentiality, according to the current laws and regulations of each country.

In those cases in which the information that has been obtained by means of this Memorandum must be disclosed to any other authority of any of the signing countries to comply with a legal mandate, both authorities commit that they will previously notify each other of this particular circumstance. Signing supervisory authorities will cooperate and made their best endeavors to preserve the confidentiality of information that has been exchanged.

(Internal laws of each country that deal with information confidentiality)

## **COOPERATION IN SUPERVISION**

Both authorities agree that cooperation is particularly useful to support each other in the execution of on-site inspections and examinations of transnational banking institutions. Banking supervisory authorities shall inform each other the beginning as well as the completion of an inspection or examination of the transnational banking organization in the host country or country of reception. Banking supervisory authorities will also provide information on the outcome of such examinations, as long as this is not forbidden by confidentiality restrictions.

Consultation and cooperation might include information exchanges regarding the outcome of examinations or inspections of banking organizations that are considered important for the proper functioning of transnational banking institutions.

The supervision of banking groups is performed in a consolidated basis, in accordance with the internal regulations each country has established for this purpose. Thus, all affiliates which have either banking or a non-banking economic purpose, but that are connected in any form and thus might represent risks for an officially regulated banking institution or financial conglomerate shall be subject to consolidation.

This supervision in a consolidated basis shall be performed independently and shall not be considered a substitute for the individualized supervision performed by other regulatory agencies for several types of financial organizations.

Both banking supervisory authorities agree that, at least once every year, they will exchange lists of those entities that are either subject or not to consolidation, and that belong to holding companies or conglomerates established in both countries. Also, both authorities agree to inform each other at least once every year on the most significant intra-group operations that have been carried out by the economic groups that have operations in both countries, according to current regulations in each of the signing countries.

Both banking supervisory authorities agree that, as an exceptional feature and as long as both banking supervisory authorities come to an agreement for each particular case, on-site examinations may be performed on those branches or other subsidiaries operating in the country of reception. This same possibility will exist for the country where the parent of the banking groups is located.

At first, these examinations will be performed with the purpose of getting a better knowledge of the businesses of the affiliate or branch and of their overall management. Also, the examinations will focus on performing assessments of the effectiveness of the internal controls of the parent organization of the corresponding affiliate. For each particular case that is presented, both banking supervisory authorities will coordinate their duties and will cooperate in the execution on this task. Additionally, whenever it is deemed convenient, banking supervisory authorities will consider the possibility of jointly performing these examinations.

For all cases where an on-site examination is required by the supervisory authority of the home country, the banking supervisory agency of the host country or country of reception shall participate in the examination process. Procedures established by local laws and regulations will be applicable to such examinations.

The representative of both parties will coordinate the tasks to be performed during the examination process. Representatives of both banking supervisory authorities will write the examination report.

## **GENERAL CLAUSES**

Both banking supervisory authorities will share all information that is collected, as long as this is not forbidden by internal laws or regulations that prohibit disclosure of such information. However, delivery of some types of information such as the ones contained in this agreement might be denied on the basis of public interest or national security or whenever there is an on-going investigation in which the disclosure of such information might be considered interference. Any information denial should be adequately supported.

Both banking supervisory authorities agree that, as far as it is permitted by the law, each of them will preserve the confidentiality of all information that has been received from the other by means of this agreement (except for information that is available to the general public).

Both banking supervisory authorities may wish to foster their cooperation by means of reciprocal visits with informational purposes and/or by means of personnel exchanges to perform practices as resident officers. Also, with the purpose of improving banking supervisory practices in both countries, signing authorities will try to identify those training areas where the personnel of one supervisory agency might benefit from the knowledge and support of the other.

The officers of the banking supervisory authorities of both countries might request their counterparts all types of explanations as well as holding meetings deemed necessary to solve any relevant issues. For this purpose, each party will inform each other of their wish to hold a meeting.

In general terms, both parties agree that this Memorandum be revised for up-dating purposes whenever this is considered necessary or whenever it is solicited by any of the parties involved.

## **VALIDITY**

This Memorandum shall come into effect on the same date in which the document is signed and accepted by both parties. This Memorandum shall be valid for an indefinite period, until the corresponding banking supervisory authorities mutually agree its extinction. Validity may also be extinguished whenever one of the corresponding banking supervisory authorities requests so unilaterally. In this last case the unilateral request shall be made with at least thirty days before the date where the extinction of the effects of this document is expected.

## **LANGUAGE**

This Memorandum will be signed in two originals. The originals will be written in the language (or in two languages, where applicable) of the signing countries. Both texts will be identical and will have the same legal value.

## **SIGNATURE**

Having analyzed the contents of this document, the Central Banks and/or Banking Supervisory Agencies of the corresponding countries have agreed that this Memorandum of Understanding be formalized by their corresponding duly authorized officers.

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## **MISSION**

To develop, disseminate, and promote banking supervisory practices throughout the Americas in line with international standards. To support the development of banking supervision expertise and resources in the Americas, through the effective provision of training and technical cooperation services.

## **INSTITUTIONAL OBJECTIVES**

The Association of Supervisors of Banks of the Americas is formed by the entities in charge of banking supervision in each of the countries of the American continent and Spain. Its main objectives are:

- > To promote and maintain close communication among the Association's Members, in order to facilitate co-operation among them, and to promote the improvement of their respective capabilities;
- > To provide its members with a high-level discussion forum for the exchange of information, ideas, techniques, experiences and knowledge over their scope of competence;
- > To promote research as well as systematic and permanent training programs, with the purpose of establishing training standards in the region and providing technical co-operation services among its Members;
- > To promote co-operation and exchange relationships with non-member bank supervisors, with similar associations as well as with international and multilateral institutions, engaged in activities similar to those of the Association; and
- > To perform any general activity related to its purposes.