Asian Shadow Financial Regulatory Committee

Regulatory Challenges Posed by Financial Conglomeration

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Abstract

The financial conglomerate (FC) has become a popular form of financial business. Although they offer benefits of economies of scope and scale, they could generate potentially serious social costs. Since an FC is a financial institution, it is exposed to all the problems arising from informational asymmetry. As a business group, it is also exposed to all the problems of business groups, particularly in Asian economies with opaque ownership, weak corporate governance and inadequate legal systems. Weak regulation of FC creates regulatory arbitrage opportunities. The governments should integrate and tighten the oversight of FC activities, make ownership transparent and accountable, and limit control of FCs by non-financial companies.

Statement

A financial conglomerate (FC) is a group of companies under common ownership and control that provides significant services in different financial sectors (banking, insurance and securities). The FC has become a popular framework for the organization of financial services. In the late 1980s, the European Union adapted its laws to allow universal banks and financial conglomerates. In response, the US passed the Gramm-Leach-Bliley Act in 1999 to repeal the Glass-Steagall Act. There followed in the US a wave of mergers and acquisitions across commercial banks, investment banks and insurance companies. Japan has had extensive cross-holdings of shares, which bound banks and insurance companies into company networks. Elsewhere in Asia, banks are often integrated into corporate pyramids.

Financial conglomeration is driven by the search for market power in global competition and the leverage of brand names and reputation. Social benefits have been claimed: economies of scope (e.g., in the use of information and cross-marketing to consumers) and economies of scale (e.g., in information technology and network externalities). However, empirical research has not yet found conclusive evidence of economies of scale and/or scope in financial firms.

Financial conglomeration presents two sets of problems: those related to business groups and those pertaining to financial firms. All business groups are susceptible to problems of related-party transactions that shift value to controlling shareholders. These problems have been addressed by mandating disclosure and regulating corporate governance to protect minority shareholders. Financial firms are subject to problems of information asymmetry, moral hazard and contagion. Recognition of these problems has led to regulation of financial institutions and markets. Regulators focus on the fitness and propriety of managers and directors, conflicts of interest, information disclosure and capital adequacy. Safety nets have been constructed to limit contagion, e.g., deposit insurance. Financial conglomerates compound the problems inherent in business groups as well as in financial firms. Most obviously, they exacerbate information asymmetry by increasing the information that must be assessed to evaluate capital adequacy. They exacerbate moral hazard as the conglomerates become “too big to fail”. They exacerbate the risk of contagion as problems in a company trigger a run on another affiliated company. They exacerbate conflicts of interest, both in the marketing of financial products and in related-party financial transactions. They permit risk to be shifted across asset classes, e.g., to banks whose assets are protected by deposit insurance, or via securitization to bypass capital adequacy requirements. Finally, they attenuate the ability of regulators to address the problems just listed.

Most countries regulate banks, insurance companies and security companies as stand-alone entities. When these are integrated into a conglomerate, there is an urgent need to integrate the regulatory structure to head off the problems of contagion, conflict of interest and regulatory arbitrage. To take one key example: the safety of bank deposits is presumed to be the primary duty of the bank’s board and management, the organizational principle of the bank’s corporate governance and internal control mechanisms, and the primary function of the bank’s capital requirement. Bank regulators operate under this presumption, imposing inspections and regulations to address these issues. But new problems arise if the bank is ultimately under the control of persons with an interest in a non-financial company or a company that issues and trades securities. Such persons could have an interest in the bank that jeopardizes its capital and the security of deposits. Financial regulators may not have the information, skills or mandate to prevent this conflict of interest.

These problems are not merely theoretical. They have already occurred — twice over. They brought on the greatest financial disaster in all history. The Great Crash of 1929, which led to the Great Depression of 1931-38, was exacerbated by the use of bank loans to fund securities speculation. To prevent a recurrence, the Glass-Steagall Act of 1932 separated banks from the securities firms. But the Gramm-Leach-Bliley Act effectively repealed the Glass-Steagall Act. Quickly there formed financial conglomerates such as JP Morgan/Chase, Citibank/Travellers/Shearson Lehman etc. Soon afterward, serious abuses were discovered by New York's Attorney General who imposed fines totaling US$400 million on essentially all the leading firms on Wall Street. It is significant that the problems of financial conglomerates were discovered and punished by someone outside the US financial regulatory system. This case highlights the regulatory gap that financial conglomerates can exploit even in a country that boasts a sophisticated system of financial regulation.

The US has now strengthened its corporate governance with the Sarbanes-Oxley Act which imposes more disclosure and greater independence of directors. The SEC and the New York Stock Exchange have strengthened the firewalls between financial activities within the same conglomerate. Various Asian countries have adopted other useful measures. For example, central banks in many Asian countries approve the board of each bank and ensure that it has sufficient stature and independence. However, these measures can be inadequate when the legal and regulatory systems are weak and enforcement is unreliable. The recent financial scandal in Taiwan brings home to East Asia the problems posed by related party transactions between financial institutions and associated companies. Thus, the rise of financial conglomerates poses an urgent challenge. We must adapt our regulatory structures to address the new problems in corporate governance, capital adequacy, risk management and transparency.

As it takes time to change the structure of financial regulation, existing regulators ought to set up immediately a forum for the exchange of information and the notification of incipient problems. For example, some countries like the Philippines already have such a mechanism. Laws and regulations should immediately be modified to mandate the free flow of information across regulatory bodies with appropriate safeguards. In the longer term, the structure of financial regulation needs to adapt to the new issues that we have noted:

1. One regulatory body should be appointed to take the lead to review the corporate governance of FCs. This is to ensure that each subsidiary has a board of directors with the authority and independence so that the subsidiary's business conforms to existing regulations and laws and that subsidiary managers fulfill their fiduciary duties. For example, if the key decisions in a bank subsidiary are, in fact, vested in the board and managers at the top of the conglomerate, then they are the ones who should be subjected to the tests of fitness, propriety and conflicts of interest.

2. This regulatory body should take the lead to review the ownership structure of each financial conglomerate to ensure that each of its subsidiaries has adequate capital and that the capital of one subsidiary is not entangled in obligations to another, possibly riskier, subsidiary. A transparent capital structure is needed to guard against contagion should investors lose

confidence in one of the subsidiaries. This could be achieved by mandating a transparent holding company structure and restricting cross-shareholding.

3. As financial statements are intended to provide information to regulators and investors, the design of any FC should meet a simple test: can its financial statements be understood? Do the financial statements disclose the information in a timely manner that a regulator or professional investor requires to determine its capital adequacy, riskiness and profitability?

4. Financial regulators should be empowered, as in Korea, to regulate the ownership of a bank to guard against effective control by a party that has an interest in securing related party loans, e.g., a party that also controls a non-financial corporation.

5. In view of the severe regulatory challenges posed by FCs and the problems that have been revealed in the region, Asian regulators should further develop their skills in monitoring cross shareholding and preventing conflicts of interest to deal with risks posed by financial conglomeration.