6 FRAMEWORK FOR CONSOLIDATED SUPERVISION[1]

Financial conglomeration has become a feature of the global financial sector architecture. Whereas in the mid 1990s only 40 per cent of the world's 500 largest financial firms were conglomerates, by the mid 2000s this had increased to close to 70 percent. Importantly, the trend towards conglomeration has occurred in emerging market countries as well as in developed economies, and is continuing.[2]

In its efforts to introduce and implement financial sector reforms essential for the smooth functioning and progress of the financial sector, the State Bank of Pakistan (SBP) recently released its 10-year vision and strategy.[3] One of the several reform pillars in the 10-year Strategic Plan is the implementation of consolidated supervision of conglomerate groups that include banks.

The need to supervise on a consolidated basis, in addition to supervising individual licensed banks, has long been recognized by the international regulatory community. In recognition of this need, the Bank for International Settlements (BIS) has included consolidated supervision as one of its 25 Core Principles for Effective Banking Supervision.[4] Pakistan is compliant with all required Core Principles (CP), except one i.e. consolidated supervision of banking groups i.e. CP 24 (**Box 6.1**). Addressing this final shortcoming is therefore one of the top priorities in SBP's Strategic Plan.

The rationale for implementing a consolidated approach to the supervision of banks is based on the need to protect banks from contagion risk. It is a characteristic of banks that they operate efficiently only to the extent that bank customers have confidence in their ability to perform the roles for which they were designed. Unlike commercial businesses and many other financial institutions, banks are highly leveraged and support liquid liabilities with less liquid assets. They are therefore inherently vulnerable to swings in confidence. Since banks are the cornerstone of the financial system through their provision of payments services, confidence in banks and the banking system is integral to the stability of the entire financial system. Where banks are closely associated with other institutions, either through common shareholding or common branding, their reputation and stability is exposed to weaknesses or perceived weaknesses in those other institutions. History is replete with cases of banks that have failed after being undermined by a subsidiary or affiliate.

If safety and soundness were the only considerations, regulators would universally prohibit associations between banks and other entities. That this is not the case reflects the fact that financial conglomeration also offers benefits in terms of financial strength, synergies, and efficiencies in the use of infrastructure. The challenge for regulators is to facilitate conglomeration involving banks, while monitoring and managing the risks that conglomeration can pose to individual institutions and to the financial system as a whole. The importance of this challenge is reflected in the fact that a number of countries refuse foreign banks the right to enter their retail markets unless the local (host) regulator is satisfied as to the quality of the consolidated supervision carried out by the foreign (home) regulator.

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[1] This chapter draws extensively on a paper written by Dr. Jeffrey Carmichael, CEO Promontory Financial Group, Australasia LLP, on a recent visit to Pakistan as a consultant on Financial Sector Strategy, and Governor SBP, Dr. Shamshad Akhtar's address on the subject at IBP, October 2008.

[2] G.de Nicolo et. Al. (2003) : "Bank Consolidation, Internationalization and Conglomeration : Trends and Implications for Financial Risk", IMF Working Paper No. 03/158.

[3] Financial Sector : Next 10-year Vision and Strategy : Address on SBP's 60th Anniversary by Governor State Bank of Pakistan, July 1, 2008.

[4] Core Principles for Effective Banking Supervision, October 2006, Basel Committee on Banking Supervision, BIS.

Box 6.1 : Basel Core Principles for Supervising Financial Conglomerates

Principle 24: An essential element of banking supervision is the ability of the supervisors to supervise the banking group on a consolidated basis.

Essential criteria

1. The supervisor is aware of the overall structure of banking organizations (i.e., the bank and its subsidiaries) or groups and has an understanding of the activities of all material parts of these groups, including those that are supervised directly by other agencies.
2. The supervisor has a supervisory framework that evaluates the risks that non-banking activities conducted by a bank or banking group may pose to the bank or banking group.
3. The supervisor has the legal authority to review the overall activities of a bank, whether the activities are conducted directly (including those conducted at overseas offices), or indirectly, through subsidiaries and affiliates of the bank.
4. There are no impediments to the direct or indirect supervision of all affiliates and subsidiaries of a banking organization.
5. Laws or regulations establish, or the supervisor has the authority to impose, prudential standards on a consolidated basis for the banking organization. The supervisor uses its authority to establish prudential standards on a consolidated basis to cover such areas as capital adequacy, large exposures, and lending limits.
6. The supervisor collects consolidated financial information for each banking organization.
7. The supervisor has arrangements with functional regulators of individual business vehicles within the banking organization group, if material, to receive information on the financial condition and adequacy of risk management and controls of such business vehicles.
8. The supervisor has the authority to limit or circumscribe the range of activities the consolidated banking group may conduct and the overseas locations in which activities can be conducted; the supervisor uses this authority to determine that the activities are properly supervised and that the safety and soundness of the banking organization is not compromised.

Additional criteria

For those countries that allow corporate ownership of banking companies:

- the supervisor has the authority to review the activities of parent companies and of companies affiliated with the parent companies, and utilizes the authority in practice to determine the safety and soundness of the bank;
- the supervisor has the authority to take remedial actions, including ring-fencing, regarding parent companies and non-bank affiliates concerning matters that could impact the safety and soundness of the bank; and
- the supervisor has the authority to establish and enforce fit and proper standards for owners and senior management of parent companies.

In developing an appropriate framework for consolidated supervision, SBP has drawn on international experience and expertise, while giving due consideration to the specific characteristics of Pakistan's financial system and its current stage of development.

While the details of the framework are in the process of being analyzed, there are four core features that are common to consolidated supervision as practiced around the world:

- **Line of sight** – it is essential that one regulator has line of sight over each bank and all of its associates. Basel Core Principle 24 on Consolidate Supervision makes it clear that the lead regulator for banking groups should be the banking supervisor. The close link between the stability of individual banks and the stability of the financial system places central banks (with regulatory powers) in the best position to supervise the risks involved.
- **Group wide information** – CP 24 also makes clear that the lead supervisor must have access to information about the group as a whole. To conduct effective consolidated supervision, the lead regulator must have the ability to evaluate the risks that non-banking activities conducted by a banking group may pose to the bank or banking

group. Not only does this require access to information about all members of the group, it also requires that the supervisor has access to inspect these members to verify the information provided and to assess the group's approach to managing its risks.

- **Supervisory powers** – CP 24 also requires that the *lead supervisor* has the power to impose prudential standards on a consolidated basis for the banking group as a whole. Supervisors typically use this authority to establish prudential standards on a consolidated basis to cover such areas as capital adequacy, large exposures, and lending limits.
- **Organisational structure** – complex organisational structures create difficulties for regulators and investors alike. CP 24 requires the lead regulator to be aware of the overall structure of the group as well as understanding the activities of all material parts of the group. In some countries regulators have encouraged, and in some cases even required, banking groups to adopt more transparent structures such as those under non-operating holding companies.

While conglomeration is commercially attractive to the industry, it raises a range of issues for financial sector efficiency and stability, which are covered in this chapter. Given that the primary risks introduced by financial conglomerates relate to their potential impact on banks, Section 1 reviews the characteristics and principles underlying banking and the way in which conglomerates can affect the banking system. Section 2 summarizes the way in which other countries have sought to mitigate these risks through the regulatory framework. Section 3 identifies particular challenges that will need to be addressed in the Pakistan context in formulating a policy for regulating financial conglomerates. Section 4 presents the proposed framework for consolidated supervision in Pakistan.

6.1 The Potential Impact of Financial Conglomerates on Banks

6.1.1 The Role of the Financial System

The financial system plays a critical role in the smooth and efficient functioning of every economy. The most fundamental contribution that any financial system makes is the channeling of resources from individuals and companies with surplus resources to those with resource deficits. In doing so the financial system not only satisfies the savings needs of the economy, it also facilitates the accumulation of investment capital that is critical to growth and development.

As financial systems have grown in sophistication, they have evolved specialist financial institutions (such as insurance companies, asset managers, market makers, and so on) that 'intermediate' different types of promises between issuers and holders. In developing their various specializations, different financial institutions offer different combinations of the core services demanded by a well-functioning financial system. These core services include: (a) Payments services, (b) Liquidity, (c) Divisibility, (d) Store of value, (e) Informational efficiency, and (f) Risk pooling.

6.1.2 Special Nature of Banks

Banks (and other deposit-taking institutions) provide an attractive bundle of most of these core financial services. By enabling depositors to write cheques and other negotiable instruments on their deposits, banks offer payments services and liquidity equal to that of currency (hence their inclusion with currency in the payments system of virtually every country in the world). Deposits

also offer exceptionally high divisibility (at least to the same level as currency and usually with greater flexibility than currency). The store of value service is similar to that of other debt instruments in that deposits promise repayment at (nominal) face value plus interest. Provided they are independent from commercial businesses and offer confidentiality to their customers, banks resolve the information conflict faced by borrowers, and generally enjoy substantial economies of scale in processing and analyzing information. Finally, each bank risk-pools borrowers' promises into a single promise by the intermediary itself. For these reasons banks invariably form the centerpiece of the financial system.

Even though banks offer a bundle of financial services, it is their roles as the centre of the payments system and a safe store of value to unsophisticated lenders that generate the intense regulatory oversight that banks receive in every country. The fact that banks are highly geared and vulnerable to swings in confidence makes the regulatory imperative even greater. For these reasons banks are regulated more intensively than any other group of financial institutions and their safety and soundness is closely protected by banking regulators.

As noted above, financial sector development invariably leads to the emergence of specialized financial institutions that offer sub-sets of the core financial services. For example, insurance companies specialize in risk pooling services, pension funds in store of value services, and so on. To avoid destabilizing the foundations of the financial sector, these specialist institutions are invariably prohibited from offering payments services and from participating in the formal payments system. While specialization requires a natural level of separation, there is still great attraction to the industry from combining specialist functions, either within the same institutions or in groups of related institutions. Conglomeration leads to larger and stronger balance sheets and to economies of scale in otherwise costly support functions including risk management; conglomeration also enables the group to leverage off best practice in pricing, risk management, and administration.

It goes without saying that conglomeration between financial institutions and commercial enterprises is also attractive from the industry's perspective. In what follows, groups that include only financial enterprises will be referred to as "financial" conglomerates and groups that include both financial and commercial enterprises as "mixed" conglomerates. A mixed conglomerate group that has a captive bank (or at least one that is closely linked through ownership) may be able to fund its commercial activities more cheaply than its competitors. It may also gain access to competitively useful information through the bank's dealings with competitors.

6.1.3 Conglomerate Risks to Banking

Financial conglomerates introduce risks for banks and pose serious challenges for regulatory authorities. The risks can be classified into two main groups: those arising from conflicts of interest and those arising from potential contagion. Whereas the former gives rise to problems related to both market conduct and prudential concerns, the latter are largely related to prudential concerns. In both cases, the risks introduced are dominated by their impact on banks within conglomerate groups. Thus the way in which countries have approached the regulation of conglomerates has been largely from the perspective of preserving the integrity of the banking system.

Conflicts of Interest

Conflicts of interest arise where the interests of the financial group run counter to the interests of the bank within the group, and thereby counter to the interests of the depositors as well as to those of the broader community that banks are expected to service.

The most obvious regulatory concern with a conglomerate is that the member bank could be used as a central source of cheap funding for the group. While it is clearly commercially attractive for the owners of the conglomerate group to use cheap deposit funding for activities throughout the group, prudential concerns arise where intra-group lending occurs without proper assessment of risks, proper pricing for risk, and proper consideration of exposure concentrations. The impact of this conflict on market efficiency and fairness is greatly amplified in the case of mixed conglomerates.

A second regulatory concern arising from conflicts of interest within a financial conglomerate is that assets and liabilities may be shifted within the group with the explicit intention of minimizing the regulatory cost to the group in terms of capital and other impositions. This is often able to be achieved without any fundamental improvement in the overall financial strength of the group.

In the case of a mixed conglomerate there is even greater risk that the group may shift impaired assets from commercial entities within the group to the bank, thereby shifting risk from shareholders to depositors, weakening the bank and potentially the entire financial system, and imposing possible recourse on any depositor protection scheme.

Contagion

A primary prudential concern arising from the inclusion of banks within a financial conglomerate is the potential for the reputation of the bank to be adversely affected by the performance, reputation, or difficulties experienced by other members of the group. It is a fundamental characteristic of banks that they operate efficiently only to the extent that depositors have confidence in their ability to perform the roles for which they were designed, and to do so in a way that does not endanger their ability to meet the promises that they make to depositors to allow them to withdraw funds on demand. This promise makes banks extremely vulnerable to reputational risk, given that a bank's assets are inherently less liquid than its deposit liabilities. The strong governance and conduct regulations imposed on banks to protect them from this type of instability can easily be undone by other members of a conglomerate group if these members are not subject to comparable standards.

6.2 Regulatory Approaches to Mitigating Conglomerate Risks

If the only objective of policy was to maintain the integrity and stability of the banking system, governments would almost certainly quarantine banks from associating with any other entities, either commercial or financial. Indeed there have been various attempts in history to achieve such outcomes.[5] However, most governments have recognized that there are potential benefits to the growth and strength of the system from conglomeration. The risks and benefits can vary widely with the nature of the financial system and the stage of development. For example, it is more common to find mixed conglomerates permitted in countries with less well developed financial systems where capital is relatively concentrated in the hands of a small number of companies (often controlled by wealthy families) and the capital markets are less able to provide the funds needed to capitalize banks.

The range of international frameworks for regulating conglomerates is thus a reflection of decisions about the trade-off between the social risks and the rewards of these structures and the ability to put in place risk management strategies to keep the risks within acceptable bounds. The overall approach to these risk mitigation strategies in most countries is constrained/guided

[5] The separation of banking and securities business in the United States under the Glass-Steagall Act following bank failures in the great depression, coupled with the still standing requirement that banks may not conduct insurance business either on their own balance sheets or through subsidiaries, is one such example.

by the desire to be compliant with the Basel Core Principles for Banking Supervision, mentioned earlier.

The main risk management strategies in practice can be categorized as follows:

- Adjustments to the regulatory architecture;
- Limits on bank ownership;
- Limits on the scope of participation in conglomerate groups;
- Limits on the structure of conglomerate groups; and
- Regulatory requirements.

6.2.1 Regulatory Architecture

There has been a global trend towards integration of financial regulatory agencies. Whereas a decade and a half ago the dominant regulatory architectural form was to have a dedicated agency to regulate each group of financial institutions, today more than 60 per cent of countries have combined two or more of their main regulatory agencies, or unified all agencies under one roof. It is no accident that this trend has coincided with the growth of financial conglomerates as the dominant corporate architecture.

In countries where amalgamation or unification of regulatory agencies has not been possible or has been ruled out for other reasons, the response to the challenge of regulating conglomerates has typically been to establish a *lead regulator*.[6] The idea is that the lead regulator should have line of sight over all members of the conglomerate group. The fact that the risks that arise from conglomeration are concentrated almost entirely on the banks within the groups, demands that the lead regulator for any group that includes a bank should always be the banking regulator. This requirement is made clear in CP 24. There is no known example of any country that has applied the lead regulator model in which this is not the case. In some cases the lead regulator is granted direct regulatory powers over all members of the group. Where the regulatory frameworks for the non-bank members are well developed, and can be relied on by the banking regulator, the need for direct powers is lessened.[7] As a general principle, however, unless the lead regulator is completely satisfied with the standard of regulation of the non-bank members, to comply with CP 24, it should have either the power to regulate directly, or the power to exercise control indirectly through licensing conditions on the bank.

6.2.2 Limits on the Ownership of Conglomerate Groups

As noted above, one of the primary conflicts that arises in the case of financial conglomerates (and with banks generally) is the temptation that can arise for the owners of the bank to view the bank as a private funding vehicle for their commercial activities. Many countries have sought to mitigate this risk by imposing limitations on the ownership and control of financial conglomerates. At a minimum, controllers of financial conglomerates should satisfy fit and proper person requirements comparable with those imposed on the controllers of banks. Beyond this, many countries impose a requirement that ownership of financial conglomerates should be diversified in order to minimize the risk that the conglomerate will be used improperly to fund the commercial interests of the owners. This is consistent with best-practice requirements for ownership of banks.

[6] While industry conglomeration has generally driven the trend towards regulatory amalgamation, the appropriate reform for any particular country at any particular time is far from pre-determined, and involves weighing a complex set of factors.

[7] For example, in the US, the Federal Reserve Board, which is the regulator of banking groups, does not take direct regulatory or supervisory responsibility for non-bank group members. Indeed, where the banking member is supervised by the Comptroller of the Currency, the Fed does not even regulate the bank directly.

6.2.3 Limits on the Scope of Participation in Conglomerate Groups

One of the most common abuses within mixed conglomerate groups is the extension of credit and other forms of finance from the financial members of the group to commercial members on terms that advantage the unregulated commercial members at the expense of the regulated financial members. One way of limiting this abuse is to restrict the eligibility for inclusion within a financial conglomerate to financial institutions by prohibiting such groups from including commercial enterprises as members.

Where such a limitation is not, or cannot, be imposed, the additional criteria in CP24 requires that the banking regulator has the authority to review the parent and related companies and to take remedial actions to ring-fence the bank from the parent and associated companies if necessary.

Regulatory complexity also increases where financial conglomerates include members that are partly owned. In some countries regulators have taken the approach of requiring members to be wholly owned. Many countries permit a small amount of investment into other financial institutions but require this to be kept below a very low threshold so that there is no ambiguity that the holding is an investment and thus that the institution in question is not a member of the group.

6.2.4 Limits on the Structure of Conglomerate Groups

The ability of supervisors to assess the risks in a conglomerate group and to ensure that regulatory restrictions are being observed is directly related to the transparency of the group. In many countries the transparency of groups is enhanced by imposing restrictions on the corporate structures that financial conglomerates may take. The two most common types of restrictions are: (a) restricting the parent company of the group to being either a bank or a non-operating holding company; and (b) limiting or prohibiting cross-shareholdings within the group, other than direct parent/subsidiary holdings.

A second line of restriction that is often placed on the structure of conglomerate groups is on the extent to which business can be done on any particular balance sheet. For example, every country requires a separation between banking and insurance in the sense that insurance business cannot be conducted directly on the bank's balance sheet – even though the insurance company may be permitted as a subsidiary of the bank. Similarly, pension fund management is always quarantined from banking. Other restrictions that are often, but not always, imposed include separating banking and investment banking business, and separating life from general insurance.

6.2.5 Regulatory Requirements

The final source of risk mitigation for financial conglomerates is the set of specific regulatory requirements that are imposed on financial conglomerates. The essence of these requirements is that they should tighten the requirements applied to stand-alone banks. Implementing these requirements requires that the banking regulator has legal regulatory responsibility for and powers over the group as a whole. The following is a summary of the most common international regulatory requirements for financial conglomerates.

Capital Requirements

Capital requirements are the cornerstone of conglomerate regulation. The major regulatory concern with financial conglomerates is the potential for the group to double-count capital, either by creating "paper" investments in subsidiaries, or by taking on debt at higher levels and cascading it throughout the group in the form of equity investment. In the absence of

consolidated supervision, the information disclosed by banks, securities firms, and insurance companies, or any other type of entity belonging to a financial group, may underestimate the extent of risks faced by these institutions as well as the conglomerate group as a whole. Under the recommendations of the Basel Committee on Banking Supervision, financial conglomerates containing banks should face capital requirements at two levels: at the individual bank level (known as the "solo" level, or Level 1) and at the consolidated banking group level (Level 2). This same principle is also applied to groups containing other regulated financial institutions, with a Level 3 requirement on the group as a whole. Best practice in measuring Level 3 capital adequacy requirements is still evolving, partly under the EU Directive on Financial Conglomerates (No. 2002/87/EC), and partly under individual country developments. A central feature of best-practice consolidated capital requirements is that they prohibit double-counting of capital.

Limits on Intra and Extra Group Exposures

An important method of limiting the potential for abuse through intra-group transactions and exposures is to impose limits on intra-group exposures that are more restrictive than those imposed by the regulations applying to the individual financial institutions. For example, if the bank law or prudential standards impose a single large exposure limit to individual borrowers (or groups of related borrowers) of, say 25 per cent of the bank's capital, the intra-group large exposure limit could be smaller than this level. It is normal to set a limit on exposures of regulated financial members of the group to other members on a stand-alone basis as well as to impose an aggregate exposure limit to the entire group.

Where the law restricts the ownership of regulated financial institutions to a relatively small percentage in order to establish a diversified ownership base, the risk of excessive exposures to related parties outside the formally-defined group are not great. However, where concentrated ownership is permitted, the door can be opened to potential abuse if the institutions within the group are used as low-cost financiers for the commercial operations of the owners of the parent companies of the group. In this case, the supervisor should have the power under law to extend the limits on intra-group exposures to include those to related parties of the group that lie outside the formal definition of the group for supervisory purposes. In addition to setting limits on intra-group exposures, some countries have imposed limits on aggregate exposures of the group as a whole to individual borrowers or groups of related borrowers.

Restrictions on Sharing of Names, Services, and Facilities

The risk of contagion is greatly increased where members of the financial conglomerate share labeling (or branding) of their services and activities, premises, and services. In many cases, members of a conglomerate may share common board members, management and infrastructure. While the risk of contagion may be reduced significantly by banning such sharing, one of the primary commercial benefits of membership of a conglomerate is usually the exploitation of brand recognition and the cost efficiencies that follow from sharing expensive services. Regulatory responses have generally attempted to find a balance between the benefits and the risk in sharing.

The main regulatory requirement of allowing such sharing is usually that there is no misrepresentation to consumers of the provider of any particular service. This may be addressed through required disclosures to consumers about the relationships involved and the extent to which other members of a group may or may not support the service in question. Where disclosures are inadequate, or where the risks are assessed to be unacceptable, the supervisor should have the power under law to prohibit sharing or any advertising or promotion that implies a relationship of support beyond that which the supervisor is prepared to allow.

Group Governance Requirements

Governance of groups is an important mechanism through which regulators control risk. In addition to requirements on the fitness and propriety of board members, some countries have imposed limitations on the structure of boards and management through conglomerate groups. Separation of management for specialized subsidiaries is common, as is the objective of providing a degree of separation between subsidiaries by requiring executive directors to specialize. The other main consideration is independence. It is best practice to require each major subsidiary type to have at least one independent director who has no other affiliation within the group. This increases the likelihood that attempts to violate prudential rules within the group will be called out. These governance requirements are most effective when supported by a mandatory whistleblower regime.

Group Audit Requirements

In order to ensure that there is a single point of audit oversight of the group, many regulators require there to be a single auditor of the group. The law in this case should give the supervisor the power to meet with the auditor, both with the financial conglomerate and separately, and to request audits of particular aspects of the group as needed. In addition, under law or conditions of license, the reporting date is aligned for all members of the group in all jurisdictions.

Requirements on Group Policies

Under a risk-based supervisory approach it is essential that the supervisor be able to evaluate the risk management policies of the group as a whole, as well as of the individual regulated entities. To this end, many countries have included in their regulations the requirement that authorized groups have policies on such matters as risk management, intra-group transactions and exposures, branding, sharing of resources etc, and support of group members by other entities in the conglomerate. These policies may be required to meet certain standards (for example, intra-group transactions are usually required to be carried out on an arms-length basis and on terms no more favorable than the terms offered to third parties) and are usually required to be made available for inspection to the supervisor.

Requirements on Providing Group Information and Supervisory Access

Finally, in order to facilitate effective supervision of financial conglomerates, it is essential that the supervisor has access to all relevant information (both financial and structural). In many countries the law includes the requirement (as a condition either for licensing financial conglomerates or for the approval for their ownership) that the supervisor is able to request whatever information it needs for assessment of the consolidated risks, and that the supervisor has access to on-site supervision to all members of the group on the same terms that it has in inspecting individual regulated members.

6.3 Inherited Challenges in Pakistan

While it is relatively straightforward to set out in principle a best practice framework for consolidated supervision, the reality is that every country that has addressed this issue has done so against a backdrop of inherited issues. In the context of Pakistan, certain inherited characteristics of the financial and regulatory systems will pose challenges for consolidated supervision. The following summarizes these briefly.

6.3.1 Regulatory Architecture

Pakistan’s current regulatory architecture is best described as semi-amalgamated. Supervision rests with two main regulators – the SBP and the SECP. Under the existing architecture, supervisory responsibilities for banks, Development Finance Institutions (DFIs), Microfinance

Banks (MFBs),[8] and exchange companies reside with the SBP, while the rest of the financial institutions (including capital markets/securities, non-bank finance companies, insurance companies, and pension funds) are supervised by the SECP.

6.3.2 Limits on the Ownership of Conglomerate Groups

Under the Banking Companies Ordinance (BCO) 1962, "qualifying" shareholdings in banks (those in excess of 5 percent) require approval of the SBP. Further, sales of qualifying shareholdings require approval. This requirement has been used to ensure the fitness and propriety of owners of banks but not to limit their control. As a result, a number of banks in Pakistan are majority owned by a single owner or group of related owners. In virtually all cases the degree of ownership concentration is very high by international standards.

6.3.3 Limits on the Scope of Participation in Conglomerate Groups

Currently, section 23(2) of the BCO limits the extent to which banks may invest in commercial entities (this limit is 30 per cent of the bank's capital or 30 per cent of the target's capital – whichever is the lower). There are no limits on commercial participation in a financial conglomerate from the perspective of the parent. Consequently, there are a number of banking groups that have significant involvement and possibly control in both financial and commercial businesses that are not required to be consolidated.

6.3.4 Limits on the Structure of Conglomerate Groups

There are currently no limitations on the structure of financial conglomerates. While most financial groups are structured with the bank at the top of the group, several mixed conglomerates have a non-operating holding company at the top of the group, with the bank and other financial institutions as siblings. There are also cross-share holdings within groups as well as other exposures.

In terms of the structure of participating financial institutions, insurance and banking are required to be structurally separated, as are banking and stock-broking, but investment banking and banking are permitted on the same balance sheet.

6.3.5 Regulatory Requirements

There are currently no specific regulatory requirements targeted art financial groups as such, although Level 2 capital requirements apply to banks and their consolidated subsidiaries.

6.4 Recommended/Proposed Framework for Pakistan

In recognition of the need to evolve an appropriate oversight policy mechanism for its evolving financial structure, SBP, as a part of its overall financial sector reforms launched in July 2008, has advocated the need for legislature to empower the central bank to augment its oversight of the financial sector.

The prevalent structure under which non-bank financial services are being offered is mostly through the parent – subsidiary form of structure wherein banks are parent of their non-banking subsidiaries, or in some cases banks have Non-banking finance companies (NFBCs) as associates. Some elements of Universal banking also exist, for example banks are allowed to undertake investment banking and leasing businesses on their own balance sheet as well. While the central bank showed flexibility in allowing these developments, the underlying legal architecture was not changed in line with the market needs and developments.

[8] While the MFBs are supervised by the SBP, there are a number of other microfinance institutions that do not fall under its regulatory ambit.

As such, the current legislation and regulatory tools are not adequate to effectively address the potential risks to the safety and soundness of the financial sector. The safety and soundness of the banking sector, being at the core of all activities of the financial sector, is critical for the general public, for the financial sector itself and for the economy as a whole. The governing law of the banking sector viz. the Banking Companies Ordinance (BCO) was introduced in 1962 and occasional changes were made in it in response to the challenges of different phases of development. The significant challenges posed by universal banking, large financial groups and holding company structures now warrant a matching legal framework to avoid any major disruptions in the economy and in the process of financial intermediation. Recognizing these challenges, SBP has sought in principle approval from the requisite forums, for amendments in the BCO to enable it to supervise banks, groups and financial holding companies in line with international trends.

Besides forestalling various risks, these amendments would enable significant benefits in the form of operational efficiency, lower costs, reduced prices and innovation in products and services. Keeping various factors in mind, three major changes are being proposed in the BCO.

Firstly, the current supervisory set up has to be changed to bring all deposit-taking Non Bank Financial Companies (NBFCs) under the fold of SBP. The major rationale for this proposal is that these NBFCs are engaged in activities incidental to banking, both on the liability as well as the asset side. Bringing such entities under SBP would lead to greater supervisory efficiency, as being the regulator of banks, its supervisory approach is well equipped for their kind of business and the associated risk profile. In this regard, the BCO ought to bring under its folds NBFCs like Investment Banks, Leasing Companies, Housing Finance Companies that are until now outside its regulatory purview.

Secondly, another change being sought is to authorize SBP to designate and regulate financial groups. Financial group for this purpose is any group in which at least one of the entities is directly regulated by SBP. This is an extremely important step because it will enable SBP to effectively monitor the potentially dubious intra-group transactions involving banks and NBFCs, and would also enable it to curtail the possible contagion risk. The proposed amendment would also enable SBP to seek information from the unregulated commercial entities and conduct limited inspection for verification of such information.

For entities in a financial group which fall under the purview of the securities regulator's supervision, the current supervisory mechanism also needs to be amended to move towards greater consolidated supervision. Under the proposed supervisory mechanism, the concept of lead and functional supervisors has been introduced. SBP would be the lead supervisor for a financial group for consolidated supervision. Functional supervisor would be the regulatory body responsible to carry out supervision of the entity on a stand-alone basis under the relevant laws in force for the time being. In order to ensure that consolidated supervision is done effectively, and that there are minimal enforcement issues, the power to seek information, conduct onsite inspection in collaboration with the functional regulator, recommend enforcement action to the functional regulator etc. are being sought for the lead supervisor.

Thirdly, the time is ripe for the introduction of a Financial Holding Company (FHC) concept. SBP has so far facilitated the increasing integration of various segments of the financial sector through various rules and regulations, and the next logical step is the creation of enabling legal provisions for the establishment of more efficient forms of conglomerate structures such as the FHC model. The FHC model is becoming popular in different countries, e.g. USA, Hong Kong, Singapore, India etc.

The benefits of adopting a financial holding company model are as follows:

(i) One of the key advantages of the FHC form of structure is that it provides separation of business activities and investment activities of financial institutions within a group.

(ii) This structure would prevent the double gearing of bank's capital and facilitate the growth of the financial sector, as new capital injection would be required for expanding businesses.

(iii) It would be easy to establish firewalls and protect banks from risks arising out of non-banking activities. While banks will not be able to directly benefit from any profits of their non bank companies, the overall group will be strengthened.

(iv) The sponsor shareholding of banking as well as non banking companies will become transparent and help SBP in ensuring that these institutions operate at arm's length. The majority shareholding in a bank will be channelled through the FHC, and since under the proposed amendments, FHC supervision is with SBP, the shareholdings can be more closely monitored.

(v) The structure provides organic growth without increasing contagion risk as it is very unlikely that the whole group will fail.

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