

From Zero to Something: The Necessity of Establishing a Regulatory
System of Financial Conglomerates in China

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I. INTRODUCTION

China's ascension in the World Trade Organization (WTO) has presented both challenges and vast business opportunities for the Chinese financial services industry. Meanwhile, China has already experienced a massive increase to foreign direct investment (FDI) in the past few decades.¹ Since most of the FDI in China has focused on the manufacturing and commercial sectors,² the demand for financial services may rely largely on the supply from the Chinese financial service industry.

¹ The cumulative level of FDI in China since the late 1980's has been almost \$400 billion. See David Hale, Opportunities for Financial Service Companies in China – Testimony for U.S – China Commission 1 (2002).

² *Id.*

The trend toward the integration of different types of financial services has facilitated the establishment of financial conglomerates, which generally are defined as “any group of companies under common control whose exclusive or predominant activities consist of providing significant services in at least two different financial sectors (banking, securities, insurance)”.³ These conglomerates achieve the competitive advantage that comes from economies of scale, economies of scope and synergies⁴. This nature and advantage enable the financial conglomerate, compared to a single financial institution, to better serve the commercial sector. As China is in need of a new policy in financial service reform to counteract the foreign competition as well as to satisfy the increasing domestic demand, permitting the establishment of financial conglomerates can be a feasible alternative. In fact, several different types of financial conglomerates, including financial holding companies, mixed financial holding companies and other structures, have existed for a couple of years.⁵ However, financial conglomerates can also pose various supervisory problems (e.g., group-wide capital adequacy, double or multiple gearing, intra-group transaction and exposure, and risk contagion) for financial regulators and supervisors. Without a proper supervisory system, risks associated with financial conglomerates may erode the foundation and stability of the entire financial market and even the economy. Developed countries with mature financial markets have not neglected these issues; on the contrary, they exerted substantial efforts to alleviate them. Relevant international organizations, have also attempted to address the same issues by creating non-binding international guidelines and standards.⁶ Nevertheless, current laws and regulations in China fall short of supervising the above-mentioned risks. Premised on the idea that

³ Tripartite Group of Banks Securities and Insurance Regulators, *The Supervision Of Financial Conglomerates* 13 (1995) [hereinafter Tripartite Group].

⁴ For details, see Takahiro Nagada, Yasuo Maeda & Hiroaki Imashigashi, *Economies of Scope in Financial Conglomerates: Analyses of a Revenue Side* 2-3 (2004), available at http://www.fsa.go.jp/frtc/english/e_nenpou/2004/02.pdf (last visited Oct. 30, 2009). See also Stijn Claessens, *Benefits and Costs of Financial Services Provision in Developing Countries* 13 (2002) ((unpublished abstract, in file with the Finance Group, Univ. of Amsterdam), available at <http://www1.fee.uva.nl/fm/PAPERS/Claessens/benefits%20of%20costs.pdf> (last visited Oct. 30, 2009).

⁵ For details, see Changyuan Lin, *Financial Conglomerates in China* 9-22 (CASS Center for International Law Studies, Working Paper No. 2003020011, Feb. 2003), available at <http://www.ssrn.com/abstract=446840> (last visited Oct. 30, 2009).

⁶ For example, the Joint Forum of Financial Conglomerates, the Basel Committee on Banking Supervision, the International Association of Insurance Supervisors (IAIS), the International Organization of Securities Commissioners (IOSCO), the OECD and the G-10.

the functioning law is the pre-requisite of economic order,⁷ this thesis contemplates to scheme a regulatory and supervisory system for financial Conglomerates in China.

Therefore, part II of this paper will provide an overview of the current Chinese financial market, especially the evolvement of financial conglomerates. Part III first will introduce advantages and disadvantages of financial conglomerates, then will debate whether financial conglomerates are feasible for China and discuss the potential challenges that financial conglomerates may pose to Chinese financial supervisors. Part IV will study whether existing laws and regulations are sufficient for the supervision of financial conglomerates in China. Then, after recognizing the insufficiency of current laws and regulations, this thesis will, from the perspective of comparative law, explore regulatory regimes for the supervision of financial conglomerates in various jurisdictions including United States and European Union. Finally, in part V, based on the result of comparative law studies, this paper will discuss how foreign experiences may help in the improvement and creation of an optimal supervisory system for financial conglomerates in China, and ultimately will propose a blueprint.

II. OVERVIEW ON THE EVOLVEMENT OF FINANCIAL CONGLOMERATES IN CHINA

Although the specific terms “financial conglomerates” or “financial holding company” are not seen in the existing financial laws and regulations in China, financial conglomerates have existed since the early 2000s. The only law that may provide legitimate ground for the establishment of a financial holding company is Article 12 of the Company Act 1999.⁸ Except for investment companies and holding companies stipulated by the State Council, it is prohibited that the investment of a company in another company exceeds 50 percent of its net assets.⁹ Currently, there are no accurate surveys regarding the actual number of financial holding companies or financial conglomerates, as no clear definition of financial conglomerates or financial holding companies was given in any promulgated laws and regulations.¹⁰ Researchers, after observing the existing financial holding companies and groups, categorize these companies or group of companies into three major types: (1) holding companies created by one financial institution’s holding of another

⁷ EDWARD SHILS & MAX RHEINSTEIN, MAX WEBER ON LAW IN ECONOMICS AND SOCIETY 11 (1967).

⁸ The Company Act 1999 was replaced by the newly promulgated Company Act of the People’s Republic of China (2006).

⁹ Xia Bin, Financial holding Companies in China 1 (2002) *available at* www.worldbank.org.cn/English/content/xiabin.pdf (last visited Jan. 17, 2010).

¹⁰ *Id.* at 3.

financial institution, (2) industrial and commercial companies' holding financial institutions, and (3) holding companies set up by state-owned banks.¹¹

A typical category one financial holding company is that established by the China International Trust and Investment Corporation (CITIC) in December 2002 and the China Everlight Group.¹² The former was founded by Yiren Rong, former vice-president of the PRC in 1979.¹³ At the end of 2001, CITIC committed 81 percent of its total assets in financial services industries including commercial banks, securities firms, insurance companies, trust and investment companies and leasing companies.¹⁴ With the establishment of CITIC Holding Ltd., CITIC actually set up a holding entity that specialized in managing banking and non-banking financial institutions.¹⁵ The Everlight Group was first established in 1991 under the direct control of the State Council.¹⁶ The corporate structure of Everlight Group is complicated due to the fact that its headquarters are split, with one located in Beijing and the other in China (Beijing is in China, so where exactly is the other headquarters?).¹⁷ Subsidiaries of the two head offices include commercial banks, insurance, investment banking, assets management, securities companies and an insurance agency.¹⁸ In addition to financial services, Everlight also engages in such industries as information technology, petroleum, and construction.¹⁹ It is regarded as the typical example of a mixed financial conglomerate.

Some state-owned enterprises as well as private corporations also have actively infiltrated the financial services market in recent years. Remarkable examples include Shandong Electricity Group (SEG), Haier Group and Delong Group. SEG, through its subsidiary holding company, has controlled several securities, insurance and trust companies.²⁰ Haier, one of the major home appliance manufacturers in China, has controlled

¹¹ Ping Xie, *Jin Rong Kong Gu Gong Si De Fa Zhan Yu Jian Guan* [Development and Supervision of Financial Holding Companies] 151-166 (2004).

¹² Changyaun Lin, *Financial conglomerates in China* 11 (2005) available at <http://ssrn.com/abstract=446840> (last visited Jan. 17, 2010).

¹³ Xie, *supra* note 11, at 151.

¹⁴ Lin, *supra* note 12, at 11.

¹⁵ *Id.*

¹⁶ Xia Bin, *Jin Rong Kong Gu Gong Si Yan Jiu* [Studies on Financial Holding Companies] 227 (2001).

¹⁷ *Id.*

¹⁸ *Id.* See also Xie, *supra* note 11, at 153.

¹⁹ Xia, *supra* note 16, at 227.

²⁰ Xie, *supra* note 11, at 157.

commercial banks, trust companies and securities firms.²¹ Delong, a company based in Xinjiang Province, has held controlling shares in two securities firms, two trust companies and two financial leasing companies.²²

While new financial conglomerates are emerging, the leading role of the four major state-owned commercial banks, The Bank of China, China Construction Bank, Industrial and Commercial Bank of China, and the Agricultural Bank of China (hereinafter Big Four) can never be neglected. The business scope of the Big Four underwent the expansion owing to the State Council's initiative on the Reform of Financial and Investment System.²³ Bank of China (BOC) was the earliest among the Big Four to march toward becoming a financial holding company. In 1979, China Construction Finance Ltd., a subsidiary of BOC engaging in investment banking, was started in Hong Kong.²⁴ The Bank of China International Holding Ltd., was incorporated in the U.K. in 1996, and then moved to Hong Kong two years later.²⁵ The insurance business of BOC began with the establishment of BOC Group Insurance Company Ltd. in 1992.²⁶ In 1998, BOC Group Life Insurance Company Ltd., a wholly owned subsidiary was founded.²⁷ Both Bank of China International Holding Ltd. and BOC Group Insurance Company Ltd. were approved to conduct their business in Mainland China in 2001.²⁸ A state-owned-bank-parent model financial conglomerate officially appeared in Mainland China.

The Industrial and Commercial Bank of China (ICBC) acquired Westminster Securities, a company specializing in investment banking, and established a financial holding company to continue acquiring financial service companies in Hong Kong.²⁹ Also, in 1994, the China Construction Bank (CCB) transferred its policy lending business to a

²¹ *Id.* at 158.

²² *Id.* at 160.

²³ Lin, *supra* note 12, at 18.

²⁴ Zhibo Zhang & Rong Tien, Dui Zhong Guo Jin Rong Kong Ku Gong Si De Kao Cha Han Yan Jiu [Observation and Study on Chinese Financial Holding Companies] 198 CONTEMPORARY FIN. & ECON. 24 (2001), available at http://history.bjchy.com.cn/second/lt/lt07_3.htm (last visited Oct. 27 2009).

²⁵ *Id.*

²⁶ Lin, *supra* note 12, at 18.

²⁷ *Id.*

²⁸ *Id.* at 19.

²⁹ Xie, *supra* note 11, at 155.

newly established policy bank and founded China International Capital Corporation Ltd. through joint venture with Morgan Stanley.³⁰

III. WHY IS AN EFFECTIVE SUPERVISORY SYSTEM FOR FINANCIAL CONGLOMERATES ESSENTIAL?

A. *Risks and Peculiar Supervisory Problems Associated with the Establishment of Financial Conglomerates*

Despite the array of benefits brought by the formation of financial conglomerates, various risks and supervisory difficulties are simultaneously incurred. Some of these risks already exist in various financial institutions, but are aggravated in financial conglomerates. Concurrently, new risks also appear with the formation of financial conglomerates. The following discussion tries to unveil these risks and supervisory problems.

1. Double or Multiple Gearing (Leverage)

Even though each sector of a financial conglomerate has its own regulatory capital requirement, it remains possible that capital items will be counted more than once within the group. This can happen either when a parent downstreams its capital to a subsidiary or when an entity holds regulatory capital issued by a higher group in the organization (upstreamed capital) or by an affiliate.³¹ In either case, if supervisors depend solely on unconsolidated data to assess the group capital adequacy, the capital will likely be overstated. The modern trend suggests that group-wide capital adequacy should be supervised on a consolidated basis.³² However, data consolidation in a heterogeneous financial conglomerate presents a problem. That is, regulatory inconsistency -- the balance sheets of banks, insurance companies, and securities firms, are based on disparate prudential requirements and different definitions of capital.³³ Even if the consolidation can be accomplished, huge additional costs present another obstacle. Hence, the new challenge for supervisors is to develop an effective mechanism to detect, adjust, and even eliminate double or multiple gearing.

Different definitions of capital that apply to various sectors within a given financial conglomerate can impede the availability of the capital of

³⁰ Lin, *supra* note 12, at 19.

³¹ Joint Forum of Financial conglomerates, *Supervision of Financial Conglomerates* 8 (1999), available at <http://www.bis.org/bcbs/jointforum.htm> (last visited Jan. 17, 2010) [hereinafter Supervision Report].

³² See 12 U.S.C. § 3105 and Council Directive 83/350, Supervision of Credit Institutions on a Consolidated Basis, arts.3 & 4, 1983 O.J (L 193) (EC).

³³ Iman van Lelyveld & Arnold Schilder, *Risks in Financial conglomerates: Management and Supervision* 10 (2002), available at <http://129.3.20.41/eps/fin/papers/0301/0301006.pdf> (last visited Jan. 17, 2010).

one entity to another. Since each entity within the financial conglomerate bears different risks, it is necessary to match capital requirements to the corresponding risks. Thus, ensuring that the capital surplus of one entity can be used to cover the risks of another entity within the same conglomerate has become an issue. In other words, the creation of a cross-sector comparison technique to determine the risks of each sector and distinguish transferable capital from non-transferable capital is another task facing financial regulators.³⁴

When assessing group-wide capital adequacy, two questions must be asked: (1) to what extent should a part owner be held responsible for risks in partially-owned subsidiaries; and (2) how much, if any, excess capital in a partially-owned subsidiary can be attributed to the partial-owner? There are two views of these questions — “full integration” and “integration on a pro-rata basis”. The former asserts that a controlling interest gives the parent company responsibility for the risks run by its subsidiaries that goes further than the mere proportion of capital it has contributed and would, in many cases, extend to the totality of the risks.³⁵ The latter argues that “full integration” is improper because surpluses in subsidiaries are not always attributable or transferable to the parent and this could exaggerate the safety and soundness of the group.³⁶ An optimal legal system for the supervision of financial conglomerates must address this highly contentious issue.

2. Risk Concentration

Risk concentration occurs when different entities within a conglomerate are exposed to the same or similar risk factors, or to apparently unrelated risk factors that interact under stressful circumstances.³⁷ Since risk concentration can occur in a financial conglomerate’s assets, liabilities, or off-balance sheet items, through the execution or processing of transactions, or through a combination of exposures across these broad categories, failure to manage it can lead to systematic risk.³⁸ Thus, ensuring that conglomerates have an adequate risk management process to manage group-wide risk concentrations, both the creation of a system to monitor material risk concentration on a timely

³⁴ For details, see Howell Jackson & Cameron Half, *Evolving Trends in the Supervision of Financial Conglomerates* 9-12 (2002) (unpublished manuscript, on file with author), available at www.law.harvard.edu/faculty/hjackson/pdfs/2002.Jackson.Half.Evolving.Trends.pdf.

³⁵ Tripartite Group, *supra* note 3, at 50.

³⁶ *Id.* at 51.

³⁷ Joint Forum of Financial Conglomerates, *Risk Concentration Principles* 2 (1999).

³⁸ *Id.*

basis and statutory control of risk concentration, are significant issues here.

There are currently some laws and regulations in developed countries which do address a few of the above issues. Details of these laws and regulations will be discussed in the later parts of this paper. Section 23A and 23B of the Federal Reserve Act in the United States, for instance, establishes both quality and quantity restrictions on affiliate lending.³⁹ Similar legislation exists in the European Union.⁴⁰ However, the existing legislation contains some loopholes. For example, in a financial holding company system, the restrictions of Sections 23A and 23B can be avoided when a subsidiary bank up-streams capital in the form of dividends to its parent holding company and the holding company, and then down-streams that capital to non-banking subsidiaries within the same group. Therefore, it is extremely important to set up a mechanism which enables supervisors to deal with material risk concentration.

3. Risk Contagion

Risk contagion, probably the most significant problem associated with the formation of a financial conglomerate, is the risk that financial difficulties suffered by a conglomerate's individual entity will have an adverse impact on the financial stability of the entire group or the markets in which the constituent parts operate.⁴¹ Risk contagion can be due to a direct financial connection between a problematic entity and a healthy one. An even worse scenario is: if the troubled entities can expect support when needed, a moral hazard problem arises, as they could be tempted to take on more risk than they would otherwise have done.⁴² Even in the absence of a direct financial connection, it can occur as a reflection of the public's confidence in the stability of an individual entity, or the conglomerate as a whole, because the public tends to view financial conglomerates as a single economic unit.⁴³ Either situation gives regulators a new problem to tackle. At least three issues are posed by risk contagion: (1) how to erect a firewall between different entities of a financial conglomerate so as to limit financial connections and prevent financial difficulties of one entity from adversely affecting another; (2) how to enhance market discipline to encourage public disclosure for the

³⁹ For details, see 12 U.S.C. §§ 371c & 371c-1 (2006).

⁴⁰ See Council Directive 92/121, Monitoring and Control of Large Exposures of Credit Institutions, arts. 3(1)-(3), 4, 1993 O.J. (L 29) (EC).

⁴¹ Tripartite Group, *supra* note 3, at 18.

⁴² Van Lelyveld & Schilder, *supra* note 33, at 11.

⁴³ L. VAN DEN BERGHE & K. VERWEIRE, CREATING THE FUTURE OF ALL FINANCE AND FINANCIAL CONGLOMERATES 161 (Springer 1998). See also Kazuhiko Koguchi, *Financial Conglomerates*, in FINANCIAL CONGLOMERATES 31 (OECD ed. 1993).

purpose of strengthening public confidence; and (3) to what extent must the official safety net be extended to address the financial problems specific to conglomerates that encompass banking sectors?

4. Intra-group Transaction and Exposure

Although intra-group transaction and risk transfer increase the efficiency of risk management among different entities within a conglomerate and thereby generate profit maximization, improvements in risk management, and the effective use of capital and funding,⁴⁴ the attendant financial interaction among sectors can cause risk contagion and the underestimation of risks. For example, securitization helps banks reduce their liquidity risks by transferring loans to securities firms to issue asset-backed securities within the same group. However, if, due to marketability, banks transfer high-rating loans and retain low-rating loans, the credit risk may collaterally increase. Also, if a securities firm takes exceedingly high risks from the bank without regard to whether it has adequate capital to cover the transferred risk, it can become undercapitalized. But how is the line drawn between permissible and impermissible risk transfers? In other words, the regulators must ensure that the transferee has sufficient capital to offset risks from the transferor, and be able to unveil transactions that are likely to adversely affect the solvency, liquidity, and profitability of individual entities within a group. It is the regulators' task to weigh the benefits and risks. Supervisory instruments must be designed to permit intra-group transaction and risk transfer, while accurately estimating group-wide risks and controlling risk contagion.

5. Conflicts of Interests

Conflicts of interest can occur both externally and internally. The former is sometimes recognized as the "principal-agent risk", which occurs when a financial institution offers a service that is beneficial to itself, but not necessarily to the customer.⁴⁵ It also occurs when financial conglomerates carry out activities involving two different groups of customers.⁴⁶ A common example of this is when a bank obtains information from its securities affiliate that the price of a certain security held by the affiliate is likely to fall. To help its affiliate dispose of this security, the bank then induces its customers to purchase it. A general truism: the broader the financial conglomerate's variety of products, the

⁴⁴ Joint Forum of Financial Conglomerates, *Intra-Group Transaction and Exposures Principles 2* (1999) [hereinafter *Intra-group Transactions and Exposures Principles*].

⁴⁵ FREDERIC S. MISHKIN, FINANCIAL MARKETS AND INSTITUTIONS 401 (3rd ed. 1999).

⁴⁶ Koguchi, *supra* note 43, at 29.

greater the possibility that conflict of interests may appear. “Because conglomerates are involved in a wider range of transactions, they have a wider range of information. Although this may be an important source of economies of scope, it may also be the source of abuse if the conglomerates make use of the information to exploit the ignorance of counterparties.”⁴⁷ The latter arises when internal units struggle with one another for market share or cross-subsidization. When this happens, make-or-buy decisions do not follow competitive market conditions and/or resources are not allocated in the most effective manner.⁴⁸ How regulators prevent these problems and protect retail investors is important. As such, the following questions must be considered when permitting the establishment of financial conglomerates: (1) how is the asymmetry of information between financial conglomerates and their customers alleviated, and how does this alleviation establish a mechanism to enhance the disclosure of potential conflicts of interests? (2) how is a complaint procedure created for consumers whose interests are “sacrificed” by a financial institution’s decision in a conflict of interest? (3) how can a “Chinese Wall” be put into place to prevent the flow of sensitive and confidential information?

6. Non-Transparency of Legal and Managerial Structure

Since financial conglomerates operate within a complex corporate, organizational and functional structure, supervision is often severely hampered. If supervisors and regulators do not fully understand the legal and managerial structure of a financial conglomerate, they will be unable to properly assess either the complete risk profile that the conglomerate faces or the risks that other group companies pose for the regulated firm.⁴⁹ Because of the regulatory arbitrage, a proper assessment of aggregate risk exposure via existing systems of internal and external controls can be extremely difficult.⁵⁰ Further, non-transparency can lead to a greater chance of fraudulent actions and insider trading. Accordingly, designing an effective method to pierce a financial conglomerate’s structure is a crucial regulatory issue.

B. *Specific Reasons For Erecting A Specialized Supervisory System For Financial Conglomerates.*

General reasons for regulating financial institutions, such as prevention of solvency, prevention of systematic disruptions, prevention of uncompetitive practice, enhancing redistributive norms and other

⁴⁷ Herring, Richard J. & Anthony M. Santomero, *The Corporate Structure of Financial Conglomerates*, 4 J. FIN. SERVICES RES. 4, 213, 227 (1990).

⁴⁸ VAN DEN BERGHE & VERWEIRE, *supra* note 43, at 163.

⁴⁹ Tripartite Group, *supra* note 3, at 28.

⁵⁰ Koguchi, *supra* note 43, at 33.

political economy reasons,⁵¹ naturally constitute reason for supervising financial conglomerates. This paper will focus only on particular reasons for erecting a specialized supervisory system for financial conglomerates.

As mentioned above, the formation of financial conglomerates not only exacerbate some risks inherent in respective financial institutions, but also create new categories of risk as well as supervisory difficulties. In other words, exposures may emerge due to the mixing of the traditionally separate market risks related to banking, securities, insurance activities, and, more specifically, form the creation of new relationships or dependencies, which may result in the danger of risk contagion and possible systemic or market collapse.⁵² Therefore, any new or aggravated forms of risk adhere to the formation of financial conglomerates in domestic or international markets and must be properly identified and assessed to allow all necessary corrective action to be taken.⁵³ The problem is that solo supervisors in the different sectors are inclined to have highly particularized supervisory concerns and approaches, and may not be adjusted to the risks and dangers which are inherent in other types of regulated activities.⁵⁴ Complicating the issue, they also have little or no control over unregulated activities.⁵⁵ Besides, since each entity or business line is supervised on an independent basis, each of these individual sector supervisors may lack a thorough understanding of the conglomerate as a whole.⁵⁶

The Joint Forum recently published a study of conglomerate risks and supervision of banking, securities, and insurance supervisors, and identified key similarities and differences in the approaches of supervisors across sectors.⁵⁷ The conglomerate is engaged in a range of activities that may be different in nature and risk profile. Banks, securities firms, and insurance companies all face distinguishing risks in their business operations, and respond to these risks in different manners.⁵⁸ Reflecting these differences in the nature of respective risks, regulators in each sector

⁵¹ For details of these reasons, see Howell Jackson, *The Regulation of Financial Holding Companies – Entry for New Palgrave Dictionary of Law and Economics*, 2-5 (1997), available at http://lsr.nellco.org/cgi/viewcontent.cgi?article=1009&context=harvard_olin.

⁵² GEORGE A. WALKER, *INTERNATIONAL BANKING REGULATION – LAW, POLICY AND PRACTICE* 176 (2001).

⁵³ *Id.*

⁵⁴ Jackson & Half, *supra* note 34, at 8.

⁵⁵ *Id.*

⁵⁶ *Id.* at 19.

⁵⁷ Joint Forum, *Risk Management Practice and Regulatory Capital: Cross-Sectoral Comparison* (2001) [hereinafter Cross-Sectoral Comparison].

⁵⁸ Jackson & Half, *supra* note 34, at 11.

adopt varying definitions of permissible capital.⁵⁹ Accounting rules may vary across jurisdictions to respond to factors such as the time horizons of associated risks, differences in asset class definitions, and differentials in tax treatment.⁶⁰ The role, definition, and purpose of allowable capital also vary across sectors. For securities firms, capital serves as a buffer against losses from market, operational, and credit risks; for banks, capital serves as a buffer principally against credit losses; and for insurance firms, it serves as the provision for paying potential claims.⁶¹ Definitions of eligible core capital also differ due to diversifying definitions of equity and qualifying capital, the treatment of reserves, and certain liabilities.⁶² Differences in calculation methodologies further complicate the situation, for example accounting for differences in the asset quality, liquidity, and other objectives.⁶³ Current capital requirements differ in their scope of application and consolidation; banking capital is generally calculated on a consolidated basis, whereas insurance is calculated on a solo basis.⁶⁴ Last, application of capital requirements may vary greatly across sectors, due to a combination of market, formal and informal supervisory pressures and incentives.⁶⁵

Similar to differences in dealing with capitals, different regulators have diversified concerns on supervision policy. Banking supervisors have historically perceived close linkages between banking and the overall macroeconomic environment, and thus typically emphasize overall systemic stability and soundness.⁶⁶ This emphasis means bank regulators are more concerned about potential contagion from non-banking to banking activities, particularly within a single conglomerate structure.⁶⁷ Potential public-sector liabilities and/or support through a deposit insurance system may heighten these concerns.⁶⁸ In contrast to the approach of banking supervisors, securities supervisors tend to be concerned primarily with the firm's liquidity, in order to respond to rapid and short-term financial flows and changing market conditions.⁶⁹ Thus,

⁵⁹ *Id.*

⁶⁰ Cross-Sectoral Comparison, *supra* note 57, at 47.

⁶¹ *Id.* at 47-48.

⁶² *Id.* at 49-50.

⁶³ *Id.* at 50-51.

⁶⁴ *Id.* at 51.

⁶⁵ *Id.* at 52-53.

⁶⁶ *Id.* at 38.

⁶⁷ *Id.* at 41.

⁶⁸ Jackson & Half, *supra* note 34, at 12.

⁶⁹ *Id.*

securities supervisors emphasize background factors such as market and operating processes and trading and settlement concerns, all of which may have an adverse impact on the firm's liquidity.⁷⁰ Insurance supervisors concentrate their efforts on the possibility that disclosure of difficulties in individual companies or of regulatory action may adversely impact confidence in the overall sector.⁷¹ Given that the systemic risks are often perceived to be relatively limited, prudential regulation, though not irrelevant in the insurance sector, receives far less attention than in banking; the primary concern is policyholder protection.⁷²

Meanwhile, the Joint Forum recently found common concerns regarding customer protection and systemic stability across all three sectors.⁷³ Given that systemic stability is the common concern across all sectors, there is a need for a system designed specifically to counter the above-mentioned differences in order to effectively supervise financial conglomerates. This is the reason the Conglomerate Directive of the European Union and the Gramm-Leach-Bliley Act of the United States are promulgated – to provide legitimate accordance for the exercise of supplementary supervision alongside existing solo-basis financial regulations. Both legislations stress the certain extent of information sharing and coordination among regulators.⁷⁴ The demand for coordination among regulators further raise the issue on whether to restructure regulators, namely, to establish a single unified regulator for the purpose of facilitating the effectiveness of supplementary supervision. Advocates of the unified regulator system assert that separate regulators cannot easily detect group-wide risk, as they only have oversight jurisdiction over a given portion of a diversified conglomerate. Also, the unified regulator's arrangements are more flexible than those of separate specialist regulators. Finally, unification can result in cost savings due to a shared infrastructure, administration, and support system. Unification advocates further allege that (1) the effectiveness of separate regulators may be impeded by "turf wars" or a desire to "pass the buck"⁷⁵ in that

⁷⁰ Cross-Sectoral Comparison, *supra* note 57, at 51.

⁷¹ *Id.* at 50.

⁷² Jackson & Half, *supra* note 34, at 13.

⁷³ Cross-Sectoral Comparison, *supra* note 57, at 58.

⁷⁴ See Council Directive 2002/87, Supplementary Supervision of Credit Institutions, Insurance Undertakings and Investment Firms in a Financial Conglomerate, 2003 O.J. (L 35) 1 (EC) and amending Council Directives 73/239/EEC, 79/267/EEC, 92/49/EEC, 92/96/EEC, 93/6/EEC and 93/22/EEC, and Directives 98/78/EC and 2000/12, arts. 11 & 12, 2002 O.J. (L 035) (EC); 12 U.S.C. § 1828 (1999). Details of both legislation will be discussed in later part of this paper.

⁷⁵ Richard K. Abrams & Michael Taylor, *Assessing the Case for Unified Financial Sector Supervision* 13-15 (Jul. 6, 2001) (unpublished conference manuscript in Risk Management and Insurance International Conference, Taipei, 2001).

there is likely to be an overlap of supervisory authority, responsibilities, and skills; (2) different agencies may not share common objectives;⁷⁶ and (3) maintaining multiple agencies is not cost-effective. On the other hand, opponents of a unified regulator system contend that unified regulators do not strike an appropriate balance among the different objectives of regulation. Given the diversity of these objectives, a single regulator may not have a clear understanding of the various goals and rationales or be able to adequately differentiate among institutions. Also, having a unified regulator may be more inefficient, as it is usually associated with a monopoly and tends to be quite bureaucratic, which can eliminate healthy regulatory competition.⁷⁷ Lastly, merging existing agencies, or creating new ones, requires political agreement among government agencies,⁷⁸ which is not easily attained. Advocates proffer that the "separate specialist regulator" has stronger expertise on each regulated business and is capable of facilitating healthy competition among regulators; thus necessarily elevating its status as a more preferable model⁷⁹.

IV. CURRENT FINANCIAL REGULATIONS REGARDING SUPERVISION OF FINANCIAL CONGLOMERATES IN CHINA

Laws and regulations specifically addressing issues related to the supervision of financial conglomerates do not exist regardless of the actual existence of financial conglomerates in China. Present financial laws and regulations are formulated on a sectoral basis under which bank, insurance companies and securities firms are subject to the regulation of different groups of laws and to the supervision of different government agencies. The following observations aim to discover instruments included in respective areas of financial laws and regulations that may be utilized to counter the supervisory problems caused by financial conglomerates.

A. *Banking Laws & Regulations*

Authority to supervise commercial banks in China, as mentioned above, once belonged to the People's Bank of China, but later was surrendered to the newly established CBRC. These commercial banks are required to abide by established ratios between assets and liabilities. One of these ratios is the lending limit to a single borrower. The Law of Commercial Banks provides that the "ratio between the balance of the loan of one borrower and the balance of the capital of the commercial bank

⁷⁶ DAVID SCOTT, THE REGULATION AND SUPERVISION OF DOMESTIC FINANCIAL CONGLOMERATES, 15 (1994).

⁷⁷ Abrams & Taylor, *supra* note 75, at 21-24.

⁷⁸ *Id.*

⁷⁹ *Id.* at 24.

must not exceed 10 percent.”⁸⁰ Except for this lending limit, no current articles in the Law of Commercial Banks discuss the capabilities of preventing risk concentration and contagion within financial conglomerates because, in principle, commercial banks are prohibited from investing in nonbank entities and are not allowed to engage in any securities or trust business.⁸¹ However, these prohibitions will not apply if otherwise provided by the central government.⁸² This exception has allowed the privileged Big Four to expand their scope of business without obstacle. Besides the Law of Commercial Banks itself, the “Guidelines on the Management of Risks in Commercial Banks’ Lending to Business Group Customers” also provides commercial banks with measures to manage the large exposure in credit extension to a business group customer. The guidelines allow the banks to resort to syndicate loans, loan participation, loan sales or other measures to diversify the risk on the occasion that the credit need of a business group customer exceeds the commercial bank’s risk tolerance.⁸³ Pursuant to the guidelines, the “risk tolerance” reaches the ceiling either where the total credit lent to a single business group customer by a commercial bank exceeds 15 percent of the bank’s total capital, or any other situation where the bank feels incapable of tolerating the risks arising in the credit extension.⁸⁴

As capital of a single financial institution serves as a buffer to mitigate the risk the financial institution encounters, capital adequacy requirement in respective financial regulations provides a mechanism for financial institutions to cope with risks at the institutional level instead of allowing the risk spread to other institutions in the group. After all, systems designed to access the group capital adequacy of financial conglomerates only plays a complementary role and does not diminish the need for the establishment of a solo capital requirement for individually regulated financial business.⁸⁵ The Law of Commercial Banks provides two mechanisms on capital requirement – the minimum registered capital and requirement on related asset-liability ratio. For incorporation of a commercial bank, the minimum registered capital required is \$125 million (RMB 1 billion), while the minimum registered capital for urban co-operative commercial banks and rural co-operative commercial banks are respectively \$12.5 million (RMB \$100 million) and \$6.25 million (RMB

⁸⁰ The Law of Commercial Banks of People’s Republic of China, art. 39(4) (2003).

⁸¹ *Id.* art. 43.

⁸² *Id.*

⁸³ Guidelines on the Management of Risks in Commercial Banks’ Lending to Business Group Customers, art. 12 (2003).

⁸⁴ *Id.*

⁸⁵ The Supervision Report, *supra* note 31, at 8.

50 million).⁸⁶ Meanwhile, the capital sufficiency rate of a commercial bank must not be less than 8 percent; the ratio between the balance of loans and the balance of deposits must not exceed 75 percent; and the ratio between the balance of circulating assets and the balance of circulating liabilities must not be lower than 25 percent.⁸⁷ The “Regulation Governing Capital Adequacy of Commercial Banks” further provides that “the required minimum ratios shall be no less than 8 percent for capital adequacy and 4 percent for core capital adequacy.”⁸⁸ Another breakthrough in this regulation is the mention of “consolidated supervision” which is deemed as the crucial element for the supervision of financial conglomerates. Financial institutions with 50 percent or more of their voting shares owned by the commercial bank are eligible for consolidation.⁸⁹ Besides, under certain conditions, the capital of financial institutions will also be consolidated even though the commercial bank does not own more than 50 percent of their voting share.⁹⁰

Banks’ disclosure in the areas of structure of capital, risk exposure and capital adequacy are critical to the supervision of financial institutions as well as financial conglomerates.⁹¹ Disclosure is also an important factor to the functioning of an efficient capital market, as the existence of information asymmetry results in managers of corporations being far more knowledgeable about the companies’ financial and risk situation than regulators and investors.⁹² Commercial banks in China are obliged to disclose their financial statements, risk management, corporate

⁸⁶ The Law of Commercial Banks of People's Republic of China, art. 13 (2003).

⁸⁷ *Id.* art.39.

⁸⁸ Regulation Governing Capital Adequacy of Commercial Banks, art. 7 (2004).

⁸⁹ *Id.* art. 10.

⁹⁰ *Id.* Section 2 of Article 10 provides that consolidation should include: “investments representing less than 50 percent of the voting shares of financial institutions, and meeting one of the following conditions:

- ☐ the bank owns more than 50 percent of the voting shares of financial institutions through agreements with other investors;
- ☐ the bank has the power to control the financial and operating policies of financial institutions in accordance with articles of association or agreements;
- ☐ the bank has the power to appoint and remove majority members of boards of directors or other decision making bodies of financial institutions; and
- ☐ the bank owns more than 50 percent of the controlling interest in boards of directors or other decision-making bodies of financial institutions;”

⁹¹ Basel Committee on Banking Supervision, *A New Capital Adequacy Framework: Market Discipline* 2 (2000).

⁹² JILL SOLOMON & ARIS SOLOMON, CORPORATE GOVERNANCE AND ACCOUNTABILITY 120 (2004).

governance and significant incidents of each year based on the principles of authenticity, accuracy, completeness and comparability.⁹³ The banking regulator has the authority to require banking institutions to disclose to the public, in accordance with applicable regulations, reliable information, including, among others, financial reports and statements, risk management policies and procedures, changes in the directors and senior managers and information on other significant matters.⁹⁴

Except for the provisions scattered in above laws and regulations, legislators have had no further action to promulgate specific laws addressing problems arising from the formation of financial conglomerates.

B. *Insurance Laws & Regulations*

The PRC Insurance Law also prohibits insurance companies from engaging in other financial-related businesses. The fund of the insurance company may not be used to set up securities operation organizations or to invest in enterprises.⁹⁵ Because insurance is a business that accepts risk transferred from others, Article 100 of the Insurance Law was created to prevent risk concentration. It provides that the liability for each risk unit of an insurance company – that is, the liability for the maximum possible loss caused by each insurance accident – may not exceed 10 percent of the combined total of its actual capital and accumulated fund. If there is any excess, it shall be reinsured.⁹⁶ This restriction on taking risk from a single risk unit can still be applicable even after the permission of the financial conglomerates.

As for the capital requirement of insurance companies in China, the minimum registered capital for the establishment of an insurance company is RMB 200 million (approximately 25 million U.S. dollars).⁹⁷ It is also mandated that insurance companies maintain their solvency margin at least in accordance with the minimum standard at any time.⁹⁸ That means an insurance company's solvency adequacy rate, the equation of the actual solvency margin divided by the minimum solvency margin, should not drop below 100 percent.⁹⁹ Otherwise, CIRC may rank those

⁹³ Tentative Measures on Information Disclosure of Commercial Banks, arts. 25 & 26 (2002), available at <http://fgk.chinalaw.gov.cn/article/bmgz/200205/20020500068768.shtml> (last visited Oct. 28th 2009).

⁹⁴ Law of the People's Republic of China on Banking Regulation and Supervision, art. 36 (2004).

⁹⁵ The Insurance Law of the People's Republic of China, art.105(3) (2003).

⁹⁶ *Id.* art. 100.

⁹⁷ *Id.* art.73.

⁹⁸ Regulations on Administration of Insurance Companies, art. 83 (2004).

⁹⁹ *Id.* art. 87.

companies with solvency adequacy rate below 100 percent as key objects for regulation, and accordingly adopt certain regulatory measures.¹⁰⁰ An insurance company's actual solvency margin is the balance of recognized assets minus recognized liabilities.¹⁰¹ The confirmation, computation, and reporting of recognized assets and liabilities must comply with the relevant regulations of CIRC.¹⁰²

A disclosure requirement is similarly imposed on insurance companies. An insurance institution must submit timely business operation reports, actuarial reports, financial accounting reports, solvency reports, and relevant regulatory reports and statements, according to regulations.¹⁰³

Overall, insurance laws and regulations are made on a standalone basis in which the possibility of their utilization for the supervision of financial conglomerates never was considered at the time of promulgation.

C. *Securities Laws & Regulations*

Securities firms in China are supervised by two regulators: the securities regulatory body and the state auditing organ. The securities regulatory body under the State Council is responsible for centralizing and unifying the supervision and administration of all stock markets in the nation. The state auditing organ supervises by auditing the accounts of stock exchanges, securities companies, securities registration and settlement organizations, and securities supervision and administration organizations.¹⁰⁴

To prevent conflicts of interest, banks are prohibited from investing funds in the securities market.¹⁰⁵ In addition, when carrying out business on its own account, a securities company shall use its self-owned funds and funds raised according to law, and business shall only be conducted in its own name, and may not be conducted in the name of another or in the name of an individual.¹⁰⁶ A securities company is also barred from giving any form of commitment with respect to its clients' profits from the purchase or sale of securities or compensation for losses from the purchase or sale of securities.¹⁰⁷ The most typical method in countering the conflicts of interest – the prohibition of insider trading – is

¹⁰⁰ *Id.*

¹⁰¹ *Id.* art.84.

¹⁰² *Id.*

¹⁰³ *Id.* art. 94.

¹⁰⁴ The Securities Law of the People's Republic of China, arts. 7 & 9 (2005).

¹⁰⁵ *Id.* art. 133.

¹⁰⁶ *Id.* arts. 133 & 134.

¹⁰⁷ *Id.* art. 143.

also provided in Articles 73 to 76 of the Securities Law.¹⁰⁸ Last but not least, it is required that securities firms devise a complete internal control system and adopt effective methods of segregation so as to prevent the conflicts of interests between the firm and customers or between different customers.¹⁰⁹

The tool provided by the Securities Law to deal with the risk concentration and risk contagion problems completely insulates securities firms, insurance companies, and banks from one another. Article 6 of the Securities Law provides that securities firms, banks, trust firms, and insurance agencies shall operate separately and be administered separately, and securities firms, banks, trust firms, and insurance agencies shall be established separately.¹¹⁰

With respect to capital adequacy of securities firms, the requirement on minimum registered capital is 50 million RMB for the brokerage firm, 100 million RMB for the underwriting firm and 500 million RMB for the comprehensive firm.¹¹¹ To mitigate market risk, operation risk and other risk, the Securities Law also provides that, “[t]he total amount of external liabilities of a securities company may not exceed the prescribed multiple of its net assets, and the total amount of its current liabilities may not exceed a certain proportion of its total current assets.”¹¹² The specific multiple, proportion and administrative measures shall be prescribed by the securities regulatory authority under the State Council.¹¹³

Likewise, supervision mechanisms in the Securities Law provide only limited help to the supervision of financial conglomerates.

D. *Structure of Regulators*

The current structure of financial regulators in China adopts the “separate specialist regulator” system. Three major types of financial services, namely banking, insurance, and securities, are supervised by different regulatory agencies on a solo basis. Commercial banks and trust companies are supervised by the CBRC while insurance companies are subject to the supervision of CIRC. Finally, the CSRC supervises securities firms.

¹⁰⁸ For details, see The Securities Law of the People's Republic of China, arts. 73 - 76 (2005).

¹⁰⁹ *Id.* art. 136.

¹¹⁰ *Id.* art. 6.

¹¹¹ *Id.* art. 127.

¹¹² *Id.* art.30.

¹¹³ *Id.*

E. Critiques

Because financial conglomerates, pursuant to the definition above¹¹⁴, comprise at least two different types of financial services, they will present supervisory challenges to countries like China that adopt solo supervisions, in which each sector or type of financial service is supervised by respective authorities on an independent basis. These individual sector supervisors each may lack an comprehensive understanding of the conglomerates as a whole.¹¹⁵ In other words, despite possessing thorough knowledge regarding the risks of one particular entity, a supervisor may nonetheless be ignorant on another entity within the same group or the parent company.¹¹⁶ Even though the specific supervisor does perceive the risk profile of the entire conglomerate, the supervisor still may be restrained to take any action due to lack of rights to access to prudential information on other parts of the conglomerate which it does not supervise.¹¹⁷ One supervisor may have access to information regarding intra-group transactions or other critical factors of group risk concentration that is essential for the performance of supervision by another, but the information may be wasted if the supervisor in need has no access to such information.¹¹⁸ As a result, identifying threats or risks to regulated entities or groups as a whole becomes extremely difficult or impossible unless information sharing mechanisms and other coordination methods exist. Currently, this is what Chinese financial supervisors lack. Therefore, to ensure effective supervision, financial supervision authorities in China must at least have adequate powers to share prudential information, in particular, intra-group exposure.¹¹⁹ This goal can be achieved through the establishment of a system of information sharing and coordination among supervisors.

It is an undeniable fact that, in China, financial conglomerates have already existed in many different forms, including “mixed conglomerates”. Mixed conglomerates are defined as “those groups which are predominantly commercially or industrially oriented, but contain at least one regulated financial entity in some part of their corporate structure.”¹²⁰ Typically, parent companies of mixed conglomerates are industrial or commercial with the regulated financial entities embedded

¹¹⁴ See *supra* Part I.

¹¹⁵ Jackson & Half, *supra* note 34, at 19.

¹¹⁶ *Id.*

¹¹⁷ Tripartite Group, *supra* note 3, at 31.

¹¹⁸ Jackson & Half, *supra* note 34, at 19.

¹¹⁹ WALKER, *supra* note 52, at 192.

¹²⁰ Tripartite Group, *supra* note 3, at 36.

downstream in the group structure.¹²¹ With such structure, supervisors encounter obstacles in assessing group capital adequacy as it is legally and practically impossible to include the capital of commercial or industrial parents and evaluate the group as a whole. Similarly, situations like harmful intra-group exposure and risk contagion, either financial or reputational, become uneasy to detect in mixed conglomerates. For this matter, legislation may either completely prohibit the mixed conglomerate or, as a least drastic alternative, add the requirement of legal and organizational separation. To date, neither of these measures has been codified anywhere in Chinese financial laws and regulations. In the short term, it is necessary for the Chinese central government and financial supervisors, either through law-making or administrative regulation, to establish a mechanism to ensure that the intra-group transaction, if there is any, within a mixed financial conglomerate can proceed at an “arms-length” basis and to assess whether the transaction is likely to cause any adverse effect to the regulated financial institution.¹²² In the long term, the Chinese government must thoroughly review the policy regarding mixed conglomerates to determine whether supervisors can afford the continuous existence and growth of mixed conglomerates.

Existing laws and regulations concerning the supervision of financial conglomerates are apparently insufficient. Since current laws and regulations of financial supervision are generally distinguished in accordance with categories and segregations of different financial services, namely banking, insurance and securities, even though some articles in some laws and regulations may be helpful in dealing with supervisory issues incurred by financial conglomerates, their function is questionable. The Law of the People’s Republic of China on Banking Regulation and Supervision, for instance, obligate CBRC to regulate and supervise banking institutions on a consolidated basis.¹²³ The law, nevertheless, does not specify how the consolidated supervision should be performed; neither does it provide any instruction on the extent of consolidation, which involves the legitimacy to consolidate institutions regulated by financial regulators other than CBRC. Other than those limited number of articles, China currently lacks a systemic legal framework that addresses risks and supervisory issues that concern the international community regarding the conglomeration of financial services. As various types of financial conglomerates have already operated in China, it is predicable that supervisory problems will start emerging in the near future. Even high-level government officials have perceived the trend and are urging lawmakers to make laws to define the

¹²¹ *Id.*

¹²² *Id.* at 37.

¹²³ The Law of the People’s Republic of China on Banking Regulation and Supervision, art. 25 (2004).

legal corporate structure of financial conglomerates, to distinguish permissible from prohibited activities, to promote disclosure, to minimize conglomerates' risk, to compute group capital adequacy and to establish coordination mechanism among regulators.¹²⁴ The demand for a legal framework specially designed for the supervision of financial conglomerates to complement the insufficiencies of current laws and regulations seems to be unavoidable.

V. EXTRACTING EXPERIENCES (1) -- LAWS AND REGULATIONS
REGARDING THE SUPERVISION OF FINANCIAL CONGLOMERATES FROM
THE UNITED STATES AND EUROPEAN UNION

This paper selects for consideration and discussion regulatory systems of countries that represent different styles of financial conglomerates and divergent methods of regulation. The selected countries are the United States and the members of the European Union (EU).

This thesis has selected the United States, because it recently enacted the Gramm-Leach-Bliley Act, which designated the Federal Reserve Board as the umbrella supervisor of financial holding companies, while sectoral supervisors still retain their role as functional supervisors. It is also representative of the financial-holding-company type of financial conglomerates. The Council Directives of the EU will also be discussed, particularly because it has thoroughly addressed supervisory issues regarding financial conglomerates, such as consolidated supervision, double gearing, risk concentration and exposure, and information sharing.

A. *The United States*

Before the enactment of the Gramm-Leach-Bliley Act (GLBA) in the United States, there were no laws or regulations designed particularly for the supervision of financial conglomerates because securities firms and insurance companies were not permitted to affiliate with banks. However, some laws and regulations promulgated before the GLBA – for example, Section 23A and 23B of the Federal Reserve Act and the Glass-Steagall Act – were often referred to as the "Chinese Wall" because they prevented the risk concentration and risk contagion problems. After the enactment of GLBA in November 1999, barriers between banking and securities created by the Glass-Steagall Act were lowered by allowing banks, insurance companies, and securities underwriters to affiliate.¹²⁵ The

¹²⁴ Xia, *supra* note 9, at 9. Mr. Xia Bin is the director of Financial Research Center of State Council.

¹²⁵ See generally Robert W. Dixon, *The Gramm-Leach-Bliley Financial Modernization Act: Why Reform In The Financial Services Industry Was Necessary And The Act's Projected Effects On Community Banking*, 49 *DRAKE L. REV.* 671 (2001).

GLBA also comprehensively restructures the U.S. statutory framework governing the banking and financial service industry.¹²⁶ It grants the Federal Reserve Board the plenary authority of "umbrella supervision," as opposed to other regulators, namely the functional regulators including securities regulators and state insurance regulators, who are granted their authority on the basis of the nature of the activity they perform.¹²⁷ Important laws and regulations prior to the GLBA and regulatory changes in GLBA will be addressed in the following paragraphs.

1. Restrictions on Affiliate Transactions

Given that intra-group transactions can facilitate the synergies within different parts of the conglomerate and thereby lead to healthy cost efficiencies, improvements to risk management, and more effective control of capital and funding,¹²⁸ its regulation has to balance the benefits and risks of intra-group transactions. Hence, pursuant to Section 23A of the Federal Reserve Act (hereinafter Section 23A), particular types of transactions, namely the covered transactions, are permitted under restricted circumstances. These covered transactions are:

- (A) A loan or extension of credit to the affiliate;
- (B) A purchase of or an investment in securities issued by the affiliate;
- (C) A purchase of assets, including assets subject to an agreement to repurchase, from the affiliate, except such purchase of real and personal property as may be specifically exempted by the Board by order or regulation;
- (D) The acceptance of securities issued by the affiliate as collateral security for a loan or extension of credit to any person or company; or
- (E) The issuance of a guarantee, acceptance, or letter of credit, including an endorsement or standby letter of credit, on behalf of an affiliate.¹²⁹

A bank and its subsidiaries are permitted to engage in a covered transaction with an affiliate only if (a) the aggregate amount of covered transactions with a single affiliate do not exceed 10 percent of the capital

¹²⁶ Joseph J. Norton et. al., *Financial Service Modernization in the U.S. and the Gramm-Leach-Bliley Act of 1999*, 1 (Jul 6, 2001) (unpublished manuscript, on file with Dept. of Risk Mgmt. & Ins., National Chengchi Univ. in Taiwan) [hereinafter Norton].

¹²⁷ Kuan-Chun Chang, *The Supervision Of Financial Conglomerates In China In The Post WTO Era-- The Challenges Of Risk Concentration And Risk Contagion* 11 U. MIAMI INT'L & COMP. L. REV. 1, 12 (2003).

¹²⁸ *Intra-group Transactions and Exposures Principles*, *supra* note 44, at 1.

¹²⁹ 12 U.S.C. § 371c(b)(7) (2006).

stock and surplus of the member bank; and (b) the aggregate amount of covered transactions with all affiliates do not exceed 20 percent of the capital stock and surplus of the member bank.¹³⁰ In order to identify the value of these covered transactions, Federal Reserve Board's Regulation W provides clear and detailed guidelines for, and timing and valuation of, different types of covered transactions.¹³¹ In addition, considering the character of affiliate transactions, Sections 23A and 23B both provide that any transaction by a bank with any person shall be considered as a transaction with an affiliate to the extent that the proceeds of the transaction are used for the benefit of, or transferred to, that affiliate.¹³² However, if "the proceeds of the extension of credit are used to purchase an asset through an affiliate of the member bank, and the affiliate is acting exclusively as an agent or broker in the transaction, and the asset purchased by the non-affiliate is not issued, underwritten, or sold as principal by any affiliate of the member bank", an extension of credit by the bank to a non-affiliate must be treated as an extension of credit to an affiliate.¹³³ In addition, for safety and soundness concerns, a member and its subsidiaries are prohibited from purchasing a low-quality asset from an affiliate unless the bank or subsidiary, based on an independent credit evaluation, committed itself to purchase the asset prior to the time it was acquired by the affiliate.¹³⁴

Further, for preventing non-arms-length transactions between the bank or its subsidiaries and affiliates, Section 23B of Federal Reserve Act requires transactions to proceed under terms and circumstances, including credit standards, that are substantially the same, or at least as favorable to such bank or its subsidiary, as those prevailing at the time for comparable transactions with or involving other nonaffiliated companies; or in the absence of comparable transactions, on terms and under circumstances, including credit standards, that in good faith would be offered to, or would apply to, nonaffiliated companies.¹³⁵ This section not only applies to the covered transactions discussed above, but also applies to transactions involving:

- (A) The sale of securities or other assets to an affiliate, including assets subject to an agreement to repurchase;
- (B) The payment of money or the furnishing of services to

¹³⁰ 12 U.S.C. § 371c(a)(1).

¹³¹ See 12 C.F.R. §§ 223.22 - 223.24 (2003).

¹³² 12 U.S.C. § 371c(a)(2); 12 U.S.C. § 371c-1(a)(3)

¹³³ 12 C.F.R. § 223.16(b).

¹³⁴ 12 U.S.C. § 371c(a)(3).

¹³⁵ 12 U.S.C. § 371c-1(a)(1)(A).

an affiliate under contract, lease, or otherwise;

(C) An affiliate acts as an agent or broker or receives a fee for its services to the bank or to any other person;

(D) Any transaction or series of transactions with a third party—(i) if an affiliate has a financial interest in the third party, or (ii) if an affiliate is a participant in such transaction or series of transactions.¹³⁶

In the event a bank or its subsidiary extends credit or provides guarantees to its affiliates in any form, stringent requirements on collateral are imposed. Each loan or extension of credit to, or guarantee, acceptance, or letter of credit issued on behalf of, an affiliate by a bank or its subsidiary shall, at the time of the transaction, be paired with collateral with the market value equal to 100 percent of the amount of such loan or extension of credit, guarantee, acceptance, or letter of credit, if the collateral involves “(i) obligations of the United States or its agencies; (ii) obligations fully guaranteed by the United States or its agencies as to principal and interest; (iii) notes, drafts, bills of exchange or bankers’ acceptances that are eligible for rediscount or purchase by a Federal Reserve Bank; or (iv) a segregated, earmarked deposit account with the member bank.”¹³⁷ Otherwise, the market value of the collateral should, respectively equal to 110 percent, 120 percent or 130 percent of the amount of such loan or extension of credit, guarantee, acceptance, or letter of credit if the collateral is composed of obligations of any State or political subdivision of any State; (i) of other debt instruments, including receivables; or (ii) of stock, leases, or other real or personal property.¹³⁸ The percentage of the collateral is required to be maintained at anytime so if any such collateral is subsequently retired or amortized, additional eligible replacement collateral should be provided¹³⁹ except for the following transactions: (1) fully secured acceptances, (2) the used portion of certain extensions of credit, and (3) purchases of affiliate debt securities in the secondary market.¹⁴⁰ In addition, the quality and type of collateral is also stated in Section 23A – low quality assets or securities issued by the affiliates of the bank are ineligible to be the collateral.¹⁴¹

Additionally, for avoiding potential conflicts of interest and possible financial risk contagion, Section 23B explicitly bans two types of

¹³⁶ 12 U.S.C. § 371c-1(a)(2).

¹³⁷ 12 U.S.C. § 371c (c)(1)(A).

¹³⁸ 12 U.S.C. §§ 371c(c)(1)(B), (C) and (D).

¹³⁹ 12 U.S.C. § 371c(c)(2).

¹⁴⁰ 12 C.F.R. § 223.14.

¹⁴¹ 12 U.S.C. §§ 371-c(c)(3) & (4).

transactions. First, a bank or its subsidiary may not, under a fiduciary relationship, purchase any securities or other assets from any affiliate unless such purchase is permitted under the instrument creating the fiduciary relationship, by court order, or by law of the jurisdiction governing the fiduciary relationship.¹⁴² Second, a bank or its subsidiary is prohibited from, despite acting as principal or fiduciary, knowingly purchasing or otherwise acquiring, during the existence of any underwriting or selling syndicate, any security if a principal underwriter of that security is an affiliate of such bank.¹⁴³ However, the second restriction does not apply to the purchase or acquisition of such securities that have been approved, by a majority of the directors of the bank based on a determination that the purchase is a sound investment for the bank irrespective of the fact that an affiliate of the bank is a principal underwriter of the securities.¹⁴⁴

Section 23A was amended to respond to the promulgation of Gramm-Leach-Bliley Act. It mandates the financial subsidiaries of a bank to be treated as affiliates rather than ordinary subsidiaries indicated in Sections 23A and 23B.¹⁴⁵ Although transactions between a bank and its financial subsidiary are generally subject to the restrictions under Sections 23A and 23B, those transactions are exempted from certain restrictions in Section 23A. For instance, the aggregate amount of covered transactions between a bank and a single financial subsidiary is not subject to the 10 percent limit set in Section 23A(a)(1)(A).¹⁴⁶ Also, for prudential purposes, a bank's investment in a financial subsidiary of that bank shall not include retained earnings of the financial subsidiary¹⁴⁷ because any purchase of, or investment in, the securities of a financial subsidiary of a member bank by an affiliate of the member bank is treated as a purchase of or investment in such securities by the member bank.¹⁴⁸

Other than existing Sections 23A, 23B, and Regulation W, it is within the authority of the Federal Reserve Board to issue such further regulations and orders, including definitions consistent with Sections 23A and 23B, which are considered necessary to administer and carry out the purposes of restricting affiliate transactions and to prevent evasions thereof.¹⁴⁹

¹⁴² 12 U.S.C. § 371c-1(b)(1)(A).

¹⁴³ 12 U.S.C. § 371c-1(b)(1)(B).

¹⁴⁴ 12 U.S.C. § 371c-1(b)(2). *See also* 12 C.F.R. § 223.53.

¹⁴⁵ 12 U.S.C. § 371c(e)(2).

¹⁴⁶ 12 U.S.C. § 371c(e)(3)(A).

¹⁴⁷ 12 U.S.C. § 371c(e)(3)(B).

¹⁴⁸ 12 C.F.R. § 223.23(c).

¹⁴⁹ 12 U.S.C. § 371c(f).

2. The Gramm-Leach-Bliley Act

Before the enactment of the Gramm-Leach-Bliley Act ("GLBA") in 1999, there was segregation in banking between commercial banking, investment banking, and insurance companies. Under the Glass-Steagal Act of 1933, because of the 1929 market crash,¹⁵⁰ banks were prohibited from engaging in any type of investment banking.¹⁵¹ In addition, the Bank Holding Company Act of 1956 also restricted commercial banks' involvement in the insurance business.¹⁵² This was also because the authority to regulate insurance companies exclusively belonged to state regulators while banks were mostly federally regulated.¹⁵³ For more than two decades, there were active discussions and disputes among politicians, regulators (i.e. Federal Reserve Board (FRB) and Office of Comptroller of Currency (OCC)), industries and academics for reforming the U.S. financial services framework in order to make it more suitable for deregulatory, internationalizing and internal and external competitive pressures (e.g. foreign universal banks).¹⁵⁴ Finally, in November 1999, Congress settled many aspects of the 20-year long boundary disputes among financial service industries, and passed the GLBA which permits financial holding companies (FHC) to operate in banking, securities and insurance business.¹⁵⁵ GLBA also rearranges the supervisory framework for the U.S. financial industry. While the Federal Reserve Board remains the authority to supervise bank holding companies and perform the function of "umbrella supervision" over financial holding companies, under the spirit of functional regulation, insurance activities are still regulated largely by the state insurance supervisors, and securities

¹⁵⁰ The Wall Street Crash of 1929 or The Great Crash was one of the most devastating stock-market crashes in American history. The crash marked the beginning of widespread and long-lasting consequences for the United States. Though economists and historians disagree on exactly what role the crash played in the ensuing economic fallout it is widely regarded as the start of the Great Depression. The crash was also the impetus for important financial reforms and trading regulations including the subsequent promulgation of the Glass-Steagal Act.

¹⁵¹ See 12 C.F.R. § 255.85.

¹⁵² Bank Holding Company Act of 1956, Pub. L. No. 84-511, 70 Stat. 133 (codified as amended in scattered sections of 12 and 26 U.S.C.). See generally Eric Gilbert, *The Risk and Scope of The Gramm-Leach-Bliley Act*, 24 ANN. REV. BANKING & FIN. L. 61 (2005).

¹⁵³ The state's power of insurance regulation was provided in 1945 McCarran-Ferguson Act. For details, see 15 U.S.C. § 1012 (2006).

¹⁵⁴ Norton, *supra* note 126, at 1.

¹⁵⁵ WILLIAM A. LOVETT, BANKING AND FINANCIAL INSTITUTIONS LAW 197 (5th ed. 2001).

activities are mostly regulated by SEC.¹⁵⁶ The following discussions are based on GLBA's financial activities provisions and function regulation provisions as well as the parallel provisions in Federal Reserve Board's Regulation Y.

a. Election to Become a Financial Holding Company

GLBA made amendments to the Bank Holding Company Act by permitting companies qualified as bank holding companies (BHC) to elect to be a financial holding company (FHC) which may engage in, or may acquire and own shares of a company engaging in, certain activities that are prohibited to BHCs that are not FHCs.¹⁵⁷ The procedure for electing to become a FHC is set forth in Regulation Y.¹⁵⁸

In order to become a financial holding company, all depository institutions controlled by the bank holding company must be and remain well capitalized¹⁵⁹ and well managed,¹⁶⁰ and the bank holding company must have made an effective election to become a financial holding company.¹⁶¹ This election must include the filing of a written declaration with the appropriate branch of Reserve Bank, which contains the following information:

1. A statement indicating the BHC's election to be a FHC;
2. The name and head office address of the bank holding company and of each depository institution controlled by the bank holding company;
3. Certification regarding the well-capitalized status of each depository institution controlled by the BHC as of the date the

¹⁵⁶ *Id.* at 198.

¹⁵⁷ MICHAEL GRUSON, GUIDE TO THE REGULATION OF FINANCIAL HOLDING COMPANIES 10 (2002).

¹⁵⁸ See 12 C.F.R. §§ 225.81 - 225.94 (2002).

¹⁵⁹ A depository institution subsidiary of a BHC is deemed well-capitalized if it maintains a total capital to total risk-based assets ratio of at least 10 percent on a consolidated basis and Tier 1 capital to total risk-based ratio of at least 6 percent on a consolidated basis. See 12 C.F.R. § 225.2(r)(2); 12 U.S.C. § 1831o(b)(1)(A) (2000).

¹⁶⁰ A depository institution is well managed if, at the most recent inspection or examination or subsequent review by its appropriate federal banking agency, the institution received (1) at least a satisfactory composite rating and (2) at least a satisfactory rating for management, if such a rating is given. In the case of a depository institution that has not received an inspection or examination rating, a depository institution is well managed if the Board has determined, after a review of the depository institution's managerial and other resources and after consulting with the depository institution's appropriate federal and state banking agency, that the institution is well managed. See Federal Reserve Board, *Bank Holding Company Supervision Manual* sec. 3901.0 (2004) [hereinafter *BHC Supervision Manual*].

¹⁶¹ 12 C.F.R. § 225.81(b).

- BHC submits its declaration;
4. Information concerning the capital ratios as of the close of the previous quarter for all relevant capital measures for each depository institution controlled by the company on the date the company submits its declaration; and
 5. Certification of the well-managed status of each depository institution controlled by the company as of the date the company submits its declaration.¹⁶²

However, an election by a bank holding company to convert to a financial holding company shall not be effective if the Board finds that any insured depository institution controlled by the BHC has not achieved at least a rating of “satisfactory record of meeting community credit needs” under the Community Reinvestment Act¹⁶³ at the institution's most recent examination, and any depository institution controlled by the BHC is not both well capitalized and well managed.¹⁶⁴ Unless those factors incurring the ineffectiveness occurs and the Board notifies the BHC about those factors before the effective date, an election filed by a bank holding company is effective on the 31st calendar day after the date that a complete declaration was filed with the appropriate branch of Reserve Bank.¹⁶⁵

b. Financial Activities Provisions

Title I of the GLBA, which eliminates most of the restrictions laid upon the activities of banks and BHCs 66 years prior by the Glass-Steagall Act, enables qualified banks and bank holding companies, through FHC or financial subsidiary, to provide a wide variety of financial services that have been reserved for insurance companies and securities firms.¹⁶⁶

c. FHC Activities

A financial holding company is permitted to engage in any activity, and to acquire and retain the shares of any company engaged in any activity, that the Federal Reserve Board (FRB) determines to be “financial in nature or incidental to such financial activity; or is complementary to a financial activity and does not pose a substantial risk

¹⁶² 12 C.F.R. §§ 225.82(a)-(b).

¹⁶³ For details, see *BHC Supervision Manual*, *supra* note 160, sec. 3901.0.

¹⁶⁴ 12 C.F.R. § 225.82(c).

¹⁶⁵ 12 C.F.R. § 225.82(e).

¹⁶⁶ KENNETH R. BENSON ET AL., FINANCIAL SERVICE MODERNIZATION: GRAMM-LEACH-BLILEY ACT OF 1999. LAW AND EXPLANATION 31 (1999).

to the safety or soundness of depository institutions or the financial system generally.”¹⁶⁷

1) Activities that are Financial in Nature

The FRB is endowed with the authority to determine whether an activity is “financial in nature” and must consult with the Department of the Treasury regarding any proposal to make such a determination.¹⁶⁸ The FRB may only declare an activity to be “financial in nature” without objections from the Department of the Treasury.¹⁶⁹ The Department of the Treasury may also recommend that the Federal Reserve Board find that an activity is “financial in nature”.¹⁷⁰ There are four factors that FRB must consider in determining whether an activity is “financial in nature”:

1. The purposes of the Bank Holding Company Act and the Gramm-Leach-Bliley Act;
2. Changes in the marketplace in which financial holding companies compete;
3. Changes in the technology for delivering financial services; and
4. Whether the activity is necessary or appropriate to allow a financial holding company to compete effectively, to efficiently deliver information and services, and to offer customers any technological means for using financial services.¹⁷¹

The Bank Holding Company Act (BHCA) identifies the following activities as “financial in nature”:¹⁷²

1. Lending, exchanging, transferring, investing for others, or safeguarding money or securities;
2. Underwriting insurance or annuities, or acting as an insurance or annuity principal, broker or agent;
3. Providing financial or investment advice;
4. Issuing or selling instruments representing interests in pools of assets permissible for a bank to hold directly;
5. Underwriting, dealing in, or making a market in securities;
6. Engaging in any activity that the FRB has determined, before the enactment of GLBA, to be closely related to banking;
7. Engaging, in the United States, in any activity that a bank holding

¹⁶⁷ 12 U.S.C. § 1843(k)(1).

¹⁶⁸ 12 U.S.C. § 1843(k)(2)(A)(i).

¹⁶⁹ 12 U.S.C. § 1843(k)(2)(A)(ii).

¹⁷⁰ 12 U.S.C. § 1843 (k)(2)(B).

¹⁷¹ 12 U.S.C. § 1843(k)(3).

¹⁷² 12 U.S.C. § 1843(k)(4).

company may engage in outside of the United States; and the FRB has determined, to be usual in connection with the transaction of banking or other financial operations abroad;

8. Merchant banking activities; and
9. Directly or indirectly acquiring insurance portfolio companies.¹⁷³

The Federal Reserve Board is instructed to adopt rules that define certain specific activities as "financial in nature": (1) lending, exchanging, transferring, investing for others, or safeguarding financial assets other than money or securities; (2) providing any device or other instrumentality for transferring money or other financial assets; and (3) arranging, effecting, or facilitating financial transactions for the account of third parties.¹⁷⁴

A FHC that commences any "financial in nature" activity is required by the new Section 4(k) of the Bank Holding Company Act to provide written notice to the Federal Reserve Board within 30 days after commencing the activity.¹⁷⁵

A FHC may also request FRB to determine whether an activity not identified by either BHCA or Regulation Y is "financial in nature".¹⁷⁶ Such request must be in writing and contain the following information: (1) identify and define the activity sought for determination and specifically describe what the activity would involve and how the activity would be conducted; (2) explain in detail why the activity should be considered financial in nature; and (3) provide information supporting the requested determination and any other information required by the FRB relating to the proposed activity.¹⁷⁷ Normally, the FRB will endeavor to make a decision on any request within 60 days following the completion of both the consultative process with Department of Treasury and the public comment period.¹⁷⁸

2) Activities that are Incidental to Financial Activity

Regulation Y regards certain activities as "financial in nature" or "incidental to financial activity":

1. Any activities that the Board had determined, either before or after the effectiveness of GLBA, to be so closely related to banking as to be a proper incident thereto.¹⁷⁹ These

¹⁷³ See 12 U.S.C. §§ 1843(k)(4)(A)-(I).

¹⁷⁴ 12 C.F.R. § 225.86(e).

¹⁷⁵ 12 U.S.C. § 1843(k)(6)(A).

¹⁷⁶ 12 C.F.R. § 225.88(a).

¹⁷⁷ 12 C.F.R. § 225.88(b).

¹⁷⁸ 12 C.F.R. § 225.88(c).

¹⁷⁹ 12 C.F.R. §§ 225.86(a)(1) & (2).

activities include: (a) providing administrative and other services to mutual funds; (b) owning shares of a securities exchange; (c) acting as a certification authority for digital signatures and authenticating the identity of persons conducting financial and nonfinancial transactions; (d) providing employment histories to third parties for use in making credit decisions and to depository institutions and their affiliates for use in the ordinary course of business; (e) check cashing and wire transmission services; (f) in connection with offering banking services, providing notary public services, selling postage stamps and postage-paid envelopes, providing vehicle registration services, and selling public transportation tickets and tokens; and (f) real estate title abstracting.¹⁸⁰

2. Any activity that the Board has determined to be usual in connection with the transaction of banking or other financial operations abroad, which embraces: “(a) providing management consulting services, including to any person with respect to nonfinancial matters, so long as the management consulting services are advisory and do not allow the financial holding company to control the person to which the services are provided; (b) operating a travel agency in connection with financial services offered by the financial holding company or others; and (c) organizing, sponsoring, and managing a mutual fund.”¹⁸¹
3. Any activity defined to be financial in nature under sections 4(k)(4)(A) through (E), (H) and (I) of the BHC Act.¹⁸²
4. The FRB is empowered to further determine whether certain activities are incidental to financial activities. For example, it may be considered “incidental to financial service” if a subsidiary of FHC performs the role as an arranger in bringing together one or more buyers and sellers of any product or service for transactions that the parties themselves negotiate and consummate.¹⁸³

In the same way as commencing activities that are financial in nature, a FHC is obliged to notify the appropriate Reserve Bank in writing

¹⁸⁰ 12 C.F.R. §§ 225.86(a)(2)(i) - (vii).

¹⁸¹ 12 C.F.R. § 225.86(b).

¹⁸² 12 C.F.R. § 225.86(c).

¹⁸³ For details, *see* 12 C.F.R. § 225.86(d).

within 30 calendar days after commencing an activity that is incidental to financial services.¹⁸⁴

3) Activities that are Complementary to a Financial Activity

Differing from activities which are financial in nature or incidental to financial services, obtaining prior approval from the FRB on a case-by-case basis is necessary if a FHC attempts to engage in or acquire more than 5 percent of the outstanding shares of any class of voting securities of a company engaged in an activity that the financial holding company believes is complementary to a financial activity.¹⁸⁵ The request for approval must be in writing and fulfill the following requirements:

1. Identify and define the proposed complementary activity, specifically describing what the activity would involve and how the activity would be conducted;
2. Identify the financial activity for which the proposed activity would be complementary and provide detailed information sufficient to support a finding that the proposed activity should be considered complementary to the identified financial activity;
3. Describe the scope and relative size of the proposed activity as well as revenues expected to be derived from and assets associated with conducting the activity;
4. Discuss risks the activity may reasonably incur to the safety and soundness of the subsidiary depository institutions of the financial holding company and to the financial system generally;
5. Describe the potential adverse effects, including potential conflicts of interest, decreased or unfair competition, or other risks, that conducting the activity could raise, and explain the methods the FHC seeks to adopt to counteract those effects;
6. Describe the potential benefits to the public, such as greater convenience, increased competition, or gains in efficiency, that the proposal reasonably can be expected to produce; and
7. Provide any information about the financial and managerial resources of the FHC and any other information requested by the FRB.¹⁸⁶

¹⁸⁴ 12 C.F.R. § 225.87(a).

¹⁸⁵ 12 C.F.R. § 225.89(a). *See also* Gruson, *supra* note 157, at 81.

¹⁸⁶ *Id.*

After considering three regulatory factors, FRB will provide the applicant FHCs its decision in writing. These factors to be considered are: (1) whether the proposed activity is complementary to a financial activity; (2) whether the proposed activity would pose a substantial risk to the safety or soundness of depository institutions or the financial system generally; and (3) whether the proposal could be expected to produce benefits to the public that outweigh possible adverse effects.¹⁸⁷

d. Acquiring banks, Insurance Companies and Securities Firms

The GLBA effectively permits affiliation between bank holding companies, insurance companies, and securities firms, under the umbrella of a FHC.¹⁸⁸ As provided in BHCA, a FHC is permitted to acquire and retain the shares of any company engaged in any activity that the Federal Reserve Board (FRB) determines to be “financial in nature or incidental to such financial activity; or is complementary to a financial activity.”¹⁸⁹ Section 225.85 of Regulation Y further implies that any company in which the FHC made a controlling or noncontrolling investment under the authority to invest in companies engaged in financial activities must be “exclusively” engaged in financial activities.¹⁹⁰ According to Regulation Y, the exclusivity still sustains even though a company acquired or to be acquired by a FHC may engage in “activities otherwise permissible” for a financial holding company.¹⁹¹ The term “activities otherwise permissible” refers to activities other than activities that are financial in nature or incidental to financial service as provided in Section 225.86 of Regulation Y.¹⁹² Nevertheless, this exclusivity requirement is subject to some exceptions, namely the mixed acquisition and substantially engagement. A FHC is permitted to acquire more than 5 percent of the outstanding shares of any class of voting securities or control of a company that is not engaged exclusively in activities that are financial in nature, incidental to a financial activity, or otherwise permissible for the financial holding company under relevant sections of BHCA.¹⁹³ Besides, it is permissible for a FHC to acquire shares of a company which is merely substantially engaged in permitted financial activities if at least 85 percent of such company's consolidated total annual gross revenues is derived from, and at least 85 percent of that company's consolidated total assets is attributable

¹⁸⁷ 12 C.F.R. §§ 225.89(b) & (c).

¹⁸⁸ Scott A. Cammarn, *Overview Of The Gramm-Leach-Bliley Act*, 4 N.C. BANKING INST. 1, 5 (2000).

¹⁸⁹ 12 U.S.C. § 1843(k)(1).

¹⁹⁰ Gruson, *supra* note 157, at 60. *See also* 12 C.F.R. § 225.85(a)(1).

¹⁹¹ 12 C.F.R. § 225.85(a)(2).

¹⁹² Gruson, *supra* note 157 at 60.

¹⁹³ 12 C.F.R. § 225.85(a)(3)(i).

to, the conduct of activities that are financial in nature, incidental to a financial activity, or otherwise permissible under the BHCA.¹⁹⁴

e. Merchant Banking Activities

The BHCA allows a FHC to engage in investment or merchant banking activities through directly or indirectly acquiring or controlling shares, assets, or ownership interests of a company or other entity, whether or not constituting control of such company or entity, engaged in any activity not authorized pursuant to the BHCA regardless of acting as principal, on behalf of one or more entities, or otherwise.¹⁹⁵ This permission is subject to several preconditions and restrictions. First, in the case that investment or merchant banking activities are performed on behalf of other entities, these entities should not be a depository institution or subsidiary of a depository institution that the bank holding company controls.¹⁹⁶ Second, the shares, assets, or ownership interests are not acquired or held by a depository institution of FHC or subsidiary of a depository institution.¹⁹⁷ Also, a FHC and subsidiaries, for prudential purposes, is not allowed to acquire or control merchant banking investments on behalf of a depository institution or subsidiary of a depository institution.¹⁹⁸ Third, investment activities are performed by a securities affiliate or an affiliate thereof; or an affiliate of an insurance company that provides investment advice to an insurance company, or an affiliate of such investment adviser.¹⁹⁹ Fourth, these activities are done as part of a bona fide underwriting or merchant or investment banking activity, including investment activities engaged in for the purpose of appreciation and ultimate resale or disposition of the investment.²⁰⁰ Therefore, a financial holding company is prohibited from directly or indirectly, owning, controlling or holding any share, asset or ownership interest for a period that exceeds 10 years.²⁰¹ Fifth, during the period of shares, assets or interests holding, the FHC is banned from routinely managing or operating such portfolio company or entity except as may be necessary or required to obtain a reasonable return on investment upon resale or disposition of the investment, such as to avoid or address a significant operating loss or in connection with a loss of senior

¹⁹⁴ 12 C.F.R. § 225.85(a)(3)(ii).

¹⁹⁵ 12 U.S.C. § 1843(k)(4)(H).

¹⁹⁶ *Id.*

¹⁹⁷ 12 U.S.C. § 1843(k)(4)(H)(i).

¹⁹⁸ 12 C.F.R. § 225.170(d).

¹⁹⁹ 12 U.S.C. § 1843(k)(4)(H)(ii).

²⁰⁰ *Id.*

²⁰¹ 12 C.F.R. § 225.172(b).

management at the portfolio company.²⁰² The period of permitted routine management is limited to “the period of time as may be necessary to address the cause of the financial holding company's involvement, to obtain suitable alternative management arrangements, to dispose of the investment, or to otherwise obtain a reasonable return upon the resale or disposition of the investment.”²⁰³ A financial holding company cannot routinely manage or operate a portfolio company for a period greater than nine months without prior written notice to the FRB.²⁰⁴

In order to avert potential risk contagion, a FHC itself is prohibited from acquiring or controlling assets, other than debt or equity securities or other ownership interests in a company unless (1) the assets are held by or promptly transferred to a portfolio company; (2) the portfolio company maintains policies, books and records, accounts, and other indicia of corporate partnership or limited liability organization and operation that are separate from the FHC and limit the legal liability of the FHC for obligations of the portfolio company; and (3) the portfolio company has management that is separate from the FHC.²⁰⁵

Since the language of Section 4(k)(4)(H) of the BHCA authorizes a FHC to make a controlling or non-controlling merchant banking investment in a company “engaged in any activity not authorized pursuant to Section 4 of the BHCA”, does this clause indicate that a FHC is not permitted to make a merchant banking investment if the investment can be made through other authorities granted elsewhere in Section 4 of the BHCA? Given that the fundamental approach of the BHCA is to make each investment authority a separate authority instead of making them exclude one another, the proper interpretation of the language is that this clause simply intends to clarify that Section 4(k)(4)(H) provides grounds for a FHC to engage in, through merchant banking investments, activities impermissible prior to the enactment of the GLBA.²⁰⁶ However, it is also noteworthy that a FHC may not use the merchant banking authority to evade restrictions such as consent or approval requirements or restrictions that address the conflict of interests or that govern the acquisition of financial companies.²⁰⁷

f. Non-financial Activities

Under limited circumstances, a FHC may acquire more than five percent of the outstanding shares of any class of voting securities or

²⁰² 12 U.S.C. § 1843(k)(4)(H)(iv); 12 C.F.R. § 225.171(e)(1).

²⁰³ 12 C.F.R. § 225.171(e)(2).

²⁰⁴ 12 C.F.R. § 225.171(e)(3).

²⁰⁵ 12 C.F.R. § 225.170(e).

²⁰⁶ Gruson, *supra* note 157, at 90-91.

²⁰⁷ *BHC Supervision Manual*, *supra* note 160, at sec. 3907.0.2.2.

control of a company that is not engaged exclusively in activities that are financial in nature, incidental to a financial activity, or otherwise permissible for the FHC under section 4(c) of the BHCA.²⁰⁸ In other words, a FHC is permitted to engage in limited nonfinancial activities. In this case, the company to be acquired must be substantially engaged²⁰⁹ in activities that are financial in nature, incidental to a financial activity, or otherwise permissible for the FHC.²¹⁰ The acquired company is also obliged, within two years from the date the financial holding company acquires shares or control, to conform, terminate, or divest all activities that are not financial in nature, incidental to a financial activity, or otherwise permissible for the FHC under section 4(c) of the BHC Act.²¹¹

In addition, a company that is neither a BHC nor a foreign bank and subsequently becomes a FHC after November 12, 1999, may continue engaging in any activity and retain direct or indirect ownership or control of shares of a company engaged in non-financial activity if (1) the holding company was lawfully engaged in the activity or held the shares of such company on September 30, 1999; (2) the holding company is predominantly engaged in financial activities;²¹² and (3) the company engaged in such activity continues to engage only in the same activities that such company conducted on September 30, 1999, and other permissible activities.²¹³ In this case, the FHC may continue to engage in such non-financial activities or hold shares in companies only to the extent that the aggregate annual gross revenues derived from all such activities and all such companies does not exceed fifteen percent of the consolidated annual gross revenues of the financial holding company.²¹⁴ The BHCA

²⁰⁸ 12 C.F.R. § 225.85(a)(3)(i)(C).

²⁰⁹ Unless the Board determines otherwise, a company will be considered to be “substantially engaged” in activities permissible for a financial holding company for purposes of paragraph (a)(3)(A) of this section if at least 85 percent of the company's consolidated total annual gross revenues is derived from and at least 85 percent of the company's consolidated total assets is attributable to the conduct of activities that are financial in nature, incidental to a financial activity, or otherwise permissible for a financial holding company under section 4(c) of the BHC Act. *See* 12 C.F.R. § 225.85(a)(3)(ii).

²¹⁰ 12 C.F.R. § 225.85(a)(3)(i)(A).

²¹¹ 12 C.F.R. § 225.85(a)(3)(i)(C).

²¹² A company is predominantly engaged in financial activities if the annual gross revenues derived by the holding company and all subsidiaries of the holding company (excluding revenues derived from subsidiary depository institutions), on a consolidated basis, from engaging in activities that are financial in nature or are incidental to a financial activity under subsection (k) of BHCA represent at least 85 percent of the consolidated annual gross revenues of the company. *See* 12 U.S.C. § 1843(n)(2).

²¹³ 12 U.S.C. § 1843(n)(1).

²¹⁴ 12 U.S.C. § 1843(n)(3).

also create a sunset clause for this type of engagement of non-financial activities. It provides that:

[A] Financial holding company engaged in any activity, or retaining direct or indirect ownership or control of shares of a company, pursuant to this subsection, shall terminate such activity and divest ownership or control of the shares of such company before the end of the ten-year period beginning on November 12, 1999. The Board may, upon application by a financial holding company, extend such ten-year period by a period not to exceed an additional five years if such extension would not be detrimental to the public interest.²¹⁵

g. Financial Subsidiaries of Banks

Section 121 of the GLBA authorizes a national bank to control a financial subsidiary that engages only in activities that are "financial in nature" under new Section 4(k) of the BHCA or activities that a national bank may engage in directly subject to the same terms and conditions that govern the conduct of activities by a national bank.²¹⁶ Therefore, a financial subsidiary of a national bank will now be able to engage in those activities that a BHC could have engaged in under Section 4(c)(8) of BHCA.²¹⁷ These activities cannot include engaging as a principal in: (1) insuring, guaranteeing, or indemnifying against loss, harm, damage, illness, disability, or death, or providing or issuing annuities; (2) real estate development or real estate investment activities; or (3) merchant banking or insurance portfolio companies.²¹⁸

h. Umbrella Supervision

The new supervisory framework created by the GLBA consists of the FRB's umbrella supervision of consolidated FHCs, oversight of the depository institutions by their respective banking agencies, and functional regulation of various nonbank entities by their respective agencies.²¹⁹

Under the GLBA, the Federal Reserve has supervisory oversight authority and responsibility for BHCs, including BHCs that operate as FHCs.²²⁰ The Federal Reserve's supervisory oversight role is that of an

²¹⁵ 12 U.S.C. § 1843(n)(7). The rationales of this restriction are: (1) non-financial affiliations may erode the separation of banking and commerce; (2) non-financial affiliations may also promote new competitive inequities; and (3) it may undermine banking supervision due to contagion risks. For details, see JONATHAN MACEY ET.AL., *BANKING LAW AND REGULATION* 460-462 (3rd ed. 2001).

²¹⁶ *BHC Supervision Manual*, *supra* note 160, at sec. 2020.1.

²¹⁷ Martin Lybecker, *Financial Holding Companies And Financial Activities Provisions of the Gramm-Leach-Bliley Act*, SL015 ALI-ABA 117, 136 (2006).

²¹⁸ *Id.*

²¹⁹ Norton, *supra* note 126, at 8.

²²⁰ For details, see 12 U.S.C. § 1844 (1999).

umbrella supervisor concentrating on a consolidated or group-wide analysis of an organization.²²¹ This framework is consistent with and incorporates principles that are well established for BHCs.²²² With regard to consolidated supervision, the Federal Reserve will assess the holding company on a consolidated or group-wide basis with the objective of ensuring that the holding company does not threaten the viability of its depository institution subsidiaries.²²³ The manner in which the FRB fulfills this role will alter with the activities and structure of FHCs, and may differ depending on the mix of banking, securities, and insurance activities of an FHC.²²⁴

First and foremost, to fulfill its GLBA responsibilities, the FRB will interact closely and exchange information with the primary bank and functional regulators.²²⁵ When considering any formal application, declaration, or notification at the FHC level, the FRB has to coordinate with the primary bank, thrift, and functional regulators.²²⁶ The FRB must also build strong relationships with senior management and the boards of directors of FHCs, and have access to timely information from FHCs.²²⁷ These relationships should be comprised of heads of significant business lines and key internal-audit, control, and risk management officials in order to understand how risk-management and internal-control policies and procedures established at the consolidated level are being implemented and assessed.²²⁸ In addition, the FRB has the duty to preserve good understanding on the consolidated organization's legal, organizational, and risk-management structure; major business activities; and risk exposures and risk-management systems.²²⁹ The FRB also needs to perceive the nature and degree of involvement of the board of directors in overseeing their organization's risk management and control process at the consolidated group level.²³⁰

Second, as to aspects of reporting and examination of FHCs, the FRB will, to the fullest extent possible, rely on reports that a FHC or its subsidiaries are required to file with federal or state authorities (or self-

²²¹ *BHC Supervision Manual*, *supra* note 160, at sec. 3900.0.1.

²²² *Id.*

²²³ *Id.* at sec. 3900.0.2.

²²⁴ *Id.*

²²⁵ *Id.* at sec. 3900.0.4.1.

²²⁶ *Id.*

²²⁷ *Id.*

²²⁸ *Id.*

²²⁹ *Id.* at sec. 3900.0.4.2.1.

²³⁰ *Id.*

regulatory organizations) or on reports that are prepared by the federal or state authorities.²³¹ The BHCA authorizes the FRB to occasionally require a FHC and any subsidiary of such FHC to submit reports under oath, which include information regarding (1) its financial condition, systems for monitoring and controlling financial and operating risks, and transactions with depository institution subsidiaries of the bank holding company; and (2) compliance by the company or subsidiary with applicable provisions of related laws and regulations.²³² With regard to the examination, the FRB is granted the authority to examine each FHC and each subsidiary of such holding company so as to (1) to inform itself of the nature of the operations and financial condition of the holding company and such subsidiaries; (2) to inform itself regarding the financial and operational risks within the holding company system that may possibly threaten the safety and soundness of any depository institution subsidiary of such holding company as well as the systems for monitoring and controlling such risks; and (3) to monitor compliance with relevant laws and regulations, including those governing transactions and relationships between any depository institution subsidiary and its affiliates.²³³ Nevertheless, the FRB's authority of examination should be in line with certain restrictions. The FRB is permitted to examine functionally regulated subsidiaries only if (1) the FRB has reasonable cause to believe that the target subsidiary is engaged in activities that incur a material risk to an affiliated depository institution; (2) the FRB, after reviewing relevant reports, reasonably concludes that examination of the subsidiary is necessary to adequately inform the FRB; and (3) according to reports and other available information, the FRB has reasonable cause to believe that a subsidiary violates related laws and regulations, including provisions relating to transactions with an affiliated depository institution, and the Board cannot make such determination through examination of the affiliated depository institution or the bank holding company.²³⁴ The focus of the examination is also limited. The FRB should, to the fullest extent possible, limit the focus and scope of any examination of a FHC to the BHC and any BHC subsidiary that could have a materially adverse effect on the safety and soundness of any depository institution subsidiary of the FHC.²³⁵ In sum, FRB's power to examine the FHC and its functionally regulated subsidiaries should be limited to exclude infringing upon the authority of respective banking and functional supervisors.

²³¹ *Id.* at sec. 3900.0.4.2.2. See also 12 U.S.C. § 1843(c)(1)(B).

²³² 12 U.S.C. § 1844(c)(1)(A).

²³³ 12 U.S.C. § 1844(c)(2)(A).

²³⁴ 12 U.S.C. § 1844(c)(2)(B).

²³⁵ 12 U.S.C. § 1844(c)(2)(C).

Third, the FRB is responsible for assessing consolidated capital adequacy of FHCs through the risk profile of the consolidated organization.²³⁶ FHCs are subject to the Federal Reserve's holding company capital guidelines,²³⁷ which set forth minimum capital ratios that serve as tripwires for additional supervisory scrutiny and corrective action.²³⁸ The FRB will review the FHC's internal risk assessment and related capital-analysis process for determining the adequacy of its overall capital position.²³⁹ Such a review will include consideration of current and future economic conditions, business development plans for the future, possible stress scenarios, and internal risk-control and audit procedures.²⁴⁰ Although the FRB is responsible for assessing the consolidated capital adequacy of FHCs, the primary bank, thrift, or functional regulators of FHC subsidiaries will continue to set and enforce applicable capital requirements for the regulated entities within their jurisdiction. Therefore, the FRB is prohibited from prescribing or imposing any capital or capital adequacy rules, guidelines, standards, or requirements on any functionally regulated subsidiary of a FHC that is not a depository institution and meet the applicable capital requirements of its regulator.²⁴¹

Fourth, FRB's supervision should also emphasize the area of risk concentration and intra-group exposure and its impact on the depository institution and the FHC. To effectively monitor intra-group exposures and risk concentrations, the FRB should: (1) collect data from each depository institution subsidiary of FHCs on their covered transactions with affiliates that are subject to sections 23A and 23B of the Federal Reserve Act and will share that data with primary bank and thrift regulators, while primary bank and thrift regulators will continue to monitor and enforce section 23A and 23B restrictions at individual level; (2) ensure that functional regulators will continue to monitor and enforce any intra-group exposure restrictions that may apply to the regulated entities within their authorities; (3) realize and monitor related-party exposures at the group level (including areas such as servicing agreements, derivatives exposures, and payments-system exposures); and (4) survey management's effectiveness

²³⁶ *BHC Supervision Manual*, *supra* note 160, at sec. 3900.0.4.2.3.

²³⁷ The "Capital Adequacy Guideline" which includes risk-based measure, leverage measure, tier 1 leverage measure and market risk measure are provided by Appendix A, B, D & E of Regulation Y.

²³⁸ *BHC Supervision Manual*, *supra* note 160, at sec. 3900.0.4.2.3.

²³⁹ *Id.*

²⁴⁰ *Id.*

²⁴¹ 12 U.S.C. § 1844(c)(3)(A).

in supervising and controlling intra-group exposures and risk concentrations.²⁴²

Fifth, the FRB can promote sound practices by monitoring trends in risk exposures and risk management practices across the FHC groups through taking efforts to: (1) initiate regular discussions with FHC management centered on specific issues and emerging risks; (2) hold regular meetings with primary bank, thrift, and functional regulators to explore and discuss issues of mutual interest or concern; (3) coordinate interagency working groups or specialty teams to gain early insight into risks that cut across the various entities of a conglomerate or groups of conglomerates; and (4) organize industry conferences on relevant topics of interest.²⁴³

Finally, the BHCA endowed the FRB with the authority to enforce certain corrective actions. If the FRB has reasonable cause to believe that the continuation by a FHC of any activity or of ownership or control of any of its nonbank subsidiaries, other than a nonbank subsidiary of a bank, not only poses a serious risk to the financial safety, soundness, or stability of a bank holding company subsidiary bank but also violates sound banking principles or the purposes of BHCA, at the election of the FHC, the FRB may either (1) order the bank holding company or any such nonbank subsidiaries, after due notice and opportunity for hearing and after considering the views of the bank's primary supervisors, to terminate such activities or to terminate its ownership or control of any such subsidiary either by sale or by distribution of the shares of the subsidiary to the shareholders of the bank holding company; or (2) order the FHC, after due notice and opportunity for hearing, and after consultation with the primary supervisor for the bank, to terminate the ownership or control of any such bank by such company.²⁴⁴

i. Functional Regulation

Title II of the GLBA provides for the functional regulation of bank securities activities. For example, the GLBA imposed functional regulation on many bank securities activities by subjecting bank broker-dealer activities as well as bank advising mutual funds to SEC supervision.²⁴⁵ However, the House-Senate conference retained some limited exemptions to facilitate activities in which banks have traditionally

²⁴² *BHC Supervision Manual*, *supra* note 160, at sec. 3900.0.4.2.4.

²⁴³ *Id.* at sec. 3900.0.4.2.5.

²⁴⁴ 12 U.S.C. § 1844(e)(1).

²⁴⁵ For details *see* 15 U.S.C. §§ 80a-2, 80a-9(a), 80a-10(c), 80a-17(a), 80a-26(b)-(f), 80a-34(a), 80b-2(a) & 80a-3(c) (1999).

engaged.²⁴⁶ These exemptions are related to the third-party networking arrangement, trust activities, traditional banking activities (such as commercial paper and exempted securities), employee and shareholder benefit plans, sweep accounts, affiliate transactions, private placements, safekeeping, custody service, asset-backed securities, and identified banking products.²⁴⁷ Other than the above-mentioned activities, securities activities conducted in a functionally regulated subsidiary²⁴⁸ of a depository institution shall be subject to regulation by the SEC, and by relevant State securities authorities, as appropriate, subject to relevant laws²⁴⁹ to the same extent as if they were conducted in a non-depository institution subsidiary of a BHC.²⁵⁰ Similarly, insurance agency and brokerage activities and activities as principal conducted in a functionally regulated subsidiary of a depository institution shall be subject to regulation by a State insurance authority to the same extent as if they were conducted in a non-depository institution subsidiary of a BHC.²⁵¹

j. Foreign FHC

Considering foreign banks' special form of existence in the U.S. and the "home country regulation"²⁵² and "reciprocity", Regulation Y provides foreign banks with special treatment as to what circumstances they will be treated as a FHC and how they elect to become a FHC if they intend to do so.

²⁴⁶ Benson, *supra* note 166, at 53.

²⁴⁷ *Id.* See also 15 U.S.C. § 78c(a)(4)(b) (1999).

²⁴⁸ Pursuant to 12 U.S.C. § 1844(c)(5), the term "functionally regulated subsidiary" means any company— **(A)** that is not a bank holding company or a depository institution; and **(B)** that is— **(i)** a broker or dealer that is registered under the Securities Exchange Act of 1934 [15 U.S.C. § 78a et seq.]; **(ii)** a registered investment adviser, properly registered by or on behalf of either the Securities and Exchange Commission or any State, with respect to the investment advisory activities of such investment adviser and activities incidental to such investment advisory activities; **(iii)** an investment company that is registered under the Investment Company Act of 1940 [15 U.S.C. § 80a-1 et seq.]; **(iv)** an insurance company, with respect to insurance activities of the insurance company and activities incidental to such insurance activities, that is subject to supervision by a State insurance regulator; or **(v)** an entity that is subject to regulation by the Commodity Futures Trading Commission, with respect to the commodities activities of such entity and activities incidental to such commodities activities.

²⁴⁹ For details see 15 U.S.C. § 6701 (1999).

²⁵⁰ 12 U.S.C. § 1844(c)(4)(A).

²⁵¹ 12 U.S.C. § 1844(c)(4)(B).

²⁵² "Home country regulation" occurs when the U.S. allow a foreign financial institution to conduct business in the U.S. under the same terms and conditions as those that apply to the foreign financial institution in its home country. See MACEY, *supra* note 215, at 800.

Where a foreign bank operates a branch or agency or owns or controls a commercial lending company in the United States, any company that owns or controls such a foreign bank will be treated as a financial holding company if: (1) the foreign bank, any other foreign bank that maintains a U.S. branch, agency, or commercial lending company and is controlled by the foreign bank or company, and any U.S. depository institution subsidiary that is owned or controlled by the foreign bank or company, is and remains well capitalized and well managed; and (2) the foreign bank, and any company that owns or controls the foreign bank, has made an effective election to be treated as a financial holding company.²⁵³ As for the “well-capitalized” requirement, principles of both home country regulation and national treatment may apply. A foreign bank will be considered “well capitalized” if one of the following two sets of criteria is satisfied:

The first criteria is as follows: (1) its home country supervisor has adopted risk-based capital standards consistent with the Capital Accord of the Basel Committee on Banking Supervision; (2) the foreign bank maintains a Tier 1 capital to total risk-based assets ratio of 6 percent and a total capital to total risk-based assets ratio of 10 percent, as calculated under its home country standard; and (3) the foreign bank's capital is comparable to the capital required for a U.S. bank owned by a FHC.

A foreign bank will also be considered “well capitalized” if the foreign bank has obtained a determination from the FRB that the foreign bank's capital is otherwise comparable to the capital that would be required of a U.S. bank owned by a FHC.²⁵⁴

With respect to the “well-managed” requirement, a foreign bank will be considered “well managed” if: (1) at least a satisfactory composite rating was given to the foreign bank's U.S. branch, agency, and commercial lending company operations in its most recent evaluation by the FRB; (2) the home country supervisor of the foreign bank agree on the foreign bank expanding its activities in the United States to include activities permissible for a FHC; and (3) the management of the foreign bank meets standards comparable to those required of a U.S. bank owned by a FHC.²⁵⁵

The procedure of election to be treated as a FHC is similar to the election process of domestic BHC. The foreign bank that operates a branch or agency or owns or controls a commercial lending company in the United States, or a company that owns or controls such a foreign bank, may elect to be treated as a financial holding company by filing a written declaration with the appropriate FRB.²⁵⁶ Such election is effective on the

²⁵³ 12 C.F.R. § 225.90(a).

²⁵⁴ 12 C.F.R. § 225.90(b).

²⁵⁵ 12 C.F.R. § 225.90(c).

²⁵⁶ 12 C.F.R. § 225.91(a).

31st day after the date that an election was received by the appropriate FRB, unless the Board notifies the foreign bank or company prior to that time that: (1) the election is ineffective; or (2) the period is extended with the consent of the foreign bank or company making the election.²⁵⁷

When performing the function of ongoing supervision over the foreign FHC, if the FRB discovers that the foreign bank ceases to be well capitalized or well managed, the FRB will notify the foreign bank and company in writing regarding the noncompliance.²⁵⁸ Regulation Y also imposes on foreign FHCs the duty of notification regarding its noncompliance.²⁵⁹ The foreign bank or company must execute an agreement acceptable to the FRB to comply with all applicable capital and management requirements within 45 days after receiving the notification from FRB.²⁶⁰ An agreement to correct a capital or management deficiency must be acceptable to the FRB and include (1) an explanation of the specific actions that the foreign bank or company will take to correct all areas of noncompliance; (2) a schedule within which each action will be taken; and (3) provision of any other information that the FRB may require.²⁶¹ If a foreign bank or company fails to correct the conditions described in FRB's notice within 180 days of receipt of the notice or additional time the FRB allows, for safety and soundness purposes, the FRB may order the foreign bank or company to terminate the foreign bank's U.S. branches and agencies and divest any commercial lending companies owned or controlled by the foreign bank or company.²⁶²

k. Critiques

There is no doubt that the enactment of the GLBA reflects regulators' and legislators' efforts in allowing the affiliation between banks, insurance, companies and securities through the financial holding company system or banks' financial subsidiaries. However, the rationale of financial activities provisions in the GLBA seems to be extremely bank centered,²⁶³ and therefore creates competitive disadvantages to both insurance companies and securities firms. Although the GLBA repealed

²⁵⁷ 12 C.F.R. § 225.92(a).

²⁵⁸ 12 C.F.R. § 225.93(a).

²⁵⁹ 12 C.F.R. § 225.93(b)(1).

²⁶⁰ 12 C.F.R. § 225.93(c)(1).

²⁶¹ 12 C.F.R. § 225.93(c)(3).

²⁶² 12 C.F.R. § 225.93(e).

²⁶³ One of the main purposes of the GLBA is to allow banks to compete more effectively with other financial service providers. See Vincent Di Lornenzo, *Gramm-Leach-Bliley Act Challenges Financial Regulators to Assure Safe Transition in Banking Industry*, 72 N.Y. St. B. J. 36 (2000).

the remaining two sections of the Glass-Steagall – sections 20 and 32,²⁶⁴ sections 16 and 21 of the Glass-Steagall remain unshaken after Gramm-Leach-Bliley. The affiliation between banks and securities firms or the expansion of a bank's power creates no two-way street for securities firms that intend to engage in commercial banking business as the remaining two sections of the Glass-Steagall explicitly prohibits securities firms from offering commercial banking service.²⁶⁵ Such design even provides banks the possibility of commencing anti-competitive activities through “tying arrangements”. To illustrate, a commercial bank may demand that one of its loan clients contract with its securities affiliate for underwriting services and reward the client with more favorable lending terms.²⁶⁶ This competitive advantage creates a threat to non-affiliated securities firms.²⁶⁷ Even though securities firms contemplate entering commercial banking business through acquiring an existing BHC or through establishing a brand new FHC, they may encounter significant disadvantages because costs to acquire a BHC or establish a new FHC are higher than for a bank to conduct permissible securities business itself or through its financial subsidiary. Similar disadvantages will affect the insurance industry as well. The GLBA actually generates intensifying competitive pressures on insurance companies by encouraging the number of banks conducting insurance to increase. Consequently, the insurance company alone will be insufficient to neutralize the unprecedented size advantage held by the largest banks over the largest insurance companies.²⁶⁸

With respect to the functional regulation, regulatory authority is allocated on the basis of the nature of the activity being performed rather than on the basis of the institutional identity of the firm conducting the activity.²⁶⁹ The issue is whether it is possible to categorize all types of activities to fit into respective functional regulation regimes. Some suggest that technological innovation and market developments have blurred the lines between banking, securities, and insurance, which has made functional regulation virtually impossible because new types of financial products, such as e-based products and services or untapped

²⁶⁴ 12 U.S.C. §§ 377-78.

²⁶⁵ See 12 U.S.C. § 378(a).

²⁶⁶ Matthew J. Restrepo, *The Convergence of Commercial and Investment Banking under the Gramm-Leach-Bliley Act: Revisiting Old Risks and Facing New Problems*, 11 SPG L. & BUS. REV. AM. 269, 287 (2005).

²⁶⁷ *Id.*

²⁶⁸ Douglas P. Faucette, *The Impact of convergence and the Gramm-Leach-Bliley Act on the Insurance Company*, 8 GEO. MASON L. REV. 623, 648 (2000).

²⁶⁹ Linda Birkin Tigges, *Notes & Comments, Functional Regulation of Bank Insurance Activities: The Time Has Come*, 2 N.C. BANKING INST. 455, 475 (1998).

sectors of hybrids, involved in banking, securities, and insurance, are becoming indistinguishable to customers and regulators.²⁷⁰

Others advocate from the theory of financial intermediaries distinguishing traditional commercial banking, insurance and securities services. The unique function of any financial intermediary is to transform one financial asset into another financial asset.²⁷¹ Banks are financial intermediaries because they occupy a position between the investor and the ultimate investment, and the investor in a financial intermediary has a claim only against the intermediary and not against the firms or other ventures in which the intermediary invests.²⁷² Further, the unique feature making the bank a special intermediary is their combination of financial intermediation with transaction services, which enable them to use short-term deposits to provide borrowers with medium- and long-term funds so as to allow the transfer of wealth among people easily.²⁷³

On the other hand, insurance companies, though financial intermediaries, possess an exclusive function too. Insurance is a risk-pooling arrangement in which the insurer assumes the risk transferred from the insured and receives premiums that are sufficient to fund its expected claim and administrative costs as consideration.²⁷⁴ Given that identifying the unique character of banks and insurance companies presents an obstacle, it is possible to distinguish banking, insurance, and securities services. In fact, there is no conflict between the two arguments. In the traditional sense, the boundary between banking, insurance, and securities is undoubtedly unequivocal. Nevertheless, rapid innovation and the increasing complexity of financial products penetrate the boundaries recurrently. Financial products that involve two or more financial sectors are growing. For example, the variable annuity sold by life insurance companies in which the return credit depends on the return of stock and bond that a policyholder chooses, and no minimum rate of return is guaranteed. Therefore, there are increasing challenges for functional regulators to identify the key features of financial products and determine to which authority it should be subjected.²⁷⁵ Closer

²⁷⁰ Jonathan Macey, *The Business Of Banking: Before And After Gramm-Leach-Bliley*, 25 J. CORP. L. 691, 709 (2000). See also Michael P. Malloy, *Functional Regulation: premise or Pretext?*, in FINANCIAL MODERNIZATION AFTER GRAMM-LEACH-BLILEY 184 (2002).

²⁷¹ JORDI CANALS, UNIVERSAL BANKING: INTERNATIONAL COMPARISONS AND THEORETICAL PERSPECTIVES 27 (1997).

²⁷² Jonathan Macey, *The Business Of Banking: Before And After Gramm-Leach-Bliley*, 25 IOWA J. CORP. L. 691, 712 (2000).

²⁷³ *Id.*

²⁷⁴ SCOTT E. HARRINGTON & GREGORY NIEHAUS, RISK MANAGEMENT AND INSURANCE 115 (1999).

²⁷⁵ *Id.* at 610.

coordination and cooperation among functional regulators and more involvement of the umbrella supervisor may be a solution to address this issue.

Another issue facing functional regulation is the overlap and competition among regulators. It is the concern that with individual financial institutions being regulated by several regulators simultaneously, some activities of these complex financial institutions might not receive the appropriate level of scrutiny if related functional regulators pass the buck amongst each other.²⁷⁶ Conversely, as respective functional regulators and umbrella supervisors have different objectives in performing supervision, competitions among these regulators and supervisors are sometimes inevitable. Although competition among regulators and supervisors is not completely unhealthy, it is possible that the outcome of regulatory competition is the product of compromise. One example is the corporate structure debate that has taken place between the FRB and OCC during the process of drafting the GLBA. The FRB took the position that banks' involvement in new financial activities should only be permitted in holding company affiliates and the use of operating subsidiaries should not be permitted because the latter can create moral hazards and therefore cause damage to the safety and soundness of banks and ultimately to Federal safety net.²⁷⁷ OCC, on the other hand, suggested a completely different direction by advocating that use of operating subsidiaries for new activities would not only strengthen banks and the Federal Deposit Insurance System, but also benefit customers.²⁷⁸ The final product of the GLBA is a compromise because it permitted a holding company affiliate model and granted limited power to financial subsidiaries. The GLBA addressed these issues by imposing on the FRB regulatory responsibility for overseeing all financial services organizations from a safety and soundness perspective.²⁷⁹ However, designating the FRB as an umbrella supervisor raises another concern of potential threats to the reduction or elimination the healthy regulatory competition that existed previously among the OCC, the FRB, the FDIC, and numerous state regulatory authorities.²⁸⁰ No solution regarding this ongoing debate seems to be available at this moment as the structure of regulation and the allocation of powers among regulators are worldwide issues. To find an ideal model for regulatory structure is no easy task.

²⁷⁶ Macey, *supra* note 272, at 711.

²⁷⁷ Constance Z. Wagner, *Structuring the Financial Service Conglomerates of the Future: Does the Choice of Corporate Form to House new Financial Activities of National Bank Matter?*, 19 ANN. REV. OF BANKING L. 329, 392-394 (2000).

²⁷⁸ *Id.* at 397-401.

²⁷⁹ Carter H. Golembe, *Reform of the Financial Regulatory Structure*, 2 & 3 GOLEMBE REP. 1, 3 (2000).

²⁸⁰ Macey, *supra* note 272, at 711.

B. *The European Union*

European Union — Directive on the supplementary supervision of credit institutions insurance undertakings and investment firms in a financial conglomerate.²⁸¹

On April 26, 2001, the European Commission presented a proposal for a Directive that would introduce group-wide supervision of financial conglomerates.²⁸² The Directive entered into force on February 11, 2003, and Member States must transpose the Directive into their national legislation within 18 months.²⁸³ This Directive would require closer cooperation and information sharing among supervisory authorities across sectors. It would also introduce initial steps to align the rules for financial conglomerates with homogeneous financial groups (dealing in a single financial sector, such as banking) so as to ensure equivalence of treatment and a level playing-field. This Directive has been prompted by continuing consolidation in the financial services sector that has created cross-sectoral financial groups with activities in both the banking/investment services and insurance sectors. The emergence of these groups, known as financial conglomerates, requires an appropriate regulatory framework.

Before the passage of this Directive, the EU legal framework for the supervision of financial institutions covered only so-called sectoral supervision; that is, supervision over institutions within a particular sector of the financial industry. Cross-sectoral supervision of financial groups, combining institutions from different financial sectors, existed only on limited occasions.²⁸⁴ This Directive has had regulated entities that have obtained an authorization pursuant to one of the sectoral directives subject to supplementary supervision within the meaning of this Directive.²⁸⁵ Supplementary supervision only applies to regulated entities that are formed and authorized in the EU.²⁸⁶ It is also important to note that this

²⁸¹ See Council Directive 2002/87, Supplementary Supervision of Credit Institutions, Insurance Undertakings and Investment Firms in a Financial Conglomerate, 2003 O.J. (L 35) 1 (EC) and amending Council Directives 73/239/EEC, 79/267/EEC, 92/49/EEC, 92/96/EEC, 93/6/EEC and 93/22/EEC, and Directives 98/78/EC and 2000/12/EC of the European Parliament and of the Council, 2002 O.J. (L 035) 1-27 (EC).

²⁸³ HENNING SCHOPPMANN ET AL., *EUROPEAN BANKING AND FINANCIAL SERVICE LAW* 37 (2004).

²⁸⁴ For example, Council Directive 2002/87, arts. 55(2), 56(4), 2003 O.J. (L 35) (EC), requires cooperation and exchange of information between the different supervisory authorities if a credit institution, financial holding company or mixed-activity holding company has as a subsidiary an insurance company or another undertaking providing investment services.

²⁸⁵ Council Directive 2002/87, arts. 1, 4(1), 2003 O.J. (L 35) (EC).

²⁸⁶ Non-EU based regulated entities are subject to another standard, namely “equivalent supplementary supervision”. For details, *see infra* part IV.E.

Directive does not replace the existing supervision of the different sectoral groups, but introduces supplementary supervision of the regulated entities. The Directive does not lead to supervision of unregulated entities within a group on a stand-alone basis.²⁸⁷

1. Financial Conglomerates

According to this Directive, a financial conglomerate is defined as a group of undertakings integrated based on the relationship of parent-subsidiary,²⁸⁸ participation,²⁸⁹ and a horizontal structure.²⁹⁰ To be qualified as a financial conglomerate, the group should meet the following conditions: (a) a regulated entity within the meaning of Article 1 is at the head of the group or at least one of the subsidiaries in the group is a regulated entity;²⁹¹ and (b) if the financial conglomerate is headed by an EU-regulated entity, the activities of the entities in the insurance sector and the activities of the entities in the banking and investment services sector (taken together) must be significant (each financial sector must represent at least ten percent of the group on the balance sheet or the balance sheets of the smallest sector in the group must exceed € 6 billion);²⁹² or (c) if the group is not headed by an EU-regulated entity, the group's activities must mainly occur in the financial sector (based on the balance sheets, the financial sector entities must represent at least forty percent of the group).²⁹³ On the other hand, a group that is headed by an EU-regulated entity qualifies as a financial conglomerate even though its activities do not mainly occur in the financial sector.

²⁸⁷ Council Directive 2002/87, arts. 4(5), 2003 O.J. (L 35) (EC).

²⁸⁸ Council Directive 2002/87, arts. 2(9) & (10), 2003 O.J. (L 35) (EC).

²⁸⁹ "Participation" means "(1) 'participation,' which means direct ownership or by way of control of 20 percent or more of the voting rights or capital of an undertaking, or (2) a right in the capital of other undertakings which 'by creating a durable link with those [other] undertakings, are intended to contribute to the company's [the holder of the participation] activities'". See Council Directive 2002/87, art. 2(11), 2003 O.J. (L 35) (EC).

²⁹⁰ A "horizontal structure" exists without an equity relationship if undertakings are managed on a unified basis pursuant to a contract or charter provision or if the administration, management or supervisory bodies of both undertakings consist for the major part of the same persons. A horizontal structure is a case of control without equity investment. See Council Directive 2002/87, art. 2(12), 2003 O.J. (L 35) (EC).

²⁹¹ "Regulated entity" refers to "entities which have obtained an authorization pursuant to Article 6 of Directive 73/239/EEC, Article 6 of Directive 79/267/EEC, Article 3(1) of Directive 93/22/EEC or Article 4 of Directive 2000/12/EC, and which are part of a financial conglomerate." See Council Directive 2002/87, art. 1, 2003 O.J. (L 35) 1 (EC).

²⁹² Council Directive 2002/87, art. 14(e), 2003 O.J. (L 35) (EC).

²⁹³ Council Directive 2002/87, art. 14(c), 2003 O.J. (L 35) (EC).

This Directive also extends its application to the “mixed financial holding company”. By definition, any financial conglomerate that is headed by a non-regulated entity is a mixed financial holding company.²⁹⁴ The mixed financial holding company could be a non-regulated financial sector entity, such as a financial institution other than an investment firm (a mere holding company without its own activities would likely be a financial institution) or a reinsurance undertaking, or it could be a commercial or industrial company.²⁹⁵ A financial conglomerate headed by a mixed financial holding company is subject to supplementary supervision only if the mixed financial holding company is located in the EU.²⁹⁶ Similarly, if the financial conglomerate is headed by a regulated entity, it is subject to supplementary supervision while the regulated entity is an EU-regulated entity.²⁹⁷ A financial conglomerate headed by a non-EU-regulated entity and a financial conglomerate headed by a mixed financial holding company having its head office outside the EU are still financial conglomerates, but the regulated entities in those financial conglomerates are not subject to supplementary supervision. Instead, they are submitted to equivalent supplementary supervision by the home country of the non-EU-regulated entity or the mixed financial holding company or to analogous or appropriate supplementary supervision by a Member State under the Supplementary Supervision Directive.²⁹⁸

This Directive also grants broad range of discretion for competent authorities. The competent authorities have discretion to apply supplementary supervision to groups that do not qualify as a financial conglomerate but are in control of or have investment in a regulated entity.²⁹⁹ Regulated entities in such quasi-financial conglomerates are subject to supplementary supervision if (1) at least one of the regulated entities is an EU-regulated entity; (2) at least one of the entities in the quasi-financial conglomerate is within the insurance sector and at least one is within the banking or investment services sector; and (3) the consolidated and/or aggregated activities of the entities in the quasi financial conglomerate within the insurance sector, and the consolidated and/or aggregated activities of the entities within the banking and investment services sector are each significant.³⁰⁰

²⁹⁴ Council Directive 2002/87, art. 5(3), 2003 O.J. (L 35) (EC).

²⁹⁵ Michael Gruson, *Supervision of Financial Conglomerates in the European Union* 8 (Working Paper No. NYDOCS01/1000894.2, 2004), available at www.imf.org/external/np/leg/sem/2004/cdmfl/eng/gruson.pdf (last visited Jan. 17, 2010).

²⁹⁶ Council Directive 2002/87, art. 5(2)(b), 2003 O.J. (L 35) (EC).

²⁹⁷ Council Directive 2002/87, arts. 2(14), 5(2)(a), 2003 O.J. (L 35) (EC).

²⁹⁸ Council Directive 2002/87, arts. 5 (3), 18, 2003 O.J. (L 35) (EC).

²⁹⁹ Council Directive 2002/87, art. 5(4), 2003 O.J. (L 35) (EC).

³⁰⁰ *Id.*

This Directive does not impose on financial conglomerates a duty to report to or file with any supervisory authority simply for the fact that they are financial conglomerates. Competent authorities must determine whether a regulated entity authorized by it is a member of a group that may be a financial conglomerate which has not yet been identified according to this Directive. If the question of existence of unidentified financial conglomerates is answered in the affirmative, the competent authority shall communicate its view to the other competent authorities concerned. The coordinator should inform the parent of the group (or in the absence of a parent, the regulated entity with the largest balance sheet held in the most important financial sector in the group) that the group has been identified as a financial conglomerate and the subsequent appointment of the coordinator.³⁰¹ The coordinator should also inform the competent authorities that have authorized regulated entities in the group and the competent authorities of the Member States in which the mixed financial holding company has its head office, as well as the EU Commission.³⁰²

2. Supplementary Supervision

The Directive introduces substantial approaches regarding the supplementary supervision of regulated entities in a financial conglomerate, particularly in the aspects of capital adequacy, intra-group transactions and risk concentration, and management. For each financial conglomerate, this Directive requires that a single coordinator should be appointed from among the competent authorities of the Member States concerned.³⁰³ It is also required that competent authorities are charged with the duty to cooperate and exchange information.³⁰⁴

a. Capital Adequacy

The financial condition of a financial conglomerate is undoubtedly the primary issue of the supervision. Thus, Annex I of the Directive requires the competent authorities to exercise supplementary supervision over the capital adequacy of the regulated entities within a financial conglomerate.³⁰⁵ The principal objective of supplementary group-wide capital adequacy requirements is to eliminate any inappropriate intra-group creation of individual funds, such as double or multiple gearing or excessive leverage. In such situations the same funds are used simultaneously as a buffer to cover the capital requirements of the parent

³⁰¹ Council Directive 2002/87, art. 4(2), 2003 O.J. (L 35) (EC).

³⁰² *Id.*

³⁰³ Council Directive 2002/87, arts. 10, 11, 2003 O.J. (L 35) (EC).

³⁰⁴ Council Directive 2002/87, art. 12, 2003 O.J. (L 35) (EC).

³⁰⁵ Council Directive 2002/87, art. 6(1), 2003 O.J. (L 35) (EC).

company as well as the requirements of the subsidiary.³⁰⁶ To reach this objective, the competent authorities must require the regulated entities in a financial conglomerate to provide their own funds at the level of the financial conglomerate that are at least equal to the capital adequacy requirements as calculated in accordance with Annex I of the Directive.³⁰⁷ In addition, certain entities in the financial conglomerate that may not be subject to capital adequacy requirements on a stand-alone basis must nonetheless be included for the purpose of calculating capital adequacy at the level of the financial conglomerate.³⁰⁸

Annex I provides three methods to calculate the solvency position on the level of a financial conglomerate:

a. Accounting Consolidation Method

The Accounting Consolidation Method uses consolidated accounts as a basis for calculating the supplementary capital adequacy so it is only applicable for consolidated groups. The supplementary capital adequacy is the difference between: (1) the individual funds of the financial conglomerate calculated on the basis of the consolidated position of the group; and (2) the sum of the solvency requirements for each different financial sector represented in the group.³⁰⁹

Because this method's starting point and basis are the fully consolidated accounts of the financial conglomerate, all intra-group on- and off-balance sheet accounts or exposures have been eliminated and the effects of double or multiple gearing and excessive leverage are equated.³¹⁰ Calculating the group-wide capital adequacy simply consists of the deduction of the solvency requirements of the group's sectors from the consolidated own funds.³¹¹

b. Deduction and Aggregation Method

The calculation of the supplementary capital adequacy in the Deduction and Aggregation Method is done on the basis of the single accounts of each entity in the group. The supplementary capital adequacy shall be calculated on the basis of the accounts of each of the entities in the group as the difference between: (1) the sum of the individual funds of each regulated and non-regulated entity in the financial conglomerate; and (2) the sum of: (a) the solvency requirements for each regulated and non-regulated entity in the group plus (b) the book value of the participations in other entities of the group.³¹²

³⁰⁶ Tripartite Group, *supra* note 3, at 17.

³⁰⁷ Council Directive 2002/87, art. 6(2), 2003 O.J. (L 35) (EC).

³⁰⁸ Council Directive 2002/87, art. 6(5), 2003 O.J. (L 35) (EC).

³⁰⁹ Council Directive 2002/87, Annex I (II), 2003 O.J. (L 35) (EC).

³¹⁰ Michael Gruson, *supra* note 295, at 19.

³¹¹ *Id.*

³¹² Council Directive 2002/87, Annex I (II), 2003 O.J. (L 35) (EC).

The effect of this method is to pretend the situation of consolidated accounts and, therefore, to eliminate multiple gearing, excessive leverage, and the misuse of accounting margins relating to the book value of participations by deducting those participations.³¹³

c. Requirement Deduction Method

Under the Requirement Deduction Method, the calculation of the supplementary capital adequacy shall be carried out on the basis of the accounts of each of the entities in the group as the difference between: (1) the individual funds of the parent undertaking or the entity at the head of the financial conglomerate; and (2) the sum of the solvency requirement of the previously-mentioned parent undertaking or the head plus the higher of the book value of the parent undertaking's participation in other entities in the group and these entities' solvency requirements.³¹⁴

The competent authorities should require regulated entities to have in place proper capital adequacy policies at the level of the financial conglomerate as well as appropriate internal control mechanisms regarding capital adequacy.³¹⁵

The competent authorities have the discretion not to include a particular entity in the calculation of group capital adequacy if: (1) the entity is located in a third country where there are legal impediments to collecting the necessary information, (2) the entity is of negligible interest with respect to the objective of the supplementary supervision of regulated entities in a financial conglomerate, or (3) the inclusion of the entity would be inappropriate or misleading with respect to the objectives of supplementary supervision.³¹⁶

Moreover, the competent authorities responsible for the supervision of the regulated entities in the financial conglomerate must ensure that the necessary measures are adopted by the entities under the circumstances that: (1) the capital adequacy position at the level of the financial conglomerate falls below the requirements, (2) the capital adequacy policies are not adequate, (3) the internal control mechanisms are not appropriate, or (4) the requirements are met but the solvency may nevertheless be jeopardized.³¹⁷

b. Risk Concentration and Intra-group Transactions

³¹³ Michael Gruson, *supra* note 295, at 21.

³¹⁴ Council Directive 2002/87, Annex I (II), 2003 O.J. (L 35) (EC).

³¹⁵ Council Directive 2002/87, art. 6(2), 2003 O.J. (L 35) (EC).

³¹⁶ Council Directive 2002/87, art. 6(5), 2003 O.J. (L 35) (EC).

³¹⁷ Council Directive 2002/87, art. 5(5), 2003 O.J. (L 35) (EC).

Another vital part of the Directive is the supplementary supervision over intra-group transactions³¹⁸ and risk concentration³¹⁹ of regulated entities in a financial conglomerate.³²⁰

Intra-group transactions can create risks and raise supervisory attention under the following circumstances: (1) their capital or income is inappropriately transferred from the regulated entity; (2) they are on terms or under circumstances which parties operating at arm's length would not allow and may be disadvantageous to a regulated entity; (3) they can adversely affect the solvency, the liquidity, and the profitability of individual entities within a group; or (4) they are used as a means of supervisory arbitrage in order to evade capital or other regulatory requirements altogether.³²¹ Intra-group transactions are closely related to the risk of contagion within a financial conglomerate. As risk contagion occurs when some parts of a conglomerate are having financial difficulties which infect other healthy parts of the conglomerate, the operation of the healthy parts may be hampered or even made impossible.³²² Therefore, intra-group transactions can significantly aggravate problems for a regulated entity once contagion spreads.³²³

According to the definition provided in the Directive, intra-group transactions are made by a regulated entity in a financial conglomerate with any other undertaking in the financial conglomerate.³²⁴ However, intra-group transactions often include transactions with natural or legal persons linked to the undertakings within the group by close links, even though such linked persons are not members of the group, and, consequently, not members of the financial conglomerate.³²⁵ Also, the intra-group transactions are not limited to transactions of EU-regulated entities within a financial conglomerate, but rather to transactions of any

³¹⁸ Intra-group transactions define as: all transactions by which regulated entities within a financial conglomerate rely either directly or indirectly upon other entities within the same group for the fulfillment of an obligation, whether or not contractual, whether or not for payment. *See* Council Directive 2002/87, art. 2(16), 2003 O.J. (L 35) (EC).

³¹⁹ Risk concentration means all exposures with a loss potential borne by entities within a financial conglomerate, which are large enough to threaten the solvency or the financial position in general of the regulated entities in the financial conglomerate, and which exposures may be caused by counterparty risk/credit risk, investment risk, insurance risk, market risk, other risks, or a combination or interaction of these risks. *See* Council Directive 2002/87, art. 2(17), 2003 O.J. (L 35) (EC).

³²⁰ *See* Council Directive 2002/87, arts 7, 8, Annex II, 2003 O.J. (L 35) (EC).

³²¹ Michael Gruson, *supra* note 295, at 22.

³²² *Id.*

³²³ *Id.* at 23.

³²⁴ *See* Council Directive 2002/87, art. 2(16), 2003 O.J. (L 35) (EC).

³²⁵ Michael Gruson, *supra* note 295, at 23.

regulated entity.³²⁶ Although there are no quantitative limits or qualitative requirements with regard to intra-group transactions within a financial conglomerate, the Directive does leave Member States discretion to introduce such limits and requirements. Similarly, the introduction of other supervisory measures that would achieve the goals of supplementary supervision with regard to intra-group transactions is left to the Member States.³²⁷

As for risk concentration, not all risk concentrations are inherently bad. On the contrary, some extent of concentration is the inevitable for a well-articulated business strategy as well as product specialization, the targeting of a customer base, or a sound strategy of outsourcing data processing activities.³²⁸ However, supervisors do need to balance the benefits against the risks of concentrations at the conglomerate level.³²⁹ In identifying risks, the competent authorities have to take into account the different ways in which large losses can develop in a conglomerate as a result of risk concentration.³³⁰

To avoid additional risks resulting from risk concentration, the EU Member States or the competent authorities should require regulated entities to have adequate risk management processes and internal control mechanisms in the financial conglomerates in order to identify, measure, monitor, and control the risk concentration at the level of the financial conglomerate.³³¹ The competent authorities responsible for supplementary supervision should particularly monitor the possible risk of contagion in the financial conglomerate, the risk of a conflict of interests, the risk of circumvention of sectoral rules, and the level of volume of risks.³³²

The Directive does not give quantitative limits or standards concerning risk concentration at the level of the financial conglomerate, but rather leaves this decision to the Member States.³³³ In addition, the Directive requires Member States to impose upon regulated entities the duty to report on a regular basis and to the coordinator at least annually regarding significant risk concentrations.³³⁴

c. Management Qualification

³²⁶ *Id.*

³²⁷ Council Directive 2002/87, art. 8(3), 2003 O.J. (L 35) (EC).

³²⁸ Michael Gruson, *supra* note 295, at 24.

³²⁹ *Id.*

³³⁰ *Id.*

³³¹ Council Directive 2002/87, art. 7(2), 2003 O.J. (L 35) (EC).

³³² Council Directive 2002/87, Annex II, 2003 O.J. (L 35) (EC).

³³³ Council Directive 2002/87, art. 7(3), 2003 O.J. (L 35) (EC).

³³⁴ Council Directive 2002/87, art. 7(2), 2003 O.J. (L 35) (EC).

The Directive provides that Member States should require persons who effectively direct the business of a mixed financial holding company to prove sufficient good repute and appropriate professional qualifications or experience to perform their duties.³³⁵ This article is intended to ensure that a manager or co-director of a non-regulated entity having a dominant influence on the performance of a regulated entity is reliable, like a manager of the regulated-entity.³³⁶ This thesis, in the next section, also responds to the recent tendency to manage financial conglomerates along the different business lines of conglomerates instead of the traditional legal entity based approaches.³³⁷

3. Measures to Facilitate Supplementary Supervision

To better facilitate the supplementary supervision, the Directive requires competent authorities of Member States to appoint a coordinator responsible for the coordination and exercise of the supplementary supervision of the regulated entities in a financial conglomerate.³³⁸ Detailed criteria regarding the appointment are established.³³⁹ Missions of the coordinator of supplementary supervision are: (1) the coordination of gathering and disseminating relevant or essential information in going concern and emergency situations; (2) the assessment of the financial situation, and the overview and monitoring of the compliance with the rules on capital adequacy, risk concentration, and intra-group transactions; (3) the assessment of the financial conglomerate's structure, organization, and internal control systems; and (4) the planning and coordination of supervisory activities as a going concern as well as in emergency situations, in cooperation with the relevant competent authorities involved.³⁴⁰ It should be mentioned that the coordinator is not granted decision-making or enforcement authority to impose measures and sanctions. The presence of a coordinator entrusted with specific tasks of supplementary supervision does not affect the tasks and responsibilities of the competent authorities responsible for the regulated entities in a financial conglomerate as provided by the sectoral rules.³⁴¹

Competent authorities are also required to work closely with each other.³⁴² The coordinator and competent authorities are obliged to

³³⁵ Council Directive 2002/87, art. 13, 2003 O.J. (L 35) (EC).

³³⁶ Michael Gruson, *supra* note 295, at 25.

³³⁷ *Id.*

³³⁸ Council Directive 2002/87, art. 10(1), 2003 O.J. (L 35) (EC).

³³⁹ For details, *see* Council Directive 2002/87, art. 10(2), 2003 O.J. (L 35) (EC).

³⁴⁰ Council Directive 2002/87, art. 11(1), 2003 O.J. (L 35) (EC).

³⁴¹ Council Directive 2002/87, art. 11(3), 2003 O.J. (L 35) (EC).

³⁴² Council Directive 2002/87, art. 12(1), 2003 O.J. (L 35) (EC).

communicate on requesting all relevant information and shall communicate all essential information on their own initiative.³⁴³ The scope of information exchange comprises: (1) identification of the group structure of all major entities of the financial conglomerate, and of the competent authorities of the regulated entities in the group; (2) the financial conglomerate's strategic policies; (3) the financial situation of the financial conglomerate, in particular the capital adequacy, intra-group transactions, risk concentration and profitability; (4) the financial conglomerate's major shareholders and management; the organization, risk management and internal control systems at financial conglomerate level; (5) procedures for the collection of information from the entities in a financial conglomerate, and the verification of that information; (6) adverse developments in regulated entities or in other entities of the financial conglomerate which could seriously affect the regulated entities; and (7) major sanctions and exceptional measures taken by competent authorities in accordance with sectoral rules or this Directive.³⁴⁴

Under the following circumstances, competent authorities are required to consult with each other prior to decision making: (1) changes in the shareholder, organizational or management structure of regulated entities in a financial conglomerate, which require the approval or authorization of competent authorities; and (2) major sanctions or exceptional measures taken by competent authorities.³⁴⁵

4. Equivalent Supplemental Supervision for Parent Undertakings outside the European Union

If the parent undertaking of a financial conglomerate is a regulated entity or a mixed financial holding company having its head office outside the EU, the regulated entities in the EU belonging to such a "non-EU group" cannot be subject directly to the same rules on supplementary supervision as regulated entities in an "EU group".³⁴⁶ The Directive, however, requires competent authorities of the EU Member State to verify whether the regulated entities in the EU, the parent undertaking of which has its head office outside the EU, are subject to supervision by a third-country competent authority that is equivalent to the supplementary supervision of regulated entities of the Directive.³⁴⁷ The verification should be done by the authority that would be responsible for the supplementary supervision in the absence of equivalent supervision by the

³⁴³ *Id.*

³⁴⁴ *Id.*

³⁴⁵ Council Directive 2002/87, art. 12(2), 2003 O.J. (L 35) (EC)..

³⁴⁶ Council Directive 2002/87, art. 5(3), 2003 O.J. (L 35) (EC).

³⁴⁷ Council Directive 2002/87, art. 18(1), 2003 O.J. (L 35) (EC).

third country.³⁴⁸ In the absence of such equivalent supervision, EU Member States shall apply the provision with regard to supplementary supervision of regulated entities set forth in the EU Directive.³⁴⁹ As an alternative to the application of the supplementary supervision rules by analogy, the Member States may allow their competent authorities to apply other methods that ensure an appropriate supplementary supervision of the regulated entities in a financial conglomerate.³⁵⁰

5. Commentary

The Supplementary Supervision Directive tries hard to be as inclusive as possible. As mentioned, this Directive makes the supplementary supervision apply to both mixed financial holding companies and financial conglomerates established based on the relationship of participation. Unlike the U.S. system where the financial holding company is limited to genuine financial holding companies and must be a bank holding company, this Directive covers a broader range of financial conglomerates. As “efficiency” is one of the five remarkable factors³⁵¹ of “good regulation”, the regulation needs to minimize costs for given benefits.³⁵² The more inclusive Supplementary Directive envisages various possible formations of financial conglomerates. Therefore, most types of financial conglomerates fall within the coverage of this Directive and can be subject to supplementary supervision even if their structure varies. Compared to legislation which only deals with one type of financial conglomerate at a time, the once-and-for-all legislation apparently is a more cost efficient solution. Similarly, when dealing with intra-group transactions, it has a broader range of application. The U.S. rules, Section 23A & 23B of the Federal Reserve Act, apply only to transactions between insured depository institutions (i.e. banks and their affiliates), whereas the Supplementary Supervision Directive applies to all transactions between all regulated entities within a financial conglomerate and other entities in the group.³⁵³

The Supplementary Supervision Directive also empowers competent authorities to determine whether a group constitutes a financial conglomerate and whether supplementary supervision applies to “quasi financial conglomerates”. Although the high degree of discretion provides

³⁴⁸ *Id.*

³⁴⁹ Council Directive 2002/87, art. 18(2), 2003 O.J. (L 35) (EC).

³⁵⁰ Council Directive 2002/87, art. 18(3), 2003 O.J. (L 35) (EC).

³⁵¹ These factors are: (1) the legislative mandate, (2) accountability, (3) due process, (4) expertise, and (5) efficiency. See ROBERT BALDWIN & MARTIN CAVE, UNDERSTANDING REGULATION- THEORY, STRATEGY, AND PRACTICE 76-85 (1999).

³⁵² *Id.* at 89.

³⁵³ Council Directive 2002/87, art. 2(18), 2003 O.J. (L 35) (EC).

competent authorities flexibility in determination, it also creates a higher possibility of different decisions amongst the Member States. If two decisions conflict, financial conglomerates may take advantage of the less scrutinized jurisdiction to dodge supervision.

The Directive requires financial conglomerates to disclose with any supervisory authority the fact that they are financial conglomerates. The Directive requires competent authorities to detect and determine whether a regulated entity is a member of a financial conglomerate.³⁵⁴ Because financial conglomerates have far better knowledge regarding their own structure than their supervisors, imposing the duty of notification upon financial conglomerates seems to be more efficient and effective. Information provided by financial conglomerates must be more accurate and complete. Competent authorities' investigation is not only time consuming but may not be as accurate as that provided by the conglomerates. Besides, as market discipline is the third pillar of the Basel Committee Capital Accord,³⁵⁵ to require groups that fall within the definition of financial conglomerates to disclose their status is appropriate. The American system is a successful example.

VI. ESTABLISHING AN OPTIMAL REGULATORY AND SUPERVISORY REGIME FOR FINANCIAL CONGLOMERATES IN CHINA IN ACCORDANCE WITH INTERNATIONAL STANDARDS AND MEETING THE NEEDS FOR THE POST-WTO ERA

A. *In General, What should an Optimal Regulation be?*

This section intends to propose a new regulatory and supervisory regime which does not currently exist. This regime is solely for the use of supervising financial conglomerates in China based on the systems discussed in the previous two sections.

Based upon the comparative law studies in the preceding sections, countries, including the U.S and the European Union, have promulgated laws and regulations dealing specifically with supervisory concerns associated with financial conglomerates. Such legislation is complimentary to existing financial laws and regulations. Because of the cross-sectoral nature of a financial conglomerate and the complexity of its supervision, it is more appropriate for China to follow in the footsteps of developed countries by promulgating new laws and related regulations for

³⁵⁴ Council Directive 2002/87, art. 4(4), 2003 O.J. (L 35) (EC).

³⁵⁵ See generally Basel Committee on Banking Supervision, *Working Paper on Pillar Three – Market Discipline* (Sep. 2001) (unpublished working paper, on file with the Bank of International Settlements), available at http://www.bis.org/publ/bcbs_wp7.pdf (last visited Oct. 30, 2009).

the supervision of financial conglomerates, rather than dealing with supervisory issues in existing sectoral rules. But to what extent can a legal framework with regards to the supervision of financial conglomerates be deemed “optimal”?

The word “optimal” is defined as most desirable or possible under a restriction expressed or implied.³⁵⁶ From preceding sections, it can be clearly observed that the history and environment of financial markets in different countries vary. Financial supervisory frameworks in respective countries that are generally blueprinted to fulfill particular supervisory demands of that specific country are also divergent. No universal approach has ever been available regarding regulation of financial institutions. Although international organizations, such as Joint Forum, strive to set up harmonized international standards, numerous flexibilities are provided for adopting countries to consider. A supervisory system that functions well in one country does not necessarily translate to another. In addition, considering the dynamic nature of the financial market, innovations in technology, financial product and service techniques are always occurring. There is no guarantee that a regulation which works well in one era will continue to do so ten or even five years later. Owing to the above facts and limitations, a perfect regulation or supervisory system for the supervision of financial conglomerates does not exist. This article has never attempted to propose a perfect or ideal framework for the supervision of financial conglomerates in China. Instead, this article attempts to tailor the most feasible system for China under such intrinsic limits, creating an optimal system. This portion of the article will discuss the essence and characteristic of an optimal regulation and supervisory framework.

B. *Rationales for Financial Regulation*

A well functioning financial system contributes to economic performance by facilitating transactions, mobilizing savings, and allocating capital across time and space.³⁵⁷ As such, the failure of financial institutions can be detrimental to the economy and cause expensive associated social cost. Thus, two major objectives that financial regulations attempt to accomplish are: safeguarding the financial system against systemic risk and protecting consumers.³⁵⁸

³⁵⁶ Webster's Online Dictionary, available at <http://www.websters-online-dictionary.org/definition/optimal> (last visited Jan. 17, 2010).

³⁵⁷ RICHARD J. HERRING & ANTHONY M. SANTOMERO, *What is optimal Financial Regulation?*, in THE NEW FINANCIAL ARCHITECTURE: BANKING REGULATION IN THE 21ST CENTURY 52 (Benton E. Gup ed. 2000).

³⁵⁸ *Id.* at 52. The two objectives are commonly agreed. Other objectives proposed include enhancing the efficiency of the financial system and achieving a broad range of social objectives.

With respect to countering the systematic risk, regulation is both inevitable and justified because the social costs of the failure of financial institutions usually exceed private costs. Further, potential costs have never been considered in the decision making of financial institutions.³⁵⁹ Systematic risk occurs when the failure of a particular institution increases the likelihood of the failure or actual failure of other institutions due to a tight network of financial linkage among institutions.³⁶⁰ In the case of banks, financial difficulties, including a default on obligations, at a particular bank can spread to others.³⁶¹ Owing to their reliance on the reinsurance market, insurance companies are subject to the same risks.³⁶² Financial conglomerates generate increased probability of systematic risk due to the frequent financial linkage caused by intra-group transactions and possible reputational risk contagion as a financial conglomerate is often viewed as a single economic unit. Accordingly, regulators must be involved in compelling financial institutions to take contagion into account through various regulatory methods, such as setting higher capital requirements in line with the institutions' contributions to systemic risk or prudential regulation aimed at maintaining the safety and soundness of the financial institutions.³⁶³ Tools commonly utilized to supervise systematic risk include capital adequacy requirements, restrictions on activities and diversification requirements, general standards of conduct on institutions as well their personnel, periodic reporting requirements, authority of on-site inspection by supervisors, and regulatory review of the establishment or acquisition of controlling interests in existing institutions.³⁶⁴ No matter which approach is adopted, an optimal regulation for the supervision of financial conglomerates should perform the function of mitigating the systematic risk.

The other fundamental rationale for financial regulation is the protection of consumers against excessive prices or risky behavior by the providers of financial services or participants in financial markets.³⁶⁵ This

³⁵⁹ David Llewellyn, *The Economic Rationale for Financial Regulation* 13 (Apr. 1999) (unpublished manuscript, on file with the Financial Services Authority), available at <http://www.fsa.gov.uk/pubs/policy/P14.pdf>.

³⁶⁰ Stephen R. Freedman, *Regulating the Modern Financial Firm: Implications of Disintermediation and Conglomeration* 5 (St. Gallen Economics, Working Paper No. 2000-21, 2000), available at <http://ssrn.com/abstract=253928> (last visited Jan. 17, 2010).

³⁶¹ *Id.*

³⁶² Alan D. Morrison, *The Economics of Capital Regulation in Financial Conglomerates* 6 (Oxford Financial Research Center, Working Paper No. 2002-FE-08, 2002), available at <http://ssrn.com/abstract=331040> (last visited Jan. 17, 2010).

³⁶³ *Id.* at 6. See also CHARLES GOODHART ET. AL., FINANCIAL REGULATION: WHY, HOW AND WHERE NOW? 5 (1998).

³⁶⁴ Jackson, *supra* note 51, at 3.

³⁶⁵ HERRING & SANTOMERO, *supra* note 357, at 54.

protection is necessary due to the asymmetry of information in the financial market. Since consumers (other than institutional customers) of financial institutions are often unsophisticated, insofar as being incapable of understanding complicated balance and off-balance sheet activities, they have neither the incentive nor the ability to perform various monitoring functions including screening, auditing, covenant formation and intervention.³⁶⁶ When consumers are ill-informed, adverse effect to the financial market can occur as the demand for services is reduced. Where consumers are aware of the existence of both good and bad products in the market but are incapable of distinguishing them at the time of purchase because the quality may be revealed only after a certain period of time, the demand of some products may decrease.³⁶⁷ Therefore, there is a need for either public or private representatives of consumers to perform the monitoring function.³⁶⁸ The government may carry out this function either by itself or by providing sufficient information that enables consumers to activate market discipline toward financial institutions and financial conglomerates. In the later case, information may be made available to consumers at very low cost by the government agency or private rating agency.³⁶⁹ Therefore, a regulation which requires the disclosure of relevant information is an essential ingredient of consumer protection.³⁷⁰ In addition, consumers need to be protected in the case of the failure of a financial institution, as it may lead to the consequence of the loss of borrowers' information, which will force borrowers to turn to other institutions with more expensive terms to fulfill their financial needs.³⁷¹ Business regulations are a necessary approach to protect consumers from such interest rate risk. The regulation should include honesty and integrity requirements on the regulated institution itself and its employees, the level of competence of the institution, fair business practice, and the way financial services and products are marketed.³⁷² In sum, an optimal regulation for the supervision of financial conglomerates also necessitates the mechanism of consumer protection.

³⁶⁶ MATHIAS DEWATRIPONT & JEAN TIROLE, *THE PRUDENTIAL REGULATION OF BANKS* 31-32 (1999).

³⁶⁷ Llewellyn, *supra* note 359, at 25.

³⁶⁸ DEWATRIPONT & TIROLE, *supra* note 366, at 32.

³⁶⁹ EIRIK G. FURUBOTN & RUDOLF RICHTER, *THE ECONOMICS AND LAW OF BANKING REGULATION* 4 (1989).

³⁷⁰ Llewellyn, *supra* note 359, at 32.

³⁷¹ FURUBOTN & RICHTER, *supra* note 369, at 5.

³⁷² Goodhart, *supra* note 363, at 6.

C. *Essence of an Optimal Regulatory System*

To determine whether a regulatory system is good or optimal, there are five key questions to be asked: (1) is the regulatory regime supported by legislative authority; (2) is there an appropriate scheme of accountability; (3) are procedures fair, accessible, and open; (4) do regulators have sufficient expertise; and (5) is the regime efficient?³⁷³

First, an optimal regulation must have legislative mandate. The fundamentals of democracy and rule of law suggests that regulation or regulatory action needs to be authorized by a legislative body (congress, parliament...etc.).³⁷⁴ It is noteworthy that as regulatory statutes may provide regulators with a broad range of discretion and implementing the mandate, interpretation through administrative direction or regulation is inevitable.³⁷⁵ Second, regulators in an optimal system must be properly accountable to democratic institutions.³⁷⁶ Regulatory independence, on the other hand, cannot be interfered with when pursuing accountability. Regulators must still have wide autonomy in setting, at minimum, prudential regulations and must be above the influence of others.³⁷⁷ Third, regulations in an optimal system must embrace due process, which is fair, accessible and open.³⁷⁸ The rationale behind this is that proper democratic influence over regulation is ensured by due process being observed and that such influence has a legitimate effect.³⁷⁹ Fourth, a functional regulatory system may require the demonstration of expert judgment.³⁸⁰ As in financial markets, supervisory judgment has to be made on the basis of a number of factors and variables, specialized knowledge and techniques as well as experience are indispensable.³⁸¹ Fifth, regulation is also required in order to achieve efficiency. The efficiency of regulation is carried out in two aspects: one is that the legislative mandate is being implemented at the least possible level of costs so as to accomplish productive efficiency; and the other is that the regulation itself leads to efficient result.³⁸² Some economists suggest the utilization of cost-benefit

³⁷³ ROBERT BALDWIN & MARTIN CAVE, *UNDERSTANDING REGULATION: THEORY, STRATEGY, AND PRACTICE* 77 (1999).

³⁷⁴ *Id.* at 78.

³⁷⁵ *Id.*

³⁷⁶ *Id.* at 79.

³⁷⁷ KENNETH K. MWENDA, *LEGAL ASPECTS OF FINANCIAL SERVICES REGULATIONS AND THE CONCEPT OF A UNIFIED REGULATOR* 20 (2006).

³⁷⁸ BALDWIN & CAVE, *supra* note 373, at 79.

³⁷⁹ *Id.*

³⁸⁰ *Id.* at 80.

³⁸¹ *Id.* at 85.

³⁸² *Id.* at 81.

analysis to determine whether a regulation is efficient and, accordingly, find that some regulations make economic sense and others do not as some regulations are likely to fail a benefit-cost test.³⁸³ Although these five elements of optimal regulation are not completely without issue,³⁸⁴ they collectively constitute a series of benchmarks for assessing the optimum of regulatory regimes.

In addition, an optimal regulatory system cannot avoid considering potential costs of regulation without lowering it. The first potential cost of regulation is the possible impediment to competition. Regulation should not impede competition but should promote it, and by correcting the asymmetries of information, make it more effective in the market place.³⁸⁵ As there are clear consumer benefits and efficiency gains to be secured through competition, regulation should not be erected in a way that hinders it.³⁸⁶ Studies surrounding the “private interest view”, or regulatory capture view, contend that governments are usually the supplier of regulations, and although consumers may demand regulation, industry actually generates major influence on the demand side both for and against certain types of regulations.³⁸⁷ Since the benefits of regulation are dispersed among many customers, while the cost and benefit of regulation are concentrated, it is likely that industry may have a predominant role in shaping the regulatory approach adopted by the government.³⁸⁸ That is to say, the one regulated will likely capture the thoughts of the regulator so that the public interests of enhancing competition and consumer protection will be impaired. In fact, regulation and competition does not necessarily conflict with each other, on the contrary, if the regulation is properly constructed to lessen the possibility of regulatory capture, they are complementary to each other.³⁸⁹ Regulatory capture can be alleviated through greater reliance on market discipline, information disclosure, lighter hand by the regulatory authorities, and significant oversight of the regulatory process.³⁹⁰ By requiring the disclosure of relevant information

³⁸³ Robert W. Hahn & Rohit Malik, *Is Regulation Good for You?*, 27 HARV. J.L. & PUB. POL’Y 893, 904 (2004).

³⁸⁴ For example, how the public evaluates the expertise of regulators and how to determine the efficiency on the occasion that objectives for regulations exist in tension or even conflict are questions raised in the discussion of the five elements. See Baldwin & Cave, *supra* note 373, at 85.

³⁸⁵ LLEWELLYN, *supra* note 359, at 46.

³⁸⁶ *Id.* at 46-47.

³⁸⁷ JAMES R. BARTH ET. AL., RETHINKING BANKING REGULATION: TILL ANGELS GOVERN 20 (2006).

³⁸⁸ *Id.*

³⁸⁹ LLEWELLYN, *supra* note 359, at 47.

³⁹⁰ BARTH, *supra* note 387, at 20.

so consumers can make informed choices, regulation can also make competition more effective in the market place.³⁹¹

The second potential cost is that over-burdensome regulation may result in losing business. If the regulation is too severe, making it difficult for the one regulated to conform except at disproportionate trouble and excessive expense, it may divert the industry to the country with more moderate regulation.³⁹² Therefore, as the risk that excessive regulation can lead to the move of business, the optimal regulatory system needs to be created in an effective but less burdensome way. The third potential cost of regulation is the risk of curbing innovation. Although the technological change and innovation can alter the form of best practice over time, the fall-behind regulation regarding the best practice may shift the balance of advantage toward the status quo and away from innovation and thus cause dynamic inefficiency.³⁹³ Hence, financial regulation should be active rather than passive, continually changing in response to economic conditions and technological innovations.³⁹⁴

The final issue concerning the optimal regulation is the role that market discipline plays in the regulatory system. The importance and function of market discipline is emphasized in Pillar Three of the New Basel Accord.³⁹⁵ Empirical studies found that countries, which adopt regulations mandating the disclosure of accurate, comparable information about financial institutions to private sector, tend to have better developed financial system.³⁹⁶ Further, academic finding suggests that regulations that require informational transparency as well as strengthen the ability and incentives of the private sector to monitor financial institutions tend to promote sound financial system.³⁹⁷ Therefore, supervision works better

³⁹¹ LLEWELLYN, *supra* note 359, at 47.

³⁹² CHARLES GOODHART ET. AL., FINANCIAL REGULATION – OR OVER-REGULATION? 21 (1988).

³⁹³ *Id.* at 25.

³⁹⁴ JOHN J. SEATER, OPTIMAL BANKING REGULATION AND MONETARY POLICY, at 31 (2001), available at <http://ssrn.com/abstract=260106> (last visited Jan. 17, 2010).

³⁹⁵ Basel Committee, *A New Capital Adequacy Framework: Pillar Three – Market Discipline*, 2-3 (2003) (Unpublished Consultative Paper) (As BCBS views increased disclosure, enhanced transparency and market discipline as increasingly important tools of supervision, Pillar Three, considered a key to improve the overall effectiveness of the Accord, is built for the purpose of enhancing transparency and promoting market discipline through supervisors' introduction of the disclosure requirement with clear remedial action in the case of non-disclosure. Under the rationale of public disclosure, market discipline performs an essential role in ensuring that the capital of banking institutions is maintained at adequate levels, because public disclosure allows market participants to assess a bank's capital adequacy, providing strong incentives to banks to conduct their business in a safe, sound and efficient manner.).

³⁹⁶ BARTH, *supra* note 387, at 255.

³⁹⁷ *Id.* at 312.

when it facilitates market discipline. An important role of the supervisor is to ensure the disclosure of high quality information from regulated institutions.³⁹⁸ An optimal regulatory system needs to include promotion of market discipline.

D. Permission of Financial Conglomerates (Licensing)

When the Chinese government establishes a set of regulation for the supervision of the financial conglomerates, the first issue to address is licensing. What type of financial conglomerates should be permitted in China? Does the establishment of financial conglomerates require the prior approval of supervisors? Both questions will be answered in the following discussion.

1. Permitted Structure and Activities of Financial Conglomerates

As mentioned earlier, existing financial conglomerates can be divided into three major categories, namely the "complete integration (universal bank)" model, the "bank parent, nonbank subsidiary" model, and the "financial holding company" (FHC) model. Each model has its advantages and disadvantages.³⁹⁹

While the complete integration model is the most advantageous in resource sharing among the various departments (i.e. to conduct different financial businesses at the lowest theoretical cost),⁴⁰⁰ potential risks associated with this model are also the highest among the three models. Conflicts of interest may arise when the bank itself engages in diverse activities and attempts, for example, to dump low quality securities or shift risk to ill-informed customers.⁴⁰¹ Besides, banks may be encouraged to engage in riskier behavior if they are provided opportunities to engage in a broader range of activities that increase the probability of risk concentration and risk contagion.⁴⁰² In addition, broad financial activities and the mixing of banking and commerce may lead to an extremely large and complex structure that is extraordinarily difficult to supervise.⁴⁰³ The large universal bank may also become so politically and economically powerful that it impedes the competition and becomes "too big to discipline."⁴⁰⁴

³⁹⁸ *Id.*

³⁹⁹ See HERRING & SANTOMERO, THE CORPORATE STRUCTURE OF FINANCIAL CONGLOMERATES, 4 J. FIN. SERVICES RES. 4, 213, 223-230 (1990).

⁴⁰⁰ *Id.*

⁴⁰¹ BARTH, *supra* note 387, at 47.

⁴⁰² *Id.*

⁴⁰³ *Id.*

⁴⁰⁴ *Id.*

A universal banking system is adopted in Germany because of the unique relationship between banks and commerce in Germany. Universal banks control a large part of the ownership and management of non-financial German companies. This relationship enables the capital to be made available to companies and makes it easier for them to adopt long-term strategies, and to carry out investment projects that are less appealing with regard to short-term results because of a long-term timeframe.⁴⁰⁵ In other words, the appearance of the universal banking system in Germany has historical and economic background. In comparison to Germany, the development of the financial service market in China is completely different. Before 1995, banks were formed to support and sustain the state-owned enterprises (SOEs), despite the presence and stability of a sound lending practice.⁴⁰⁶ The relationship between banks and industry was established under the direction of the government, and banks were designated to finance the large size of fundamental construction projects and to extend credit to enterprises that ordinary commercial banks would not finance.⁴⁰⁷ This thesis does not suggest that China should adopt the universal banking model as a model of financial conglomerates in China, given that the evolution of banking service and the relationship between banking and commerce in China and Germany are totally divergent, and that Chinese banks have not conquered the non-performing loan problems,⁴⁰⁸ having only reached the early stage of developing modern risk management and operational practice.

Debates occurred during the legislation of Gramm-Leach-Bliley Act in the U.S. regarding the adoption of the "bank parent, non-bank subsidiary" model and the "financial holding company" model. The Federal Reserve Board (FRB), as mentioned earlier, took the position that non-banking activities should only be permitted in holding company affiliates and that the use of operating subsidiaries should not be permitted at all. FRB stressed that while the new activities being considered were not unusually risky, such activities caused additional risk and that any losses realized thereto would have to be absorbed by a national bank, or by the owner of an operating subsidiary.⁴⁰⁹ In this case, the erosion of market

⁴⁰⁵ JORDI CANALS, *UNIVERSAL BANKING: INTERNATIONAL COMPARISON AND THEORETICAL PERSPECTIVES* 161 (1997).

⁴⁰⁶ The Role of the Financial System in Enterprise Reform, <http://www.oecd.org/dataoecd/39/23/1889325.pdf> (last visited Feb. 23, 2005).

⁴⁰⁷ CHAOMING LIU & XIAN ZHANG, *ZHONG GUO JIN RONG TI ZHI GAI GE YAN JIU* [A Study on the Reform of Financial System in China], 108 (2003).

⁴⁰⁸ See Nicholas R. Lardy, *The Challenge of Bank Restructuring in China*, in *Strengthening the Banking System in China: Issues and Experience* 26-28 (BIS Policy Paper 1999).

⁴⁰⁹ *Financial Services Modernization: Hearing on H.R. 10 Before the S. Comm. on Banking, Housing and Urban Affairs*, 105th Cong. (1998) (testimony of Alan

confidence and damage to the reputation may impair the safety and soundness of banks.⁴¹⁰ FRB also expressed concern about the potential adverse effects that the subsidiaries may cause to the federal safety net due to the banks' excessive risk-taking triggered by the moral hazard.⁴¹¹ The Treasury Department and the Office of Comptroller of Currency (OCC), on the other hand, expressed a completely opposite viewpoint. It indicated that the use of an operating subsidiary for non-banking financial activities would create an additional source of income for banks so as to sustain banks during the downturn in other economic sectors, as well as to lower the probability of bank failure and strengthen the Federal Deposit Insurance system.⁴¹² The OCC also challenged the FRB opinion by advocating that the safety net subsidy would not happen if firewalls were properly created.⁴¹³ These firewalls include the restrictions on affiliate transactions created by Sections 23A and 23B of the Federal Reserve Act and adjustment of regulatory capital.⁴¹⁴

In fact, differing from the universal bank, both models allow the corporate separation between the two entities. As long as the subsidiary is not deliberately undercapitalized, and the separate accounting and corporate records are well maintained, both models are able to insulate the bank from any undue risks associated with new financial activities.⁴¹⁵ Eventually, the GLBA accepted both models but narrowed the scope of the authorized activities of banks' financial subsidiaries.⁴¹⁶ Therefore, there seems to be no significant ground to determine whether one of the two models is better than the other. Hence, under the premise that the safeguard is adhered to, both models should be permitted for banks to engage in non-banking financial activities. As China is in the middle of establishing the deposit insurance system,⁴¹⁷ it is essential to consider

Greenspan, Chairman, Board of Governors of the Federal Reserve System) [hereinafter Greenspan Testimony 1998].

⁴¹⁰ Constance Z. Wagner, *Structuring The Financial Service Conglomerates Of The Future: Does The Choice Of Corporate Form To House New Financial Activities Of National Banks Matter?* 19 ANN. REV. BANKING L. 329, 394 (2000).

⁴¹¹ Greenspan Testimony 1998, *supra* note 409.

⁴¹² Wagner, *supra* note 410, at 397-398.

⁴¹³ *Financial Services Modernization: Hearing on H.R. 10 Before the S. Comm. on Banking, Housing and Urban Affairs*, 105th Cong. (1998) (testimony of Julie Williams, Acting Comptroller of the Currency) [hereinafter Williams Testimony 1998].

⁴¹⁴ *Id.*

⁴¹⁵ Wagner, *supra* note 410, at 409.

⁴¹⁶ *Id.*

⁴¹⁷ Central Government: Deposit Insurance Act has been in the Line of the Legislative Project, http://news.xinhuanet.com/fortune/2005-09/17/content_3502913.htm (last visited Jan. 17, 2010).

arranging proper limits on its coverage in order to prevent the safety net subsidy in the future.

2. Non-financial Activities: Case of Mixed Holding Company or Mixed Conglomerates

As previously discussed, the Tripartite Group has identified mixed conglomerates and mixed holding companies as a factor that can create additional risks to the conglomerate and increase the supervisory difficulties.⁴¹⁸ Typically, parent companies of mixed conglomerates are industrial or commercial, with the regulated financial entities embedded downstream in the group structure.⁴¹⁹ With such a structure, supervisors encounter obstacles in assessing group capital adequacy, as it is neither legally nor practically possible to include the capital of commercial or industrial parents and evaluate the group as a whole.⁴²⁰ Similarly, situations like harmful intra-group exposure and risk contagion, either financial or reputation-wise, become uneasy to detect in mixed conglomerate.⁴²¹

With regard to this matter, Conglomerate Directive of European Council endowed competent authorities to decide whether to include supplementary supervision when certain conditions are fulfilled.⁴²² These rules imply that Members of the European Union basically accept and allow the existence of mixed conglomerates but regard them as “genuine financial conglomerates” subject to the same degree of supervision. The United States, on the other hand, do not affirm the mixed holding companies. Except for merchant banking activities that are subject to strict restrictions (i.e., no involvement in the daily operation), U.S. laws generally prohibit the new establishment of mixed holding companies and set up the grandfather rule to require the mixed financial holding company formed before a specific date to divest the non-financial activities within a certain period of time.⁴²³ Taiwan insists only on the “pure holding company” for the purposes of: (1) simplifying the supervision of financial holding companies; (2) maintaining the specialization of the holding company; and (3) minimizing the intervention of supervisors.⁴²⁴

⁴¹⁸ See Tripartite Group of Bank, Securities, and Insurance Regulators, *The Supervision of Financial Conglomerates*, 36 (1995).

⁴¹⁹ *Id.*

⁴²⁰ *Id.*

⁴²¹ *Id.*

⁴²² See Council Directive 2002/87, art. 5, 2003 O.J. (L 35) 4 (EC).

⁴²³ See 12 U.S.C. § 1843(n)(7).

⁴²⁴ JIN-LONG PENG, JING RONG KONG GU GONG SHI FA ZHI YU JING YING CHEE LUE [Financial Holding Company: Regulation and Strategy] 43-44 (2004).

Since no sufficient empirical studies provide a clear answer on which system is superior, this thesis does not attempt to give any judgment on either system. Instead, this thesis proposes the following:

If the prohibition of mixed conglomerates is chosen, considering the actual existence of mixed conglomerates in China,⁴²⁵ it is necessary to enact the grandfather rule like the one in the U.S. in which a reasonable period of time for divestment is provided.

If the policy maker selects to give permission to the mixed holding companies, except for mandating the mixed holding companies surrender to the regular supervision rules and procedures of financial conglomerates, competent authorities should adopt a legal provision requiring the formation of a financial institution sub-group within mixed-activity groups for the purpose of insisting the legal and organizational separation.⁴²⁶ The sub-group should contain all group members engaged predominantly in financial service activities. The design of a sub-group structure will separate the relevant financial sector operations in order to simulate a financial conglomerate structure, which will facilitate the application of regulation and the conduct of supervision, and help to build a more level playing field among financial and mixed-activity conglomerates.⁴²⁷ Furthermore, if mixed-activity groups are allowed, regulators will need to determine permissible structures for the ownership relationship between the financial institution sub-group and group members engaged predominantly in commercial or industrial activities.⁴²⁸ By requiring a structure within which all group commercial and industrial entities are upstream of the financial sub-group may promote transparency, and can more easily identify the financial responsibility of those entities for the financial sub-group.⁴²⁹ In addition, supervisors should also be empowered to decline the application of the formation of the mixed conglomerates if their structure does not meet the transparency requirement, and to force the mixed conglomerate to divest the non-financial activity if such activity has posed significant and clear danger to the safety and soundness of financial sub-groups.

3. Procedure of Licensing

a. Prior Approval by Supervisors

Approaches employed to address the issue regarding the establishment of new financial conglomerates differ from country to

⁴²⁵ See *infra* Part II of this paper.

⁴²⁶ Tripartite Group, *supra* note 3, at 37.

⁴²⁷ DAVID H. SCOTT, THE REGULATION AND SUPERVISION OF DOMESTIC FINANCIAL CONGLOMERATES 18 (1994).

⁴²⁸ *Id.*

⁴²⁹ *Id.* at 19.

country. The British system represents a system that does not require prior approval from a competent authority before the formation of financial conglomerates. Pursuant to British law, supervisors of financial firms can initiate the identification of financial conglomerates once they discover that a regulated entity is a member of a consolidated group that may be a financial conglomerate.⁴³⁰ Then, the competent authority should notify the financial conglomerate that it has been identified as a financial conglomerate.⁴³¹ A member of a group may also start such process by notifying one of the competent authorities that its group may be a financial conglomerate.⁴³² As for the American system, although a BHC may become an FHC simply by filing a declaration of election with the FRB, as long as it fulfills the requirement of being well-capitalized and well-managed, the prerequisite of becoming an FHC – the establishment of a BHC – still requires the approval from FRB based on the factors enumerated in related laws and regulations.⁴³³ In Taiwan, China's neighbor, which shares common language and cultural background with China, the submission of an application to the Financial Supervision Commission for approval is also the prerequisite for the establishment of a financial holding company.⁴³⁴

The requirement for prior approval is critical to the implementation of supervisory policies because the authorization process for the establishment of a new financial conglomerate begins when supervisors first establish an appropriate working relationship with the institution's directors, managers and external auditors, whose qualifications must be reviewed by the authorities.⁴³⁵ In addition, approval requirements can perform the function of promoting organizational, managerial and financial transparency, as well as apply suitability standards promoting the autonomy of directors, managers and external auditors.⁴³⁶ More importantly, the approval process enables supervisors to screen applicants so as to ensure they are “fit and proper.”⁴³⁷ By imposing the appropriate level of entry requirements, only the highest quality applicants can be

⁴³⁰ FSA, General Prudential Sourcebook for Banks, Building Societies and Investment Firms, GENPRU 3.1.3(2) (2007) [hereinafter GENPRU].

⁴³¹ *Id.* at 3.1.3(8).

⁴³² BIPRU, The Prudential Sourcebook for Banks, Building Societies and Investment Firms, 3.1.3 (4) (2007) [hereinafter BIPRU].

⁴³³ See 12 U.S.C. §§ 1842(a) – (c); 12 C.F.R. §§ 225.11 - 225.16.

⁴³⁴ Financial Holding Company Act of Taiwan, art. 9(1) (2004).

⁴³⁵ Scott, *supra* note 427, at 20.

⁴³⁶ *Id.* at 20-21.

⁴³⁷ BARTH, *supra* note 387, at 111.

granted approval and thereby the overall performance and stability of financial conglomerates can be enhanced.⁴³⁸

The liberal entry system, such as the British system, needs to be built on the foundation of a well-functioned market discipline that most financial markets of developing countries like China do not have.⁴³⁹ Considering the benefits of prior approval and the ineffectiveness of market discipline, this thesis prefers entry screening by the supervisors before approving the establishment of financial conglomerates. Rules regulating the information that a financial group is required to provide for approval should at least include: (1) a draft of by-laws; (2) an intended organizational chart; (3) the background, experience and suitability of significant shareholders, future directors and managers; (4) financial plans and the existence of adequate capital; and (6) business plans.⁴⁴⁰

b. Commencement of New Financial Activities

With respect to whether a supervisor's prior approval is needed for an established financial holding company to conduct a new financial activity or to acquire a new subsidiary that engages in financial activities, distinctions also exist between American law and Taiwanese law. The BHCA of United States permits an FHC to acquire any company or commence any activity that has been enumerated in related laws and regulations or pre-approved by competent authorities by simply providing written notice to the FRB within a certain period of time after commencing the activity or acquisition.⁴⁴¹ On the other hand, regarding activities that have yet to be approved by the FRB, the FRB may, upon request by the FHC, determine whether a certain activity is financial in nature.⁴⁴² It is noteworthy that this determination is conducted on an activity basis rather than an institution basis so that a one-time decision will turn a new activity into pre-approval and, therefore, produce efficiencies. The Financial Holding Company Act of Taiwan, however, requires prior approval before conducting a new activity without regard as to whether such activity has been listed in the FHCA or not.⁴⁴³ The primary reason why Taiwan adopts the prior-approval system is to

⁴³⁸ *Id.*

⁴³⁹ Empirical studies indicate that market discipline is less effective in countries where corruption exists. See Haizhou Huang & Chenggang Xu, *Financial Institutions, Contagious Risks and Financial Crisis* 31 (William Davidson Institute, Working Paper No. 444, Nov. 2001), available at <http://ssrn.com/abstract=307103> (last visited Jan. 17, 2010).

⁴⁴⁰ BARTH, *supra* note 387, at 111; Scott, *supra* note 427, at 20.

⁴⁴¹ See 12 U.S.C. § 1843(k)(6). See also *infra* Part V.

⁴⁴² See 12 U.S.C. § 1843(k)(5); 12 C.F.R. §§ 225.86(c)-(e).

⁴⁴³ Financial Holding Company Act of Taiwan, arts. 36-37(1) (2004).

maintain the safety and soundness of both the investing holding company and the invested company by ensuring that the applicant has no issues in capital adequacy and management, as well as no significant violation of related laws and regulations.⁴⁴⁴ Although such reasoning makes sense, the requirement of authorization seems to create an unnecessary burden to financial holding companies. As for the capital adequacy, management and operations are subject to the ongoing supervision of FSC. The objective of this pre-approval process can be satisfied regardless of the existence of this requirement. Hence, weighing the potential anti-competition costs of excessive regulatory intervention, the American system seems to allow more flexibility and efficiency without impeding supervisors' power in overseeing the safe and sound practice of financial conglomerates.

E. Supervision of Potential Risks Associated with Financial Conglomerates

Potential risks that may adversely affect the safety and soundness of a financial conglomerate and even the entire financial market have been identified in section III of this thesis. The following discussion attempts to delineate a regulatory system for China to address issues concerning capital adequacy, risk concentration, intra-group transaction and exposure, risk contagion and the internal risk management system of financial conglomerates.

1. Group Capital Adequacy

The rationale for requiring the capital adequacy of financial conglomerates arises from the reason behind imposing the capital requirement on individual financial institutions – customers of financial institutions fail to price the risk of such institutions that tend to take excessive risk incurred by moral hazard regardless of the potential systematic risk.⁴⁴⁵ The purpose of imposing a regulatory capital adequacy requirement is to reflect the magnitude and importance of risks that financial institutions ignore when conducting their activities.⁴⁴⁶ The capital adequacy requirement charges financial institutions and their shareholders the risk they do not consider by making them suffer the loss of their own money once the risk realizes.⁴⁴⁷ That way, financial institutions will be more cautious about the risks they take. Supervisors' further concerns in the supervision of financial conglomerates, however, is that even if each member of a financial conglomerate has met its own

⁴⁴⁴ REN-REN SHI, JING-RONG KONG KU GONG SHI FA ZHI YU SHI WU [Laws and Practice of Financial Holding Company Act] 156 (Taiwan 2006).

⁴⁴⁵ Morrison, *supra* note 362, at 4-5.

⁴⁴⁶ *Id.* at 4.

⁴⁴⁷ *Id.* at 5.

regulatory capital requirement, capital will be used several times to determine the adequate capital coverage for the group, as well as for the different sectors of the conglomerate.⁴⁴⁸ This risk of double or multiple gearing should be prevented. Moreover, the traditional solo supervision, as emphasized in section III of this thesis, actually creates a barrier for supervisors of each sector to obtain a coherent understanding of the group as a whole so that the problem of double gearing may not be discovered through solo supervision. Only through the consolidated supervision can the group capital adequacy be properly determined.⁴⁴⁹ Regarding the consolidation, two more questions that remain to be answered are: (1) to what extent should a partial owner be held responsible for risks in partially-owned subsidiaries; and (2) how much of any excess capital in a partially-owned subsidiary can be attributed to the part-owner? All these issues should be addressed when establishing a supervisory system for financial conglomerates.

In addition, the innovation of financial conglomerates' self-regulation with regard to capital is noteworthy. Since financial conglomerates tend to aggregate risks across diverse business lines, the capital of financial conglomerates needs to be sufficient to provide a buffer for those risks.⁴⁵⁰ A Survey conducted by the Joint Forum indicates that financial conglomerates, in recent years, have developed centralized risk management functions to counter the difficulties in aggregating risk exposures across the full range of a conglomerate's activities and to quickly develop more consistent methods to monitor risks across sectors within a conglomerate.⁴⁵¹ Associated with the evolvement of centralized risk management mechanism, modern financial conglomerates also establish a methodology of risk aggregation called the "economic capital method" designed to assess the amount of capital needed to support a given set of risks.⁴⁵² This fashion can be deemed as the enhancement of financial conglomerates' self-regulation in the aspect of capital. Although it is always inappropriate for supervisors to intervene in the design and erection of each conglomerate's positive development in self-regulation, the important responsibility of supervisors is to realize those revolutionized risk management process and methodologies and develop

⁴⁴⁸ Van den Berghe & Verweire, *supra* note 43, at 162.

⁴⁴⁹ Tripartite Group, *supra* note 3, at 17.

⁴⁵⁰ Andrew Kuritzkes et. al., *Risk Measurement, Risk Management and Capital Adequacy in Financial Conglomerates* 4 (2002) (unpublished manuscript, on file with Wharton Financial Institutions Center at the Univ. of Pa.), available at <http://fic.wharton.upenn.edu/fic/KSW%20Financial%20Conglomerates%201.3.pdf> (last visited Oct. 30, 2009).

⁴⁵¹ The Joint Forum, *Regulatory Difference: Issues and Observations* 6 (2006).

⁴⁵² The Joint Forum, *Trends in Risk Integration and Aggregation* 5 (2003). See also *infra* Part VI.

the ability to communicate with financial conglomerates about them.⁴⁵³ If this is not implemented, an increased difficulty in assessing the risk management capability of a conglomerate can rise from a supervisor's failure in understanding the risk management system of a financial conglomerate.⁴⁵⁴

2. Preventing Double or Multiple Gearing

The Joint Forum and all regulatory regimes discussed in previous chapters have provided methods of tackling the risk of double or multiple gearing. The Joint Forum proposed three approaches, namely the "building block prudential approach", the "risk-based aggregation" and the "risk-based deduction".⁴⁵⁵ The European Union, in Annex I of its "Directive On The Supplementary Supervision Of Credit Institutions Insurance Undertakings And Investment Firms In A Financial Conglomerate,"⁴⁵⁶ also provides three methods resembling the Joint Forum approaches.⁴⁵⁷ Taiwan addresses the double gearing issue by utilizing the "two-step process" provided in the administrative rule titled "Regulation Governing the Consolidated Capital Adequacy of Financial Conglomerates."⁴⁵⁸ Such a "two-step process" can be regarded as the variation of Joint Forum's building block prudential approach. In the U.S., given that financial holding companies naturally possess the identity of the bank holding company, capital adequacy of FHC's need to conform to the risk-based approach designed for bank holding companies in FRB's Regulation Y.⁴⁵⁹ Nonetheless, the double gearing issue is identified and addressed in FRB's Bank Holding Company Supervision Manual.⁴⁶⁰ Observing measures across different regulatory regimes, the three methods proposed by the Joint Forum are broadly accepted except in the U.S. In fact, the purpose of the implementation of the risk-based capital measure in the U.S. is basically to: (1) assist in the assessment of the capital adequacy of banking organizations; (2) make regulatory capital

⁴⁵³ *Id.* at 12.

⁴⁵⁴ *Id.*

⁴⁵⁵ See Supervision Report, *supra* note 31, at 15-18.

⁴⁵⁶ Council Directive 2002/87, Annex I, 2003 O.J. (L 35) (EC).

⁴⁵⁷ These three methods are: "accounting consolidation method", "deduction and aggregation method" and "requirement deduction method." See Council Directive 2002/87, Annex I (II), 2002 O.J. (L 35) (EC).

⁴⁵⁸ Regulations Governing the Consolidated Capital Adequacy of FHCs, art.3-5 (2003), available at <http://law.banking.gov.tw/Eng/FLAW/FLAWDAT0202.asp>.

⁴⁵⁹ See 12 C.F.R. §225, Appendix A, B, D & E.

⁴⁶⁰ BHC Supervision Manual, *supra* note 162, secs. 2010.1 & 3900.0.4.2.3 (2004).

requirements more sensitive to different risk profiles among banking organizations; (3) include off-balance sheet exposures in the assessment of capital adequacy; and (4) minimize disincentives to holding liquid, low-risk assets.⁴⁶¹ The design of this approach was virtually bank-centered and was merely aimed to satisfy the needs of the supervision of “bank” holding companies rather than financial holding companies. Owing to the unique connection between BHC and FHC, it is questionable whether it is appropriate to transplant the U.S. system of capital adequacy of FHC to another country, such as China, that does not specify becoming BHC as a pre-condition of becoming an FHC. Conversely, methods prepared by the Joint Forum, as mentioned earlier, can be recognized as international soft laws that allow countries to adopt the principles it provides with flexibility. The Joint Forum measures are, thereby, more feasible. Further, it is clear that all three methods, as discussed in the previous chapter, have advantages and limits. Under the circumstance that no empirical evidence clearly favors any one of the three, the choice of methods may be determined based upon a determination of which method is more suitable for a particular conglomerate structure. The “building block prudential approach” may be preferable in the case of the pure holding company structure due to the fact that the capital adequacy is calculated based on the actual capital surplus or deficit of each sector (subsidiary).⁴⁶² On the other hand, in “risk-based aggregation method” or “risk-based deduction method”, group capital adequacy is calculated based on the capital requirement of both the parent bank and financial subsidiaries⁴⁶³ so that it is more feasible in the “bank parent other subsidiary” type of financial conglomerates.

In addition to the calculation of group capital adequacy, the Joint Forum report stated five principles advising how to design the supervisory system for the measurement of group capital adequacy. The acceptable capital adequacy evaluation system should be able to carry the following functions:

- Detect and deal with situations of double or multiple gearing (i.e., where the same capital is used simultaneously as a buffer against risk in two or more legal entities);
- Detect and provide for the excessive leverage incurred by a parent’s transfer of the proceeds from selling its own debt to the subsidiary in the form of equity;
- Include a mechanism to detect and provide for the effects of double, multiple or excessive gearing through unregulated intermediate holding companies which have

⁴⁶¹ 12 C.F.R. §225, Appendix A 1.

⁴⁶² Supervision Report, *supra* note 31, at 20.

⁴⁶³ *Id.* at 21.

participation in dependants or affiliates engaged in financial activities;

- Include a mechanism to address the risks accepted by unregulated entities within a financial conglomerate that are engaging in activities similar to the activities of entities regulated for solvency purposes (e.g., leasing, factoring, reinsurance); and
- Address the issue of participation in regulated dependants and ensure that the treatment of minority and majority interests is prudentially sound.⁴⁶⁴

Existing Chinese financial conglomerates have a relatively complicated corporate structure with a significant number of unregulated entities in every level of the corporate structure. The third, fourth, and fifth principles above target precisely those financial conglomerates with a complex structure like current Chinese financial conglomerates. Thus, it is appropriate to create the new capital adequacy supervisory system for Chinese financial conglomerates in accordance with those guiding principles.

3. Issues on Consolidation

Where a parent company has 100 percent participation in its subsidiary, there is no question that the parent company should be held 100 percent responsible for the regulatory capital shortfalls in the subsidiary, and, conversely, capital in such subsidiary will, in ordinary cases, be available to the parent for the purpose of consolidated supervision subject to the condition that certain types of the subsidiary's excessive capital are permissible types of capital for transfer pursuant to regulations of parent company's supervisor. The question at issue is simply this - in the case where a parent company's participation in its subsidiary is less than 100 percent, does the responsibility of the parent company and the transferability of subsidiary's capital remain same?

The European Union generally employs the "full-consolidation" but authorizes the consolidation on pro-rata basis under certain circumstances.⁴⁶⁵ Since the solvency requirements for each separate financial sector represented in a financial conglomerate continue to be covered by capital elements in accordance with respective sectoral rules, in case of a deficit of capital at the financial conglomerate level, only capital elements that are eligible according to each of the sectoral rules

⁴⁶⁴ *Id.* at 8-11.

⁴⁶⁵ See Council Directive 92/30, On the Supervision of Credit Union on a Consolidated Basis, art. 3, 1992 O.J. (L 110) 52-58 (EC), available at http://folk.uio.no/olavt/direktiver/en_392L0030.shtml (last visited Jan. 17, 2010). See also Directive 2002/87, Annex I, 2003 O.J. (L 35) (EC).

shall qualify for the verification of the compliance with the solvency requirements at the financial conglomerate level.⁴⁶⁶ One reason for requiring adequate capital for a financial conglomerate on the group level is because in case a regulated entity in the group suffers the difficulty, the group capital will be made available to the needy, regulated entity.⁴⁶⁷ The Supplementary Supervision Directive does not, however, establish a source of strength doctrine so that the group capital is unavailable to the regulated entity in need despite capital surplus of the group.⁴⁶⁸ On the other hand, in the U.S, BHC's capital is evaluated with regard to the volume and risk of the operations on a consolidated basis. The holding company's capital on a consolidated basis is expected to serve as the ultimate source of support and strength to the entire corporation. As FRB clearly stated in the BHC Supervision Manual regarding the capital adequacy of a BHC:

[T]o be considered adequate, holding company capital must: (1) support the volume and risk characteristics of all parent and subsidiary activities; (2) provide a sufficient cushion to absorb unanticipated losses arising from holding company and subsidiary activities; (3) support the level and composition of corporate and subsidiary borrowing; and (4) serve as a source of strength by providing an adequate base for the growth of risk assets and permitting entry into the capital markets as the need arises.⁴⁶⁹

Therefore, a U.S. bank holding company, and indirectly its subsidiaries, is expected to support a deposit-taking subsidiary in case of need. The Gramm-Leach-Bliley Act of 1999, amendments to the U.S. Bank Holding Company Act of 1956, affirmed this doctrine with certain limitations.⁴⁷⁰

The Joint Forum addressed this issue by providing different solutions based on the percentage of the parent company's participation. It proposed that partially-owned subsidiaries should be categorized as follows: (1) subsidiaries over which control is established, either by the group owning more than 50 percent of the shares or the voting rights, or through a contractual or other agreements; (2) entities over which the

⁴⁶⁶ Council Directive 2002/87, Annex I, sub. II, 2003 O.J. (L 35) (EC).

⁴⁶⁷ Michael Gruson, *supra* note 157, at 22.

⁴⁶⁸ *Id.*

⁴⁶⁹ BHC Supervision Manual, *supra* note 160, at sec. 4070.08.

⁴⁷⁰ Gramm-Leach-Bliley Act of 1999, Pub. L. 106-102, § 730, 113 Stat. 1338 (1999).

group does not have control but does have significant influence (i.e. a group shareholding or share of the voting rights of 20 percent or more but under 50 percent); and (3) simple minority shareholding in an entity over which the group has neither control nor significant influence (i.e. the group shareholding or share of voting rights is less than 20 percent).⁴⁷¹ It was generally agreed that that simple minority shareholding in entities over which the group has neither control nor significant influence to the participated entity, so that these small portions of participation need not be consolidated for accounting purpose, should be treated in accordance with the solo entity rules for assessing the capital requirements of the participating company.⁴⁷² The same understanding was reached with respect to the second category.⁴⁷³ As for the first category, diverged views exist. Some members of the Tripartite Group favor “the full integration of such controlling interests while others advocate integration on a pro-rata basis.” Advocates in favor of “full integration” point out that from a growing concern standpoint, full integration makes more sense than pro-rata integration in the assessment of capital adequacy from an overall group perspective.⁴⁷⁴ They recognize the majority shareholder’s ability to affect the transfer of marketable assets or the granting of loans within the group.⁴⁷⁵ Also, it is apparent that controlling participation imposes on the parent company a responsibility for the risks incurred by its subsidiary, which is normally greater than the mere proportion of capital it has contributed.⁴⁷⁶ Similarly, in the case of controlling participation, the parent company’s extent of control over the capital of a subsidiary is higher than its contribution to the subsidiary’s capital.⁴⁷⁷ Those who opposed the full integration hold that there is a need to examine the transferability and to check the availability of any capital surplus.⁴⁷⁸ They further argue that it is inappropriate to include the capital surplus of a subsidiary in the regulatory capital of its parent if there is any doubt concerning subsidiary’s ability to transfer that surplus to another undertaking in the group.⁴⁷⁹ The main reason is that “bringing into account at group level surpluses in subsidiaries, which are not attributable to the parent, or which may prove not to be transferable to it, could give an

⁴⁷¹ Tripartite Group, *supra* note 3, at 49.

⁴⁷² *Id.*

⁴⁷³ *Id.*

⁴⁷⁴ *Id.* at 50.

⁴⁷⁵ *Id.*

⁴⁷⁶ *Id.*

⁴⁷⁷ *Id.*

⁴⁷⁸ *Id.*

⁴⁷⁹ *Id.* at 51.

illusory feeling of confidence about a group.”⁴⁸⁰ These members insist that the only value of a non-transferable surplus is that it will provide a buffer against exceptional losses in the subsidiary in which the surplus is located.⁴⁸¹

This thesis finds no dilemma in choosing between the two arguments. In fact, the identification of transferability is the only concern raised in the argument opposing the full integration. The opposing theory has never, explicitly or even implicitly, endorsed the consolidation on a pro-rata basis and has never guaranteed that the issue of transferability does not exist in the case of consolidation on pro-rata. As a financial conglomerate is often deemed a single economic unit regardless of the structure of shareholding, to have the parent company be ultimately liable for the subsidiary’s deficit can strengthen the confidence of investors so as to mitigate the likelihood of risk contagion. It is uncomfortable to imagine that the majority shareholders would allow a subsidiary to fail merely because minority shareholders were unwilling to provide funds exceeding their limited responsibility. Therefore, on the premise that government regulations provide guidelines regarding capital items that are permissible to transfer, this thesis prefers introducing the full integration into the Chinese supervisory regime for financial conglomerates.

4. Risk Concentration

As revealed previously, risk concentration occurs when different entities within a conglomerate are exposed to the same or similar risk factors, or to apparently unrelated risk factors that interact under stressful circumstances.⁴⁸² Realizing the magnitude of damage and possible systematic risk that risk concentration can cause, all supervisory regimes have addressed the issue via erecting quantitative limits. The U.S. places quantitative restrictions on the interbank liability and both quantitative and qualitative restrictions on affiliate lending.⁴⁸³ While the Conglomerate Directive of European Council identified that risk concentration may be caused by counterparty risk/credit risk, investment risk, insurance risk, market risk, other risks, or a combination or interaction of these risks,⁴⁸⁴ it does not provide quantitative limits or quantitative requirements with regard to risk concentration at the level of the financial conglomerate.⁴⁸⁵ The Conglomerate Directive leaves the power to introduce such limits and

⁴⁸⁰ *Id.*

⁴⁸¹ *Id.*

⁴⁸² Risk Concentration Principles, *supra* note 37, at 2.

⁴⁸³ See 12 U.S.C. §§ 371(b)(2), 371(c) & 371(c)(1). See also 12 C.F.R. §§ 206 & 223.

⁴⁸⁴ Council Directive 2002/87, art. 2(19), 2003 O.J. (L 35) (EC).

⁴⁸⁵ Gruson, *supra* note 295, at 24.

requirements or other supervisory measures to the Member States.⁴⁸⁶ Two of the EU Member States, Germany and U.K., for example, have all employed quantitative limits in its sectoral rules.⁴⁸⁷ The Prudential Source Book for Banks, Building Societies and Investment Firms of British FSA explicitly leaves the task of counteracting risk concentration to sectoral rules.⁴⁸⁸ With the idea that if risk concentration can be effectively limited and controlled at the sectoral level, the potential of risk concentration at the group level may be significantly reduced; this thesis also suggests that China set sectoral rules similar to those widely accepted around the world.

Furthermore, various guidelines, provided by the Joint Forum, with respect to supervising risk concentration are also noteworthy. Those guiding principles have been discussed in the previous section. Summaries of those principles are as follows:

- Supervisors should, through regulation or other approaches, provide that conglomerates have adequate risk management processes (i.e., centralized risk management mechanisms) in place to manage group-wide risk concentrations,⁴⁸⁹ and maintain good understanding of such processes. When necessary, supervisors should consider appropriate measures, such as reinforcing these processes with supervisory power.⁴⁹⁰
- Supervisors should monitor material risk concentrations on a timely basis, through regular reporting or other means, to obtain clear information of the risk concentrations of the financial conglomerate.⁴⁹¹
- Supervisors should encourage or mandate public disclosure of risk concentrations.
- Supervisors should work closely with one another to exchange concerns and coordinate any proper supervisory action relative to risk concentrations within the group.⁴⁹²
- Supervisors should deal effectively and appropriately with material risk concentrations that are considered to have a

⁴⁸⁶ Council Directive 2002/87, art. 7(2) and 8(2), 2003 O.J. (L 35) (EC).

⁴⁸⁷ See German Banking Act, sec. 13a; BIPRU, *supra* note 432, at 10.5.6 (2007).

⁴⁸⁸ See BIPRU, *supra* note 432, at 8.9.

⁴⁸⁹ Risk Concentration Principles, *supra* note 37, at 3.

⁴⁹⁰ *Id.*

⁴⁹¹ *Id.*

⁴⁹² *Id.*

detrimental effect on the regulated entities, either directly or through an overall detrimental effect on the group.⁴⁹³

This thesis proposes that the above principles be introduced into practice by adding them to the responsibility and job description of supervisors via an amendment of present laws and regulations.

5. Intra-group Transaction and Exposure

Financial conglomerates are created to generate synergies between different lines of business.⁴⁹⁴ One of the measures to reach increased efficiency is through intra-group transactions and risk transfer so as to maximize the profits. However, intra-group transactions are not always harmless. Such transactions can not only create new prudential risks or exacerbate the existing one, but can also lead to excessive exposure and increase the probability of risk contagion.⁴⁹⁵ Given that intra-group transaction has both advantage and disadvantages, it makes the design of a supervisory system extremely difficult. On the one hand, because intra-group transaction is the intrinsic part of conglomerate operation and the conglomerate can actually benefit from it, it should not be completely prohibited. On the other hand, the potentially large exposure associated with intra-group transaction makes the effective supervision inevitable and indispensable. Different supervisory regimes covered by this thesis basically follow the common philosophy that intra-group transaction should be permitted under very limited conditions and be subject to various supervisory scrutiny and monitoring.

In the U.S, Sections 23A and 23B of the Federal Reserve Act and parallel Regulation W address the intra-group transaction with four principal ideas: (1) a laundry list of “covered transaction”,⁴⁹⁶ (2) quantitative restrictions and qualitative (i.e., no purchase of low-quality assets and collateral requirements) requirements,⁴⁹⁷ (3) arm’s-length requirements,⁴⁹⁸ and (4) a list of prohibited transactions.⁴⁹⁹ The Conglomerate Directive of European Council provides the definition and scope of intra-group transaction but, as mentioned above, leaves the detail of supervisory approach for member countries to decide.⁵⁰⁰ British rules

⁴⁹³ *Id.*

⁴⁹⁴ VAN DEN BERGHE & VERWEIRE, *supra* note 43, at 170.

⁴⁹⁵ *Id.*

⁴⁹⁶ See 12 U.S.C. § 371c(b).

⁴⁹⁷ See 12 U.S.C. § 371c(a); 12 C.F.R. §§ 223.22, 223.23 & 223.24.

⁴⁹⁸ See 12 U.S.C. § 371c-1(a).

⁴⁹⁹ See 12 U.S.C. § 371c-1(b).

⁵⁰⁰ Council Directive 2002/87, art. 2(19), 2003 (L 35) (EC).

respond to the supervisory demand of intra-group transaction in three aspects: (1) applying quantitative requirements,⁵⁰¹ (2) mandating financial institutions to establish an internal system to monitor and control large exposure;⁵⁰² and (3) imposing disclosure requirements.⁵⁰³ The merit of the American system is the logical process for controlling the excessive exposure incurred by intra-group transaction – first to ask what transaction should be permissible or banned, then, to decide to what extent should such transactions be allowed, then to seek further insurance to avoid exposure (quality control and collateral), then to ensure that all transactions are performed on an arm's-length basis. The British system, on the other hand, focuses on the establishment of conglomerates' monitoring system and supervisors' and consumers' right to access related information through the enforcement of disclosure.

In order to effectively supervise intra-group transactions and exposure, this thesis recommends a hybrid system combining the substantial part of both the American and British system. This idea is, in fact, in line with the Joint Forum's principles regarding the intra-group transaction and exposure.⁵⁰⁴ Such principles are thereby summarized below:

- Supervisors should require conglomerates to carry out adequate risk management processes including those addressing ITEs for the conglomerate as a whole.⁵⁰⁵ The supervisors may reinforce these processes with supervisory limits and can do this directly or through regulated entities.⁵⁰⁶
- Supervisors should monitor material ITEs of the regulated financial entities on a timely basis through regular reporting or by other means to help achieve a clear understanding of the ITEs of the financial conglomerate.⁵⁰⁷
- Supervisors should require public disclosure of ITEs.
- Supervisors should closely cooperate with one another to understand each other's concerns and to coordinate any supervisory action relative to ITEs within the group.⁵⁰⁸

⁵⁰¹ See BIPRU, *supra* note 432, at 10.5.6.

⁵⁰² *Id.* at 10.12.1.

⁵⁰³ *Id.* at 11.6.1.

⁵⁰⁴ Intra-Group Transaction and Exposures Principles, *supra* note 44, at 2-5.

⁵⁰⁵ *Id.* at 3.

⁵⁰⁶ *Id.*

⁵⁰⁷ *Id.*

⁵⁰⁸ *Id.*

- Supervisors should deal effectively and appropriately with material ITEs that are considered to have a detrimental effect on the regulated entities or on the group.⁵⁰⁹ This includes setting the quantitative limit in advance and requiring the conglomerate to cease certain activities.

6. Risk Contagion

As indicated in section III of this thesis, risk contagion is considered the most significant problem associated with the formation of a financial conglomerate, as it can arise from the financial connection between group entities as well as from psychological effects on the image, reputation and credibility of the conglomerates.⁵¹⁰ The risk contagion may result in the explosion of systematic risk and harm consumers due to the asymmetry of information. Counteraction of this type of supervisory issue should, according to the objectives of financial regulation, always be a supervisors' priority. Some arguments assert that contagion risks are unavoidable since it is the inherent characteristic that difficulties originating in one of the conglomerate members spread to the rest of the conglomerate.⁵¹¹ Besides, with the existence of a safety net in most countries, financial conglomerates may engage in riskier activities owing to the moral hazard resulting from the extension of the safety net.⁵¹² Indeed, it is highly unlikely that risk contagion will be completely eliminated within the financial conglomerate, but it is not impossible to alleviate and control it.

With regard to the contagion incurred by the financial connection, since the financial connection is often built through intra-group transactions, supervisory measures utilized to monitor and restrict the intra-group transaction such as qualitative standard and quantitative restriction may also serve as a "firewall" in preventing the risk contagion. In addition, regarding the moral hazard generated from the extension of safety net, to design a safety net system which contains the following mechanism may help effectively reduce the moral hazard to: (1) limit the coverage of deposit insurance; (2) endow concerned authorities the power to terminate the protection of the safety net under certain circumstances; and (3) make the adequate capitalization a criteria for providing deposit insurance coverage. As mentioned earlier, China is on its way to establishing a deposit insurance system. Regarding the mitigation of the risk contagion through the particular design in the safety net regulation, certain mechanisms provided in Federal Deposit Insurance Corporation

⁵⁰⁹ *Id.*

⁵¹⁰ Van den Berghe & Verweire, *supra* note 43, at 161-162.

⁵¹¹ Kazuhiko Koguchi, *supra* note 43, at 31.

⁵¹² *Id.*

Improvement Act (FDICIA) of the U.S. can be useful. The FDICIA grants the OCC and RRB authority by regulation or order, to impose restrictions or requirements on relationships or transactions between a national bank and a subsidiary of the national bank for the purpose of avoiding any significant risk to the safety and soundness of insured depository institutions or any Federal deposit insurance fund.⁵¹³ The OCC also possesses the authority to decline indemnification payments if the insolvency can be attributed to the insured bank's affiliate.⁵¹⁴ In addition, safety and soundness firewalls applicable to a bank's financial subsidiaries are built by FDICIA. An insured bank is not allowed to control or hold an interest in a subsidiary that engages in activities as the principal if either the bank or the subsidiary is not well capitalized.⁵¹⁵ Furthermore, supervisors must also have the authority to access the necessary information either through the related reports submitted by the regulated institution or information sharing mechanism and to quickly respond to emergencies through proper enforcement.⁵¹⁶

The reputational risk contagion is even harder to prevent as this type of risk is often caused by consumers' lack of full information. The common sense of a layman provides him with the impression that a financial conglomerate is a single economic unit. When difficulties for a member of the conglomerate occurs, asymmetry of information can lead to diverged views about the future between customers and service providers,⁵¹⁷ ordinary people may assume that the rest of the conglomerate is also in difficulty, even though that is not the case. Thus, only through the elimination of the information asymmetry can reputational risk contagion be reduced. To impose disclosure requirements on financial conglomerates that obligate them to unveil information regarding significant risk concentration and intra-group exposure may help consumers to judge the condition of the financial conglomerate and help to build the confidence with the healthy conglomerate and discipline the unsafe one.

In sum, in dealing with risk contagion, China needs to include the firewall system as a way to add certain mechanisms into the safety net and to launch disclosure requirements.

⁵¹³ See 12 U.S.C. §§ 1828a(A) & (B).

⁵¹⁴ See 12 U.S.C. § 1828(k)(2)(B).

⁵¹⁵ See 12 U.S.C. § 1831(w)(a).

⁵¹⁶ Koguchi, *supra* note 43, at 32. In fact, laws and regulations with regard to the safety net and deposit insurance system need to provide all these mechanisms. Since deposit insurance and safety net is not the subject this thesis intends to cover, the details of the subject will not be discussed here. Relevant information can be found in 12 U.S.C. §§ 1828 & 1831(o).

⁵¹⁷ PETER D. SPENCER, *THE STRUCTURE AND REGULATION OF FINANCIAL MARKETS* 6 (2000).

F. *Solutions for Other Supervisory Issues*

1. Conflicts of Interests

Conflicts of interests, as unveiled in section III of this thesis, can occur both externally and internally. The former is sometimes regarded as the “principal-agent risk”, which occurs when a financial institution offers a service that is beneficial to itself, but not necessarily to the customer.⁵¹⁸ The latter appears when internal units struggle with one another for market share or cross-subsidization. In this case, make-or-buy decisions do not follow competitive market conditions and/or resources are not allocated in the most effective way.⁵¹⁹ Internal conflicts of interest may be less necessary for regulation because the core objective of financial regulation is to protect consumers and prevent systematic risk. As long as the inefficient resource allocation is not detrimental to the safety and soundness of any of the entities within the conglomerate, there is no need for supervisors to be deeply involved in the philosophy of the internal operation of the financial conglomerate.

With respect to the supervision of external conflicts of interest, FRB of the U.S. not only identifies various types of conflicts of interests that need to be addressed,⁵²⁰ but also provides some solutions for these conflicts of interests. Pursuant to the BHC Supervision Manual, various supervisory tools employed to counteract the conflicts of interests are: (1) disapproval of or limits on investments or activities that can lead to conflicts of interest;⁵²¹ (2) requiring the internal control system of an FHC to recognize potential conflicts of interests and subjecting the system to FRB’s review;⁵²² (3) determining and evaluating significant conflicts during the inspection especially when inspecting companies with separate shareholders but common managements;⁵²³ and (4) mandating the customer complaint system and reviewing it during the inspection.⁵²⁴ The work of identifying numerous types of conflicts of interests seems to be left to the sectoral rule and functional regulators.

⁵¹⁸ FREDERIC S. MISHKIN, FINANCIAL MARKETS AND INSTITUTIONS 401 (3rd ed. 1999).

⁵¹⁹ Van den Berghe & Verweire, *supra* note 43, at 163.

⁵²⁰ For example, the potential conflicts of interests between the traditional banking business and underwriting service, the conflicts of interests aroused when a conglomerate’s credit rating firm rates its affiliates, the multiple duties carried by the same managerial personnel and conflicts of interest incurred by investment advisors or fund managers. For details, see BHC Supervision Manual, *supra* note 160, at secs. 3600.21.2; 3330.0; 3700.7; 3251.0.1. & 3130.1.1.

⁵²¹ *Id.*, at sec.3560.0.

⁵²² *Id.* at sec. 3950.11.1.3.

⁵²³ *Id.* at sec. 3130.3.3.

⁵²⁴ *Id.* at sec. 3240.0.12.

Given that conflicts of interest vary within different lines of businesses and different management and corporate structures, it is virtually impossible to identify, through a laundry list, all types of potential conflicts of interest that can occur between every entity of the financial conglomerate and consumers. It is possible that supervisors can learn conflicts of interest only after such has caused damage to consumers. Owing to this intrinsic difficulty and possible delay for supervisors to identify the conflicts of interest, the supervision of conflicts of interest must rely heavily on the self-regulation of financial conglomerates. The management body is the one who has supreme knowledge regarding business profiles and potential conflict of interests, thus to impose disclosure requirements on the financial conglomerates is the most efficient approach available to supervise information concerning the conglomerates' conflicts of interests, and to achieve better consumer understanding and protection. Besides, supervisors should require financial conglomerates to enact internal ethical rules to increase the integrity of management and related personnel.

Another possible measure supervisors may adopt is to build a "Chinese Wall" between different departments regarding the sensitive customer information and management.⁵²⁵ However, it is often criticized that "Chinese Wall" rules can be easily broken and the breaches are often undetected so that the "Chinese Wall" is in fact paper thin within financial conglomerates.⁵²⁶ Hence, this thesis suggests that the better supervisory system addressing the conflicts of interest is to mandate financial conglomerates to prepare their internal control system to deal with conflicts of interests plus the disclosure requirement. The responsibility of supervisors is to inspect and review the effectiveness internal control system based on the information the conglomerate reveals.

2. Disclosure

It is acknowledged that disclosure is one of the most broadly functional supervisory tools applicable and effective with regard to various supervisory issues such as the transparency of corporate structure, risk concentration, risk contagion, intra-group transaction and exposure and conflicts of interests. More fundamentally, disclosure of the information of financial conglomerates is the most direct tool to conquer the asymmetry of information and accomplish better consumer protection by having consumers informed.⁵²⁷ Information disclosure is regarded as a critical factor in determining whether or not a regulation fulfills the regulatory objective. As stated in the previous section, Pillar 3 of the New

⁵²⁵ Koguchi, *supra* note 43, at 30.

⁵²⁶ HARRY McVEA, FINANCIAL CONGLOMERATES AND THE CHINESE WALL: REGULATING CONFLICTS OF INTEREST 213 (1993).

⁵²⁷ Spencer, *supra* note 517, at 4; Herring & Santomero, *supra* note 47, at 55.

Basel Accord promotes the idea that enhanced information disclosure will facilitate market discipline based upon the rationale that the more market participants have been informed, the more likely they are able to make informed judgments so as to influence the demand and price of a particular financial product. Furthermore, this forces the financial institutions to reveal their private information.⁵²⁸ As discussed previously, however, although the function of market discipline is not entirely promising,⁵²⁹ empirical studies do indicate that countries who adopt regulations forcing the disclosure of accurate, comparable information about financial institutions, tend to have better developed financial institutions that conduct their business with higher degrees of integrity.⁵³⁰ Furthermore, based upon the “private interest” theory, interest group competition and the battle among the interests are key determinants to explaining regulatory outcomes.⁵³¹ To illustrate, given that the interest of the industry is more concentrated, it is the primary role of financial institutions to allocate their resources to attract the attentions of various interest groups (i.e. bankers, politicians, etc.). These different interest groups will compete in an attempt to manipulate national policies of financial markets towards their favor.⁵³² Accordingly, the private interest view supports a higher extent of reliance on market discipline, information disclosure, a light hand by regulatory authorities, and significant oversight of the regulatory process itself.⁵³³

Based on the discussion in the preceding paragraph, this thesis affirms the value of disclosure and suggests enacting regulations that encourage information disclosure. Another issue to be addressed is whether disclosure should be voluntary or mandatory. Studies reveal that a firm will voluntarily disclose all its information when three assumptions are met: (1) consumers know that the firm has certain information; (2) the firm cannot lie, though they can refuse to disclose the information; and (3) disclosure is without cost.⁵³⁴ Since asymmetry of information always exists, consumers are often unsophisticated, and financial institutions are

⁵²⁸ Basel Committee, International Convergence of Capital Measurement and Capital Standard 229 (2006). *See also* Spencer, *supra* note 517, at 4.

⁵²⁹ BARTH, *supra* note 387, at 255.

⁵³⁰ *Id.*

⁵³¹ Randall S. Kroszner & Phillip E. Strahan, *Obstacles to Optimal Policy – The Interplay of Politics and Economics in Shaping Bank Supervision and Regulation Reforms in PRUDENTIAL SUPERVISION: WHAT WORKS AND WHAT DOESN’T* (Frederic S. Mishkin ed. 2001).

⁵³² BARTH, *supra* note 387, at 20.

⁵³³ *Id.*

⁵³⁴ Luigi Zingales, *The Cost and Benefits of Financial Market Regulation* 18 (2004) available at <http://ssrn.com/abstract=536682>.

unwilling to make disclosure primarily because of compliance cost, the theory in favor of voluntary disclosure fails. Conversely, although firms which violate the disclosure requirement may benefit from cost-saving in the short term as long as their violation remains undetected, when the violation is exposed, the financial market, where most participants play by rule, may be able to send a powerful message to the violator and discipline same.⁵³⁵ In addition, another subtle reason for regulation is the benefit of standardization.⁵³⁶ Even when the financial institution cannot lie, they can still choose the format in which to present information in a positive light so as to make comparison more difficult and further confuse the consumers.⁵³⁷ In sum, it is clear that disclosure of information can, to some extent, enhance the market discipline. Such disclosure has to be mandatory because voluntary disclosure is inconsistent with the market reality and the intent of consumer protection.

Most supervisory regimes observed by this thesis have adopted mandatory disclosure in accordance with the above finding. Under its authority of umbrella supervision, the FRB in the U.S. may be provided with the report filed by FHC and its subsidiaries.⁵³⁸ Also, the BHCA authorizes FRB to occasionally require a FHC, and any subsidiary of such FHC, to submit reports under oath, which include certain prudential information.⁵³⁹ In addition, the BHC Supervision Manual recognizes the importance of public disclosure with regards to affiliate transactions and exposure, equity investment, corporate structure as well as its contribution to market discipline.⁵⁴⁰ The European Union imposes upon every credit institution the duty to report the large exposure.⁵⁴¹ In the U.K, although mandatory disclosure is generally required,⁵⁴² there is an exception to financial groups initiating the process of identification as a financial conglomerate – the notice to competent authorities is completely voluntary.⁵⁴³ In Germany, universal banks are also legally required to

⁵³⁵ Thomas C. Baxter, *Governing the Financial or Bank Holding Company: How Legal Infrastructure Can Facilitate Consolidated Risk Management* (2003) (unpublished abstract, on file with author), available at <http://ideas.repec.org/a/fip/fednci/y2003imarnv.9no.3.html> (last visited Jan. 17, 2010).

⁵³⁶ Zingales, *supra* note 534, at 20.

⁵³⁷ *Id.*

⁵³⁸ See 12 U.S.C. § 1843(c)(1)(B).

⁵³⁹ See 12 U.S.C. § 1844(c)(1)(A).

⁵⁴⁰ See BHC Supervision Manual, *supra* note 160, at Sec. 4090.3; 2124.01; 3900.0.4.3; and 3909.0.3.

⁵⁴¹ See Council Directive 92/121, On the Monitoring and Control of Large Exposures of Credit Institutions, art. 3, 1992 O.J. (L 29) 1 (EC).

⁵⁴² See BIPRU, *supra* note 432, at 11.6.1.

⁵⁴³ *Id.* at 3.1.3 (4).

report their large exposure.⁵⁴⁴ In Taiwan, in an administrative regulation titled, “Regulations Governing the Required Information in the Annual Report of Financial Holding Company,” enumerates a long list of information that an FHC should disclose in its annual report. This regulation, however, neglected to include potential conflicts of interest in the list of required information.⁵⁴⁵

Based on the theoretical discussion and comparative studies, this thesis proposes a mandatory disclosure system in which information regarding the corporate and managerial structure of the conglomerate, potential conflicts of interests, significant intra-group transactions, and potential risk contagion must be revealed. One final point is that for the purpose of ensuring unsophisticated consumers are “informed”, information disclosed to consumers should contain proper guidelines and use plain language.⁵⁴⁶

3. Qualification of Management Personnel

The rationale for scrutinizing the qualification of managers in the licensing process is simple: (1) to ensure that all entities within the financial conglomerates are soundly and prudently managed; (2) to initiate the arrangements of consultation channels between supervisors and managerial bodies; and (3) to check the integrity of management so as to avoid “fraud and swindle.”⁵⁴⁷

The most sophisticated screening regime is the Taiwanese law. Pursuant to the “Regulation Governing Qualification of Responsible Persons of a Financial Holding Company and their Holding of Concurrent Positions in Subsidiaries”, a list including the criminal record, the history of violation of certain laws and regulations and the history of receipt of certain sanctions are all factors to determine the qualification of the FHC personnel.⁵⁴⁸ As mentioned in the supervision of licensing, the purpose of entry screening is to ensure the quality of the market entrant. Regulatory standards for determination regarding the fitness and propriety are suitable under this purpose. This thesis recommends that China create regulatory

⁵⁴⁴ See German Banking Act, sec. 13a.

⁵⁴⁵ See Regulations Governing the Required Information in the Annual Report of Financial Holding Company, arts. 1 - 4 (2001).

⁵⁴⁶ JOANNA GRAY & JENNY HAMILTON, IMPLEMENTING FINANCIAL REGULATION: THEORY AND PRACTICE 202 (2006).

⁵⁴⁷ The Joint Forum, *Fit and Proper Principles Paper*, in THE SUPERVISION OF FINANCIAL CONGLOMERATES 39 (1999). See also BARTH, *supra* note 387, at 29.

⁵⁴⁸ See Regulations Governing Qualification Requirements for Responsible Persons of a Financial Holding Company and their Holding of Concurrent Positions in Subsidiaries, art. 4 (2005).

standards resembling the Taiwanese regulation, as well as following the seven fit and proper principles provided by Joint Forum.⁵⁴⁹

4. Structure and Organization of Supervisors

Empirical studies on the recent development of various supervisory regimes indicate that a trend toward the unification of supervisory powers is evolving.⁵⁵⁰ The unified supervisor system has been adopted in Germany, U.K. and Taiwan, while the U.S. still maintains its peculiar separate regulator system by assigning FRB as the umbrella supervisor for FHCs and leaves the authority to supervise various financial activities to the different functional regulators. Although the trend toward a unified regulator is clear, do the advantages claimed by the advocates of unified regulator truly outweigh its disadvantages? Is the separate specialist regulator system truly useless? Is there any convincing evidence clearly in favor of the unified system? All these questions will be discussed and answered in the following discussions.

a. Arguments in Favor of the “Unified Regulator” System

Advocates of the unified regulator system have presented four major reasons for its advantage. First, a single regulator may generate efficiency.⁵⁵¹ A single regulator's position allows one to look across the entire financial industry and allocate regulatory resources to locations they are most needed⁵⁵² so as to reach cost-effectiveness.⁵⁵³ Second, a single regulator responds to the trend of the innovation and evolvement in the financial market.⁵⁵⁴ A single regulator is advantageous because it reflects the nature of modern financial markets, where old distinctions between different sectors and different products have blurred.⁵⁵⁵ Besides, the rise of financial conglomerates that operate across sectors has made sectoral supervisors nearly unable to detect group-wide risk, as they only have oversight jurisdiction over a given portion of a diversified conglomerate.⁵⁵⁶ Hence, the single regulator system has its logical,

⁵⁴⁹ See Joint Fit and Proper Principles, *supra* note 547, at 41-42.

⁵⁵⁰ Donato Masciandaro, *Financial Supervision Architectures and the Role of Central Banks*, 18 TRANSNATIONAL LAW 351, 352 (2005).

⁵⁵¹ Richard K. Abrams & Michael Taylor, *Assessing the Case for Unified Financial Sector Supervision in* DOUGLAS W. ARNER & JAN-JUY LIN FINANCIAL REGULATION: A GUIDE TO STRUCTURAL REFORM 43 (2003); Eilis Ferran, *Examining the United Kingdom's Experience in Adopting the Single Financial Regulator Model*, 28 BROOK. J. INT'L L. 257, 283 (2003); Mwenda, *supra* note 377, at 41.

⁵⁵² Ferran, *supra* note 550, at 283; Mwenda, *supra* note 377, at 41.

⁵⁵³ Abrams & Taylor, *supra* note 551, at 43-44.

⁵⁵⁴ Ferran, *supra* note 551, at 277.

⁵⁵⁵ *Id.*

⁵⁵⁶ Abrams & Taylor, *supra* note 551, at 44.

superficial attraction. Third, the single regulator system may provide a more effective system of regulation.⁵⁵⁷ A single regulator may be more effective because the single regulator may be in the ideal position to maintain coherence and clarity of purpose due to its unified management structure, which creates an effective mechanism for resolution of conflicts between different regulatory objectives.⁵⁵⁸ In the multiple regulator system where different agencies may not share common objectives,⁵⁵⁹ regulatory competition is likely to occur. The unified regulator system may generate competitive neutrality.⁵⁶⁰ Fourth, a single regulator is more accountable because it has no other regulatory body to which it can transfer blame for regulatory failure.⁵⁶¹ It is suggested that the philosophy that "the buck stops here" stipulates the regulator's strong incentive to establish a clear mandate, to stick to it in its practical operations, and to educate consumers of financial services on what protections they can and cannot reasonably expect from the regulatory system.⁵⁶² The effectiveness of separate regulators may be impeded by "turf wars" or a desire to "pass the buck", as there is likely to be an overlap of supervisory authority, responsibilities, and skills.⁵⁶³

b. Arguments in Favor of the "Separate Specialist Regulator" System

Opponents of a unified regulator system contend that a single unified regulator may encounter difficulties in striking an appropriate balance among the different objectives of regulation.⁵⁶⁴ Given the diversity of these objectives, a single regulator may not have a clear understanding of the various goals and rationales or be able to adequately differentiate between institutions.⁵⁶⁵ Also, a unified regulator may be more inefficient, as it is usually associated with a monopoly and tends to be quite bureaucratic, which can eliminate healthy regulatory competition.⁵⁶⁶ Synergies a single regulator can gain from unification are very limited. Economies of scope are more significant than economies of scale and the multiple regulator system enjoys the former.⁵⁶⁷ Third,

⁵⁵⁷ Ferran, *supra* note 551, at 290.

⁵⁵⁸ *Id.*

⁵⁵⁹ HARRINGTON & NIEHAUS, *supra* note 274, at 15.

⁵⁶⁰ Abrams & Taylor, *supra* note 551, at 45.

⁵⁶¹ Goodhart, *supra* note 392, at 181.

⁵⁶² *Id.* at 151-52.

⁵⁶³ Abrams & Taylor, *supra* note 75, at 21-24.

⁵⁶⁴ Abrams & Taylor, *supra* note 551, at 49.

⁵⁶⁵ *Id.*

⁵⁶⁶ Abrams & Taylor, *supra* note 75, at 21-24.

⁵⁶⁷ Abrams & Taylor, *supra* note 551, at 50.

merging existing agencies or creating a single, new agency requires political agreement among government agencies, which is not easily obtained.⁵⁶⁸ Finally, the “separate specialist regulator” has stronger expertise on each regulated business and is capable of facilitating healthy competition between regulators, making it a more preferable model.⁵⁶⁹

c. Is an Integrated Supervisory System Necessary?

In the British case, internal studies conducted by FSA indicates that FSA has completed most parts of the plan to develop: (1) a single set of central support services; (2) a more efficient allocation of regulatory resources across both regulated entities and types of regulated activities; and (3) plans for the development of the FSA’s proposed single handbook of rules and guidance emphasize on both the need to harmonize, consolidate and rationalize the various principles, rules and guidance.⁵⁷⁰ FSA also presented numbers to prove that there has been a cost saving effect since the promulgation of the new rule.⁵⁷¹ This thesis has no doubt about all the adjustments FSA has accomplished or the cost saving effects that have actually been generated. It is undeniable, however, that the empirical studies weighing on the debate regarding single or multiple regulators are too scarce⁵⁷² so that no convincing evidence is available to support either side. More surprisingly, in the U.S, empirical studies in favor of a multiple specialized regulator system are also available. A study sponsored by the Federal Reserve strongly supports maintaining beneficial specialization of regulators and are in favor of the system currently in place in the U.S.⁵⁷³ Similar studies also indicate that multiple regulators can benefit from competition.⁵⁷⁴

Owing to the extremely limited availability of empirical evidence, and further that no evidence is sufficient to prove that one system transcends the other, this thesis does not attempt to select either system before creating a schematic reform project for China. Instead, the

⁵⁶⁸ Abrams & Taylor, *supra* note 75, at 23.

⁵⁶⁹ *Id.* at 24.

⁵⁷⁰ See Clive Briaut, *The Rationale for a Single National Financial Services Regulator* 18 (1999) (unpublished occasional paper, on file with The Financial Services Authority), available at <http://www.fsa.gov.uk/pubs/occpapers/OP02.pdf>.

⁵⁷¹ *Id.*

⁵⁷² BARTH, *supra* note 387, at 92.

⁵⁷³ Richard J. Rosen, *Do Regulators Search for the Quiet Life? The Relationship between Regulators and the Regulated in Banking* 19 (ITAM, Working Paper, Aug. 2001), available at http://papers.ssrn.com/sol3/abstract_id=336859.

⁵⁷⁴ Richard J. Rosen, *Is Three a Crowd? Competition among Regulators in Banking* 21 (2002) (unpublished manuscript), available at http://papers.ssrn.com/sol3/abstract_id=345440 (last visited Jan. 17, 2010).

following discussion will examine which system incurs lower transitional costs. Theoretically, the transition plan that arouses the least amount of structural change is the less expensive plan. As discussed in section VI, three major financial supervisors currently operating in China are China Banking Regulatory Commission (CBRC), China Insurance Regulatory Commission (CIRC) and China Securities Regulatory Commission (CSRC). To integrate all three agencies into one newly formed agency will cause major structural change and, therefore, incur greater transitional costs. It is also worthless to simply combine three authorities under one common roof but still allow all three agencies to remain operating in a separate manner. Therefore, this thesis suggests that current arrangement on supervisory authorities should be retained subject to some improvement. China needs to enhance two aspects: (1) establish an information-sharing system and coordination system among supervisors, and (2) increase the independence of all three agencies. With regard to the former, the Joint Forum's "Principles for information Sharing" and "Coordination Paper" are the guidelines to follow.⁵⁷⁵ As for the later, it is important for financial supervisors to be independent from undue pressure and influence imposed by politicians and industries.⁵⁷⁶ The influence of officials from the Communist party may be the most significant obstacle to achieve the independence. To appoint high-level officials of these three agencies to a fixed-term position could be a solution for elevating officials' degree of independence. Ultimately, this might be a political issue beyond the coverage of this paper.

VII. CONCLUSION

It has been over two decades since China commenced its economic reform in the early 1980s. After China's WTO accession, the rapid growth in economics, including the financial market, has brought wealth to the country, the private enterprises, and individuals, but has also created various issues regarding the maintenance of the market order. Among these issues, the supervision of financial conglomerates is paramount and cannot be neglected during the opening-up of the financial market. Several themes involved in this issue demand solutions – the supervision of existing financial conglomerates, the erection of a level playing field for the establishment of new domestic and foreign financial conglomerates, and the assurance that their operation is effectuated in a safe and sound manner. This thesis intended to address this issue by utilizing the comparative law approach, as well as following the decision making process, and has completed the following observations:

Financial conglomerates benefit from competitive advantages brought by economy of scale, economy of scope, synergy and

⁵⁷⁵ See Supervision Report, *supra* note 31, at 47-62.

⁵⁷⁶ BARTH, *supra* note 387, at 95.

diversification of risk. It is a common understanding that without market liberalization, it is impossible for the Chinese financial industry to efficiently allocate capital and make it more circulative. Given that the inevitable consequence of liberalization inspired by WTO accession – competition -- comes from both external and internal side, it is necessary to allow financial conglomerates to establish in order to facilitate the competitiveness of Chinese financial service industry. As financial conglomerates can incur various new supervisory and even policy issues, including double gearing, risk concentration and contagion, intra-group transaction and exposure, transparency of structure and even the supervisory framework, it is indispensable to prepare an effective system to meet the supervisory need.

Despite the fact that the terms “financial holding company” or “financial conglomerates” cannot be found in any of the current financial laws and regulations in China, financial conglomerates have existed since the early 2000s. Since present financial laws and regulations are made in accordance with sectoral segregation, their function in the supervision of financial conglomerates is extremely limited, though some provisions in respective laws and regulations may be utilized in the supervision of financial conglomerates. As the potential risks and supervisory issues associated with financial conglomerates has been identified, the demand of a legal framework created specifically for the supervision of financial conglomerates to complement the insufficiencies of current laws and regulations is imminent in China.

In helping China to establish a feasible supervisory framework for financial conglomerates, this thesis researches relevant laws and regulations in different developed countries including the Federal Reserve Act and the Gramm-Leach-Bliley Act, as well as parallel regulations of the U.S. and Council Directive 2002/87/EC on the supplementary supervision of credit institutions insurance undertakings and investment firms in a financial conglomerate of the European Union. Through the comparative law studies, the countries selected have all been aware of supervisory issues regarding financial conglomerates and the different approaches these countries adopt to address such issues share common ground. However, as the history, political agenda, environment and demand of financial markets in each country varies, distinctions of supervisory framework can be found in several aspects – approaches of assessing the capital adequacy of financial conglomerates, disclosure requirements, permissible forms of financial conglomerates, and structure of regulators. These divergences are designed to respond to the particular needs of each country. Hence, a one-size-fits-all method for the supervision of financial conglomerates does not exist.

Government has to regulate and supervise the financial service industry because customers fail to price the risk and elaborate supervision due to the lack of incentive and the asymmetry of information. On the

other hand, the overly stringent regulation and over-expanded supervision are of no help in improving the development of financial market as well its efficiency or even integrity. Regulations that provide appropriate level of scrutiny and promote market transparency to assist private sectors to monitor financial service industry are indispensable. Thus, regarding the supervision of financial conglomerates, this thesis concludes that China must, by following the international standard and referring to systems of other developed countries, establish a supervisory framework with an appropriate level of government involvement to address issues concerning licensing, permitted conglomerate structure, capital adequacy, risk concentration, intra-group transaction and exposure, risk contagion, qualification of managerial body and conflicts of interest. This framework should also promote the transparency and market discipline through more sophisticated disclosure requirements. As for the structure of supervisors, no preponderant evidence is clearly in favor of single unified regulators or multiple specialized regulators. As long as a proper coordination mechanism among supervisors is available, and the independence of supervisors can be enhanced, the structural change of supervisors is not imminent.

There are a couple of final remarks this thesis would make. First, to make a rule is one thing but to implement a rule is altogether another challenge. Good legislation does not guarantee a satisfying outcome, as the legislation does not automatically translate into solid implementation. It is agreed that corruption is rampant in both central and local governments due to the failure of the Communist party to discipline itself. This fact may cause the well-established laws and regulations regarding the supervision of financial conglomerates to be ignored at any level and at any stage of supervision. If the political system reflects only the interests of a small group of “elites,” the transparency and competition of the market can possibly be undermined.⁵⁷⁷ Therefore, whether the Chinese government is capable of coping with the corruption is a critical factor for the success of financial supervision.

Second, owing to the dynamic nature of financial markets, financial products as well as the management techniques of financial institutions and conglomerates are evolving rather than static. Besides, even when academia reaches a consensus about what form of regulation to adopt, the real world sometimes produces something quite different.⁵⁷⁸ As the essence of law contains both the supply and demand side,⁵⁷⁹ laws and regulations regarding the supervision of financial conglomerates need to fluidly respond to the change of market condition and any innovative

⁵⁷⁷ BARTH ET AL., *supra* note 387, at 15.

⁵⁷⁸ Mishkin, *supra* note 45, at 24.

⁵⁷⁹ NEIL K. KOMESAR, *LAW'S LIMITS: THE RULE OF LAW AND THE SUPPLY AND DEMAND OF RIGHTS* 3 (2001).

development influencing financial conglomerates, including technology, the availability of information, and management techniques. Given that financial conglomerates are newly launched in China, they may be ill-informed on related rules once China has the same, and may be ill-intentioned to comply with such rules, laws and regulations; therefore, it is better to include stronger enforcement to deal with deliberate avoidance of supervision.⁵⁸⁰ However, once the situation shifts to the stage of well-intentioned but ill-informed or ill-intentioned but well-informed, approaches of supervision and enforcement should accordingly change so as to meet reality. Government involvement may be reduced to the least extent once institutions are both well-intentioned and well-informed.

⁵⁸⁰ See Baldwin & Cave, *supra* note 373, at 101.