The Supervision of Financial Conglomerates in the Philippines

AUTHORS

Thea Josefina Natalia W. Santos
joined the Bangko Sentral ng Pilipinas in 1998 as a bank examiner for the then Department of Thrift Banks and Non-Bank Financial Institutions. Since 2003, she has been with the Office of Supervisory Policy Development, the policy arm of the Supervision and Examination Sector.

Andy Mullineux
is Professor of Global Finance and Director of the Global Finance Research Group and the Finance Group of the Department of Accounting and Finance in the Birmingham Business School at the University of Birmingham. He has published extensively on monetary policy and business cycles as well as on financial restructuring and regulatory and supervisory reform in developed and emerging market economies. More recently, he has been working on financial exclusion, access to finance, micro and small enterprise financing and the corporate governance of banks. Andy Mullineux can be contacted at: a.w.mullineux@bham.ac.uk.
Introduction

The global financial landscape has undergone tremendous changes in the last three decades. The primary drivers of change were the rapid pace of technological innovation, as well as international and regulatory liberalization. One outcome of these developments is the emergence of financial conglomerates. Loosely defined, a financial conglomerate is a “group of firms that engages in financial activities that have been kept separate, by law and regulation, for many years in many countries” (Van Lelyveld and Schilder, 2002) where the firms are connected by common ownership, management, or interest. Through time, these conglomerates have come to hold a considerable amount of assets, offer a breadth of services, and are now considered as major players in the financial services industry.

The presence of these complex financial structures brings new risks. Ultimately, the failure of a large conglomerate may have a negative implication on the stability of the financial system. These have raised questions on the applicability of the traditional supervisory approach—where each financial activity is overseen separately—to the oversight of financial conglomerates. There have been different responses to these new challenges, such as the institution of supplemental regulations for financial groups, ratification of enabling laws (such as the Financial Conglomerates Directive in the European Union), and even changing the institutional structure of supervision through the establishment of supervisory agencies that are responsible for the prudential regulation of all financial firms in a number of countries. Moreover, the role of systemically important financial institutions in the recent financial crisis led to discussions about integrating the macroprudential approach in the supervisory framework, which takes into account system-wide risks rather than just an institution-focused risk assessment.

The Philippines has experienced similar developments in its financial system. Financial conglomerates dominate the domestic financial landscape as a result of the liberalization in the regulatory environment, particularly with the introduction of universal banking in the early 1980s (Milo, 2002). However, the regulatory framework for financial services in the country is still founded on the traditional approach. Supervisory responsibility is shared by three supervisory agencies.

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1 A more formal definition is cited in the section on Financial Conglomerates in the Philippines.
agencies, with the supervision of financial groups largely addressed by the Philippine central bank’s supervisory mandate over banks and quasi-banks. This arrangement has been cited as inadequate in addressing the risks of conglomerates. On one hand, there may be companies within a group that are not effectively supervised. On the other hand, the sharing of supervisory responsibilities among multiple agencies may result in confusion as to which agency is ultimately responsible for the oversight of a particular firm.

An often-cited case is that of Urban Bank, a commercial bank that was closed in 2000 due to liquidity problems. It was later determined that bank funds amounting to P4.6 billion were used to support withdrawals and pre-terminations of placements made by clients of the trust department of its investment house affiliate, Urbancorp Investment, Inc. The transfer was done through the purchase by Urban Bank of the investment house’s receivables at face value. The receivables were classified as “substandard,” or “doubtful,” implying that they had poor prospects for collection. Rizal Commercial Banking Corporation (RCBC), one of the country’s universal banks, also suffered from increased reputational risks due to troubles in an affiliated pre-need company, Pacific Plans, Inc.

These circumstances indicate that the oversight for financial groups may need to be improved to achieve tighter coordination among the relevant regulatory agencies. This paper presents a review of the existing international practices as well as Philippine regulations that relate to the supervision of financial conglomerates. It also provides insights on the possible design of an enhanced supervisory framework for financial conglomerates.

1. Financial Conglomerates, Their Rewards and Risks

Merton (1995) offers a theoretical underpinning for the emergence of financial conglomerates. He states that financial intermediaries fulfill a central economic function, i.e., the allocation and deployment of economic resources. Over time, the manner by which the function is carried out and the institutions that perform it may change in the pursuit of enhancing efficiency. Among the well-observed drivers of this structural change are developments in finance theory, financial innovation, technological advancements and liberalization both within and across borders (Merton, 1995; Allen and Santomero, 1999; and Borio and Filosa, 1994). An offshoot of these structural changes is “financial integration,” which is characterized by the production or distribution of a financial service that is traditionally associated with one of the three major financial sectors—banking, securities and insurance—by an entity from another sector. The delivery of varied services by financial conglomerates is a type of firm-level integration that can be deemed as the middle ground between having all three services offered by one entity (largely a theoretical construct) and forming alliances or joint ventures with entities from different sectors (Skipper, 2000).
Skipper (2000) outlines three possible structures for financial conglomerates. First is the universal banking model, which has a universal bank owning subsidiaries offering insurance and other financial services. The universal bank undertakes both commercial banking and securities activities. The second model is where a bank or an insurance company serves as a parent firm and owns separately-capitalized subsidiaries engaged in different financial services. The third model is a holding company structure, in which a holding company’s business is limited to the ownership of stock in and the supervision of management of other corporations. The dominant structure in a particular jurisdiction will be dictated by factors such as a country’s history, laws, and existing regulatory framework for financial institutions (Half, 2002). The universal banking model is common in continental Europe while the holding company model is associated with the United States and Japan.

1.1 Benefits from Conglomeration
A number of reasons have been cited for the creation of financial conglomerates and why they continue to be dominant forces in financial systems.

1.1.1 Economies of scale and scope
The sheer size of financial conglomerates facilitates the realization of economies of scale and cost reduction because it makes possible the distribution of costs over a large volume of outputs. Economies of scope are likewise achieved since this set-up makes it highly probable for information technology systems for risk management to be used for both securities and banking activities, thereby reducing operational costs across different business lines. Firms undertaking new activities can likewise leverage on existing resources such as informational capital, research departments, and distribution channels. The conglomerate may also realize savings from the centralization of administrative functions (Skipper, 2000).

1.1.2 Portfolio diversification
Financial groups make possible the reduction of risk through portfolio diversification. The National Australia Bank (1996) cites a number of studies that document differences in bank and non-bank operations in the United States. One finding is that insurance has less volatile returns than banking. Given that revenues from various business lines are not highly correlated, they tend to offset each other and thus lessen the risks for the entire group.

1.1.3 Revenue enhancement
Conglomeration enhances revenues. This is important as investors have become increasingly sophisticated and discriminating (Van Lelyveld and Schilder, 2002). Banks that have traditionally obtained most of their revenues from corporate lending may see their margins eroded with the development of financial conglomerates.
of capital markets that provide alternative and cheaper sources of funding to their corporate clients. Banks may also be playing a diminished role in the payments system owing to the widespread use of credit cards and money market accounts that allow investors the flexibility to withdraw money with less difficulty. Banks, therefore, engage in ancillary businesses such as trust and fiduciary services and brokerage to recoup lost revenues (Allen and Santomero, 1999). Another way that conglomeration contributes to revenues is through cross-selling. Branches can be used more intensively to facilitate the sale of products of other entities in the group, e.g., insurance products being sold in banks.

1.1.4 One-stop shop for multiple services

Financial conglomerates confer benefits to consumers who require multiple services. An institution offering a wide menu of products and services functions as a one-stop shop\(^6\) that may lower search costs for clients.\(^7\) At the same time, there may be a psychological benefit derived from the familiarity of dealing with only one institution and their personnel (Skipper 2000, Santos 1998), unless customers prefer the expertise of specialized institutions.

1.2 Risks of Conglomeration

Notwithstanding the benefits that can be obtained from the delivery of services by a group-wide structure, the operation of conglomerates also poses risks to the groups themselves, their stakeholders, and the financial system.

1.2.1 Multiple gearing

One problem that is attributed to the layered structures of conglomerates is the occurrence of multiple or excessive gearing. This refers to a situation wherein the actual capital held by the group is not enough to support the risks being run by the entities that comprise it. Multiple gearing is present when a parent raises funds by issuing capital instruments, invests these funds to a subsidiary, and the subsidiary, in turn, downstreams the same funds to its own subsidiaries and affiliates. Multiple gearing can also occur when funds are upstreamed from the subsidiary to the parent company. When viewed separately, it may seem that the parent company and all the subsidiaries are adequately capitalized when, in fact, the funds are merely being recycled from one level of the conglomerate to another. There is greater risk if the investment of the parent in its subsidiaries is sourced from debt rather than equity issues. Given the size of some financial conglomerates and the wide reach of their activities, multiple gearing and inadequate capital may have negative impact on financial stability when the conglomerate suffers large losses (Tripartite Group, 1995).

\(^6\) Also as a “financial supermarket” or “financial mall.” This is also related to cross-selling, i.e., a borrower who takes out a car loan from a bank can immediately avail of car insurance from the same institution.

\(^7\) The financial conglomerate, however, may impute this implicit service in the price it passes on to clients.
1.2.2 Conflicts of interest

Financial conglomerates also lead to multiple conflicts of interest in dealings with clients. The client base already represents a “captive market.” As such, clients may be offered risky or mispriced investment products or they may, unknowingly, be induced to purchase products or obtain services with related firms in the belief that they are dealing with the entity that they are most familiar with (e.g., a bank). At times, they even expect that their investments are covered by deposit insurance even when they are not.

Conflicts of interest also arise in the misuse of privileged information. Information obtained through a creditor-debtor relationship can be used by a unit in the group that is involved in capital markets or in securities trading. Another example is when terms offered to related entities such as commercial and industrial firms are more favorable than those which are offered to clients who do not enjoy any ties with the conglomerate (Santos, 1998).

1.2.3 Contagion

The interrelationship between firms in a conglomerate makes it susceptible to contagion, which happens when the problems of one entity within the group affects other entities in the group. The Tripartite Group (1995) cites two types of contagion: (i) psychological contagion and (ii) intra-group exposures. Psychological contagion occurs when one entity with no inherent weaknesses is affected by the adverse condition of a related entity. It arises when the public perceives that the relatively healthy member(s) of the conglomerate would be vulnerable to the same difficulties because of its association with the fragile entity. This implies that firms within a financial conglomerate may run a higher level of reputational risk compared to stand-alone institutions. On the other hand, contagion attributed to intra-group exposures occurs when the weakness of one entity is transmitted to other entities because of actual linkages such as shared resources, borrowings, and guarantees, among others. The situation is exacerbated when the stronger entities are compelled to “help” the weaker institutions in order to protect their own operations (Tripartite Group, 1995).

1.2.4 Multiplicity of functions

The multiplicity of functions and activities in a conglomerate places a higher demand on its management. Ensuring that the group is functioning optimally requires greater coordination among its units. Different businesses give rise to different types of risk or they may create the same types of risks but in different magnitudes and degrees of importance. Managers of a financial conglomerate must, therefore, be able to assess the risk of the group as a whole and develop appropriate policies to manage these risks (Skipper, 2000). Moreover, there may be significant monitoring costs involved in producing a comprehensive view of operations, particularly in terms of report generation.

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8 This type of conflict of interest can also occur within a single organization, i.e., when two businesses are conducted in separate departments of one firm. However, a wider range of products offered by an institution may also widen the scope for conflicts of interest (Claessens, 2002).

9 Formally known as the Tripartite Group of Bank, Securities and Insurance Regulators, a cross-sectoral initiative formed in 1993 at the instance of the Basel Committee on Banking Supervision.
1.2.5 Moral hazard in public safety nets

From the supervisory perspective, an important consideration is how the agglomeration of risks in a financial group impacts on the extent of public safety net. When large financial institutions are in danger of failing, authorities may feel obliged to save or come to their aid in order to preserve the stability of the financial system, otherwise known as the “too big to fail” argument (Claessens, 2002). With recent developments, the argument has been extended to institutions that are “too interconnected” (with other financial firms), as their failure has likewise been proven to cause instability. Large firms are often members of groups or form groups themselves (FSA, 2009). As such, the “too big” and “too interconnected” arguments are likely to apply to financial conglomerates too.

If a bank is present in the group, the lender of last resort (LOLR) facility may be extended to the ailing bank to preserve its role in the payments system and to avert a system-wide panic. If the difficulties of the conglomerate did not stem from the bank itself but from another firm within the group, the LOLR function is, in effect, extended to non-bank institutions, even those that are, by law, not regulated.

If the bank or regulated entity is not saved and liquidation procedures are undertaken, the failure of a conglomerate would also have implications on the coverage of deposit insurance or similar guaranty funds. The sub-prime crisis showed that even if a bank is not part of a group, it is possible for the government to step in to prevent a firm that has heavy exposures to banks from failing and to prevent a failure in another financial sector.\(^{10}\)

In order to prevent such bailouts and hence guard against the abuse of the LOLR functions and guaranty schemes, the framework for prudential supervision needs to be altered to ensure that the additional risks that are present in large institutions and conglomerate structures are being monitored. Initially, proposals for more intense oversight over groups were introduced. This increases the cost of supervision and requires a significant amount of coordination between and among the supervisors of all regulated entities. It could also necessitate an integrated supervisor to oversee the activities of a conglomerate as a whole. Additional prudential safeguards by way of regulations will have to be instituted, including mechanisms for compliance (Claessens, 2002).

In light of the recent crisis, the importance of monitoring unregulated entities and activities within groups has been underscored (FSA 2009). Discussions have also focused on incorporating the macroprudential approach to supervision, which takes into account system-wide risks rather than those of individual institutions only. This may again involve changes in regulatory structures and the use of new supervisory tools. This is also likely to impact on large and interconnected firms and widen the scope of regulation.

Such transformations in prudential supervisory frameworks, particularly the expansion of the scope of regulation, can cause boundary problems to develop (Brunnermeier et al., 2009). Regulation is an added cost and is seen as a disadvantage by regulated firms. This can lead to regulatory arbitrage when firms increasingly engage in business activities that are less regulated.

\(^{10}\) AIG was bailed out by the US Federal Reserve in order to protect not only the insurance industry but also the banking industry, given that AIG’s failed subsidiary was the counterparty of banking institutions.
It can also deepen moral hazard problems. Firms in a conglomerate-including those that are not directly subject to supervision-can be induced to take on risky activities knowing that the government stands ready to bail them out. Prudential regulations may also diminish the public’s incentive to exert market discipline over firms as they rely more on regulators to safeguard their interests.

2. Financial Conglomerates in the Philippines

A commonly accepted definition of a financial conglomerate is “any group of companies under common control whose exclusive or predominant activities consist of providing significant services in at least two different financial sectors such as in banking, securities, and insurance” (Tripartite Group, 1995). Groups that are engaged only in banking-related activities and therefore have a risk profile that is similar to banks are referred to as “banking groups” (Macdonald, 1998).

In the Philippines, there is no law or regulation that formally defines financial conglomerates. However, certain financial groups are recognized in banking and insurance regulations.

Banking regulations are derived from relevant laws, principally the New Central Bank Act (Republic Act No. 7653) and the General Banking Law of 2000 (Republic Act No. 8791). The New Central Bank Act defines the responsibilities and powers of the Bangko Sentral ng Pilipinas (BSP) as the country’s central monetary authority and banking sector supervisor. The General Banking Law, on the other hand, sets out the powers and authorities of banks and other financial institutions and defines the broad parameters that govern their operations. The law is implemented by the BSP through the issuance of specific guidelines in the form of circulars and memoranda duly approved by the Monetary Board, the BSP’s governing body. These circulars and memoranda, including amendments, are codified into the Manual of Regulations for Banks, which serves as the compendium of all regulatory issuances.

Under the relevant provision of the New Central Bank Act, the BSP is responsible for the supervision of banks, quasi-banks, and their subsidiaries and affiliates engaged in allied activities.12 Allied activities may be financial or non-financial. Financial allied enterprises include insurance companies, venture capital corporations, leasing companies, investment houses, financing companies, credit card companies, securities brokers/dealers, foreign exchange brokers/dealers, holding companies whose investments are limited to the allowed allied and non-allied undertakings allowed for universal banks (UBs). Non-allied enterprises for UBs/commercial banks/thrift banks (TBs) are: warehousing/storage/safety deposit box companies, companies primarily engaged in the management of mutual funds but not the mutual funds themselves, providers of computer services, insurance agencies/brokerages, companies engaged in home building and development, service bureaus, the Philippine Clearing House Corp, Philippine Central Depository, Fixed Income Exchange, health maintenance organizations; for TBs/rural banks: companies engaged in warehousing and post-harvest facilities, fertilizer and agricultural chemical and pesticides and farm equipment distribution, trucking and transportation of agricultural products, marketing of agricultural products, leasing.
percent (50%) of the outstanding voting stock of which is directly or indirectly owned, controlled or held with the power to vote by a bank. An affiliate, on the other hand, is defined as an entity linked directly or indirectly to a bank by means of:

a) Ownership of, control or power to vote up to 10 percent or more of the outstanding voting stock of the entity, or vice-versa;

b) Interlocking directorship or officership, except in cases involving independent directors as defined under existing regulations;

c) Common stockholders owning 10 percent or more of the outstanding voting stock of each financial intermediary and the entity;

d) Management contract or any arrangement granting power to the bank to direct or cause the direction of management and policies of the entity, or vice-versa; and

e) Permanent proxy or voting trusts in favor of the bank constituting 10 percent or more of the outstanding voting stock of the entity, or vice-versa.14

Among the banking institutions in the Philippines, the largest are the universal and commercial banks. Subject to prudential limitations, they are allowed to invest in the equity of other financial institutions and, in effect, form financial groups. Table 1 shows the list of domestic banks which own financial allied subsidiaries and affiliates. The table also identifies the group that the banks belong to as either banking groups or financial conglomerates.15,16

Table 1

<table>
<thead>
<tr>
<th>Banking Institution</th>
<th>Type of Group</th>
<th>Total Assets (Php Millions) September 2010</th>
</tr>
</thead>
<tbody>
<tr>
<td>Allied Banking Corporation</td>
<td>Financial Conglomerate</td>
<td>155,964</td>
</tr>
<tr>
<td>Asia United Bank Corporation</td>
<td>Banking Group</td>
<td>46,130</td>
</tr>
<tr>
<td>Banco de Oro Unibank, Inc</td>
<td>Financial Conglomerate</td>
<td>869,501</td>
</tr>
<tr>
<td>Bank of the Philippine Islands</td>
<td>Financial Conglomerate</td>
<td>621,329</td>
</tr>
<tr>
<td>China Banking Corporation</td>
<td>Banking Group</td>
<td>231,556</td>
</tr>
<tr>
<td>LandBank of the Philippines</td>
<td>Banking Group</td>
<td>526,790</td>
</tr>
<tr>
<td>Metropolitan Bank &amp; Trust Company</td>
<td>Financial Conglomerate</td>
<td>701,185</td>
</tr>
<tr>
<td>Philippine National Bank</td>
<td>Financial Conglomerate</td>
<td>306,153</td>
</tr>
<tr>
<td>Rizal Commercial Banking Corporation</td>
<td>Financial Conglomerate</td>
<td>247,432</td>
</tr>
<tr>
<td>Security Bank Corporation</td>
<td>Financial Conglomerate</td>
<td>145,147</td>
</tr>
<tr>
<td>Union Bank of the Philippines</td>
<td>Financial Conglomerate</td>
<td>235,802</td>
</tr>
<tr>
<td>United Coconut Planters Bank</td>
<td>Financial Conglomerate</td>
<td>166,305</td>
</tr>
</tbody>
</table>

* Information on bank activities based on latest Annual Reports; asset figures from the BSP website

14 Subsection X192.12, Manual of Regulations for Banks
15 Strictly following the definition in the New Central Bank Act, a financial group of bank-related companies may be identified through lateral relationships (common ownership) and not only through vertical relationships (direct or indirect ownership). Moreover, thrift and rural banks may also be part of financial groups, either as parents or affiliates. However, they are much smaller in size.
16 Foreign banks are usually supervised on a group-wide basis by the regulators in their home country. This section focuses on the supervision of domestic institutions.
As for groups recognized under insurance regulations, the Insurance Code refers to holding company systems, which are groups comprised of a controlling person17 (the “holding company”), the insurance company, and other entities that the controlling person controls. Control is presumed to exist when a person directly or indirectly has forty percent voting power over an insurance company. One will note that if a holding company system includes a firm that undertakes banking or securities-related business, it constitutes a financial conglomerate. However, if it includes a bank, the system is equivalent to a financial group recognized under banking laws.

An example of a holding company system would be the ATR Kim Eng Group of companies (See Figure 1). It has held the distinction of being the largest financial group that does not include a bank.18 Its consolidated assets amount to P6.236 billion at the end of September 2010.19

2.1 Supervision of the Philippine Financial Services Industry

The financial services industry in the Philippines is supervised by three agencies, namely, the BSP, the Securities and Exchange Commission (SEC) and the Insurance Commission (IC). The BSP supervises banks, quasi-banks, their financial allied subsidiaries and affiliates (except insurance companies); non-stock savings and loan associations; and pawnshops. In addition, the Philippine Deposit Insurance Corporation (PDIC) monitors banks in accordance with its role as the deposit insurer. The SEC oversees investment houses, financing companies, securities dealers/brokers, and investment companies. Finally, the IC supervises insurance and reinsurance companies, insurance brokers, mutual benefit associations, and pre-need companies.

![Structure of the ATR Kim Eng Group](image-url)

*Not a comprehensive representation; for illustrative purposes only
Source: Company disclosures

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17 A person pertains to “an individual, partnership, firm, association, corporation, trust, any similar entity or any combination of the foregoing acting in concert.” (Section 282 of P.D. No. 1460)
18 This may change eventually with the purchase by Aseam Credit Sdn Bhd, a subsidiary of May-Bank, of 44.63% of Kim Eng Holdings, one of the major shareholders of ATR KimEng Financial Corporation. (The other major shareholder is ATR Holdings.)
19 From the group’s SEC Form 17-Q
The supervisory ambit of the BSP, as defined in its charter, provides the basis for the implementation of consolidated banking supervision as it allows the BSP to examine not only a bank or quasi-bank but also its subsidiaries and affiliates engaged in allied activities. The organization of the BSP’s supervisory function supports this approach as all related companies are also overseen by the same unit that supervises a particular bank or quasi-bank.

Moreover, the BSP regularly conducts simultaneous on-site examinations of banks and their subsidiaries and affiliates, using common cut-off dates. This arrangement makes it possible to assess the condition of a bank, taking into account the activities that are being conducted in entities that, while legally separate from the bank, contribute to risks that should be controlled by the bank itself. More importantly, it is easier to verify inter-company transactions such as transfers of funds that could contribute to double-gearing. To a certain degree, regulatory arbitrage is also being addressed since activities that may have been passed on to financial allied subsidiaries can be uncovered during on-site examinations. Subsidiaries and affiliates to be examined are chosen on the basis of their importance, the type of activities and transactions they undertake, and the extent of the impact that such transactions or activities may have on the parent bank.

Quasi-banks and non-bank financial subsidiaries and affiliates are also subject to a number of BSP regulations. For monitoring purposes, they are required to submit monthly financial reports and corporate information, including data on directors and officers on an annual basis, among others. In addition, they are also subject to corporate governance regulations that apply to their parent banks/quasi-banks such as those pertaining to disqualification procedures for directors and officers, requirements for the engagement of services of independent auditors, and regulations on credit card operations.

BSP regulations likewise promote the construction of firewalls between the bank and related firms through the following rules on:

a) **Equity investments**—Banks’ investments that accord them control over the investee company are capped at specific percentages of total subscribed and voting stock of the investee.

b) **Large exposures and credit concentrations**—Banks must subject exposures that exceed five percent of net worth to more intensive monitoring and inform the BSP when these may potentially impact on capital adequacy.

c) **Single borrower’s limit**—Credit accommodations to one person/related group should generally be less than 25 percent of net worth.

d) **Loans to directors, officers and related interest, commonly known as DOSRI**—These should not exceed 15 percent of the total loan portfolio or 100 percent of net worth, whichever is lower.

e) **Loans to subsidiaries and affiliates**—These are capped at 10 percent of net worth for each subsidiary/affiliate, five percent of net worth for unsecured loans to each subsidiary/affiliate and 20 percent of net worth for the total loans to all subsidiaries and affiliates.

A key prudential regulation that the BSP has implemented on a consolidated basis for financial groups is the risk-based capital adequacy requirement. It

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Section 25 of R.A. 7653 (The New Central Bank Act)
adopted the Basel principles in 2001 and began implementing the Basel 2 framework in July 2007. In the calculation of capital requirements, the BSP has opted to deduct from available capital the full amount of investments in subsidiary broker/dealers and insurance companies and any capital shortfalls of these regulated entities, given that these institutions are subject to distinct capital regimes. However, this approach requires coordination with the primary regulator, i.e., the SEC or the IC, as to the extent of the broker/dealer or insurance subsidiary’s compliance with their respective capital rules.

Even with the seemingly extensive coverage of BSP’s supervision over financial groups (i.e., its charter and the banking law allow it to supervise and examine subsidiaries and affiliates that are engaged in allied activities), there is no provision in existing laws that allows it to acquire information from non-allied affiliates or permits examination of the operations of these firms, even if warranted. A regulated firm may indirectly engage in unauthorized transactions by passing these off as normal business operations of its unregulated subsidiaries and affiliates. The BSP is also constrained from obtaining information from parent companies or entities, which may sometimes be important considering that they are able to direct the actions of a firm. The BSP’s recourse is through the regulated bank, which may not always yield optimal results.

The problem of unregulated entities is not specific to financial conglomerates. There are certainly cases of unlicensed stand-alone firms that engage in unauthorized transactions. When such firms are connected to regulated entities, the regulatory concerns span from putting an end to unauthorized operations to avoiding contagion. Thus, it is important to have safeguards in place to ensure that failures in unregulated entities do not spill over to the operations of the well-functioning units in the group.

With regard to the holding company systems defined in the Insurance Code, insurance companies are required to register with the IC as “controlled” institutions once they are classified as such. The controlled insurer can be compelled to produce information about the holding company and any of its controlled firms if these are deemed relevant to the condition of the insurer in the group. Moreover, the commissioner of the IC may direct the examination of any of the firms in a holding company system if there are grounds to believe that their operations would have material effect on the insurer. In this regard, the Insurance Code is more accommodating vis-a-vis banking regulations when it comes to addressing the activities of non-regulated entities within a recognized group.

The existing mandates of the regulatory agencies and the regulations that govern the supervised entities have led to some overlaps in supervisory jurisdictions. As noted earlier, financial groups that are subjected to

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21 The risk-based capital adequacy framework for broker/dealers was formally adopted by the SEC in November 2004, while risk-based capital rules for insurance companies were released by the IC in October 2006.

22 See FSA 2009

23 Special purpose entities (SPEs) present a special case of unregulated entities. Banks were given incentives to set up their own SPEs to aid in cleaning up their balance sheets given the build-up of non-performing assets (NPAs) during the Asian financial crisis. However, in order to qualify for derecognition of transferred assets from their books, banks can only own up to five percent of these SPEs. While it is the SEC that has responsibility for approving the SPE’s business plan, the SPE itself is not subject to audit by either the BSP or the SEC.

24 Section 288 of P.D. 1480
consolidated supervision by the BSP are in some instances equivalent to the holding company systems recognized in the Insurance Code. The two agencies involved may have similar concerns over the operations of the group as a whole.

The current set-up likewise subjects non-bank institutions that are subsidiaries of banks and quasi-banks to dual supervision by the BSP and the SEC. The SEC remains as the primary regulator of investment houses, financing companies and securities broker/dealers. These entities are typically included in bank-led financial groups.

Recognizing that coordination is needed to discharge their respective supervisory functions, the BSP and the SEC signed memoranda of undertaking (MOUs) regarding the institutions that they both supervise. The latest MOU was in 2004, which defines the responsibilities of each regulator and establishes operational procedures for the conduct of joint examinations of dually-regulated entities. In addition, both agencies agreed to harmonize and streamline reporting requirements.25

The BSP also signed a memorandum of agreement (MOA) with the PDIC to share information and relevant data (Bautista, 2004). Work has also progressed on agreements with the PDIC and the IC for the conduct of coordinated examinations.26

In July 2004, the regulatory agencies and PDIC formed the Financial Sector Forum (FSF) via the signing of a master MOA. The FSF is essentially a cooperative effort without any legal mandate, lest it be construed as an integrated supervisory body, which is not yet supported by the current legal and regulatory framework. The members of the FSF are the heads of the four member agencies: the BSP Governor, the SEC Chairperson, the Insurance Commissioner, and the PDIC President. It is chaired by the BSP Governor. The FSF essentially aims to improve the supervision of financial conglomerates and address the occurrence of firms operating in “regulatory grey areas.” It has working groups for three core areas: supervision policy, reporting and information exchange, and consumer protection (FSF Secretariat, 2004).

In April 2006, FSF members signed a MOA on information exchange, which lays down the procedures for sharing relevant information among the four agencies. The framework covers a broad spectrum of data and information such as submitted and generated reports; information on reputation agents; and regulatory issuances.27 In 2009, MOAs were likewise signed to harmonize the accreditation process for external auditors of supervised institutions and the process flow for the evaluation of mergers and consolidations of banks.

The foregoing agreements are testament to the value of the FSF in making processes more efficient and consistent across regulatory agencies and supervised institutions. However, an approach or a framework for the supervision of financial conglomerates that puts all the member agencies on a common platform has yet to be put in place.

3. Concluding Remarks and Recommendations

The recent crisis has shown that supervisory attention should be devoted to improving consolidated supervision over financial groups, such that regulators are aware of the risks of the group, wherever they may lie.

25 SEC Annual Report 2004
26 BSP Media Releases, 1 February 2005 and 19 August 2005
27 BSP Media Release, 20 April 2006
The largest financial groups in the Philippines—including most of the institutional structures that can be described as financial conglomerates—already fall under the BSP’s regulatory ambit (Milo 2002). Nonetheless, there is still scope to further strengthen the BSP’s ability to oversee the financial groups under its jurisdiction. This includes an amendment to the BSP charter that would explicitly empower it to obtain information on institutions related to the bank, especially unregulated entities.

There is much to be gained from intensifying coordination efforts among the different regulatory agencies. One agency can benefit from the resources and expertise of another supervisor with regard to concerns about entities within the same group that fall outside its regulatory realm. For instance, if the IC would need information on a particular holding company system that has a member-bank, supervisory information could be shared by the BSP.28 An organized framework for coordination could be established for this purpose.29

This can begin by establishing the concept of a financial conglomerate in the local context. This would aid in identifying which institutions are regulated, by which agency, and to what extent these are regulated. The definition could be informally adopted by all the regulatory agencies (BSP, SEC, IC, and PDIC) in order to have a common reference point. As a starting point, the formal definition given earlier, the grouping of a bank and its subsidiaries and affiliates as delineated in banking laws and regulations, as well as the holding company system in the Insurance Code can be considered.

After the concept of financial conglomerates has been defined, these conglomerates should be identified. Although the BSP publishes a list of all its supervised institutions, this does not include pre-need companies and insurance companies that are subsidiaries and affiliates of banks as these are not examined by the BSP. Moreover, there may be a number of conglomerate structures that exist apart from those that include big banks. Priority should be given to organizations that are deemed systemically important30 but the identification of smaller groups should not be ignored. These smaller financial institutions may have a developmental role to play as they are able to reach niche markets and non-mainstream clients.

Once the groups have been identified, the regulators can agree on the scope of information sharing regarding the operations of the financial groups. As part of its verification process of banks’ capital adequacy requirements, the BSP may need information on the capital position of its subsidiary broker/dealers and insurance companies. Risk exposures, concentrations and intra-group transactions may be taken up as well (Joint Forum, 2001). If this is the case, then the regulators should commit to a regular exchange of information. For this purpose, a coordinator for the group can be identified.

The designation of a coordinator would depend on the structure of the conglomerate and the information requirements of other supervisors (see Table 2). The choice of a coordinator, including its roles and responsibilities, should be agreed upon by all supervisors concerned. Moreover, the role of coordinator can be extended to coordinating supervisory activities, if any, such as making group-wide assessment. However, the appointment of a coordinator and the

28 This presupposes that there are no legal impediments to information sharing.
29 This borrows heavily from the approach of the Financial Conglomerates Directive of the EU.
30 The concept of a systemically important group would also need to be defined.
manner in which its tasks are carried out should not result in an excessive regulatory burden nor give the impression that the safety net is being extended to certain institutions. The coordinator is not intended to replace the role of the original supervisor (Joint Forum, 2001).

Any forthcoming initiatives can be the subject of a memorandum of understanding among all the regulators concerned. Such an agreement can reference the financial conglomerates that are to be the subject of coordination effort, the relevant supervisory areas, and the responsibilities of each regulator.

Given that this would be a multilateral effort, it would seem that the most appropriate venue for discussion and implementation would be the FSF. Since it concerns the relevant agencies, structuring a multilateral approach to overseeing financial conglomerates can be part of its agenda. It may be useful to designate working groups consisting of personnel of member agencies to operationalize the plans. It is recognized that these working groups would operate in a spirit of cooperation as the FSF does. It would then be useful to set a clear task list to guide their activities, including a timeline for completion. They should also be made to report on a regular basis to FSF members in order to promote accountability.

Table 2

<table>
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<th>Identifying a Coordinator</th>
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<td>The coordinator can be –</td>
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<tr>
<td>• The supervisor of the parent entity if it is a bank, securities firm or insurance company.</td>
</tr>
<tr>
<td>• The supervisor of the dominant entity in the group (in terms of assets, revenue or solvency requirements) even if the parent company is a supervised institution.</td>
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<tr>
<td>• The supervisor of the parent holding company if it is supervised.</td>
</tr>
<tr>
<td>• The supervisor of the dominant entity in the group (in terms of assets, revenue or solvency requirements) even if the parent holding company is a supervised institution.</td>
</tr>
<tr>
<td>• The supervisor of the dominant entity in the group (in terms of assets, revenue or solvency requirements) even if the parent company is an unsupervised holding company.</td>
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</table>

Source: The Coordinator Paper of the Joint Forum, 1999

Coordination among supervisory agencies is crucial in addressing regulatory overlaps. The overlaps can be viewed in terms of regulation of particular activities or institutions. Overlaps in terms of regulation of activities encompass products or services with the same nature and underlying risks being offered by different institutions that fall under the jurisdiction of separate regulatory agencies. Overlaps in terms of institutions would refer to one institution being subjected to the supervision of two agencies, following the existing legal framework. Of course, any agreement pertaining to shared supervisory responsibilities should be within legal boundaries. Existing bilateral or multilateral arrangements should also be consulted. Moreover, it would be useful to determine if there are any impediments to the implementation of current provisions so that these can be addressed through proper enforcement and, if necessary, legislative action.
Lastly, it has been evident in recent events that coordination plays a mitigating role in crises. Thus, management arrangements for such occurrences can likewise be a subject of discussion among the relevant agencies.

References: