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Cynthia C. Lichtenstein

ARTICLES

INTERNATIONAL STANDARDS FOR CONSOLIDATED SUPERVISION OF FINANCIAL CONGLOMERATES: CONTROLLING SYSTEMIC RISK

*Cynthia C. Lichtenstein**

In the interest of protecting the system of intermediation between savings and business working capital, the necessity of prudential regulation for depositary intermediaries has always been recognized in the United States and elsewhere. Whether chartered as banks or chartered as securities firms, firms that are major participants in the wholesale securities markets also need prudential supervision to ensure that they do not fail. This latter proposition, however, has been recognized only much more recently with the arrival of the technology for the instantaneous global transfer of payments for, and settlement of, securities trading.[1] The electronic payments system described in a New York Times Magazine article[2] has been in existence since the 1960s, but the participants and the regulators have, apparently, preferred not to talk in public fora about the fragility of the system or about the fact that no central bank is willing to guarantee the payments put through the system by banks originating

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* Professor, Boston College Law School; Special Consultant, Milbank, Tweed, Hadley & McCloy, New York. The original version of this paper was presented at the Brooklyn Law School Symposium on Global Trends Toward Universal Banking, Nov. 9, 1992. I am grateful to the commentator on my paper, Professor Michael Klausner, for causing me to rethink my presentation of the topic. I am also grateful to my research assistant at Boston College Law School, Jonathan Hugg, for his research help in connection with the Market Reform Act.

1. For the first time, to the author's knowledge, the extraordinary risks to the international financial system that are created by the funnelling of over 90% of all the world's dollar payments through a computer system in New York have appeared in the popular media. Peter Passell, *Fast Money*, N.Y. TIMES, Oct. 18, 1992, (Magazine), at 42.

2. *Id.*

from its jurisdiction.

It is not often realized that the electronic transfer system within the United States borders, Fed Wire, is in effect underwritten by the United States central bank. The Federal Reserve (Fed) guarantees to each bank receiving a payment that if the sending bank fails, the Fed will make payment to the recipient, thus permitting the recipient banks to treat transfers made through the system as cash in hand upon arrival of the order. On the contrary, as Peter Passell describes in his New York Times Magazine article,[3] no bank participating in the international dollar payment system through the Clearing House Interbank Payments Systems (CHIPS) can be assured that it has received a payment until settlement at the end of the day. Indeed, what might happen if one of the banks putting payments through CHIPS should be unable to pay what it owes at the end of the day gives the industrialized world's regulators chills. Since the banks in the system receive enormous payment orders from securities firms in the capital markets, they are, in effect, by executing the orders, extending credit to those firms unless they have received payment for the orders before sending them. Therefore, to the extent that a major securities firm was to fail and be unable to put a CHIPS bank in funds, the entire system would be at risk from this failure. Thus, in a very real sense, major players in the international securities markets are also "too-big-to-fail."[4]

While it is true that in 1990 the securities firm of Drexel Burnham Lambert Group, Inc. (Drexel) was allowed to fail and an orderly liquidation was carried out without undue market tremors, this description of events surrounding the failure of the broker-dealer Drexel Burnham Lambert, Inc. (DBL) is far too simple. It is true that the liquidation of the broker-dealer was carried out without incident, but the parent company had been withdrawing capital from the broker-dealer until ordered to stop by the Securities and Exchange Commission's (SEC) Division of Market Regulation and the New York Stock Exchange (NYSE), the broker-dealer's examining authority. As the Division has written in the preamble to its Proposed Rule Amendment, Net Capital Rule; Prohibited Withdrawal by Registered Broker-

3. Passell, *supra* note 1, at 42.

4. For the proposition that governments do act to prevent failure of their largest banks, see RICHARD DALE, INTERNATIONAL BANKING DEREGULATION 10-13 (1992).

Dealers:

> Had the Commission and the NYSE not intervened when they did, Drexel would have continued to withdraw funds out of DBL and probably would have continued until the broker-dealer's early warning level was reached. Especially in light of Drexel's precarious financial position and the uncertainty with respect to DBL's valuation of its high yield portfolio, this would have created the risk that the broker-dealer's customers and its counterparties would have been subjected to a liquidation under the Securities Investor Protection Act.[5]

Note the suggestion in this statement by the SEC's Division of Market Regulation that a liquidation of Drexel under the Securities Investor Protection Act[6] would *not* have been an orderly one without effect upon the markets. Is the SEC saying here that Drexel could not have been allowed to fail where the Securities Investors Protection Corporation (SIPC), the securities firms' equivalent of the banks' Bank Insurance Fund, would have been involved? Or was the SEC here recognizing what is often referred to as "systemic risk," the risk described above as destruction of the global payments system by the failure of a major participant? If the SEC *was* recognizing systemic risk, this recognition is a new one for a securities regulator. Prior to the 1980s, securities regulators had tended to view their function primarily as insuring the integrity of the markets, truth in securities selling, and, subsidiarily, the oversight of net capital requirements to insure that when a firm failed, the firm had sufficient liquidity to return to the customers their securities and free credit balances when the firm was closed.[7]

By the late 1980s, however, the OECD[8] set up an Ad Hoc Group on Securities Markets under the chairmanship of Mr. M. E. Hewitt of the Bank of England. The purpose of the Ad Hoc Group was to prepare an extensive report on the nature and functioning of the global financial system, a clear recognition of

5. 55 Fed. Reg. 34,027, at 34,029 (1990).

6. 15 U.S.C. § 780(c)(3) (1988).

7. *See, e.g.*, Gary Haberman, *Capital Requirements of Commercial and Investment Banks: Contrasts in Regulation*, FED. RESERVE BANK OF N.Y. Q. REV., Autumn 1987, at 1-10.

8. The Organisation for Economic Co-operation and Development (OECD) was created in 1961; its purposes include contributing "to the development of the world economy . . . and the expansion of world trade on a multilateral non-discriminatory basis in accordance with international obligations." ORGANISATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT, SYSTEMIC RISKS IN SECURITIES MARKETS 2 (1991).

the involvement in the health of the system of financial intermediaries trading in the global securities markets. The OECD published this report in 1991 under the title, *Systemic Risks in Securities Markets.*[9] The description in the report of the "[i]nterdependence and volatility of securities markets"[10] is a convincing delineation of why adequate prudential supervision of securities dealers active in the international financial markets is as important as prudential supervision of the credit and transaction risks undertaken by international banks.[11]

Even before the OECD Ad Hoc Group began its work, Bevis Longstreth, a United States SEC Commissioner, published an article in 1983 entitled, *Averting a Chain Reaction Disaster in the Money World.*[12] There, he gave examples of crises for broker-dealers, as well as describing the Penn Square crisis in the banking sector, and argued that *all* of the situations were:[13]

> examples of how, with increasing frequency, the difficulties of a single financial institution threaten to trigger a chain reaction, extending well beyond the entities immediately involved. And they suggest the need for a [g]overnment safety net, at the ready and capable of moving swiftly, to supply liquidity and act in other ways necessary to protect the stability of our nation's financial system.[14]

Very recently, the Chairman of the Board of Governors of the Federal Reserve System, Mr. Alan Greenspan, spoke before the Federation of Bankers' Association of Japan. He entitled his talk *International Financial Integration* and warned of the possible difficulties caused by technological changes that have been "accelerating the rapidity with which payments are made and securities transferred in the United States and around the world."[15] Chairman Greenspan, apparently speaking not only of

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9. *Id.*

10. *Id.* at 8-11.

11. Once again, for the proposition that governments do regularly intervene to prevent the closing of their major banks, see DALE, *supra* note 4, at 10-13. Professor Dale, however, does not seem to consider the major securities firms a risk to the system unless they are affiliated with banks. He appears to take the view that lone securities firms do not involve risks to the financial system however much they may need regulation to insure transparency in the markets and fairness to consumers. DALE, *supra* note 4, at 10-13.

12. BUS. & SOC'Y REV., Summer 1983, at 32-36.

13. *Id.* at 33.

14. *Id.* at 33-34.

15. Alan Greenspan, International Financial Integration, Remarks Before the Feder-

international banks, but also of international securities firms, continued on to say:

> In retrospect it appears that the transition from manual, paper based systems to electronics may not have been managed by those sufficiently sensitive to credit and risk exposures . . . only after the fact did we all become aware that the financial systems were at risk with serious implications for world markets.[16]

The focus of this paper, therefore, is not on the risks to banks of engaging in securities activities or a discussion of whether it is possible to allow United States banking organizations to join in the trend toward universal banking by permitting them to have affiliated securities firms.[17] This paper does not address the question of risk to a deposit guaranty scheme by operation of a universal bank or the affiliation of securities business with banking business; rather, the piece addresses current efforts to deal with the systemic risks presented by securities activities and financial intermediation.

Just as there are large banking organizations so involved in global payments that their possible failure involves systemic risk, there are also large securities firms whose collapse could have systemic consequences.[18] The issue of systemic risk in-

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ation of Bankers' Association of Japan 3 (Oct. 14, 1992) (on file with *Brooklyn Journal of International Law*).

16. *Id.*

17. The Treasury Bill, S. 713, implementing the Treasury Department Study, *Modernizing the Financial System, Recommendations for Safer, More Competitive Banks* (excerpts *reprinted in* 56 BANKING REP. (BNA) No. 6, at 270 (Feb. 11, 1991) would have permitted financial services holding companies with enhanced capital requirements to own both depositary banks and full-scale broker-dealers, so long as the broker-dealers were a separately incorporated subsidiary. S. 713, 102d Cong., 1st Sess. §§ 201, 202 (1991). The Treasury appears to have thought that the requirement of separate incorporation of the securities business would insulate the United States safety net for depositary banks from the risks incurred by the financial services holding company in the securities business. Professor Richard Dale's book, *supra* note 4, offers extensive argument as to why the financial health of depositary institutions cannot be protected in this way. However that may be, it is the thesis of this paper that securities firms that operate as broker-dealers in the international markets, whether free standing, separately affiliated with a banking institution, or operated as a department of a chartered bank, involve systemic risk for the global markets and must be subject to adequate supervision on a conglomerate basis.

18. This possibility has been "officially" recognized in the introduction to the recently released International Organization of Securities Commissions' (IOSCO) Technical Committee's report cited below.

> However the growth of very large securities firms turning over large volumes of securities on a daily basis has meant that the collapse of such a firm could have systemic consequences. This could happen, for example, where there appear,

volves not universal banking, but the size of the participants in the global markets. There is no trend toward universal banking. Universal banking in the sense of the combination of investment banking, insurance, and commercial banking is an existing part of the global financial system. The United States is an outlier in its continued insistence on permitting financial conglomerates containing a commercial bank to have only a very restricted investment banking business. The important question to be asked about such financial conglomerates is not whether they should be regulated by requiring the separation of the investment banking business into a separate subsidiary.[19] Rather, the question is what are the appropriate principles for adequate supervision of entities, whether they be large securities firms or large banks or a combination thereof on the universal model, that present systemic risks. This paper will briefly describe a number of recent initiatives which are attempting to deal with this question by articulating methodologies of risk assessment of the conglomerate in which such a financial institution is contained. The paper, thus, will cover a range of developments, including the portions

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> superficially, to be sufficient liquid assets to repay all liabilities without loss to customers and counter parties, but the sheer size of the positions requiring liquidation makes it difficult to liquidate these quickly and without moving the market adversely. There could also be systemic consequences where the size of security deliveries and payments due from the failed security firm could cause significant problems for counterparties if there were any delay at all in the firm's meeting its commitments and this could conceivably cause gridlock in the settlement and payment systems. The failure of such a securities firm might have a ripple effect spreading widely through the securities industry and the financial system as a whole and could trigger a general lack of confidence. TECHNICAL COMMITTEE'S REPORT, PRINCIPLES FOR THE SUPERVISION OF FINANCIAL CONGLOMERATES, INTERNATIONAL ORGANIZATION OF SECURITIES COMMISSIONS, IOSCO Doc. 7, at 7, ¶ 11 (1992) [hereinafter *IOSCO Principles*].

Indeed, the United States Congress seems to recognize this possibility in recently extending to nonbank investment firms the ability to borrow under certain circumstances directly from the central bank, thus recognizing that the failure of such firms could also pose issues of systemic risk. Federal Deposit Insurance Corporation Improvement Act of 1991, Pub. L. No. 102-242, § 4-1(4), 105 Stat. 2236 (1992). *See also* Dr. Thomas F. Huertas, The Regulation of International Financial Conglomerates; The Importance of Market Supervision, Address Before the XVII Annual Conference of IOSCO, London (Oct. 29, 1992) (on file with *Brooklyn Journal of International Law*).

19. It may be that, for internal reasons involving the inability of a particular country to limit adequately the responsibility of its deposit guaranty scheme to protect small depositors, it is necessary to provide a particular structure that seems more appropriate to the protection of the safety net. This, however, is an argument for a particular structure to protect the deposit guaranty scheme, not an argument for a particular structure to permit universal banking.

of the United States Market Reform Act[20] that permit the SEC to judge the financial impact of significant affiliates upon a regulated broker-dealer; the recent amendments by the SEC to its Net Capital Rule;[21] the Fed's insistence upon individual capital for broker-dealer subsidiaries, thus carrying out the Basle Accord's suggestion of non-consolidation of specific subsidiaries;[22] the recent Basle Minimum Standards for Supervision;[23] and, finally, IOSCO's recently released *Principles for the Supervision of Financial Conglomerates*.[24]

In the United States, the issue of adequate supervision for prudential purposes of financial conglomerates did not come into view until very recently. Since enactment of the Bank Holding Company Act of 1956[25] (BHCA), those entities traditionally considered to present systemic risks, the large money-center banks, have not been permitted to be affiliated with any companies, other than those found by the regulator in charge of supervision under the BHCA, the Fed, to be "so closely related to banking as to be a proper incident thereto . . . ."[26] It is not necessary, given the plethora of articles on the BHCA, as subsequently amended, to describe here just how this prohibition on the affiliation of United States commercial banks with non-financial entities has worked out.[27] Suffice it to say that, given that prohibition and the thorough-going banking type supervision and examination to which bank holding companies and both their non-bank and bank subsidiaries are subjected, it is not necessary to develop principles for risk assessment of affiliates of United States banks. It should be noted, however, that the United States is virtually alone in providing such comprehensive supervision and examination of the affiliates of commer-

20. Market Reform Act of 1990, Pub. L. No. 101-432, 104 Stat. 963 (1990).

21. Net Capital Rule, Exchange Act Release No. 34-28 927, 56 Fed. Reg. 9124 (1991) (to be codified at 14 C.F.R. § 240).

22. *See infra* note 30 and accompanying text.

23. BASLE COMMITTEE ON BANKING SUPERVISION, MINIMUM STANDARDS FOR THE SUPERVISION OF INTERNATIONAL BANKING GROUPS AND THEIR CROSS-BORDER ESTABLISHMENTS, (July 6, 1992) [hereinafter *Basle Minimum Standards*].

24. *IOSCO Principles, supra* note 18.

25. 12 U.S.C. §§ 1841-1850 (1988 & Supp. 1989-1990) (§ 1845 repealed 1966).

26. 12 U.S.C. § 1843(c)(8).

27. See, for recent journalism on the topic, Paul J. Mason & David A. Massey, *Holes in the Dike: The Riddled Barrier Between Banking and Insurance*, 10 BANKING EXPANSION REP. 1 (Jan. 21, 1991); *see also* Clyde Mitchell, *The Affiliation of Foreign Banks and Insurance Companies*, N.Y. L.J., June 26, 1992, at 3.

cial banks.[28]

However, when the Fed decided that it would authorize the acquisition by bank holding companies of broker-dealers under the BHCA's standard of "so closely related to banking as to be a proper incident thereto,"[29] the Fed took special precautions to insure that these entities, registered as broker-dealers and thus subject to the primary oversight of the SEC, would present no risk to the holding company or its subsidiary banks. The methodology utilized for this goal is that of separately stated capital requirements. At the present time, banks originating from over twenty countries are subject to risk-based capital adequacy requirements, the framework for which was articulated by the Basle Supervisors' Committee in its paper, *International Convergence of Capital Measurement and Capital Standards*[30] (Basle Accord). Of the twenty countries, however, the United States is the only one which applies the risk-based capital requirements not only to all of its commercial banks subject to federal regulation, but also to their bank holding companies.[31] As the IOSCO Principles point out, if a regulated entity subject to capital requirements is able to count its investment in another regulated entity as part of its own capital, while the second regulated entity counts its parent's investment in it as its own required capital, this combination may "allow excessive gearing through the recycling of capital."[32] The Basle Committee has expressed this

28. For the argument that commercial banks or their holding companies should be permitted to own interests in non-banking entities, see Cynthia C. Lichtenstein, *Thinking the Unthinkable: What Should Commercial Banks Or Their Holding Companies Be Allowed To Own?*, 67 IND. L.J. 251 (1992). The article, however, does not address the question of whether commercial companies should be permitted to own banking organizations. Adoption of adequate systems of risk assessment along the lines suggested by some of the documents discussed in this article should go far to aid consideration of that possibility for restructuring of financial regulation in the United States. *See, e.g., supra* notes 7-8 and accompanying text; *see, e.g., supra* notes 20-27 and accompanying text.

29. 12 U.S.C. § 1843(c)(8) (1988).

30. The Basle Committee on Banking Regulations and Supervisory Practices, *Report on International Convergence of Capital Measurement and Capital Standards*, 30 I.L.M. 978 (June 1988) [hereinafter *Basle Accord*]. For the history of the adoption of the *Basle Accord*, see Cynthia C. Lichtenstein, *Introductory Note*, 30 I.L.M. 967 (June 1988).

31. While the holding companies have somewhat more leeway in what kind of capital counts as capital for the capital/assets ratio, essentially a bank holding company's risk-based capital adequacy requirements are the same as those for its subsidiary banks and the holding company requirements are imposed on a consolidated basis.

32. *IOSCO Principles, supra* note 18, at 33-35. The IOSCO Principles in Annex 2 give examples of the full consolidation and the deduction method of accounting for regulatory capital. *IOSCO Principles, supra* note 18, at 33-35.

idea (for banks, not bank holding companies) by providing that "investments in subsidiaries engaged in banking and financial activities which are not consolidated in national systems"[33] shall be deducted from the capital base for the purpose of calculating the risk weighted capital ratio. The Basle Accord continues on to explain:

> The normal practice will be to consolidate subsidiaries for the purpose of assessing the capital adequacy of banking groups. Where this is not done, deduction is essential to prevent the multiple use of the same capital resources in different parts of the group. The deduction for such investments will be made against the total capital base . . . .[34]

In accordance with this method of control, while deciding to permit bank holding companies to invest in broker-dealer subsidiaries, the Fed, nevertheless, declined to permit the bank holding companies to consolidate these so-called Section 20 subsidiaries in their regulatory reports to the Fed for capital adequacy purposes.[35] Thus, the bank holding company investment in the stock of the broker-dealer subsidiary is deducted from the calculation of the holding company's capital for the purpose of the risk-based capital adequacy requirement. Moreover, each holding company requesting permission to acquire the stock of such a broker-dealer subsidiary has been required to submit a separate capital plan for the broker-dealer. In addition, of course, the broker-dealer subsidiaries are subject to the SEC's completely separate Net Capital Rule.[36] Thus, to the extent that the Fed hopes to maintain bank holding company capital as a source of strength for the subsidiary banks, that capital is fully insulated from any risks originating from the Section 20 subsidiary.[37] If, in fact, the Fed does have the power to force bank holding companies to utilize their capital to support subsidiary

33. *Basle Accord, supra* note 30, at ¶ 24(ii).

34. *Basle Accord, supra* note 30, at ¶ 24(ii).

35. Section 20 of the Glass-Steagall Act, 12 U.S.C. § 377 (1988), forbids affiliation of banks that are members of the Federal Reserve System and firms "engaged principally" in securities dealing and writing. Thus, in order to permit bank holding companies the acquisition of broker-dealers, the Fed had to impose on the subsidiaries conditions insuring that they were *not* "principally" engaged in the forbidden business - and the subsidiaries are referred to by the number of the statute they were found *not* to violate.

36. *See* Net Capital Rule, *supra* note 21.

37. *See* MCorp Fin., Inc. v. Board of Governors of the Fed. Reserve Sys., 900 F.2d 852 (5th Cir. 1990), *rev'd in part on other grounds*, 112 S. Ct. 459 (1991).

banks in trouble,[38] then, in the case of United States bank holding companies' combination of commercial banking and securities dealing, the Fed would seem to have achieved the greatest amount of insulation possible for the banking safety net.

In contrast to the above described scheme for United States commercial banks, until 1988, the United States system for supervision of registered broker-dealers was not in the least concerned with broker-dealer affiliation with either its parent companies or its non-broker-dealer sister companies or even its non-regulated securities subsidiaries. The stock market crash of October 1987 brought home both to the SEC and apparently to Congress in its hearings[39] the difficulties for regulated broker-dealers that could be caused by the unsoundness of their unregulated associates. In June of that year, the SEC, in its legislative recommendations to Congress, proposed broker-dealer holding company system risk assessment legislation. Congress did adopt the proposal in Section 4 of the Market Reform Act,[40] and the SEC implemented the statutory direction by issuing, in September, its 1991 Proposed Temporary Risk Assessment Rules[41] and in July of 1992, its Final Temporary Risk Assessment Rules.[42] These Temporary Risk Assessment Rules (Rules) became fully effective on December 31, 1992. The SEC has entitled the Rules "Temporary" because it wishes to reevaluate them "after some experience is gained with the information obtained pursuant to the temporary rules . . . ."[43] The Division of Market Regulation is to prepare a study evaluating the effectiveness of the Rules after they have been fully operative for two years, and the Division's report will be issued for public comment.[44] Thus, only in

38. This at the moment is not clear. The Fed claims it does have the power. The proposition was challenged by MCorp and the case has been remanded on other grounds. *Id.*

39. *See Stock Market Reform: Hearings on H.R. 1609 Before the Subcomm. on Telecommunications and Finance of House Comm. on Energy and Commerce*, 101st Cong., 1st Sess. (1989); *see also* John D. Dingell, *Securities Market Reform Act of 1990*, H.R. Rep. No. 524, 101st Cong., 2d Sess. 8; Proposed Temporary Risk Assessment Rules, Exchange Act Release No. 34-29,635, 56 Fed. Reg. 44,014, at 44,016 (Sept. 6, 1991).

40. Market Reform Act of 1990, Pub. L. No. 101-432,104 Stat. 963 (1990).

41. Proposed Temporary Risk Assessment Rules, Exchange Act Release No. 34-29,635, 56 Fed. Reg. 44,014 (Sept. 6, 1991).

42. Final Temporary Risk Assessment Rules, Exchange Act Release No. 34-30,929, 57 Fed. Reg. 32,159 (July 21, 1992) (to be codified at 17 C.F.R. §§ 240, 249) [hereinafter Final Rules].

43. *Id.* at 32,161.

44. *Id.*

two years will we have a full-scale review of the effectiveness of the risk assessment procedure set up by the SEC.

A full-scale analysis of the Rules will not be attempted here, but their general tendency will be described. It should be noted that one of the few articles to describe the Rules in their proposed form[45] criticized the Rules on the grounds that "[t]he SEC is not responsible . . . for the soundness of holding company financial structures. While the SEC may need to understand the nature and extent of systemic risk in the securities market, it does not need to regularly monitor those risks to fulfill its statutory obligations."[46] This author would suggest that the statutory language of Section 4 of the Market Reform Act[47] indicates that Congress considers that the SEC should have responsibility for the oversight of the soundness of holding company financial structures, at least insofar as the structures impact upon the soundness of the broker-dealer.[48] While the SEC is not a lender of last resort, it certainly has access to the lender of last resort and, indeed, in early November 1987, the first week after the market crash of October 27, worked closely with the Fed to assure that sufficient liquidity flowed from the banking system to the major broker-dealers at risk in the crisis. It certainly is true that the statutory language itself, as well as its implementation in the Rules, does not provide for risk assessment by across-the-board reporting from and oversight of *all* affiliates of registered broker dealers.[49] In short, neither under the statute nor under the Rules is the SEC performing the kind of consolidated supervision of securities firms and their mixed activity holding companies, as those terms are used and as such consolidated supervision is required in the European Community's Consolidated Supervision Directive.[50] Instead, the Act requires the keeping of records by the broker-dealer of the "financial and securities ac-

45. Roberta S. Karmel, *Risk Assessment Reporting for Large Traders*, N.Y. L.J., Apr. 16, 1992, at 3.

46. *Id.* at 11.

47. Market Reform Act of 1990, Pub. L. No. 101-432, 104 Stat. 963 (1990).

48. *Id.*

49. The term "registered broker-dealer" is used here as a short-cut. Although the text of Section 4 of the Market Reform Act covers registered brokers or dealers, registered municipal securities dealers, registered municipal securities brokers, and government securities dealers, all for whom the SEC is the appropriate regulatory agency. The statutory text makes different provisions for the different entities, but these details are not considered in this discussion.

50. *See supra* notes 42-47 and accompanying text.

tivities" and "the customary sources of capital and funding of" its associated persons whose "business activities are reasonably likely to have a material impact on the financial or operational condition"[51] of the broker-dealer.

It is clear from the preamble to the Final Rules that the SEC thinks that the concern is with the financial condition of an affiliate of the broker-dealer upon which the broker-dealer is "financially dependent." The SEC gives as an example of such dependencies, that the broker-dealer relies on the commercial paper or other unsecured credit of its holding company for financing.[52] The SEC also gives as an example the situation where the broker-dealer relies on the affiliate for "significant operational facilities or services."[53] The SEC also believes that the subsidiaries or sister corporations set up by broker-dealers to do much of their new, risky business, such as bridge loans, transactions in derivative products, merchant banking, venture capital activities, or swaps dealing, should also be included in the category of affiliates as to which reports are kept.[54] Again, in short, the SEC's concern would seem to be the financial soundness of the holding company systems. To the extent that the SEC does not think that an ultimate manufacturing parent would be a financial threat to the grandchild broker-dealer, the SEC does not seem to think that reports from the ultimate holding companies should be required.[55] However, the SEC refused to restrict the reporting requirement, as requested by a number of commentators, to only those affiliates engaged in financial or securities transactions.[56]

The SEC's present concern with and interest in systemic risk is demonstrated by the fact that broker-dealers not carrying customer accounts with capital under $20 million are exempted from the requirements.[57] However, the SEC did include, presumably because of its historic role as a consumer protection agency, all firms with capital over $250,000 having customer assets.[58] The SEC pointed out, in reply to commentators' protests,

51. Market Reform Act of 1990, Pub. L. No. 101-432, 104 Stat. 963 (1990).

52. Final Rules, *supra* note 42, at 32,161.

53. Final Rules, *supra* note 42, at 32,161.

54. The term utilized by the Final Rules is Material Associated Persons (MAP). Final Rules *supra* note 42.

55. Final Rules, *supra* note 42, at 32,162.

56. Final Rules, *supra* note 42, at 32,162.

57. Final Rules, *supra* note 42, at 32,164.

58. Final Rules, *supra* note 42, at 32,164.

that only 280 broker-dealers out of the approximately 5,600 broker-dealers that conduct a public business would be caught at these levels.[59] Finally, the SEC stressed that it plans "to focus its efforts on the largest 50 to 75 broker-dealers."[60] Presumably, the reason for this focus is, again, the concern with systemic risk.

While, as is pointed out above, the SEC's Temporary Risk Assessment Rules are hardly a full-blown consolidated supervision scheme, the SEC, in its March 5, 1991 Final Amendment to its Net Capital Rule,[61] has given itself greater power over insuring that the parent company of the registered broker-dealer does not strip that broker-dealer of more assets than, so far as we now know,[62] the Fed has over bank holding company parents of commercial banks. Under the amendment, a broker-dealer must notify the SEC in writing before withdrawals of equity capital exceeding certain percentages of the broker's excess net capital may be made. This "early warning" system will permit the SEC to take advantage of the authority given to it by the Market Reform Act to insist that the excess net capital remains in the broker-dealer if the financial situation of the firm warrants it and is an important tool for stability.

The Market Reform Act's risk assessment provisions as implemented by the SEC's Temporary Rules appear mild indeed when compared to the European Community's requirements in the Council Directive on the Supervision of Credit Institutions on a Consolidated Basis (Consolidated Supervision Directive).[63] It is not possible in an article of this scope to review in any detail the process of Community lawmaking. Suffice it to say that the national Member States will be required to carry out in their national law the procedures for consolidated supervision of "credit institutions" (banks) set out in the Consolidated Supervision Directive. The Directive is very clear. It states that, for supervision on a consolidated basis to be effective, it must be applied to all banking groups, including those in which parent undertakings are not "credit institutions."[64] The Directive points out that Member States can refuse or withdraw the bank-

59. Final Rules, *supra* note 42, at 32,164.
60. Final Rules, *supra* note 42, at 32,165.
61. *Supra* note 21.
62. *See supra* note 38.
63. Council Directive 92/30, 1992 O.J. (L 110).
64. *Id.* art. 2.

ing license "in the case of certain group structures considered inappropriate for carrying on banking activities, in particular because such structures could not be supervised effectively."[65] Moreover, the Directive recognizes that the Community is still attempting to work out a Capital Adequacy Directive for market risks of firms carrying on securities activities and that until this directive comes into force,[66] the Consolidated Supervision Directive requires the competent authorities to include in consolidated supervision "financial institutions which are principally exposed to market risk in accordance with methods determined by the authorities in light of the particular nature of the risks involved."[67] Thus, for the moment, the banking supervisory authorities in the European Community are required to include any separately incorporated broker-dealers affiliated with banks under their supervision in consolidated supervision.

The purpose of such supervision is stated in Article 3: "Supervision of solvency, and the adequacy of owned funds [capital] to cover market risks and control of large exposures, as governed by the relevant Community acts in force . . . ."[68] It is clear from the Directive, however, that the supervisory authorities need not require their bank holding companies to report on *every* affiliate in order to comply with the Directive. Article 6 provides that, in the case of mixed activity holding companies and their subsidiaries, which include at least one credit institution, the regulatory authorities must approach the parent companies and "require them to supply any information which would be relevant for the purpose of supervising the credit institution subsidiaries."[69]

Thus, at the moment, in the Community, there is no requirement for consolidated supervision of a securities firm that is not linked to a bank. However, this situation will change as soon as the Investment Services Directive[70] is finally adopted by

65. *Id.* art. 3.

66. As this is written, the Community has reached agreement on the shape of its "single passport" scheme for securities firms, *see infra* note 67, and the accompanying Capital Adequacy Directive, but neither are now due to be implemented until January 1, 1996. *See* Clifford Chance, EC FIN. SERVICES NEWSLETTER, Jan. 1993, at 29.

67. Council Directive 92/30, art. 4, 1992 O.J. (L 110).

68. *Id.* art. 3.

69. *Id.* art. 6(1). A mixed activity holding company is defined as a parent company that is neither a credit institution nor a financial holding company (*i.e.*, a holding company whose subsidiaries are mainly credit institutions or financial institutions).

70. Amended Commission's Proposal for a Council Directive on Investment Services in the Securities Field, 1990 O.J. (C 42).

the Community, that directive being the one providing for Community-wide basic standards for supervision of stand-alone securities firms.[71] Securities firms that are subsidiaries of a bank or a sister company of a non-banking company owning a bank are subject, as indicated above, to the Consolidated Supervision Directive.[72] Thus, the Community does, or will as of the implementation date of the Consolidated Supervision Directive, require substantial supervision of any conglomerate containing an entity licensed as a "credit institution" under Community rules and is far along the road to requiring the same for any investment services firm that will be licensed under the Investment Services Directive.[73]

In working on its Consolidated Supervision Directive, the European Community surely was aware of the work of the Basle Committee on Banking Supervision to enhance its Basle Concordat first issued in 1975 and revised in 1983.[74] The Concordat was issued as a result of the concern of the central banks of the Group of Ten Countries[75] (G-10) over the failure of Bank Herstadt in 1974 and the implications for the international financial system of the failure of that bank.[76] However, the Concordat merely divided up the respective supervisory jurisdictions of home and host countries for banking supervision.[77] To the contrary, the Minimum Standards for the Supervision of International Banking Groups and their Cross-border Establishments[78]

71. *Id.* § 14.1.

72. *Id.* § 14.3.

73. *Id.* §§ 14.4, 14.5.

74. Basle Committee on Banking Requirements and Supervisory Practices (June 1983), 22 I.L.M. 900 (1983) [hereinafter *Basle Committee*]. The original 1975 Concordat is reprinted in *Internal Capital Markets; Recent Developments and Short-Term Prospects*, 7 INT'L MONETARY FUND 29-32 (1981).

75. The Group of Ten countries [hereinafter G-10] are actually twelve industrialized countries, Belgium, Canada, France, Germany, Italy, Japan, Luxembourg, Netherlands, Sweden, Switzerland, United Kingdom and the United States that first began cooperating in international monetary affairs under the IMF organized General Arrangements to Borrow. *See* ANDREAS F. LOWENFELD, THE INTERNATIONAL MONETARY SYSTEM (2d ed. 1984).

76. Bank Herstadt was a small private German bank with large foreign exchange dealings that had been put through the Clearing House Interbank Payments System. When it was closed by the German authorities, there were significant consequences for the participants in CHIPS and the G-10 central banks realized the fragility of the system.

77. *Basle Committee*, *supra* note 74, at 900 ("[a]mong the first tasks . . . was to seek some general agreement about the respective roles of home country and host country supervisors . . . .").

78. *Basle Minimum Standards*, *supra* note 23.

(Basle Minimum Standards), released on July 6, 1992 by the Basle Committee, with the endorsement of the central bank governors of the G-10, is intended to be a framework for harmonized basic standards of supervision that all of the supervisory authorities presently enforcing the Basle Accord on capital adequacy[79] will be "required" to follow. As the Basle Committee Press Statement, releasing the Basle Minimum Standards indicates, "[t]he minimum standards are designed to reinforce the so-called Basle Concordat . . . in a context of continued rapid growth of international banking activities and in the wake of experience gained in the supervision of seriously troubled international banking institutions, notably Bank of Credit and Commerce International [BCCI]."[80] This, in short, is the banking regulatory community's response to BCCI. Again, as the Press Release indicates, "the minimum standards are designed to provide greater assurances that in the future no international bank can operate without being subject to effective consolidated supervision."[81]

For the purposes of this article, the Basle Minimum Standards are of interest because they are to be applied, not just to a parent bank, but to the ultimate parent of the "banking group," as a holding company family is termed in the Basle Minimum Standards.[82] If a holding company is headquartered in a different country than its subsidiary bank that is applying to the host-authority for approval to establish a branch, then the holding company supervisory authority must also meet the minimum standards.[83]

This is the first time that the Basle Committee has addressed banking conglomerates. It must also be noted that, in most parts of the world, banking conglomerates also include broker-dealers and that there are very few broker-dealers active in the international capital markets (apart from United States broker-dealers that are statutorily prohibited from being affiliated with United States banking organizations) that are *not* affiliated

79. *See supra* note 30 and accompanying text. The Introductory Note cited in note 30 not only gives the history of the adoption of the Basle Accord, it discusses the "legal process" used by the Committee to ensure compliance with the standards.

80. Basle Committee on Banking Supervision, Bank For International Settlements, Press Statement, at 1 (July 6, 1992).

81. *Id.* at 2.

82. *Basle Minimum Standards, supra* note 23, at 3.

83. *Basle Minimum Standards, supra* note 23, at 4.

with a bank. Thus, the Basle Minimum Standards will apply to most financial conglomerates in the international capital markets *other* than the Merrill Lynches. The "Merrill Lynches" will receive only United States SEC oversight under the Risk Assessment provisions described above.

The four specific minimum standards that the bank's or banking group's home country authority must meet are as follows:

1. The home country authority must capably perform consolidated supervision.[84]

2. The establishment of the host-country "branch" should receive prior consent from the home country supervisor.[85]

3. The home country supervisors must have the right to gather information from cross border establishments, i.e., secrecy laws must not get in the way of prudential supervision on a consolidated basis.[86]

4. Host country authorities must have the power to condition or prohibit entirely the foreign banking group's entry into the host country if the minimum standards are not met.[87]

According to the document, certain of the principles of the Concordat and its 1983 supplement have been "reformulated as minimum standards . . . which G-10 supervisory authorities *expect each other to observe*."[88] It may be presumed that this means that banking organizations originating from countries whose supervision does not meet the minimum standard will be refused the right to branch into the G-10 countries, or other special conditions of entry will be applied to them. Like the European Community's Consolidated Supervision Directive, the Basle Minimum Standards provide that the home country supervisory authority should receive "consolidated financial and prudential information on the bank's or banking group's global operations . . . and assess the information as it may bear on the safety and soundness of the bank or banking group."[89] Similarly, the supervisory authority is to have the "capability to prevent corporate affiliations or structures that either undermine efforts to maintain consolidated financial information or otherwise hin-

84. *Basle Minimum Standards*, *supra* note 23, at 3.
85. *Basle Minimum Standards*, *supra* note 23, at 4.
86. *Basle Minimum Standards*, *supra* note 23, at 5.
87. *Basle Minimum Standards*, *supra* note 23, at 6.
88. *Basle Minimum Standards*, *supra* note 23, at 1 (emphasis added).
89. *Basle Minimum Standards*, *supra* note 23, at 3.

der effective supervision of the bank or banking group . . . ."[90]

While there is no requirement that the financial state of *every* entity in the banking group's universe be monitored, nevertheless, it would seem that the national law must give to the supervisory authority the ultimate capacity to make its own decision as to which affiliates have an impact upon the financial health of the bank and therefore must be included in the consolidated supervision. Under Basle's Minimum Standards, universal banks will be universally supervised.

But, as stated, there is one form of financial conglomerate to which the Basle Minimum Standards will not be applied, essentially because the G-10 banking supervisors are not involved in oversight of any of the units of the conglomerate. This is the conglomerate that does not have as a subsidiary at least one "bank" or, as the term is in the European Community, "credit institution."[91] This is where IOSCO, which held its 17th Annual Conference in London in the last week of October 1992, comes in.[92] At the Conference, IOSCO's Technical Committee released its document, Principles for the Supervision of Financial Conglomerates (IOSCO Principles).[93]

At the present time, IOSCO has no system similar to that of the Basle Committee for putting any form of pressure on its member organizations to conform to such principles. The principles are, in effect, only precatory, but their promulgation rounds out what might be referred to as a "soft law" regime for consolidated supervision of financial conglomerates.[94] As the Technical Committee itself states in paragraph 16 of its Introduction, the "general principles should form the basis for the risk assessment of financial conglomerates and should be used, as far as possible, to guide the development of regulatory practice and regulatory

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90. *Basle Minimum Standards, supra* note 23, at 3-4.

91. The European Community First Banking Directive, at Article 2.2, defines a credit institution as "an undertaking whose business is to receive repayable funds from the public and to grant credit for its own account." Council Directive 77/780 of 12 December 1977 First Banking Directive, 1977 O.J. (L 322) *available in* LEXIS, Intlaw Library, Eurscp File, at *2.

92. For a history and description of IOSCO and its Technical Committee, see Lichtenstein, *supra* note 30, at 970-71.

93. *IOSCO Principles, supra* note 18.

94. The Technical Committee is particularly interested in certain conglomerates: "Although the Technical Committee believes that the principles set out here are of relevance to the question of conglomerate supervision generally, the main concern of the Technical Committee is with groups where securities business plays a significant part." *IOSCO Principles, supra* note 18, at 3, ¶ 2.

co-operation in this area."[95] Without a doubt, they will be influential indeed.

Principle (a) of the IOSCO Principles is that risk assessment should be "group based"[96] if the regulated firm that is part of the financial conglomerate is vulnerable to what the Principles call "the risk of contagion."[97] As paragraph 12 of the Introduction to the Principles points out, "[e]ven where the failure of a regulated securities firm is unlikely to have serious consequences for the securities industry and the financial system generally, the risk of contagion means that it is highly desirable for the securities regulator to have early warning of problems elsewhere in the group."[98] Thus, in effect, the Technical Committee is recommending that "the traditional approach of securities regulators to the prudential regulation of securities firms on a solo basis should be complemented through an assessment of the risk which the rest of the financial conglomerate poses for the regulated securities firm."[99] In short, the Technical Committee, in this international "soft law" regime, seems to be rejecting the approach of the BHCA in favor of the much more limited approach of the SEC in its Temporary Risk Assessment Rules under the Market Reform Act.

The remainder of the IOSCO Principles, however, go on to be much more substantive. Since the focus of this paper has been primarily on consolidated supervision of financial conglomerates, the remainder of the Principles will merely be mentioned here. Any person interested in observing the regime for multinational financial services companies will be well-advised to read the IOSCO Principles in their entirety. Principle (b) concerning the question of deduction from capital of an investment in another group company has been previously mentioned.[100] This Principle recommends that the amounts counted toward regula-

95. *IOSCO Principles, supra* note 18, at 10.

96. *IOSCO Principles, supra* note 18, at 11.

97. *IOSCO Principles, supra* note 18, at 11.

98. *IOSCO Principles, supra* note 18, at 8.

99. However, paragraph 14 does go on to warn that:

> [I]n all cases, the objective of group based risk assessment should be to enhance the regulation of the regulated firm. Every effort should be made to avoid creating any impression hitherto unregulated entities in a financial conglomerate have been made de facto subject to regulation, or that the regulators accept any responsibility for the prudential supervision as of the group as a whole where this is not, in fact, the case.

IOSCO Principles, supra note 18, at 10.

100. *IOSCO Principles, supra* note 18, at 17.

tory capital should be controlled by appropriate regulations.[101] Principle (c) indicates that effective risk assessments of financial conglomerates require careful monitoring of intra-group exposures and, where necessary, limits on such exposures in the regulated entity.[102] Principle (d) is the rather obvious principle that the corporate and managerial structure of the financial conglomerate should be fully understood by the regulator.[103] Principle (e) concerns the equally obvious suggestion that regulators should seek, as far as possible, to identify shareholders with such a stake in the conglomerate as would enable them to exert material influence.[104] Principle (f) suggests appropriate regulatory standards for managers of a regulated entity.[105] Principle (g) urges supervisory cooperation and the desirability of appointing a lead regulator where a group has, as is the case with a conglomerate having both a securities firm and a banking firm, two separate regulatory authorities.[106] Finally, Principle (h) states that, "[r]egulators should recognise the importance of the role of the external auditors of a regulated firm and the possible contribution they may be able to make to group-based risk assessment."[107]

The latter suggestion is one which, as of yet, our United States securities supervisors have not begun to consider. However, Congress in its latest banking legislation, Federal Deposit Insurance Corporation Improvement Act of 1991,[108] has deliberated at length over the responsibility for audits of banking institutions.[109]

Once again, for this author, the great interest of the IOSCO Principles is that IOSCO's Technical Committee has articulated standards for group-based risk assessment which take into account that a financial conglomerate, even though it may lack a subsidiary bank, nevertheless may implicate systemic risk. As the Principles articulate in paragraph 14 of the Introduction, in

101. *IOSCO Principles, supra* note 18, at 17, ¶ 29.

102. This topic will be covered by the European Community in its Large Exposures Directive. Directive on Monitoring and Control of Large Exposures, 1992 O.J. (C 175) *available in* LEXIS, Intlaw Library, Eurspc File, at *7.

103. *IOSCO Principles, supra* note 18, at 21, ¶ 39.

104. *IOSCO Principles, supra* note 18, at 22, ¶ 42.

105. *IOSCO Principles, supra* note 18, at 23.

106. *IOSCO Principles, supra* note 18, at 24.

107. *IOSCO Principles, supra* note 18, at 28, ¶ 53.

108. Pub. L. No. 102-242, 105 Stat. 2236 (1992).

109. *Id.* § 112.

complementing prudential regulation of securities firms on a solo basis with a group-based assessment:

> . . . [T]he extent of this assessment may need to distinguish between those securities firms whose operations give rise to systemic risk and those which do not . . . the greater the systemic risk inherent in a securities firm operations the more ambitious the approach to group-based risk assessment will need to be.[110]

The issue is safeguarding the health of the international financial system through adequate group-based risk assessment for all financial conglomerates, whether or not "universal banks," that do pose issues of systemic risk. The IOSCO Principles, recently released in London, are beginning to chart these new seas.

110. *IOSCO Principles*, *supra* note 18, at 9-10.